

RETHINKING DEVELOPMENT STRATEGIES AFTER THE FINANCIAL CRISIS

Volume I: Making the Case for Policy Space





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RETHINKING DEVELOPMENT STRATEGIES AFTER THE FINANCIAL CRISIS

Volume I: Making the Case for Policy Space

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Table of contents

	<i>Page</i>
<i>Explanatory notes</i>	<i>vi</i>
<i>Abbreviations and acronyms</i>	<i>vii</i>
<i>About the authors</i>	<i>viii</i>
INTRODUCTION	
<i>Alfredo Calcagno, Sebastian Dullien, Alejandro Márquez-Velázquez, Nicolas Maystre and Jan Priewe</i>	<i>1</i>
RETHINKING DEVELOPMENT STRATEGIES AFTER THE GLOBAL FINANCIAL CRISIS	
<i>Alfredo Calcagno</i>	<i>9</i>
<i>Abstract</i>	<i>9</i>
<i>Introduction</i>	<i>9</i>
I. A “big crisis”	<i>10</i>
A. Causes and nature of the crisis	<i>10</i>
B. Inadequate policy responses	<i>12</i>
II. The case for a reorientation of development policies	<i>12</i>
A. The global economic environment after the crisis	<i>12</i>
B. A more balanced approach on the demand side	<i>15</i>
III. The need for policy space	<i>19</i>
A. Rediscovering industrial policies	<i>19</i>
B. Foreign capital flows and domestic sources of finance	<i>20</i>
C. Fiscal space	<i>22</i>
IV. Concluding remarks	<i>23</i>
<i>Notes</i>	<i>24</i>
<i>References</i>	<i>24</i>
SEVEN STRATEGIES FOR DEVELOPMENT IN COMPARISON	
<i>Jan Priewe</i>	<i>27</i>
<i>Abstract</i>	<i>27</i>
<i>What is a strategy for development and why do we need one?</i>	<i>27</i>
I. Traditional strategic concepts	<i>28</i>
A. Washington Consensus	<i>28</i>
B. Plain neo-liberalism	<i>29</i>
C. Good governance	<i>30</i>
D. Millennium Development Goals	<i>31</i>
E. Outward development and export-led growth	<i>32</i>
F. Structural change: Towards industrialization or commodities and services?	<i>33</i>
II. Strategic concepts based on macroeconomic policies	<i>34</i>
III. Learning from success and failure – growth performance in the long run	<i>38</i>
IV. Conclusions	<i>41</i>
<i>Notes</i>	<i>43</i>
<i>References</i>	<i>43</i>

RESTORING THE DEVELOPMENT DIMENSION OF BRETTON WOODS

<i>Eric Helleiner</i>	45
<i>Abstract</i>	45
Introduction.....	45
I. Growing discontent.....	46
II. American goals for Bretton Woods.....	48
III. Inclusive multilateralism and North-South dialogue.....	51
IV. The fate of the development content of Bretton Woods.....	53
<i>References</i>	54

THE MIDDLE-INCOME TRAP AND EAST ASIAN MIRACLE LESSONS

<i>Veerayooth Kanchoochat</i>	55
<i>Abstract</i>	55
Introduction.....	55
I. Three approaches to the middle-income trap.....	56
A. Getting education and institutions right.....	57
B. Changing export composition through comparative advantage.....	57
C. Industrial upgrading through State intervention.....	57
II. Education and institutions as magic bullets?.....	58
A. Education needs to link with industrial targets.....	58
B. Growth-enhancing governance is more relevant than “good governance”.....	58
III. Structural transformation through comparative advantage?.....	59
A. Long-term economic development requires structural transformation.....	59
B. Changing export compositions usually goes against comparative advantage.....	60
IV. Industrial policy without yardsticks and macroeconomic stability?.....	60
A. East Asian policies entailed variation in carrot-and-stick incentives.....	60
B. Macroeconomic stability matters, but in unconventional ways.....	61
V. The middle-income trap: Future research agenda.....	62
<i>Notes</i>	64
<i>References</i>	64

THE ROLE OF INDUSTRIAL POLICY IN DEVELOPING COUNTRIES

<i>Robert H. Wade</i>	67
<i>Abstract</i>	67
Introduction.....	67
I. The return of industrial policy?.....	69
II. The developmental State Mark II.....	71
III. “New structural economics” and industrial policy.....	72
IV. Political and organizational determinants of industrial policy.....	74
A. State-society relations.....	74
B. Making effective industrial policy bureaucracies.....	75
V. The future of industrial policy.....	76
<i>Notes</i>	78
<i>References</i>	78

THE REAL EXCHANGE RATE AS A TARGET OF MACROECONOMIC POLICY

<i>Roberto Frenkel and Martín Rapetti</i>	81
<i>Abstract</i>	81
Introduction.....	81
I. SCRER and economic performance	82
A. Empirical evidence.....	82
B. Mechanisms.....	83
II. SCRER management	86
A. SCRER and external equilibrium	86
B. SCRER and internal equilibrium	87
III. Conclusions.....	89
<i>Notes</i>	90
<i>References</i>	90

**DEFENDING DEVELOPMENT SOVEREIGNTY: THE CASE FOR INDUSTRIAL POLICY
AND FINANCIAL REGULATION IN THE TRADING REGIME**

<i>Rachel Denae Thrasher and Kevin P. Gallagher</i>	93
<i>Abstract</i>	93
I. Crisis-era protectionism and the expanding trade regime	93
II. The soft foundations of soft protectionism	95
III. The threat to financial stability and industrial development policies	98
A. Tariffs	98
B. Import licensing and bans	99
C. Tax-based export incentives.....	100
D. Performance requirements	100
E. Financial regulation	101
F. Public welfare and “green” measures	101
G. Public procurement	102
IV. Alternatives for emerging market and developing countries.....	103
<i>Notes</i>	104
<i>References</i>	104

Explanatory notes

Classification by country or commodity group

The classification of countries in this publication has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

The terms “country” / “economy” refer, as appropriate, also to territories or areas.

References to “Latin America” in the text or tables include the Caribbean countries unless otherwise indicated.

References to “sub-Saharan Africa” in the text or tables include South Africa unless otherwise indicated.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2014* refers to *Trade and Development Report, 2014* (United Nations publication, sales no. E.14.II.D.4).

References in the text to the United States are to the United States of America and those to the United Kingdom are to the United Kingdom of Great Britain and Northern Ireland.

The term “dollar” (\$) refers to United States dollars, unless otherwise stated.

The term “billion” signifies 1,000 million.

The term “tons” refers to metric tons.

Annual rates of growth and change refer to compound rates.

Use of a dash (–) between dates representing years, e.g. 1988–1990, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 2000/01, signifies a fiscal or crop year.

Decimals and percentages do not necessarily add up to totals because of rounding.

Abbreviations and acronyms

ASEAN	Association of South-East Asian Nations
ATIGA	ASEAN trade in goods agreement
BW	Bretton Woods
BRICS	Brazil, Russian Federation, India, China and South Africa
CRA	Contingent Reserve Arrangement
DAAD	German Academic Exchange Service (Deutscher Akademischer Austauschdienst)
EMDE	emerging market and developing economies
FDI	foreign direct investment
FEFI	Fraser Economic Freedom Index
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNI	gross national income
GPA	government procurement agreement
IAB	Inter-American Bank
IBRD	International Bank for Reconstruction and Development
ILO	International Labour Organization
IMF	International Monetary Fund
LMICs	low- and middle-income countries
MDG	Millennium Development Goal
MERCOSUR	Common Market of the South (Mercado Común del Sur)
MIT	middle-income trap
NAFTA	North American Free Trade Agreement
NDB	New Development Bank
NIE	newly industrializing economy
OECD	Organisation for Economic Co-operation and Development
PPP	purchasing power parity
PWT	Penn World Table
RER	real exchange rate
SCRER	stable and competitive real exchange rate
SDRM	sovereign debt restructuring mechanism
TDR	Trade and Development Report
TNC	transnational corporation
TPP	Trans-Pacific Partnership
TRIMs	trade-related investment measures
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
WDI	World Development Indicators
WTO	World Trade Organization

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INTRODUCTION

*Alfredo Calcagno, Sebastian Dullien,
Alejandro Márquez-Velázquez, Nicolas Maystre and Jan Priewe*

The global financial crisis that erupted in 2008 marks the starting point for a comprehensive rethinking of economic theories and policies, particularly in the field of development strategies. A number of questions need to be addressed for economic analysis and policy recommendations to be relevant, including the assessment of the causes of the crisis, its potential remedies and the way in which the crisis challenges our understanding of economic and social processes.

The crisis shed new light on the economic trends that led to it, including the developments in different developing and transition economies.¹ Moreover, the crisis may be changing the economic framework in which developing countries formulate and implement their development policies; therefore, it is necessary to assess the extent to which these policies need to be reformulated. These considerations call for examining development strategies from a historical perspective. Indeed, different groups of developing and transition countries had experienced quite divergent performances in the decades preceding the global financial crisis. This has provided a rich set of experiences from which a very valuable learning can be extracted.

When looking at the long-term performance of developing countries from 1980 until 2013, it is possible to identify three major features. First, Asian countries perform remarkably better on most indicators, and especially in terms of per capita gross domestic product (GDP) growth, compared with African and Latin American countries. Second, while the 1980s and 1990s were practically two lost decades for development in most countries outside Asia,

transition and developing economies have boomed since the early 2000s; even after the Great Recession of 2008–2009, output growth has been more buoyant in developing countries than in developed countries, despite strong diversity of performances within the regions. Third, after several decades in which the share of developing countries in global output remained virtually constant, it almost doubled in the decade following 2003.

In the 1980s and 1990s, per capita GDP growth rates in most developing countries were well below those of developed countries, and in many cases they actually contracted (table 1). This trend of developing countries lagging behind visibly changed in the period from 2000–2013, when per capita GDP in the developed countries expanded by a meagre average annual rate of 0.9 per cent, while developing and transition economies caught up with a (weighted) average annual increase in per capita incomes of 4.6 per cent. All developing and transition regions improved their economic performance: Asian economies continued their strong dynamic, several African and Latin American countries reoriented their economic policies away from the Washington Consensus and benefited from a commodity boom, while transition economies in Europe and Central Asia recovered from the huge output losses from the economic collapse of the early-1990s. This growth acceleration was achieved despite the industrialized countries being in the doldrums for most of this period.

Rapid output growth was associated with significant increases in per capita incomes in many

Table 1
GDP PER CAPITA GROWTH IN CONSTANT 2005 DOLLARS, 1981–2013

Country group	1981–1990	1991–2000	2001–2013	1991–2013
	Median			
Developed	2.0	2.1	1.1	1.9
Developing and transition	0.3	1.1	2.8	2.0
	Average of the group/region			
Developed	2.6	2.0	0.9	1.5
Developing and transition	1.3	2.0	4.6	3.5
<i>of which:</i>				
Developing Africa	-0.5	0.0	2.4	1.7
Developing America	-0.3	1.4	2.3	1.7
Developing Asia	3.2	4.7	6.0	5.2
Transition	...	-4.8	4.9	2.5
Number of developing and transition with growth...				
above 5 per cent	19	14	27	18
above 3 per cent	36	41	77	47
above 0 per cent and below 3 per cent	45	71	67	97
below 0 per cent	66	53	20	19
above average weighted growth of developed	41	63	124	96
below average weighted growth of developed	106	102	40	67
Number of developing and transition with data	147	165	164	163

Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN-DESA), *National Accounts Main Aggregates* database.

Note: GDP per capita is calculated by dividing the corresponding total GDP by the total population of each country group.

developing countries, and particularly those that are highly populated. Therefore, in terms of the population that benefited from it, the improvement was remarkable: in 1990, 52 per cent of the world's population lived in low-income countries (defined here as below the \$1,000 level in per capita GDP in constant prices of 2013); in 2013, that share had plummeted to 10 per cent (table 2). First, China left the low-income group, followed after 2000 by India, among others. Hence, the accelerated income growth has had real effects for the living conditions of hundreds of millions of the poor across the world. Developmental indicators like the reduction of absolute poverty or improvements in health and education usually go hand in hand with higher average levels of income. However, the strength of the nexus between growth and social improvement strongly differs across countries. Indeed, it may be significantly reduced if – as has frequently happened – growth is associated with rising inequality and environmental damages. Therefore, the drivers and characteristics of growth hold the utmost importance, not only for

determining the social impacts of growth but also for its environmental sustainability.

The overall positive developments in the economic and social indicators of developing regions require two major qualifications. First, after the financial crisis, growth in developing and transition economies has become more erratic and the prospects gloomier, with uncertainty about the future growth of the world economy being on the rise. In many large emerging markets from Brazil to South Africa and the Russian Federation, there are doubts about whether the growth spell of the past 15 years can be continued. Second, even if some catching-up occurred, the income gap between developed and developing countries remains large. When using per capita income at constant 2005 dollars as a yardstick, developing countries on average only reached 8.3 per cent of the developed countries level in 2013, and only marginally improved from 5.5 per cent in 1990. At current exchange rates, developing countries' average income reached 11.6 per cent of that of the

Table 2
EVOLUTION OF COUNTRY GROUPS ACCORDING TO PER CAPITA INCOME, 1990–2013

	Number of countries in sample			Population (per cent)		
	1990	2000	2013	1990	2000	2013
Below \$1,000	51	66	54	53.4	41.2	10.3
\$1,000–\$5,000	85	60	65	25.8	34.4	37.8
\$5,000–\$20,000	41	43	43	6.8	10.3	36.9
More than \$20,000	29	38	46	14.0	14.0	14.9
Total reported	206	207	208	100.0	100.0	100.0

Source: UNCTAD secretariat calculations, based on UN-DESA, *National Accounts Main Aggregates* database.

Note: All economies are categorized according to their GDP per capita in current dollars. The World Bank Atlas Method was used for conversion to dollars and for the benchmarks adjustment. For example, the 2013-benchmark of \$1,000 was applied like \$803 in 2000 and \$663 in 1990. Population is presented as percentage of the world total population for the country groups.

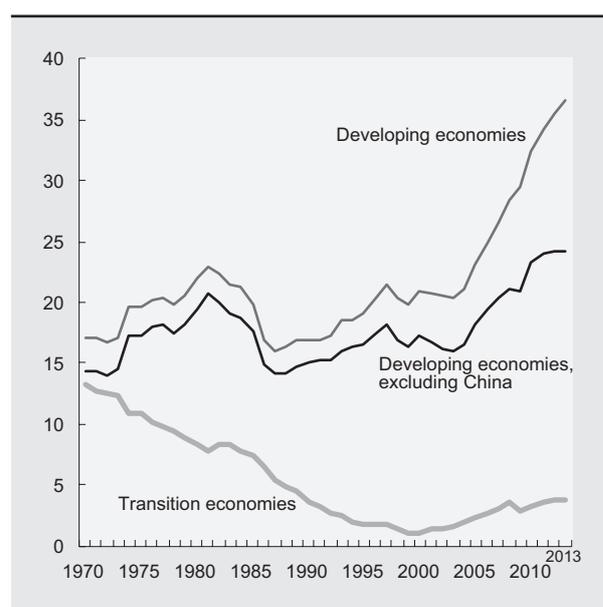
developed countries in 2013 (improving from 5.4 per cent in 2000).

Whatever the measure for proper cross-country income comparisons, there is no doubt that there has been a significant change in the relative weight of developing and developed countries in the world economy. The share of developing countries in world output fluctuated between 16 and 23 per cent during 1980–2003 (chart 1). By contrast, from 2003 until 2013 it almost doubled from 20.3 to 36.5 per cent (when China is excluded, this share rises from around 16.0 to 24.3 per cent). This is due to both accelerating growth in developing countries and decelerating growth in developed countries. This structural change is likely to continue as long as developed countries maintain their low growth path, as has been the case – on average – after the financial crisis. However, this should not be interpreted as a decoupling between developed and developing countries since global interdependence is stronger than ever. Nonetheless, the characteristics of this interaction and the nature of growth drivers are changing, whereby development strategies must adapt accordingly.

Furthermore, there has been considerable diversity in the developing countries' growth performance, both *between* the different broader regions of developing countries and to a lesser extent *within* the regions. There is no clear and unique formula for success or failure, no “one size fits all” approach to development strategies. One of the lessons that can be extracted from experience is that policies need to adapt to specific conditions and national goals, which implies avoiding rigid precepts for both targets and

Chart 1

CONTRIBUTION OF DEVELOPING AND TRANSITION ECONOMIES TO GLOBAL OUTPUT, 1970–2013
(Per cent of global GDP in current dollars)



Source: UNCTAD secretariat calculations, based on UN-DESA, *National Accounts Main Aggregates* database.

tools. However, this does not mean that strategies have to be replaced by ultra-pragmatic and flexible policies, constantly changing according to short-term conditions. The adoption of a better combination of macroeconomic pragmatism and a clear development orientation is one of the reasons why the performance of many developing and transition economies

dramatically improved in the early-2000s. Volume I of this publication discusses these general issues that all developing countries need to handle, as well as highlighting some key policy areas of interest for most of them.

Theoretical thinking on economic development largely relies on comparative analysis. In particular, it explores the reasons why some countries or regions have performed better than others in the long run. Essays in Volume II of this publication contribute to this approach, as well as examining why the performance in a given country or group of countries has improved or deteriorated in the long-term depending on changing development strategies. From this perspective, poor economic results in vast developing regions and transition economies in the 1980s and 1990s have to be compared with rapid output growth and social improvements in the two preceding decades, as well as the 2000s. Several factors have contributed to explaining these contrasts. In particular, the existence of a developmental State that uses its room for manoeuvre to act on both the supply and demand side is a common denominator of most successful experiences. On the contrary, neoliberal policies that restrained the role of the State in the economy and dismissed the need to preserve any policy space prevailed in the slow-growing regions during the 1980s and 1990s.

The demise of the Washington Consensus owing to failing empirical tests (Birdsall and Fukuyama, 2011), the failures of neoliberal recipes and the dramatic consequences of the global financial crisis (after several regional financial crises) have altogether generated enormous new challenges. Consequently, old certitudes have to be abandoned. Development models championed by governments and academia in developed countries as well as by several international organizations are increasingly questioned. Moreover, in parallel to their rising economic weight, the leading developing economies have gained increased influence in the debate about the functioning of the global financial and trading system, as well as global political issues.

Against this historical background, this publication intends to explore the nature and consequences of the crisis, as well as the diversity of economic and social development among developing countries. It looks at the reasons behind the recent improvement in developing countries performances and its potential for continuation after the financial crisis.

The recent economic trends and the challenges posed by the global crisis reinforce the importance of implementing strategies for development as opposed to leaving the economy to market forces. Countries need a strategic compass for long-run economic development, either explicitly or implicitly. Among other ingredients, this comprises macroeconomic policies, sectoral policies (including the financial sector, trade and industrial policies), institution building in key areas and development-friendly global governance. Within a chosen medium- or even long-term strategy, governments need more policy space to adjust to the specific (and evolving) social, historical and institutional context. The experience of Asia shows that rather than implementing narrow and rigid general guidelines, experimental approaches – which require policy space – are a recipe for success. Furthermore, the slow-growth periods endured by several countries (the “lost decades”) allowed inferring which policies should be avoided. The authors of this publication share the notion that developing countries can and should learn more from each other, as well as from their own past experience. It is important to look at comparisons between developing countries, including both success and failure stories.

A developmental State needs to use a variety of tools to intervene in several key areas. Most authors in this book hold the view that more active macroeconomic management with a stronger focus on domestic demand is needed. This should replace export-led growth when associated with entrenched incomes and austere public spending. More prudent financial sector development is necessary to enhance investment with predominantly domestic sources of finance. Industrialization is a major target of any development strategy, and this requires industrial policy. Small countries – even more than larger ones – need a focus of policies on certain sectors to shape potential comparative advantages beyond agricultural or mineral commodities. Boom-bust cycles of short-term capital flows undermine growth and development. Cross-border capital flows should be governed by prudent management, which can include capital controls. Unregulated capital flows negatively affect market-driven exchange rates, generating strong volatility or chronic overvaluation of exchange rates, both of which are strong hindrances for development, given that currency-related conflicts or even currency wars may need to be resolved in the framework of a new global financial architecture. Strong and sustainable development requires a developmental State supported by increased fiscal space

for providing public goods and income redistribution. Reducing income inequality beyond curtailing absolute poverty can have positive impacts for growth, employment and structural change (*TDR 2012*).

Many of the chapters in this publication were written by authors who collaborated within the “Partnership on Economic Development Studies”, a network of 11 universities from the South and HTW Berlin – University of Applied Sciences, with which UNCTAD has been cooperating. This network was funded by the German Academic Exchange Service (DAAD) from 2009 until 2013.² We are grateful to the DAAD for their generous support of this project. Most of these contributions stem from the workshop on “Development Strategies: Country Studies and International Comparisons” held in November 2013 in Shanghai (hosted by the East China Normal University). Other chapters are from well-known scholars who work or regularly cooperate with UNCTAD.

As already mentioned, this publication is presented in two volumes with a total of 14 chapters. The first volume addresses the more general issues, while the second focuses on country studies and country comparisons. Due to space limitations, many issues cannot be addressed here. For instance, environmental problems as well as the debate on the Sustainable Development Goals are not included, and in the second volume we mainly cover large economies with significant regional impact, although several lessons that can be extracted from their experiences also hold interest for many least developed countries. While all authors are academic economists, we attempt to reach a broader readership within and outside academia, from graduate students to journalists and policymakers. Therefore, unnecessary technical presentations are avoided. Lastly, the opinions expressed are those of the authors and do not necessarily represent those of UNCTAD, HTW Berlin or the institution to which the authors are affiliated. The remainder of this introduction provides an overview of the first volume’s chapters.

Alfredo Calcagno analyses the need to adjust developing strategies after the global financial crisis in a context of expected future slow growth in the North. The global financial crisis that started in 2008 has exposed a number of fundamental flaws in how the world economy has been functioning under a “finance-driven globalization” and often export-led growth, with increasing income inequality and a

diminishing economic role for the State. Calcagno pleads for a stronger emphasis on domestic demand-led growth based upon rising incomes rather than credit and asset bubbles, addressing the role of a change in income distribution and the establishment of a developmental State that should also promote structural change and industrialization.

Jan Priewe analyses seven development strategies, namely the Washington Consensus, neo-liberalism, good governance, the UN Millennium Development Goals, export-led growth, industrialization and a heterodox macroeconomic strategy for development, which is suggested by the author. Priewe argues that – at least in the case of large developing countries – a strong focus needs to be placed upon coherently managed macroeconomic policies to provide a stable environment that is conducive to development, namely one that minimizes the risk of balance-of-payments crisis, promotes domestic demand and finance for both fixed investment and human capital formation. He further argues that successful countries have pursued industrial policies, a combination of inward and outward approaches in the course of industrialization and diversification of production.

On the occasion of the 70th anniversary of the Bretton Woods institutions in 2014, *Eric Helleiner* argues that remembering the original development content of Bretton Woods may be politically very useful for reformers seeking to construct a more development-friendly global financial system today. The author recalls that the then-negotiations are often described as an Anglo-American affair in which developing countries played little role and development issues were largely ignored. However, he underscores that the Bretton Woods architects included officials from many poorer countries and international development goals were explicitly prioritized in the design of the post-war international financial order. As discontent with Bretton Woods institutions grows among developing countries policymakers, the proposed reforms may recover the original idea of constructing a multilateral economic order that would support the development aspirations of poorer countries.

Veerayooth Kanchoochat aims to identify the main middle-income traps and presents a critical review of the literature. The author discusses three strands, which he labels as (i) getting education and institutions right, (ii) changing export composition

through comparative advantage and (iii) industrial upgrading through State interventions. Among the author's conclusions is that rather than focusing only on alphabetization and institutions assuring the well-functioning of the market, governments should try to focus on developing institutions (including education) geared towards the development of modern industries targeted at changing the export composition of countries. He criticizes suggestions of following a country's traditional comparative advantage to achieve a structural transformation. Last but not least, he underscores that while industrial and technological policies are essential to transform the economic structure of a country, such policies must be guided by the carrot-and-stick principle applied in the first-tier newly industrialized economies within a stable macroeconomic environment.

Robert Wade discusses the relevance of industrial policy for developing countries, given the rising interest shown in this type of policy by politicians and economists in both the developed and developing world after the 2008 global financial crisis. For this purpose, he presents examples showing that industrial policy has regained relevance in the post-2008 world. At the micro level, he argues that agencies in charge of industrial policy should be directed by capable managers who have weak ties with the ruling elite when appointed and subsequently develop a strong tie with the president while still maintaining weak ties with the rest of the elite. He concludes by recommending that policymakers in developing countries should undertake industrial policy despite the opposition to this idea shown by mainstream economics and many international financial institutions.

Concentrating on one of the key macroeconomic policies of a development strategy, *Roberto Frenkel* and *Martin Rapetti* make the case for developing countries targeting a “stable and competitive real

exchange rate” (SCRER) as part of their development strategy. For this purpose, the authors review a sample of the empirical literature reporting a positive impact of real exchange rate undervaluation on growth, as well as another strand of the literature concerned with the possible transmission channels from SCRER to increased growth. The authors argue that the main growth transmission channels of targeting a SCRER are the greater macroeconomic stability brought about by the reduced risks of balance of payment crises, the greater availability of foreign exchange and the stimulus that a higher relative price of tradeables has on investment in modern tradeable sectors. Moreover, they argue that targeting a SCRER is sustainable at the national level since financing the consumption of other countries can be sustained across time and that internal equilibrium can be attained at no or a relatively low cost if the exchange rate, monetary policy, capital controls, fiscal and wage policies can be coordinated.

Rachel Denae Thrasher and *Kevin P. Gallagher* argue that it is imperative for countries to have the national-level flexibility to meet global development goals. The authors analyse a sample of trade agreements to show that a new ‘trade’ policy has evolved seeking to liberalize all perceived impediments to global commerce, reaching into the realms of financial regulation, innovation policy, as well as a range of domestic regulations that promote public welfare. They argue that there is a fine line between what may be perceived as ‘protectionism’ by actors seeking further market access and the legitimate deployment of domestic regulation for sustainable and inclusive growth on the part of emerging market and developing countries. The authors conclude by stating that global and regional trade rule-making will need to preserve nation States’ ability to deploy country-specific policy for development.

Notes

- 1 In our view, there is not a completely satisfactory classification of countries in “developed”, “developing” and “transition economies”. In some cases, the participation in a given group or organization (e.g. being a member of the OECD or of the “Group of 77 and China” (G77)) is used to distinguish developed and developing countries. However, this does not exclude overlapping or paradoxes, such as some G77 countries having per capita GDP higher than some OECD countries. Some institutions classify countries in low-, middle- and high-income groups, using their per capita income levels as the sole criterion and setting arbitrary thresholds. For instance, the World Bank (2014) currently defines low-income countries as those whose per capita income is below \$1,045, middle-income countries as those with an income between \$1,045 and \$12,746 and high-income countries as those exceeding \$12,746 (thresholds are periodically adjusted with inflation). However, using the income level as the criterion for dividing countries in “developing” and “developed” is problematic (Nielsen, 2011). A number of small oil-exporting countries (e.g. Brunei Darussalam, Equatorial Guinea, Oman and Qatar) or offshore financial centres have higher per capita income levels than countries with a much more developed and diversified production capacity, higher technological mastery and better qualified working force (e.g. Argentina, Brazil, the Republic of Korea, the Russian Federation and Turkey). In this introduction, we generally use the United Nations classification of developed, developing and transition economies. According to the United Nations Statistical Division (UNSD, 2013), “there is no established convention for the designation of ‘developed’ and ‘developing’ countries or areas in the United Nations system. In common practice, Japan in Asia, Canada and the United States in northern America, Australia and New Zealand in Oceania, and Europe are considered ‘developed’ regions or areas.” The group of transition economies comprises the CIS and the South-East European countries that are not European Union members.
- 2 See <http://daadpartnership.htw-berlin.de/>.

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RETHINKING DEVELOPMENT STRATEGIES AFTER THE GLOBAL FINANCIAL CRISIS*

Alfredo Calcagno

Abstract

The global financial crisis that erupted in 2008 and its long-standing effects have evidenced a number of fundamental flaws in the way in which the world economy has been functioning under a “finance-driven globalization”. This has been characterized by increasing income inequality and a diminishing role of the State in the economy. The crisis has evidenced a changing structure of the world economy, with a larger share in global output and trade for developing countries. Development strategies should thus rely less on export-led growth oriented to developed countries markets and more on domestic and regional demand, based upon better income distribution.

In this framework, there is an essential role for a developmental State on both the demand and the supply side. Developing countries need to preserve and creatively use the remaining policy space within the multilateral rules to implement industrial policies to diversify and upgrade their economies. They also need to strengthen their domestic sources for financing investment and reinforce the fiscal space, which is essential for a successful developmental State.

Introduction

The situation in the global economy has always provided the framework for development processes, setting specific configurations of trade, migratory flows, capital movements and the exchange of knowledge and technology. These exchanges have been shaped by the rules established in multilateral, regional or bilateral spheres; moreover, they are also affected by the action and policies of influential actors, including governments, domestic elites,

international banks and transnational corporations (TNCs). However, the global context has not completely determined the development path: developing countries have always had some room for manoeuvre regarding the way in which they have integrated this international environment.

All these factors – the international economic environment, the situation of developing countries

* Many of the ideas and most of the statistical evidence presented in this chapter have been elaborated by the team that has prepared the *Trade and Development Report (TDR)* of the United Nations Conference on Trade and Development (UNCTAD) in the last few years, with the author being a member of that team since 2003, and its coordinator since 2012. In addition to recognizing this intellectual debt, I wish to specially thank three members of the team, Pilar Fajarnés, Jörg Mayer and Nicolas Maystre, for their detailed comments on a previous version. However, this text does not necessarily fully reflect the views of all the *TDR* team members or those of UNCTAD.

and the role of relevant actors – have been upset by the global financial crisis. The perceived nature and depth of the crisis crucially determines the need to redefine development policies and how such a reorientation should be designed.

According to the view that the crisis was an accident caused by policy mistakes, excessive risk appetite and regulatory shortcomings, it may be possible to return to the pre-crisis growth regime without major changes in the development strategies. From this perspective, some structural reforms may be helpful – in particular, those aimed at further trade and capital account opening, labour market flexibilization and reduced state intervention in the economy. However, these reforms would reinforce

the features of the pre-crisis economic system rather than transforming them.

This chapter adopts an alternative approach, in line with UNCTAD's analysis of the crisis (see in particular *TDRs 2009 to 2014*). It contends that the global financial crisis that erupted in 2008 has evidenced a number of fundamental flaws in the way in which the world economy has been functioning under a “finance-driven globalization” (UNCTAD, 2011). The crisis thus marks a breaking point, after which it will be neither possible nor desirable to return to the pattern of growth that prevailed before the crisis. Accordingly, developing countries need to rethink their development strategies in accordance with the new environment.

I. A “big crisis”

A. Causes and nature of the crisis

The global financial crisis has been extraordinary in several respects. Regarding its severity, global output contracted for the first time since the Second World War (2.1 per cent in 2009). It was also extraordinary for its reach, as it spread to virtually all regions in the world. Output fell in absolute terms in developed and transition economies, while in developing countries, there was a mix of reductions of gross domestic product (GDP) and significant growth slowdowns. The strength and speed of the transmission of the crisis were also remarkable. An apparently minor shock – the burst of the subprime bubble in the real estate market of the United States – severely struck international financial markets and affected global economic activity and employment, as well as international trade. The rapidity with which the crisis spread contrasts with the sluggishness of the recovery, especially in several developed countries that continue struggling to restore a sustainable and employment-creating growth path.

Therefore, this is a “big crisis” regarding its magnitude, extension and time length. It may also be characterized as a “big crisis” in the different – more qualitative – meaning, which was introduced by Robert Boyer (1979). The history of capitalism has been punctuated by many crises. Most of them

(the “small crises”) were functional to the endogenous adjustment (the “regulation”) of the economy: they corrected excess expenditure and credit, adjusted relative prices (including real wages), depreciated and concentrated the real and financial capital in a way that re-established the conditions for growth. These were crises *within* an economic regime (*mode de régulation*). A different case in point is that of a “big crisis”, i.e. a crisis *of* the economic regime itself. This happens when the economic system enters into a prolonged recession from which it cannot recover without changing some of its fundamental aspects. In this situation, market mechanisms and short-term adjustment measures (e.g. automatic stabilizers) cannot restart growth on a solid basis because they do not address the roots of the problem.

An important indication of the nature of the crisis is the fact that this time its epicentre was in the most advanced countries in the world. This contrasts with the financial crises that have recurrently hit developing or transition economies since the beginning of economic and financial liberalization in the early-1980s. The global financial crisis originated in the most sophisticated financial markets from countries that were leading in all the rankings of financial efficiency and good governance prepared by different “market friendly” institutions. The crisis was not due to imperfect functioning of institutions or

bad implementation of liberalizing policies, but rather to the very nature of those institutions and policies.

The crisis reveals a number of fundamental problems of the economic system that have accumulated tensions and imbalances at both the national and global level in recent decades. These went largely unnoticed in the pre-crisis years of widespread complacency – a period known as the “Great Moderation”. It was then thought that, thanks to the wisdom of independent Central Banks, inflation was definitely under control and that the complete liberalization of all markets (including financial markets) would lead to strong and sustained growth within this framework.

The optimism in a context of positive economic growth that prevailed during those years masked rapidly mounting internal and external disequilibria. Some imbalances were too large to be ignored, such as the current account deficit of the United States (6 per cent of its GDP in 2006). However, rather than being a cause of concern, they were seen as proof of the United States’ economic strength. It was contended that the rest of the world was generating a “savings glut”, which could not find a use as profitable as in the United States, a country where the investment opportunities exceeded its population’s desired savings (Bernanke, 2005; see also Economic Report of the President, 2006).

These external imbalances resulted from internal problems, which were also ignored or underestimated. If the United States and other developed countries had rising deficits, it was not only because their consumption was very high, but also because they consumed a large proportion of imported goods and services. Their firms had lost market shares and capital inflows tended to finance consumption rather than investment. Furthermore, the rise in households’ expenditure did not primarily reflect the rising income of wage earners, whose share in total income had been declining in several countries over the last few decades; rather, it largely resulted from expanding consumption and mortgage credit. This evidenced the rising income and wealth inequality since the 1980s, following the increasing dominance of globalized finance, the erosion of the welfare State and the weakening of workers’ bargaining power (*TDR 2012*).

Real wage growth lagged behind that of productivity, and in some countries they did not increase at all. Therefore, many households had to resort to

debt, not only for financing housing, but also for consumption. Their access to credit was boosted by the rising price of real estate and financial assets, which were used as collateral. This set in place a classical financial bubble, whereby expanding credit supported the rise in the prices of the real estate and financial assets, which in turn backed new credit to finance consumption and the continued acquisition of financial assets.

Firms also had to increase their borrowing, since their managers were under pressure to increase equity values and thus used benefits to distribute dividends rather than reinvesting them. This reflects an increasing hegemony of shareholders in the governance of firms in developed countries, which contrasts with the previous dominance of the “techno-structure”, i.e. corporate management, analysed by John K. Galbraith (1972).

On the credit-supply side, the financial system allowed for the disequilibria to subsist, and even enlarged them. It benefitted from widespread de-regulation to extend its business without proportionally increasing its capitalization. In particular, it introduced financial innovations (e.g. securitization, financial derivatives) and barely regulated institutions (e.g. hedge funds, investment vehicles). Larger leverage spurred the return on capital, although it also augmented the risk of insolvency. In addition, the banking system relied more on short-term credits and less on deposits for its funding, which increased maturity mismatch and liquidity risk. Financial fragility was further aggravated by incentives that encouraged risky behaviour among financial agents, who received bonuses when they generated gains but suffered no penalties in case of running losses.

These developments led to an extraordinary expansion of the financial system worldwide, with financial assets climbing from \$12 trillion in 1980 (1.2 times the global output) to \$225 trillion in 2012, which is close to three times the global output.¹ The growing predominance of the financial sector over the real economy also contributed to income inequality. Indeed, a significant part of the very high incomes (those received by the “top 1 per cent”) comprises interest payments and substantial compensations and bonuses in the financial system, as well as dividends distributed by firms. This created a vicious circle in which the unequal distribution of income pushed many households and firms to resort to credit rather than current income to fund their consumption and

investment. In turn, this increased financial profits and income concentration.

B. Inadequate policy responses

After a first generalized and short-lasting response to support the economy, policymakers in most developed countries focused on recovering the confidence of financial markets through fiscal austerity (Ostry et al., 2010; IMF 2011a and 2011b). They also tried to expand exports with “supply-side” measures to improve competitiveness, including wage constraints, although this did not address the fundamental causes of the crisis. In a situation of insufficient private demand, these kinds of measures were particularly detrimental to economic growth, and to some extent self-defeating: lower growth in many countries at the same time hampered fiscal revenues and external demand.

Expansionary monetary policy was the only tool that remained to support economic growth. However, this did not translate into larger credit supply. Potential borrowers (households and firms) were trying to reduce their indebtedness, and potential lenders were reducing their leverage. This was an illustration of the well-known debt-deflation situation (or “balance-sheet recession”) described by Irving Fisher (1933) and more recently by Richard Koo (2011).

The coexistence of strong monetary expansion with subdued consumption and investment demand in developed countries channelled significant amounts of liquidity to speculative uses and emerging market economies. This again pushed up the prices for a number of financial assets and in real estate markets, contributing to recovering domestic demand in some countries (e.g. the United Kingdom and the United States) at the risk of re-creating financial bubbles. Financial flows also led to an appreciation of a number of developing-country currencies and an increase in primary commodity prices. However, such capital flows tend to be volatile and rather than a sustained rise, they led to increased instability in those markets.

Summing up, rather than a temporary accident, this appears to be the crisis of a pattern of growth (a “big crisis”), whose main features are the dominance of de-regulated finance over the real economy, the mounting inequality in the distribution of income and wealth and the State’s lesser role in the economy, which have led to rising domestic and external imbalances that can no longer be sustained. Subsequent policies in developed economies that intended to handle the crisis have not addressed its roots. On the contrary, they have somewhat tended to reinforce some of its causes by accentuating income inequality, restricting governments spending and generating new financial bubbles, while the announced re-regulation of the financial sector is lacking behind.

II. The case for a reorientation of development policies

A. The global economic environment after the crisis

The crisis has changed the economic landscape, particularly for development policies. After growing at an average annual rate close to 4 per cent in 2004–2007, the growth of global output fell to around 2.4 per cent between 2012 and 2014. Economic deceleration affected developed, transition and developing economies alike, although the latter maintained a growth rate of around 5 per cent (table 1).

Even more remarkable is the slowdown in international trade, whose annual average growth rate fell from around 8 per cent in 2004–2007 (twice

as much as global output) to around 2.5 per cent in 2012–2014 (similar to that of global output). This is mostly due to stagnating trade in developed countries since 2011 (chart 1). This was a reflection of weak domestic demand simultaneously affecting most trade partners.

Developing countries have not been immune to the slower demand in developed economies. Trade in developing countries kept growing in volume, albeit at half the pre-crisis growth rate. Growth in exports from developing countries decelerated, partly due to the weaker demand from developed economies, which put a break to exports of manufactures to final destinations. Moreover, this affected the trade of

Table 1
WORLD OUTPUT GROWTH, 2004–2014
 (Annual percentage change)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
World	4.1	3.6	4.1	4.0	1.6	-2.1	4.1	2.8	2.2	2.3	2.5
Developed countries	3.0	2.5	2.9	2.5	0.1	-3.7	2.7	1.5	1.1	1.3	1.7
Transition economies	7.8	6.6	8.5	8.7	5.4	-6.5	4.8	4.6	3.3	2.0	0.9
Developing countries	7.4	6.8	7.7	8.0	5.3	2.6	7.8	5.9	4.7	4.6	4.3
of which:											
Africa	5.7	6.0	5.8	6.1	5.4	2.8	4.9	0.5	5.2	3.2	3.0
Latin America and the Caribbean	5.9	4.5	5.6	5.6	3.7	-1.7	5.8	4.2	3.0	2.6	1.3
West Asia	10.3	7.2	7.6	5.5	4.6	-1.0	6.7	7.5	3.9	4.0	3.4
East, South and South-East Asia	7.9	8.0	9.0	10.0	6.2	5.2	9.3	7.0	5.5	5.7	5.8

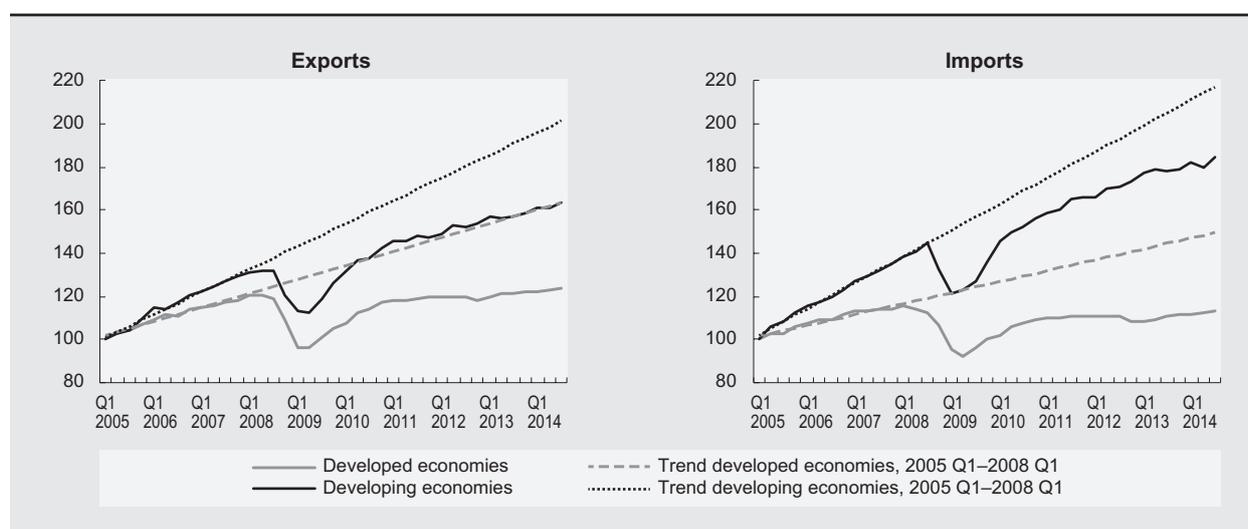
Source: UNCTAD secretariat calculations, based on United Nations, Department of Economic and Social Affairs (UN-DESA), *National Accounts Main Aggregates* database, and *World Economic Situation and Prospects (WESP): Update as of mid-2015*; ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 2014*; OECD, *Economic Outlook* No. 96, November 2014; IMF, *World Economic Outlook*, April 2015; Economist Intelligence Unit, *EIU CountryData* database; JP Morgan, *Global Data Watch*; and national sources.

inputs among the developing countries participating in international production networks. Imports were relatively less affected due to the more resilient GDP growth and the gains in the terms of trade that commodity exporters benefitted from during most of the post-crisis period (chart 1).

Development strategies are highly dependent upon the extent to which these differentials in

growth rates of GDP and international trade between developed and developing countries are a short-term phenomenon or a long-term trend. This is particularly the case for developing countries that have engaged in export-led growth policies, where exports were mostly oriented to developed country markets. Taking a long-term perspective, it appears that the growth differential between developed and developing countries was not caused by the crisis; rather, the crisis

Chart 1
WORLD TRADE BY VOLUME, 2005 Q1–2014 Q3
 (Index numbers, 2005=100)



Source: UNCTAD secretariat calculations, based on UNCTADstat.

Table 2
**SHARE IN GLOBAL OUTPUT,
COUNTRY GROUPS, 1970–2013^a**

(Per cent)

	1970	1981	1992	2003	2013
Developing economies	16.8	22.9	18.0	20.9	36.9
Transition economies ^b	13.4	7.9	2.7	1.6	3.9
Developed economies	69.8	69.2	79.3	77.5	59.2
Total	100.0	100.0	100.0	100.0	100.0

Source: UNCTADstat.

- a** Calculated using GDP in dollars at current prices and current exchange rates.
b Comprises Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Georgia, Kazakhstan, Kyrgyzstan, Montenegro, Republic of Moldova, the Russian Federation, Serbia, Tajikistan, the former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine and Uzbekistan.

simply rendered more visible some trends that were already under way, such as the increasing economic weight of a number of large developing countries.

From 1970 onwards, it is possible to identify four major periods (table 2). Between 1970 and 1981, developed countries represented a relatively stable share of 70 per cent of global output, while developing countries gradually increased their part from 17 to 23 per cent, at the expense of the transition economies.² The following decade witnessed a further fall on the part of transition economies, from

8 per cent to 3 per cent of global output between 1980–1981 and 1990–1991 (compared to 13 per cent in 1970–1971), while developing countries lost their previous gains. Developed economies increased their share to almost 80 per cent in 1992. The third period showed little changes, with the share of developing countries slowly increasing, the collapse of the Soviet Union further lowering that of transition economies and developed countries maintaining their part slightly below 80 per cent.

These long-term trends sharply changed since 2003. In only ten years, the share of developing countries jumped from 21 to 37 per cent of world output, that of transition economies improved from 1.5 to 4 per cent and the part of developed countries fell from 78 to 59 per cent. Indeed, the trend towards the increasing share of developing countries and decline in developed ones has continued during the crisis and its aftermath.

This evolution in the contribution to total output was parallel to that of international trade. In 1995, developed economies accounted for 70 per cent of total exports and 69 per cent of total imports; in 2003, these shares had declined to 65 and 69 per cent respectively, and they further fell to 51 and 54 per cent in 2013. Similarly, the part of developing countries in total exports rose from 28 per cent in 1995 to 33 per cent in 2003 and 45 per cent in 2013, and that of imports from 29 per cent in 1995 and 2003 to 42 per cent in 2013 (table 3).

Table 3
WORLD EXPORTS BY ORIGIN AND DESTINATION, SELECTED COUNTRY GROUPS, 1995–2013
(Per cent of world exports)

	Origin	Destination			Total
		Developed economies	Developing economies	Transition economies	
1995	Developed economies	52.2	16.6	0.9	69.7
	Developing economies	16.1	11.9	0.3	28.3
	Transition economies	1.0	0.3	0.6	2.0
	Total	69.3	28.8	1.8	100.0
2003	Developed economies	49.5	14.0	1.1	64.6
	Developing economies	17.9	14.5	0.3	32.8
	Transition economies	1.5	0.5	0.6	2.6
	Total	69.0	29.1	2.0	100.0
2013	Developed economies	34.2	14.9	1.6	50.7
	Developing economies	17.8	26.4	0.9	45.0
	Transition economies	2.4	1.1	0.8	4.3
	Total	54.3	42.4	3.3	100.0

Source: UNCTAD secretariat calculations, based on UNCTADstat.

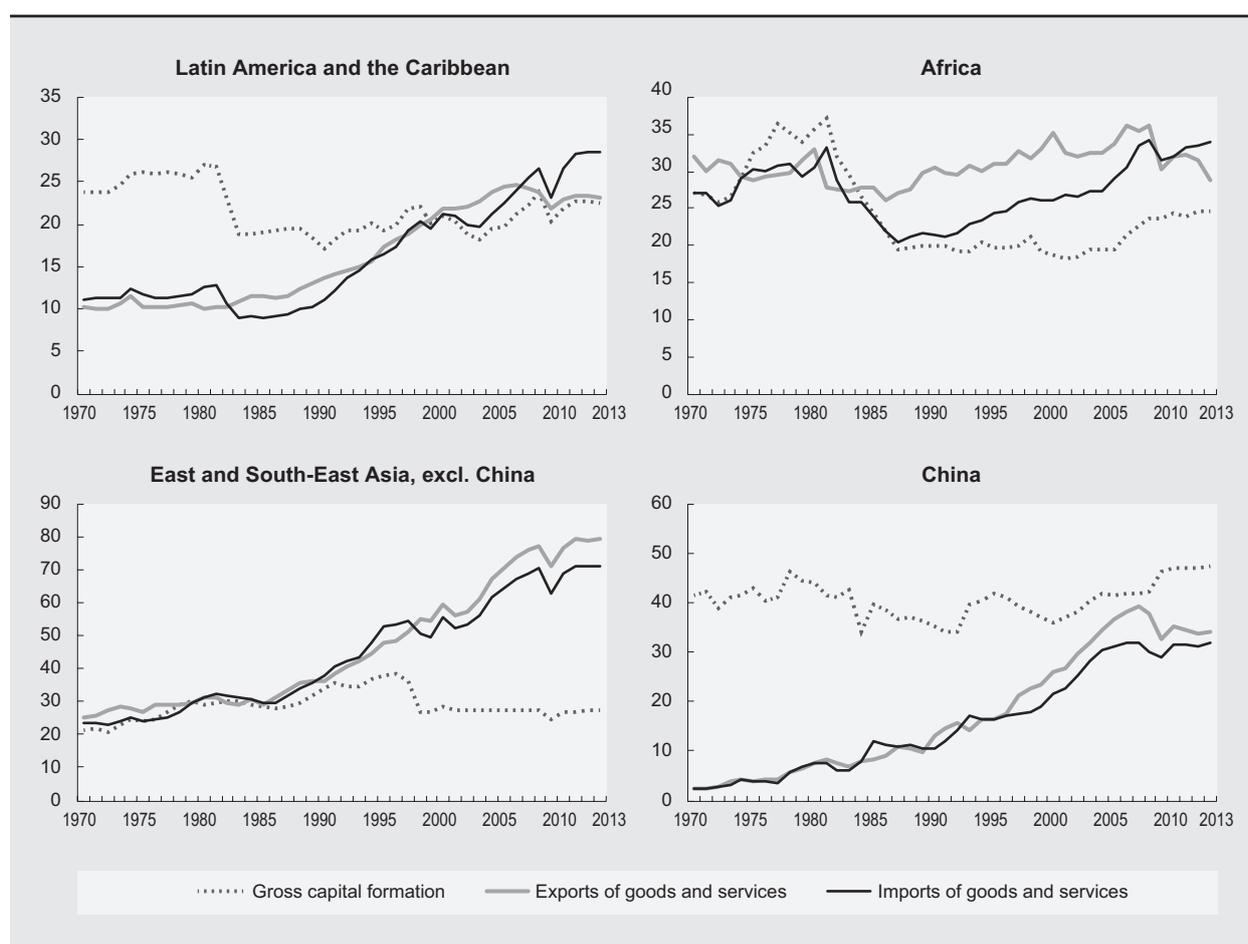
B. A more balanced approach on the demand side

Export-led growth, mainly directed towards developed economies, has long been the preferred development strategy in many developing countries. It involved either exporting directly to those markets or participating in some global value chains, eventually finishing in developed markets. The main debate about this strategy concerned the links between the export-oriented activities and the rest of the economy. Indeed, it was possible (and quite frequent) that a country managed to rapidly expand its international trade without significant improvements in capital accumulation, productive diversification and GDP growth. By themselves, neither larger exports nor foreign direct investment (FDI) inflows necessarily lead to increasing productive capacities. In fact, they

may simply develop some outward-oriented enclaves without generating domestic productive linkages or distributing a significant amount of income to local agents. This is the case, for instance, in assembly industries that import most of their inputs, employ low-qualified working force and benefit from fiscal incentives. Likewise, the contribution of activities in extractive industries to domestic growth may be rather small when they generate little employment, import most inputs and services rather than creating linkages with domestic suppliers, export the raw material, transfer profits abroad and contribute insufficiently to tax revenues. As a result, increasing trade openness was not associated with larger fixed capital formation in most developing countries (chart 2).

Within this export-led approach to growth, many developing countries sought to accelerate

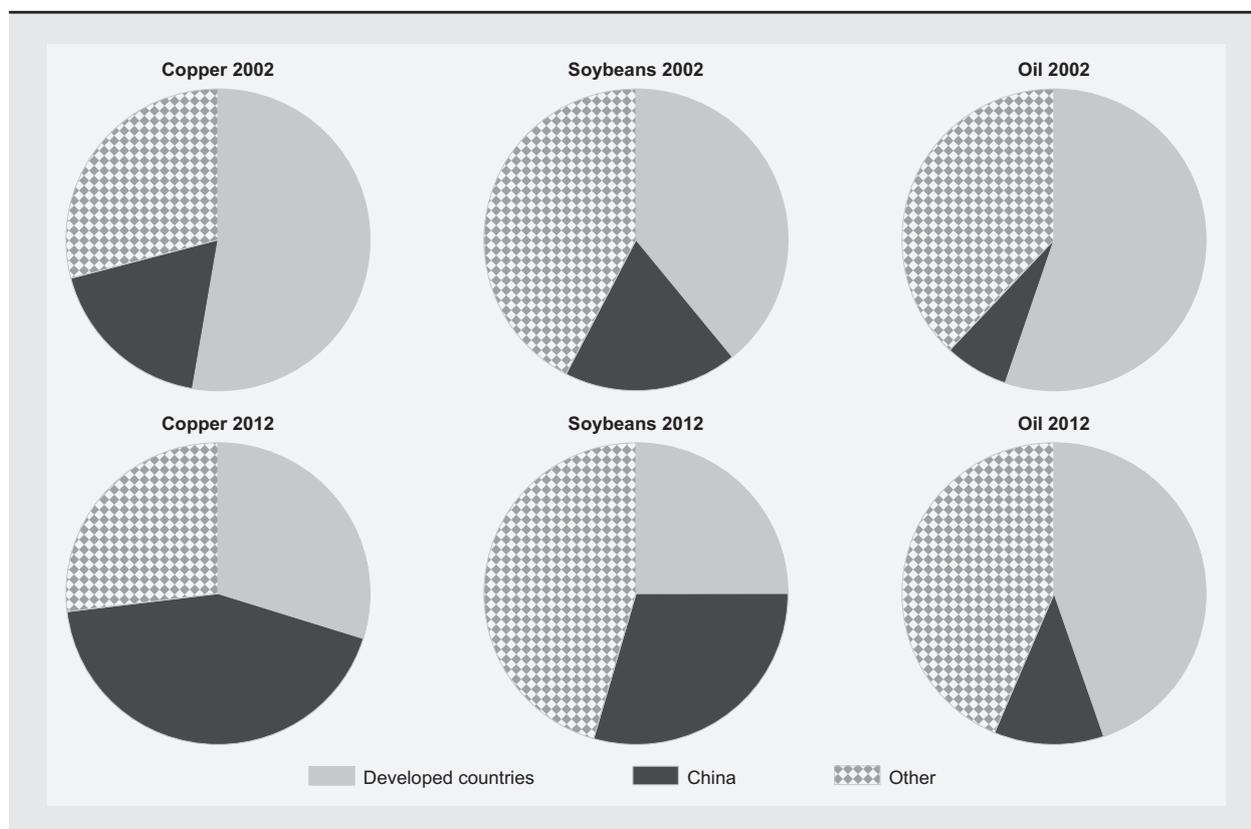
Chart 2
TRADE AND INVESTMENT AT CONSTANT PRICES, 1970–2013
 (Per cent of GDP)



Source: UNCTAD secretariat calculations, based on UNCTADstat.

Chart 3

CONSUMPTION OF COPPER, SOYBEANS AND OIL IN SELECTED GROUPS OF COUNTRIES, 2002 AND 2012
(Share in global consumption in per cent)



Source: UNCTAD secretariat calculations, based on *World Bureau of Metal Statistics Yearbook 2013*; BP, *Statistical Review of World Energy 2013*; and United States Department of Agriculture (USDA), *Production, Supply and Distribution* online database.

their integration with developed economies by signing bilateral free trade and investment agreements. However, such agreements severely restricted their ability to apply the accompanying macroeconomic and industrial policies that were needed to make this integration conducive to development (*TDR 2007*). In other words, there seemed to be a trade-off between market access and policy space. With the crisis and the subsequent loss of dynamism in developed country markets, the gains from market access are more uncertain. Thus, the terms of this trade-off may have changed: if those markets have entered into a prolonged period of slow growth, the export-led strategy directed to them is not viable. Therefore, there is a need for a more balanced approach in development strategies, giving a larger role to domestic and regional markets and, more generally, to South-South trade.

Some factors of such a reorientation on the demand side are already visible. As mentioned above,

the composition of global trade is changing, with a larger participation of South-South trade, which exceeded 26 per cent of total trade in 2013, compared to only 11 per cent in 1995. The rapid expansion of very large countries, and particularly China, India and Indonesia, has modified the trade geography, as well as its composition. Strong GDP growth associated with rapid urbanization and industrialization lead to an expanding demand for commodities. China alone has deeply transformed these markets in just a decade (chart 3).

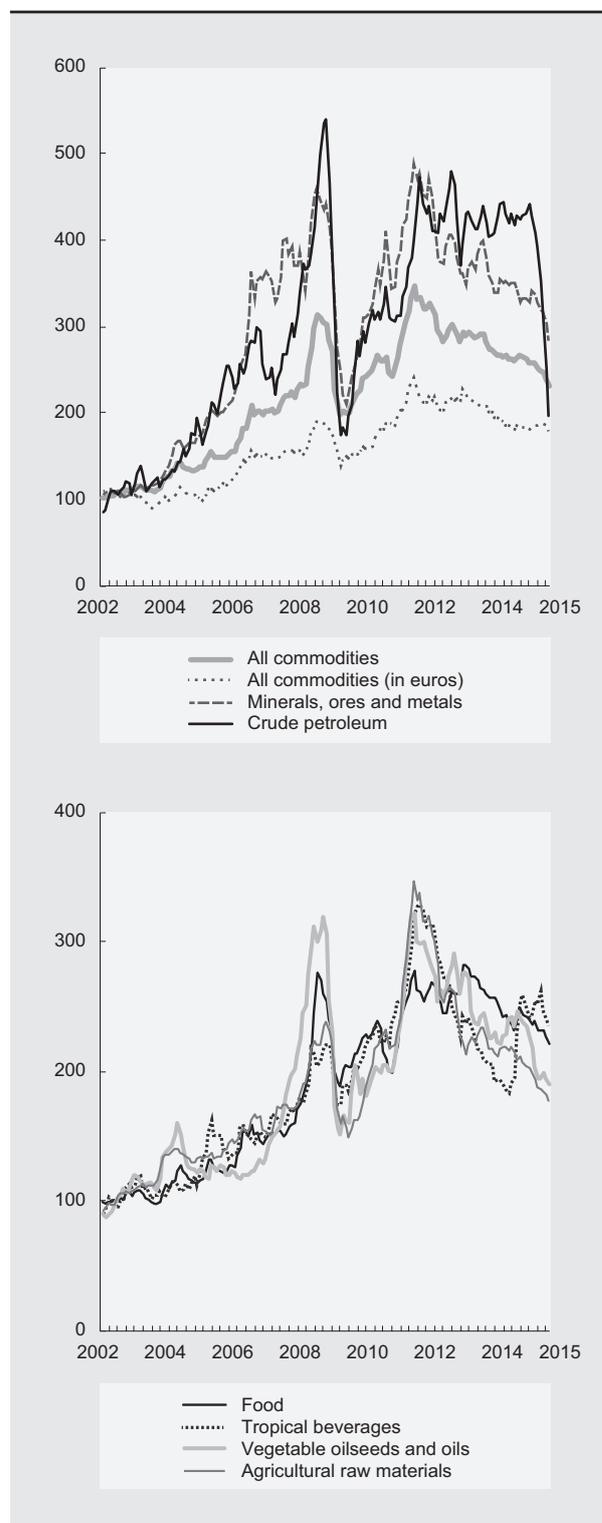
Given the size already attained by the Chinese economy, it is likely to continue playing a key role in global commodity demand in the foreseeable future, even if it grows at slower rates than before the crisis. Between 2007 and 2013, China's GDP in current dollars increased from \$3.5 to \$9.6 trillion. A more moderate growth rate of 11.5 per cent in current dollars (and 7.6 per cent at constant prices) in 2013 represented a larger increase in global demand

(\$960 billion) than that generated in 2007 (\$711 billion) with a growth rate of 25.5 per cent in current dollars (and 14.2 per cent in real terms), according to UNCTADstat data.

However, this does not guarantee that commodity prices will keep growing indefinitely. In response to the high prices, new supply capacities also came to the fore, particularly in mining and hydrocarbons. It is mainly developments on the supply side that explain the substantial reduction of prices experienced in 2013–2014 (*TDR 2014*). In addition, in financialized commodity markets, prices are affected by financial operators that tend to exacerbate upward and downward movements. Moreover, geopolitical factors (which play a strong role in hydrocarbon markets) can also influence commodity prices; therefore, these prices are very difficult to forecast, especially in the short run. Taking a long-term perspective, however, it is important to analyse whether the present downward movements evidence the declining phase of a “super cycle”, which would bring back commodity prices to the early-2000s levels. On the other hand, the new conditions of demand may have pulled durably commodity prices to a higher level, even if they remain subject to wide oscillations. This is illustrated by the fact that even after the substantial reduction experienced in 2013–2014, commodity prices remained well above their 2002–2007 average (chart 4).

UNCTAD has leaned towards the second view on the prospects for commodity prices. The size already attained by the economies of China and India, the evolving consumption pattern of their population and their persistently large investment needs are structural factors that provide the basis for sustained demand for commodities in the coming years (*TDR 2013*).³ Nonetheless, this should not lead to complacency in commodity exporting countries, as strong price volatility continuously shows. In particular, they should strengthen their domestic production linkages around these activities. They should also use the revenues generated in export-oriented primary industries to diversify their economies and thus reduce their dependence on commodities. The government’s role is key in this process, as it is the actor that can capture a significant part of the rent generated in primary production and apply it in social and economic investment. Moreover, diversifying production and generating production and incomes linkages tends to develop domestic markets, which are essential to establishing a sustained development process.

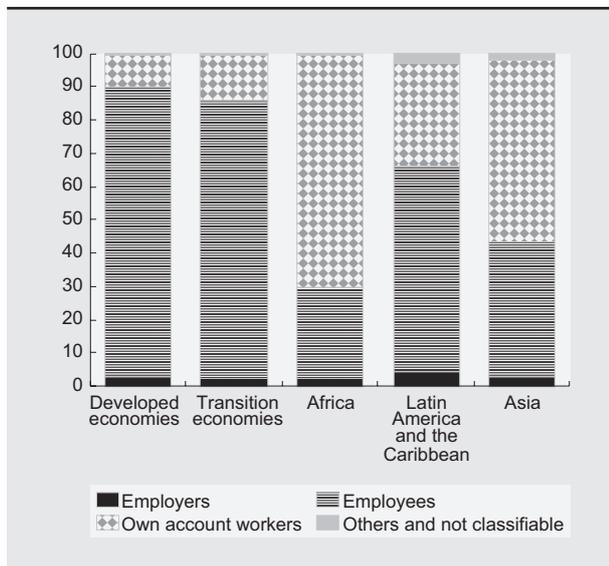
Chart 4
MONTHLY COMMODITY PRICE INDICES, SELECTED AGGREGATES, JAN. 2002–JAN. 2015
(Index numbers, 2002=100)



Source: UNCTAD secretariat calculations, based on UNCTAD, *Commodity Price Statistics Online* database.

Note: Crude petroleum price is the average of Dubai/Brent/West Texas Intermediate, equally weighted. Index numbers are based on prices in current dollars, unless otherwise specified.

Chart 5
COMPOSITION OF EMPLOYMENT
BY REGIONS, 2008
 (Per cent)



Source: UNCTAD secretariat calculations, based on *ILO Laborsta* database; and national official publications.

Note: Own account workers include contributing family workers.

This does not mean that there is an opposition between domestic and external markets. Much on the contrary, international trade cannot revive without a significant recovery of domestic demand in a sufficiently large number of countries. In fact, too many countries seeking to grow through net exports and gain competitiveness in ways that depress domestic demand would necessarily lead to a fallacy of composition: weak domestic markets, if generalized, also weaken global markets.

In addition to recognizing the importance of domestic demand for a more balanced and sustainable growth, it is necessary to consider the composition of that demand, which in turn critically depends on income distribution. Very unequal distribution patterns concentrate consumption in high-income sectors, with a high proportion of imported goods and services and weak domestic production linkages.

Therefore, this kind of domestic demand has little impact on domestic growth and employment, negatively affects the trade balance and does not provide the necessary support for industrialization (Prebisch, 1963; Pinto, 1970). On the contrary, a more equal income distribution has a positive impact on total domestic demand (as low- and middle-income social groups have a higher propensity to consume than high-level income groups). It also alters its composition by increasing the share of goods (including manufactures) and services that are more likely to be supplied by domestic and regional producers. Consequently, a better income distribution not only supports consumption but also investment.

Governments can use several policy tools for reducing income inequality and combine them according to specific situations. They can support job creation, in particular in the modern and formal sector; moreover, they can also implement incomes policies so that wages increase (at least) in line with the average productivity growth in the economy plus the targeted inflation rate. With this aim, they can establish minimum wages, empower unions with a nation-wide mandate, implement collective bargaining mechanisms and provide general guidance within these negotiations. However, in many developing countries (particularly in Africa and Asia), a large part of workers are self-employed or employed in the informal sector and thus they do not benefit from wage policies (chart 5). Therefore, specific measures aimed at increasing the income of small peasants (through changes in their production and commercialization schemes) are also needed. Public policies for income redistribution also need to be developed, through progressive taxation and social transfers. Recent improvements in income distribution in Latin America largely resulted from a larger redistributive role of the State (*TDR 2012*).

Giving a larger place to domestic and regional demand (especially to low- and middle-income groups) is not only important for providing a stronger and more reliable source of growth, but more importantly because it leads to a more inclusive kind of growth.

III. The need for policy space⁴

A. Rediscovering industrial policies

Strengthening domestic demand, and particularly that of the low- and middle-income social groups, is a necessary yet not a sufficient condition for economic development. Inadequate production capacities for responding to rising demand and a limited possibility of financing increasing imports with exports may lead to balance of payments restrictions. As discussed above, the prospects for expanding exports mainly depend on expanding domestic demand in a large number of countries. The involvement of large economies is particularly relevant. In this sense, current policies aimed at reorienting the structure of demand in China towards domestic markets and consumption can help to boost global demand. Indeed, a number of countries are incorporating large parts of their population into a middle class. Demand in this group is not only increasing in volume, but also diversifying in composition, providing new opportunities to domestic and foreign producers (see *TDR 2013*, chapter II).

It is also essential that developing countries expand and adapt their production capacities to respond to the new demand pattern, although such adjustments would not take place spontaneously. In order to increase investment, firms not only need to have good demand prospects, but also supportive macroeconomic and industrial policies, basic infrastructure and long-term finance.

Industrial policies were sidelined for many years, during which the main strategy involved liberalizing trade and capital flows (see Robert Wade's contribution in this volume). The only active policies frequently used were providing incentives and advantages to TNCs. It was expected that through these means the country would expand its commodity exports or entry into international production networks (depending on their static comparative advantages) and engage in export-led growth. Since industrial policies no longer seemed relevant, losing policy space through World Trade Organization (WTO) disciplines and even more by signing Bilateral Investment Treaties and Regional Trade Agreements with developed countries (mostly in the 1990s) seemed a low price to pay compared to the promise of larger market access and FDI inflows. However, subsequent experience has shown that even

in export-led growth schemes, public policies were essential to avoid the country remaining locked into low-value added activities or seeing their extractive industries becoming enclaves with barely any domestic productive linkage and little income (including taxes and royalties) distributed within the country.

Since the beginning of the financial crisis, many countries, both developed and developing, have acknowledged the importance of industrial policy to sustain or expand their manufacturing sectors and firms. Both the United States and the European Union launched economic packages aimed at smoothing the impact of the crisis, particularly on their manufacturing sectors. With a longer-term perspective, the American Recovery and Reinvestment Act of 2009 allocated an \$800 billion package to favour the structural adjustment of the manufacturing sector, the repatriation of offshore manufacturing and the development of clean energies. Furthermore, the Government of the United States has been supporting strategic industries and the development of new technologies by funding very risky research and creating innovation networks. The European Union seeks to support research and development, innovation and competitiveness in the context of the Lisbon Strategy (adopted in 2000) and the Horizon 2020 Programme (adopted in 2010) (see *TDR 2014*: 93–96).

With the Uruguay Round Agreements in 1995, developing countries have at least partly lost some of the tools that several East Asian countries used for their rapid industrialization. Indeed, they now face restrictions in the use of subsidies, they cannot set export requirements or domestic content to foreign firms and are not allowed to reverse engineering and imitation for technology access.⁵ However, the remaining room for manoeuvre is not negligible. WTO members can use tariff policy when there is a gap between bound and applied tariffs and modulate it to support specific industries. They may use certain flexibilities through export credits or environment-related subsidies, compulsory licensing and parallel imports and sector-specific entry conditions on FDI (see *TDR 2014*: ix and 84–86). They can also offer tax incentives, provide long-term credit at moderate interest rates and use government procurement to support local providers. Much of these remaining flexibilities may disappear if developing countries accept the terms of Free Trade Agreements or

Bilateral Investment Treaties that contain more stringent provisions than those included in the multilateral regime (“WTO-plus”) or go beyond the multilateral agreements (“WTO-extra” provisions). When considering the signature of those new agreements, developing countries should carefully consider their costs in terms of the loss of policy space (see *TDR 2014*: 86–89. See also Mayer, 2008).

Any process of structural change is normally associated with “creative destruction”. Industrial and macroeconomic policies should aim at ensuring that creation prevails over destruction. This was not the case with neoliberal reforms that took place in many countries of Latin America in the 1980s and 1990s. Growth and employment were greatly affected because rapid and unilateral opening to trade and capital movements, regressive income distribution and dismantling of the developmental State strongly hit the tradable sectors, particularly those dependent on domestic markets. The destruction of capital and human qualification in the affected sectors was not compensated by expected improvements in other sectors. This was partly because these losses on both the demand and supply side created a downward spiral that depressed investment, despite the availability of foreign capital. Furthermore, openness to capital movements led to an appreciation of domestic currencies (which undermined exports from the supposedly competitive sectors), generated debt overhang and boom-and-bust episodes and led to severe financial crises (Calcagno, 2008). To be successful, structural change must be driven by the expansion of new sectors, whereby the decline of other sectors (in relative or absolute terms) should be the result of that expansion, and not the other way around.

B. Foreign capital flows and domestic sources of finance

The global financial crisis evidenced the flaws and risks entailed by a financial globalization characterized by huge private capital movements and large foreign-held capital stock without proper international or national financial governance. In this framework, access to abundant international finance, which could have been a blessing for many developing countries by easing their balance of payment restriction, became in many cases a problem.

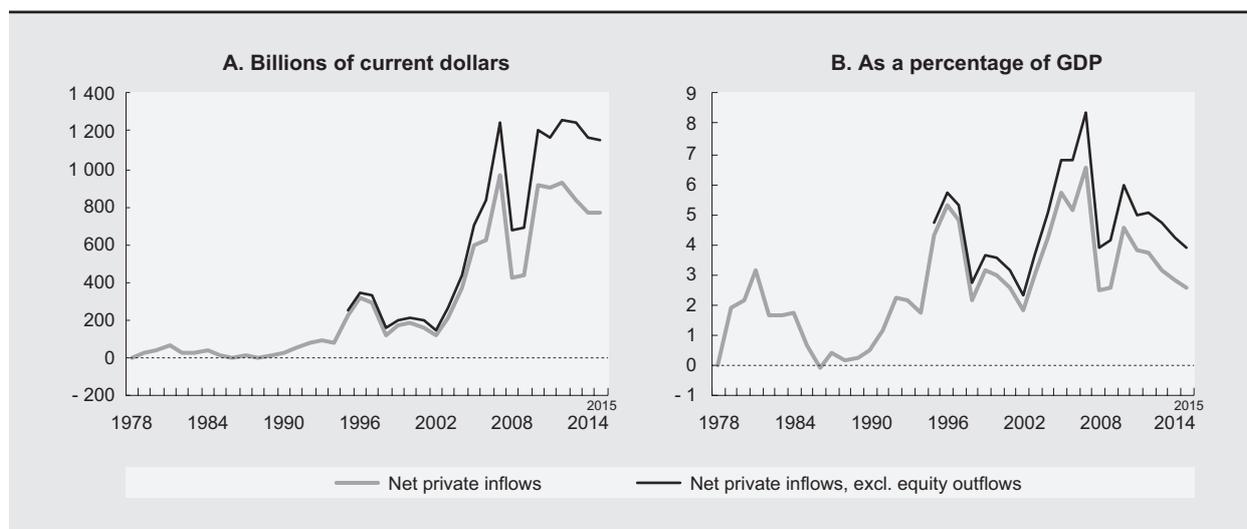
The main issue is that, more often than not, the amount, use and timing of predominantly private

capital movements do not respond to developing countries’ needs. Capital flows tend to follow a global financial cycle, whereby “push factors” in the developed economies where the main suppliers of international credit are based have more influence than country-specific “pull factors” (i.e. countries’ demand for credit; see Akyüz, 2012; Rey, 2013). Indeed, almost all of the major “waves” of capital inflows received by developing countries since the late-1970s have been triggered by expansionary monetary policies in developed countries. They were amplified by the leverage cycles of global banks (chart 6).

The volume of such inflows is frequently too large for relatively small economies (Haldane, 2011). Much of it is channelled by the domestic financial system to consumption, real estate and financial assets, rather than productive equipment and machinery. Consequently, rather than spurring investment and growth, they have frequently generated macroeconomic instability, distorted prices and created trade imbalances and credit bubbles. When economic policies changed in developed countries or any event affected market confidence, a “sudden stop” or reversal of capital flows triggered financial crises. Therefore, it is little wonder that empirical studies have generally failed to find a positive correlation between openness to capital flows and development (see for instance Bhagwati, 1998; Prasad et al., 2003; Prasad et al., 2007; Jeanne et al., 2012; *TDR 2014*, chapter VI).

Development strategies should prevent or at least reduce the macroeconomic instability and economic fragility caused by international capital movements. It is increasingly accepted that as long as multilateral regulation mechanisms are not in place, governments have to resort to capital management measures, including capital controls (*TDR 2011*; IMF, 2012). Managing the *volume* of capital inflows and outflows is essential for prudential reasons, to avoid financial fragility and conduct macroeconomic policies. Similarly important is the regulation of their *composition* and *use* (e.g. long-term credits for investment projects vs. short-term flows for consumption or speculation). A cautious and selective approach towards cross-border capital flows would reduce the vulnerability of developing and transition economies to external financial shocks, as well as channelling foreign capital to development-enhancing purposes (*TDR 2013*, chapter III).

Chart 6
NET PRIVATE CAPITAL INFLOWS TO EMERGING MARKET ECONOMIES, 1978–2015

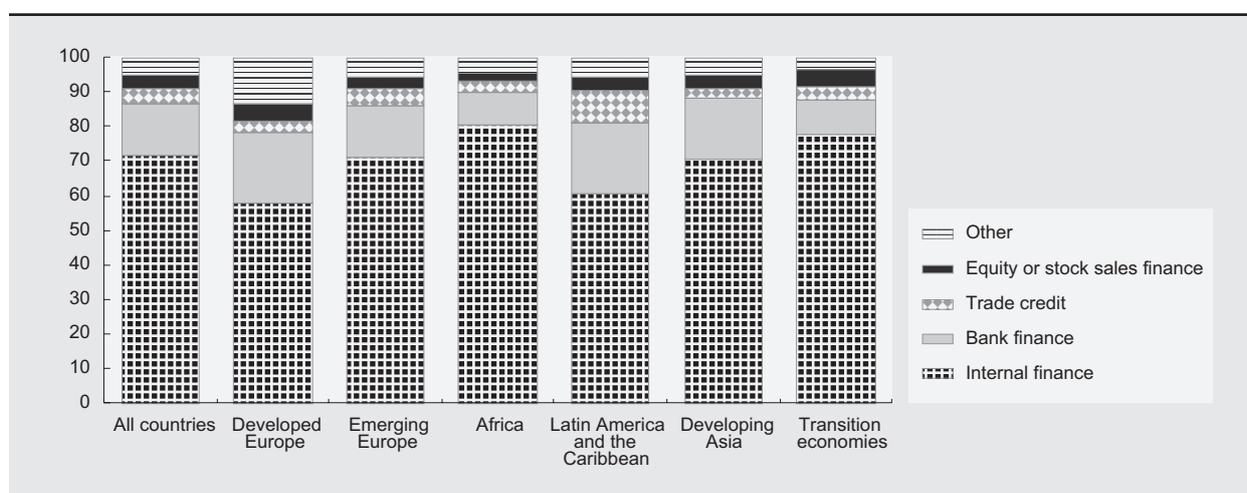


Source: UNCTAD secretariat calculations, based on Institute of International Finance, *Capital Flows* database; and UNCTADstat.

The management of capital flows should be seen as a way to make them a complement to domestic sources of investment. Indeed, domestic sources are quantitatively the most important for investment financing, whereby firms' retained profits⁶ overwhelmingly constitute the main source of finance for investment, followed by bank credit (chart 7). Economic policies should aim at strengthening the profit-investment nexus and apply active credit

policies to increase real investment. This would be more effective in promoting investment than seeking to increase domestic and foreign savings through higher interest rates and capital inflows deregulation. Furthermore, the usual policy tools aiming at increasing savings (e.g. increasing real interest rates, adjusting fiscal spending and increasing income inequality) may actually discourage investment, as they tend to reduce expected demand and profits. If

Chart 7
SOURCES OF INVESTMENT FINANCE, SELECTED COUNTRY GROUPS, 2005–2014
 (Per cent)



Source: UNCTAD secretariat calculations, based on World Bank, *Enterprise Survey* database.

Note: Developed Europe comprises Germany, Greece, Ireland, Israel, Portugal and Spain. Emerging Europe comprises Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

that is the case, they would be self-defeating since lower investment would lead to lower growth and income generation, and thus lower savings.⁷

C. Fiscal space

The global crisis provided new evidence concerning the importance of the State's role in the economy. Even in the neoliberal view, it was recognized that public action was essential to avoid a complete financial implosion and a deeper economic contraction. Moreover, it was acknowledged that there was a need for a greater participation of the State in the economy on a more permanent basis. In particular, there was certain agreement on the need for improving public supervision and regulation of the financial system. In some countries, incomes policies (including social transfers and employment programmes) for supporting domestic demand and improving low revenues gained wide acceptance. Furthermore – as mentioned above – an increasing number of countries are implementing industrial policies and expanding the public provision of essential services.

Fiscal space is an essential aspect of the policy space needed by the developmental State (see *TDR 2014*, chapter VII). Even if governments are allowed to conduct some development policies within the multilateral, regional or bilateral frameworks, they still need to finance them. To that end, strengthening public domestic revenues is key, given that they are more sustainable in the long run than relying on aid or debt, as well as being less subject to restrictions and conditions that hamper policy space.

Public revenues as a percentage of GDP normally increase during the development processes. On the one hand, higher public revenues reflect the expansion of taxable income, wealth and transactions as economies progress and the informal sector squeezes. On the other hand, they can cover rising demands in terms of social services, public investment and transfers. The specific ways in which economies raise taxes and other public revenues critically depend upon country characteristics and political choices.

However, the globalized economy poses serious challenges to increasing tax revenues, as it prompts tax competition among countries (a “race to the

bottom”, mainly on direct taxation) to attract foreign capital. This competition has been particularly damaging in mining and hydrocarbons: an estimate for a sample of resource-rich developing countries shows that governments only captured about 17–34 per cent of the rents generated in extractive industries dominated by private firms between 2004 and 2012. This share increased to 64–87 per cent when a public firm had a dominant role in the activity.⁸

Finance-driven globalization has also seen the development of a dense network of tax havens, offshore financial centres and secret jurisdictions that host them. They provide various means for tax avoidance to the main potential taxpayers, including internationalized firms and wealthy households. While the magnitude of tax leakages is difficult to assess, all estimations agree that they are huge (see *TDR 2014*: 175–176).

For instance, Henry (2012) calculated that rich households held between \$21 and \$32 trillion in tax havens in 2010. A conservative calculation of the resulting loss of public revenues amounts to \$190–\$290 billion per year, of which \$66–\$84 billion is lost from developing countries.⁹ As for corporates, their main vehicle for tax avoidance or evasion and capital flight from developing countries is the misuse of “transfer pricing” (i.e. when international firms price the goods and services provided to different parts of their business to create profit-loss profiles that minimize tax payments). By this means, developing countries may be losing over \$160 billion annually (Christian Aid, 2008).

These examples suggest there are significant potential gains from seriously checking tax avoidance mechanisms and reversing the “race to the bottom” behaviour in tax matters, which only benefits some TNCs. Those gains would not only be important from an economic perspective, but also by introducing some fairness in the distribution of the costs of the crisis. Furthermore, this would represent a true structural change, as these mechanisms allowing for tax leakages are part of modern business practices and are integrated into the trade and financial systems of many developed economies.

Therefore, the first condition to end these practices is to have the political will to place limits upon the globalized financial system, stemming “tax optimization” strategies by TNCs, reducing inequalities and strengthening governments' fiscal space.

This is an ambitious programme that would address the roots of the “big crisis”, as well as contributing

to generate social and political support for the new development strategy.

IV. Concluding remarks

This chapter argues that the global financial crisis has been a “big crisis”, in the sense that it was not just a temporary disruption that could be reabsorbed without any fundamental change in the economic and social framework. Indeed, its resolution would require a number of structural reforms to address a number of fundamental flaws in the world economy. Such reforms cannot result from market mechanisms; rather, they need to be implemented through a political process.

Many observers would agree that structural reforms are needed; however, the content of such reforms critically depends upon the perceived causes of the crisis. The view conveyed in this chapter is that the crisis resulted from a number of long-term trends that gained momentum since the mid-1970s and early-1980s. The most important were the dominance of the increasingly unregulated financial sector over the real economy, the State’s diminishing role in the economy and the increasing income inequality. Based upon a different understanding of the causes and nature of the crisis, many of the proposed or on-going reforms – mainly in developed countries

– are either too timid in addressing some factors of the crisis (e.g. insufficient financial re-regulation) or they actually worsen its very causes, by further weakening the role of the State in the economy or increasing income inequality.

Developing countries need to adapt their development strategies to the new, less conducive, international conditions. This would not only require applying supportive macroeconomic policies, but more generally reinstating a developmental state and enlarging its policy space. Public action should sustain domestic demand through incomes policies and expand the production capacities, particularly through public investment and industrial policies. Reorienting the financial system and mobilizing resources to finance development policies are challenging tasks, whose success critically depends upon the willingness and ability to tame the globalized financial system and strengthen governments’ fiscal space. This ambitious programme would address the roots of the “big crisis” and contribute to generating social and political support for the new development strategy.

Notes

- 1 Financial assets include equities, bonds issued by the public and private sectors, and loans. See Lund et al. (2013).
- 2 The group “transition economies” has significantly evolved with the incorporation of several former socialist countries into the European Union, which were thus included in the “developed countries” group. For consistency, countries in this group are those still considered in transition by 2014; see the complete list in table 2.
- 3 In China, it is expected that 400 million persons will move from rural to urban areas in the following 15 to 20 years, which mean building 200 medium-size cities and the corresponding infrastructure. See Aglietta (2012).
- 4 This section largely draws on *TDR 2014*, chapters V, VI and VII, whose main authors are Jörg Mayer; Alfredo Calcagno and Ricardo Gottschalk; and Diana Barrowclough, Pilar Fajarnés and Nicolas Maystre, respectively.
- 5 These restrictions are established in the Agreement on Subsidies and Countervailing Measures (SCM), the Agreement of Trade-related Investment Measures (TRIMs) and the Agreement on Trade-related aspects of Intellectual Property Rights (TRIPS), respectively.
- 6 Retained profits include reinvested profits by TNCs, which is a component of FDI flows.
- 7 This issue refers to the fundamental debate between the neoclassical view that sees savings as a precondition for investment and the Keynesian/Schumpeterian view, which sustains that investment can be financed by banking credit (created *ex-nihilo*) and savings is an endogenous variable resulting from the income generated in the economic process. See *TDR 2008*, chapters III and IV; Dullien, 2009.
- 8 The study comprised Angola, Colombia, Ecuador and the Bolivarian Republic of Venezuela for oil, and Chile, Ghana, Mali, Peru, the United Republic of Tanzania and Zambia for mining. See *TDR 2014*, chapter VII, table 7.1.
- 9 In Henry’s calculation, this would result from a 30 per cent income tax paid over a hypothetical return of only 3 per cent per year.

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SEVEN STRATEGIES FOR DEVELOPMENT IN COMPARISON*

Jan Prieue

Abstract

Four traditional mainstream development strategies are discussed (Washington Consensus, plain neo-liberalism, “good governance” and Millennium Development Goals and two long-debated key strategic issues are reconsidered (inward or outward development, industrialization or growth with predominant primary goods exports) in this comparison, adding a heterodox approach with a focus on macroeconomic policies and structural change. The rough empirical comparison finds that countries and areas with strong emphasis on macroeconomic policies, mainly in Asia, have performed unambiguously better than the mainstream approaches since 1980. From successful Asian countries, it can be learnt that a long-run continuous growth and development performance with more resilience against adverse shocks is key. Almost all larger middle-income countries have embarked on industrialization, thereby strategies based upon primary commodities or high current account deficits are unlikely to be successful in the long run. A stronger role of a package of six macroeconomic policies is advised for the larger economies; for instance, those 21 countries with a GDP of more than 100 billion in constant 2005 dollars, comprising around 87 per cent of the total GDP and 72 per cent of the population in the South in 2013.

What is a strategy for development and why do we need one?

In our understanding, a development strategy is an economic conception that defines the priority goals, coherently explains how set goals can be reached, identifies the policy tools and explores trade-offs and the time frame. It is a kind of vision with normative goals, balanced against what is feasible. Such a strategy does not necessarily have to be explicit; rather, it can be implicit in the mind-set of policymakers or a tacit agenda of governments. Moreover, it does not need to be comprehensive, but it must address key issues for the medium to long term. If such a vision does not exist, it is likely that the policymakers in charge, including external advisers, will simply follow the historic track, with a focus on short-term issues barely related to long-term

goals. Pragmatism without a compass might prevail with rather low ambitions.

A number of “guidelines” or blueprints for development are offered in academic economics and the political economy of development, which we will discuss and compare in this essay. They are often general, i.e. not country-specific, recommendations for economic development that can to some extent be adapted to the specific needs of a country. After the demise of guidelines of the *one-size-fits-all* type, a backlash occurred as if anything would go and nothing can be said in general. I will argue here that this is not the case; rather, there are clear success stories and clear stories of failure or stagnation.

* A longer version of this essay is available online with more empirical details, see Prieue (2015).

After many of the old ideas for quick development success after World War II had failed, such as the “Big Push” or heavy aid-led development based upon “saving gap” concepts, or grand-scale import substitution policies as practised in many countries of the South until the 1980s, a transition to more simple recipe-like recommendations emerged. The (in)famous “Washington Consensus”, often misunderstood as plain liberalization and market fundamentalism, was promulgated in 1989, before later being complemented by cooking recipes for “good institutions” and “good governance”. The plea for financial globalization added an important part to the comprehensive liberalization agenda, concentrating on free trade, free capital flows, the privatization of State-owned enterprises and a small

State in contrast to a developmental State (which is not necessarily large). Seemingly a backlash, the sudden about-face to the “Millennium Development Goals” (MDGs) was in part only a complement to the continuing neo-liberalism.

These concepts will be recapitulated in section I. The debates on inward or outward development will also be picked up, while the overdue debate on industrialization versus commodity-led development will be addressed. In section II, a macroeconomic approach to development will be sketched, put forward by ideas stemming from adapted Keynesianism and dependencia theories. Section III reviews the stylized facts of developmental success or failure since 1980, before section IV concludes.

I. Traditional strategic concepts

A. *Washington Consensus*

As is well-known, John Williamson summarized in 1989 (Williamson, 1990) what he believed to be the consensus of four Washington-based institutions regarding economic policies in Latin America at the time: the State Department, the Treasury, the World Bank and the International Monetary Fund (IMF). Easily understandable, it was used as a set of ten commandments that were more or less applicable to the rest of the world, including the collapsing countries of the former Soviet Union and in Eastern Europe. It was a much-needed makeshift in the absence of sound and coherent strategies of western nations for development. The ten guidelines do not truly sound like a full-fledged neoliberal agenda. In hindsight, many postulates seem innocuous and not particularly controversial, yet sufficiently ambiguous for a broad range of interpretations:

- Reduction of budget deficits to a non-inflationary level.
- Redirection of public expenditure to areas such as education, infrastructure, etc. As tax increases are ruled out, lower marginal tax rates and a broadened tax base are advised, similar to what was practised in the United States at the time.
- Domestic financial liberalization towards “market-determined interest rates”, with no mention

that interest rates are largely determined by central banks, and hence tight monetary policy might be the key idea in disguise. Moreover, there is no mention that domestically liberalized interest rates likely also trigger cross-border liberalization of capital flows. Again, much discretion for interpretation remains.

- Sufficiently competitive exchange rates that induce rapid growth in non-traditional exports. In plain text, avoiding the over-valuation of exchange rates is demanded, which makes industrialization difficult. Alternatively, it could be read as currency under-valuation, as well as a plea for market-determined flexible rates. Regarding trade, quantitative restrictions should be lifted and tariff reductions be instituted.
- The privatization of State-owned enterprises. One of the few unequivocal quests, similar to the better protection of property rights and the liberalization of foreign direct investment inflows.
- More competition for start-ups and other enterprises.

In hindsight, it is stunning how narrow the range of the consensus was and how much ambiguity can be found in the wording. Williamson, not a plain neoliberal, used a wording that left sufficient

room for interpretation and hence risked strong misunderstanding. Carefully read, one cannot see a clear plea for free trade and free international capital flows or a minimalist state. It is interesting to see what is not addressed, either due to a missing consensus or lacking concern: import substitution or export promotion, poverty reduction or any kind of social spending, the choice of the exchange rate regime, external debt and the balance of payments, let alone environmental issues. Furthermore, time and sequencing are ignored; accordingly, the agenda can be seen as a shock therapy or Chinese-type of gradualism. From the viewpoint of neoclassical or endogenous growth theories, almost nothing is said about technological upgrading, while from a structuralist view structural change and industrial policy are unaddressed, let alone foreign aid. In retrospect, the most stunning characteristic of the “Washington Consensus” seems to be the simplicity and naivety, its selectivity and blindness vis-à-vis so many obvious economic problems.

B. Plain neo-liberalism

The ambiguity of the Washington Consensus was often used to interpret it as plain neo-liberalism. The imperatives would then be to free all goods, labour and financial markets as much as possible from regulations, reducing the size of governments, avoiding counter-cyclical fiscal policies, giving priority to price stability over growth and employment objectives and keeping taxation low. The legal framework of economic systems has to be geared to securing property rights, including privatising public enterprises and promoting market-friendly institutions.

The implicit rationale of the neoliberal philosophy is the notion that developing countries suffer from manifold market distortions, similar to transition economies, whereby the unleashing of the invisible hands of markets could drive growth and development. From this perspective, the main drivers for development are seen in free trade and free cross-border financial flows, supported by institutional reforms towards what is considered as “good governance”. Trade and capital flows follow the comparative advantage theory in the Heckscher-Ohlin form, where

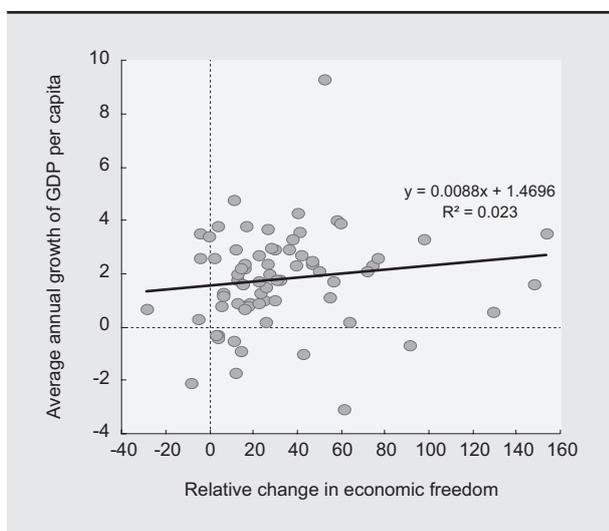
developing countries can exploit their cheap labour and natural resources while rich countries provide capital, technology and knowledge. Openness for foreign direct investment and all other capital flows is a key ingredient of this conception (e.g. Mishkin, 2006). The classical view that capital accumulation and related technical progress are engines of growth is out of focus, as well as the Keynesian idea of active macroeconomic management. The notion of public goods, and particularly education, training, research and development, which are considered as key for development by endogenous growth theories, do not form the centrepiece of this concept. Nonetheless, this philosophy is sufficiently vague and flexible to adjust to special needs or combine it with other ingredients, as long as it remains the backbone for a growth and development strategy.

Some economists have pondered on the sequencing of this strategy. John Williamson and others have advised careful gradualism, with steps to freer trade such as dismantling quantitative restrictions as the first step and liberalized capital accounts for short-term financial flows as the last stage (Williamson, 1997). Others have called for quick sequencing or big-bang reforms to pressure countries into overcoming resistance against reforms (e.g. Ishii et al., 2002).

Using the *Fraser Economic Freedom Index* (FEFI, 2014), a composite indicator of the degree of economic liberalization for a comparison of the FEFI of 71 low- and middle-income countries (LMICs) with the ranking of per capita gross domestic product (GDP) shows no clear linkage. The FEFI integrates more than 50 single indicators concerning the regulation of markets, protection of property rights, low inflation, free trade, good governance and small government, providing a grading from zero to ten (high liberalization). The change of the FEFI over the period 1990–2011 does not correlate with per capita GDP growth, nor does the FEFI level in 2011 correlate with the level of per capita GDP (charts 1 and 2). Advanced countries generally have a higher score in the FEFI compared with less developed countries, similar to often-used corruption indices or “good governance” indices. However, growth rates of GDP do not correlate with levels or changes of these indicators.

Chart 1

CHANGE IN FRASER ECONOMIC FREEDOM INDEX AND PER CAPITA GDP GROWTH, SELECTED ECONOMIES, 1990–2011

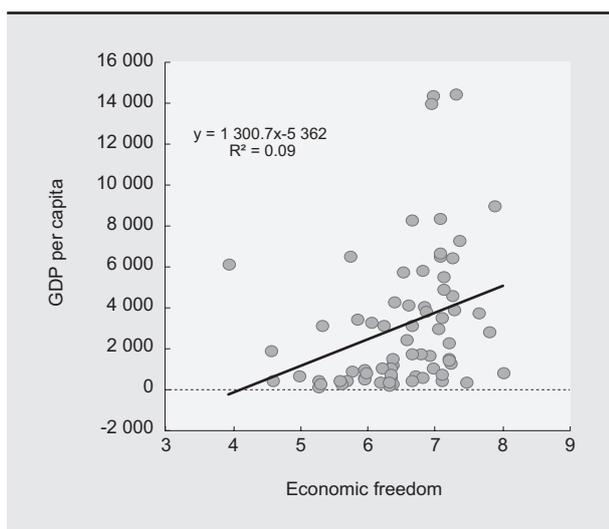


Source: Author's calculations, based on World Bank, *World Development Indicators (WDI)* database, and Fraser Institute (2014), *Economic Freedom of the World 2014 Annual Report*.

Note: Selected economies refer to the 71 countries classified by the World Bank as developing for the year 1990 and with data available in the *WDI* database. All data refer to the changes between 1990 and 2011.

Chart 2

FRASER ECONOMIC FREEDOM INDEX AND PER CAPITA GDP, SELECTED ECONOMIES, 2011



Source: Author's calculations, based on World Bank, *World Development Indicators (WDI)* database; and Fraser Institute (2014), *Economic Freedom of the World 2014 Annual Report*.

Note: Selected economies refer to the 71 countries classified by the World Bank as developing for the year 1990 and with data available in the *WDI* database. All data refer to the levels of 2011, in constant 2005 dollars.

C. Good governance

Many mainstream economists argued that the weak nexus between the liberalization of markets and development could be rooted in poor “institutions”. The latter is often interpreted as “good governance”, measured in six dimensions in the CPIA indicators of the World Bank (“Country Policy and Institutional Assessment”). These indicators were often criticized (being opaque, biased, without conceptual base, one-size-fits-all approach, etc.). In particular, the dimensions of “regulatory quality” and “government effectiveness” with an emphasis on “sound policies” are critical and biased (e.g. Langbein and Knack, 2010; Kaufmann et al., 2007; and Wade in this volume).

What is more important is that *policies* are left out in favour of “governance” or simple neoliberal policies often return through the backdoor. The linkage between good governance in this sense and economic growth and development is weak. As with the FEFI, high income levels correlate with high CPIA scores across countries, although the level of CPIA scores do not correlate with per capita GDP growth and income growth does not significantly correlate with score changes. In most LMICs, the CPIA scores change very slowly, even when growth and structural change are booming. It seems that good governance, whatever it is in essence, is quite diverse and more a long-term *result* of development rather than a precondition. Many of the fast growing emerging economies are not winners of high CPIA score medals. It took developed countries more than a century to climb up to the score that they now have (e.g. Chang 2003).

Some much debated institutionalists like Acemoglu and Robinson (2012) believe, following Douglas North, that the *fundamental* causes of weak or strong development are rooted in “economic institutions”, while the *proximate* causes lie in the determinants of growth, as analysed in standard growth theories. It is unclear what development-friendly economic institutions really are, nor is it justified to exclude policies from the fundamental determinants of growth and development. An often-used broad understanding of institutions may leave the determinants of development in the darkness of black boxes. Besides this, basic, long-standing entrenched institutions are hard to change.

D. Millennium Development Goals

The United Nations turning to the MDGs in 2000 signified a paradigm shift in the policies of supranational institutions. Quantitative goals were set in great detail, with a fixed timeframe, identical for all developing countries and in conjunction with the support of developed countries, whereby income distribution was addressed in part for the first time. However, the MDGs, translated in poverty reduction strategy papers as medium-term national strategies, were confined to goal-setting, although they missed economic strategies, apart from the verbal commitment of donor countries to markedly increase official development aid. Perhaps strategies had been deliberately left out by the initiators of the MDGs to find global consent and delegate the choice of strategy to the respective country. Ironically, the usual set of policy advice as shown above was not really changed, with the exception of the IMF's initiative to include capital flow management (alias capital controls) into the official toolbox of the Fund from 2010. Hence, the MDGs can be considered as a social policy complement of the mainstream roadmap for broad-based liberalization of markets in the "South". While setting proper goals is an important part of defining development strategies, the MDGs miss a *production view* on development so that the eradication of absolute poverty and the related other goals can be achieved sustainably and

eventually self-reliantly. Development has often been interpreted and reduced to simply overcoming poverty, predominantly understood as absolute poverty, as well as reaching the other goals to enable "capabilities" (Sen, 2001) and open opportunities for individual freedom for all citizens. Accordingly, the MDGs can be understood as a reduced substitute for genuine, broader development as perceived in traditional development discourses (e.g. Chang, 2010). From this perspective, the advent of the MDGs was a reduction of developmental ambitions in disguise.

Nevertheless, the reduction of absolute poverty advanced towards a key benchmark for development. As shown in table 1, the results thus far are mixed. Global poverty, relative to the population, was reduced remarkably, and other MDGs could be approached similarly. The share of absolute poverty (conceived as \$1.25 in purchasing power parity (PPP) per day in 2005 prices) fell from 43 per cent of the population in the "South" in 1990 to 21 per cent in 2010, and from 65 per cent to 41 per cent when the margin for poverty is taken as \$2 per day. If East Asia is excluded, the absolute number of poor was slightly higher in 2010 than 1990 and increased considerably when using the \$2 margin, mainly due to strong population growth in Africa and India. Of course, it is questionable whether the progress made was really driven by MDG-related policies or owing to other factors.

Table 1
POVERTY HEADCOUNT IN LOW- AND MIDDLE-INCOME COUNTRIES, 1990–2010
(Per cent of the population, unless otherwise specified)

	Below \$1.25 a day			Below \$2 a day		
	1990	1999	2010	1990	1999	2010
East Asia and the Pacific	56.2	35.6	12.5	81.0	61.7	29.7
Latin America and the Caribbean	12.2	11.9	5.5	22.4	22.0	10.4
Middle East and North Africa	5.8	5.0	2.4	23.5	22.0	12.0
Sub-Saharan Africa	56.5	57.9	48.5	76.0	77.4	69.9
South Asia	53.8	45.1	31.0	83.6	77.8	66.7
All developing countries	43.1	34.1	20.6	64.6	57.4	40.7
All developing countries, excl. East Asia	34.8	33.2	25.0	54.3	54.9	46.6
Memo item:						
All developing countries (in million)	1 782	1 642	1 153	2 674	2 767	2 276
All developing countries, excl East Asia (in million)	882	1 004	908	1 378	1 659	1 692

Source: Author's calculations, based on World Bank, *World Development Indicators* database.

E. Outward development and export-led growth

After the end of Latin American import substitution strategies, the debate concerning whether import substitution or export orientation or inward or outward development is the right strategy approached an end, with outward orientation alias export promotion seen as the winner. The enormous growth of world trade, as well as the strong export orientation of many successful East Asian countries, seemed to endorse the defeat of the Latin American dependency theories. However, it was overlooked that many Asian countries applied both import substitution *and* export promotion, mostly first the former and then the latter, but often concurrently (e.g. Bruton, 1998; Cypher 2014), with the Republic of Korea, China and Viet Nam being cases in point. In China and Viet Nam, particularly State-owned enterprises or even joint ventures with multinational companies defended domestic market shares, while foreign funded enterprises and some domestic served the world market (e.g. Amsden, 2001: 190). With tariff and non-tariff barriers, the promotion of technological innovations and energy saving or domestic energies, developed countries also attempted to practice import substitution, or at least the defence and overt or hidden protection of domestic suppliers. Moreover, export promotion was extended into outright neo-mercantilistic export-surplus oriented growth in a number of countries, both developed and developing, at times supported by under-valuation of the currency and by targeting export promotion with direct and indirect policies. The pressure to achieve price competitiveness forced many developing countries to repress prices and wages and hence domestic demand, which has contributed to large current account imbalances. China and Germany, and to a lesser extent Japan, were the main culprits, while China turned to domestic demand-led growth after the great financial crisis and strongly reduced its current account surplus.

Regarding development strategies, the question of import substitution versus export promotion was posed incorrectly, given that neither are both mutually exclusive nor does development depend on exports regardless of *what* is exported or imported. Exports of low-value commodities with a low income and price elasticity of world demand and, conversely, imports with high income elasticity and low price elasticity contribute little to growth and development. Terms of trade, income elasticity of demand

Table 2

EXPORTS OF GOODS AND SERVICES, SELECTED GROUPS OF LOW- AND MIDDLE-INCOME COUNTRIES, 1990–2012

	Per cent of world exports		Per cent of GDP	
	1990	2012	1990	2012
East Asia and Pacific	3.7	14.2	20.3	33.5
Europe and Central Asia	2.6	3.5	20.3	36.2
Latin America and the Caribbean	3.8	5.0	17.3	23.7
South Asia	0.8	2.3	8.5	22.5
Sub-Saharan Africa	1.8	2.2	26.1	31.9
World	12.7	27.2	19.6	30.3

Source: World Bank, *World Development Indicators* database.

Note: Data only include low- and middle-income countries, except for the world. Data for Middle East and North Africa are not available.

and technological sophistication of traded goods are key parameters for the nexus of exports and GDP growth. For instance, sub-Saharan Africa's share in world trade is marginal and remained so from 1990 to 2012, although its export to GDP ratio is similar to East Asia, whose share in world exports grew almost fourfold during this period, as can be seen in table 2. However, Africa's exports were mainly commodities, while East Asia's were mainly manufactured goods. Moreover, South Asia, and predominantly India, also has a tiny world market share and – like Latin America – had a lower degree of trade openness than sub-Saharan Africa during the entire 1990–2012 period.

Even though import substitution is still relevant and by no means outdated, economies of scale are extremely important for exporting manufactured goods. Besides a few huge domestic markets in large economies, structural change towards manufacturing compellingly requires exports. Increasing exports is imperative for importing those goods and services that are indispensable for technology upgrading if a current account balance (or a contained deficit) is envisaged. The feat of a successful development strategy is to combine export promotion with import substitution without jeopardising the balance of payment equilibrium and without restricting necessary imports of sophisticated goods produced in advanced countries.

F. Structural change: Towards industrialization or commodities and services?

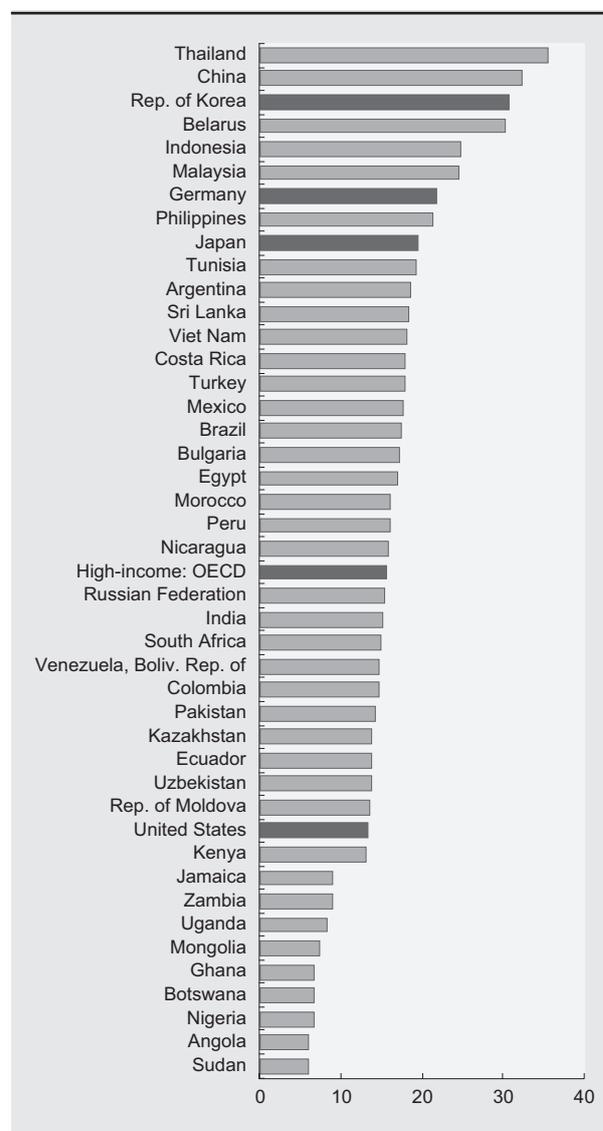
Orthodox theories on growth and development do not care much for structural change and hence sector-specific policies. Market forces determine what is produced, whereby market-determined optimal allocation of resources should be aligned to static comparative advantage. This would guide developing countries towards the production of commodities and developed ones to manufactures and knowledge-intensive goods and services. Those who believe that this might corroborate underdevelopment will plea for policies for structural change towards *dynamic* comparative advantages, overcoming the confines of nature and the historic role of developing countries as latecomers.

Amazingly, most mainstream concepts bypass this issue. In East Asia, industrialization – understood here as manufacturing, excluding mining and construction – is strongly promoted by governments, whereas in sub-Saharan Africa it has hardly started, and in almost all Latin American countries value added in manufacturing as a share of GDP is shrinking after the high values achieved in the 1970s and early-1980s. In India, as the core of South Asia, the level reached by 1980 was maintained until the mid-1990s and shrank gradually thereafter.¹

Despite a trend of deindustrialization in many developing countries, a quick look at the data shows that almost all middle-income countries, except oil exporters, have a higher share of manufacturing value added than most Organisation for Economic Co-operation and Development (OECD) high-income countries, which have a level of 15.7 per cent of GDP in 2010 (chart 3). In contrast to advanced OECD countries, the structural change regarding employment in middle-income countries has usually led directly from low-income agriculture, often subsistence farming, to low-income services, often petty trade and other petty services, with a small share of the high-value service sector, which is prevalent in OECD countries. With few exceptions, almost all rapidly growing economies have de facto embarked on industrialization. Therefore, calling developed countries industrialized in contrast to developing ones has long been outdated.

For a number of reasons, manufacturing has been key for development in economic history, for

Chart 3
MANUFACTURING VALUE ADDED, SELECTED COUNTRIES, 2010
(Per cent of GDP)



Source: Author's calculations, based on World Bank, *World Development Indicators* database.

Note: For comparison, the average of the high income OECD economies is also reported.

both now developed countries – only a handful of them developed with primary goods rather than industrialization, such as Canada, Australia and New Zealand (e.g. Taft Morris and Adelman, 1989) – and successful emerging economies after World War II. Manufacturing used to be the epicentre of applied technical progress in economic history: while inventions may be made in the service sector, product and process innovation pertain to mainly manufactured goods, whereas primary merchandise largely stems

Table 3
COMPOSITION OF EXPORTS OF GOODS AND SERVICES, SELECTED COUNTRY GROUPS, 2013
(Per cent of total group exports)

	<i>East Asia</i>	<i>South Asia</i>	<i>Latin America and the Caribbean</i>	<i>Sub-Saharan Africa</i>	<i>High income OECD</i>
Merchandise goods	89.2	68.2	88.0	83.0	77.7
<i>of which:</i>					
Manufactured goods	73.7	45.1	45.6	21.4	55.4
Services	10.6	31.4	10.7	11.0	23.5
Errors ^a	0.2	0.4	1.3	6.0	-1.2

Source: Author's calculations, based on World Bank, *World Development Indicators* database.

a Data errors prevent that merchandise goods and services add to 100. All country groups, but the high-income OECD, only include low- and middle-income countries.

from nature-made resources, with technical progress in extraction or land use generated in either the service sector or manufacturing. Manufactured goods are tradables with increasing value added, based upon productive employment, while primary goods involve – if profitably sold – rents. Strong demand surges for primary goods, with supply constraints due to natural scarcity or long gestation periods, risk Dutch disease or even resource curse problems, which hamper manufacturing. The extent to which services can be rendered tradable is uncertain. For most LMICs, service exports have not increased above a ten percent share of total exports, with the exception of India (see table 3). Future developments

may differ from history, but to date there is very little evidence that services can substitute manufactured exports on the road to economic development, apart from small countries that can live from niches in the world market.

The share of service exports has been on the rise in recent decades, having reached 23.5 per cent of all exports in high-income OECD countries, mainly driven by the United States. A great portion of these services pertains to either merchandise goods, such as transportation, or high-end knowledge, such as patents, trademarks or similar, where LMICs have a competitive disadvantage.

II. Strategic concepts based on macroeconomic policies

In the strategic concepts sketched above, macroeconomic policies were only marginally mentioned. In general, the belief prevails that “sound money” for low inflation requires sovereign independent monetary policy, independent from monetary policy in advanced countries by having flexible exchange rate regimes. Strong swings in exchange rates have to be accepted. Since overly expansionary fiscal policy, and particularly monetized budget deficits, is seen as the main culprit for inflation, tight fiscal policy is advisable most of the time, since developing countries generally suffer from greater inflationary pressures than advanced economies. Free capital flows, especially for private equity flows, allow the financing of

current account deficits. Structural adjustments are advised when the current account deficit becomes too great and if the competitiveness of enterprises is at risk due to overly high inflation or over-valued exchange rates. Free capital flows sanction fiscal profligacy and bad governance and reward the economy if the opposite prevails. Thus, the policy space for potential misbehaviour of governments is narrowed to the benefit of the country. Macroeconomic policy of this kind, mostly restrictive and geared towards priority for low inflation and a flexible exchange rate, is considered quite relevant in this view, although the long-run growth is determined by the private sector, first and foremost by the ability to make profits and

invest them profitably and innovatively to generate technical progress in the sense of technology transfer from more advanced countries. This is by and large the standard application of neoclassical thinking.

Keynesian thinking, blended with structuralist ideas borne in Latin America in the tradition of dependencia theories, believes that cyclical or chronic shortage of aggregate demand can influence medium- to long-run growth. Abundant labour is available and skills could be provided by concomitant policies. Representative for this macroeconomic view on development is Bresser-Pereira's "New Developmentalism" (e.g. Fundação Getulio Vargas, 2014; Bresser-Pereira, 2010) or similar macroeconomic views on development in Priewe and Herr (2005). Empirical evidence for the characteristics of the best growth performers in comparison can be found in the report of the Spence-Commission (Commission on Growth and Development, 2008), in line with the reasoning put forward here.

One of the main roots of underdevelopment is the low ranking of the local currency in the global currency hierarchy, led by the leading reserve currencies. Domestic money may not fulfil all of its functions properly, and particularly not the store of value and medium of credit function, while the rating of the currency and the respective domestic financial sector tends to be poor. Wealth owners have a higher propensity to hold part of their wealth in other currencies compared with advanced countries. By and large, the preference to hold financial wealth in liquidity or short-term assets is higher, which effectuates higher interest rates, even if the central bank policy rates are low. Poor collateral and risks of depreciation make long-term loans impossible or very dear. Hence, the virtuous cycle of money and credit creation, inducing investment and employment, aggregate demand and GDP growth, can be impeded. External credit in foreign currency can substitute weak domestic finance, although it generates "original sin", i.e. long-term exchange rate risks that can paralyse the use of the exchange rate to devalue if necessary for the balance of payments; hence, a fear of depreciation arises.

Furthermore, countries that wish to catch-up with advanced economies encounter balance-of-payments constraints, as they tend to have a faster growth of imports than exports (e.g. Thirlwall, 2011). In principle, this predicament can be overcome by a structural change of exports towards merchandise that is more income and price elastic and hence more

competitive. However, this is a difficult and long process of innovation. Devaluations of the local currency may be contractionary in the short to medium term (see Krugman and Taylor, 1978; Blecker and Razmi, 2008). Even worse, not only might devaluations be difficult, but the currency might tend to be appreciated by natural resource price booms (Dutch disease) or similar capital inflow surges. As a result, many developing countries struggle with balance-of-payments constraints, which require containing current account deficits by tight fiscal policies.

Achieving competitiveness of trade might subsequently require reducing wages and other incomes relative to productivity, although this can weaken domestic demand and may drive people in partial subsistence or a working poor status with normally low productivity. Repressed wage increases and high unemployment or under-employment in the subsistence or informal sector, which are prevalent features in many developing countries at all stages of development, tend to keep domestic demand low.

Finally, in an open economy context, monetary, fiscal and exchange rate policies are less efficient than in most developed countries. The notion that expansionary monetary policy can function efficiently under flexible exchange rates, as stipulated by the standard Mundell-Fleming model, obfuscates that strong depreciation with massive capital outflows might follow, triggering inflation and an increased burden of external debt. Instead, the truth seems to be that monetary policy in most developing countries with an open capital account is strongly dependent on the policy rates of central banks of the leading currency areas (e.g. Priewe, 2015); moreover, specific country risk premiums have to be added to the external benchmark rates. Furthermore, the transmission of monetary policy to investment and aggregate demand might be much looser than in highly monetized advanced countries. Fiscal policy is facing a smaller fiscal multiplier in small and very open economies, as most developing economies are nowadays.

While macroeconomic policies seem to be less efficient and have no suitable substitute, developing countries tend to be more exposed to shocks. Commodity prices are more volatile, as are real exchange rates, and a lower degree of diversification of the economies makes them susceptible to sector-specific shocks. Last but not least, the push factors for capital inflows and outflows, depending on the whims

of risk appetite of global wealth owners, face them with boom-bust-cycles of external financial flows (Rey, 2013). Uncertainties seem to be much greater in developing countries compared to advanced ones, let alone political instability, poor governance, etc.

While Keynes envisaged the necessity to stabilize the fundamentally unstable advanced capitalist economies, mainly with monetary, fiscal and exchange rate policies, predominantly conducted by the central banks and the treasuries, besides multilateral governance, this need might be even more urgent in developing economies.

In contrast to the problems and disadvantages of developing countries in this regard, they are also privileged in many aspects compared to developed countries. The most important ones are the potential access to advanced knowledge and technologies – the “advantage of backwardness”, as Gerschenkron (1962) christened it long ago. Furthermore, even the salaries of people with equal skills as in developed countries are much lower and hence reflect a competitive edge, let alone unskilled workers. Revenues from abundant natural resources can help, beyond the shadows of Dutch disease, to kick-start productive development and finance infrastructure and other public goods, if used prudently.

The outcome of this brief analysis is that macroeconomic policies do matter for the short and long run, and hence for development strategies. Adverse macroeconomic conditions, especially the prices with macro impact like wages, interest and profit rates, exchange rates, as well as taxes, tariffs, fiscal deficits and public debt, depress growth and can hardly be offset by the utmost business-friendly policies as favoured by the neoliberal approaches to development.

The conclusion from this analysis is a package of seven policies (e.g. Priewe and Herr, 2005):²

- *Monetary and exchange rate policy*: to enable sovereign monetary policy geared to the needs of the country, a managed exchange rate regime with either permanent or occasional use of capital flow controls might be necessary, whereby the central bank should be committed to low inflation, as well as supporting growth with low real interest rates. This implies that the inflation control has to use either a nominal wage anchor or an exchange rate anchor.
- Occasional exchange rate adjustments must not be excluded. Low inflation is necessary for financial stability and contains unexpected inflation and uncertainty. Overly high inflation likely induces overshooting currency depreciations and possibly capital flight, whereby macro uncertainty rises and triggers interest rate hikes. A mild under-valuation of the real exchange rate can support net exports, if embedded in a set of other policies and multilaterally acceptable.
- *Fiscal policy*: some degree of counter-cyclical fiscal policy, including the usage of automatic stabilizers, would be conducive to support both inflation control and growth. Nonetheless, debt sustainability should be accomplished, predominantly with debt in local currency.
- *Balance-of-payments management*: the avoidance of current account deficits and ever-increasing net international debtor position is necessary. This may require capital inflow and outflow controls, or general import taxes, apart from orderly devaluations. Mild exchange rate under-valuation over a longer period can help to promote exports.
- *Financial sector development*: key for avoiding excessive external finance is the unfolding of local credit and – with lower priority – equity markets, preferably credit markets with long-term maturity for promoting fixed investment. A bank-based financial system with mildly repressed finance can be conducive to growth and structural change. This implies that the credit to GDP ratio as well as the broad money to GDP ratio rise in the process of development.
- *Industrial policy*: for the promotion of non-traditional tradables and import substitution, targeted industrial policy bound to the performance of enterprises should be conducted with a broad variety of tools. This should support structural change and alleviate pressures in the balance of payments. While industrial policy is rather of a micro and sector policy nature, since it is targeting economic growth and balance of payments equilibrium it is strongly intertwined with macroeconomic policies, similar to those regarding financial sector development.
- *Labour market policies*: wages should rise, on average, in line with increases in aggregate

Table 4
DEVELOPING COUNTRY CHARACTERISTICS,
SELECTED GROUPS BY ECONOMIC SIZE AND POPULATION, 2013

A. GDP				
	<i>Number of countries^a</i>	<i>Aggregate GDP as percentage of total developing countries' GDP</i>	<i>Aggregate GDP as percentage of world GDP</i>	
Above \$100 billion	21	87.5	22.7	
\$20–100 billion	27	9.2	2.3	
\$10–20 billion	19	2.0	0.5	
Below \$10 billion	63	1.5	0.4	
All	130	100.0	25.9	

B. Population				
	<i>Number of countries^a</i>	<i>Aggregate population (Billion)</i>	<i>Aggregate population (Percentage of developing country aggregate)</i>	<i>Aggregate population (Percentage of world aggregate)</i>
Above 50 million	18	4.452	76.5	62.5
20–50 million	26	0.820	14.1	11.5
10–20 million	24	0.325	5.6	4.6
Below 10 million	71	0.221	3.8	3.1
All	139	5.818	100.0	81.7

Source: Author's calculations, based on World Bank, *World Development Indicators (WDI)* database.

Note: Developing countries refer to country with a GNI per capita up to \$12,745.

a Data refer only to the numbers of countries for which data are available in the *WDI* database.

productivity plus the target inflation rate to avoid price-wage-spirals. This is easier to implement with a centralised wage bargaining system, strongly in contrast to deregulated labour markets. Dynamic minimum wages and indexed salaries in the civil service can help to shape institutions for productivity-led wages.

- *Pro-poor income redistribution:* In countries with high income and wealth inequality, profits and rents are saved abroad to a greater extent (free capital outflows presumed), thus dampening domestic financial intermediation and aggregate demand. Redistribution policies could curb such leakages and channel purchasing power to lower income groups with a high propensity to consume; it helps to raise tax revenues to provide more public goods, and capital outflow controls could contain leakages and improve tax collection. This might increase domestic aggregate demand to a permanently higher level, thus supporting employment and growth and thereby changing the Kuznets curve.

As Asian countries have shown, policy space and an experimental, gradualist approach can help to optimise the package of policies. Macroeconomic policies play a stronger role in this concept compared to developed countries, although they are often more difficult to implement.

When checking the applicability of macroeconomic policy packages as outlined above, one has to bear in mind the small size of the majority of LMICs, measured in terms of both GDP and population (see table 4). 87 per cent of the GDP of those 130 LMICs listed by the WDI database for 2013 stems from only 21 countries. For example, rank 21 is held by Hungary with a GDP of 113 billion dollars, while India is ranked second and has a GDP half of Germany's, which ranks behind China; the latter has a size of one-third of the United States GDP. All LMICs' GDP together has the magnitude of the United States GDP. Regarding population, the size structure is similar, whereby only 18 LMICs have a population of 50 million and more, together comprising around 76 per cent of the populace of LMICs.

This size structure poses great differences for the choice of strategies, as independent macro policies are more difficult to apply in smaller countries. In

these countries, probably only few macro policies out of the package are applicable, while industrial policy for strategic sectors becomes more important.

III. Learning from success and failure – growth performance in the long run

While per capita GDP growth is certainly not a synonym for development, many development indicators such as life expectancy, absolute poverty, health, etc. require higher per capita GDP and hence GDP growth as a necessary yet not sufficient precondition. The well-known Human Development Indicator from the United Nations Development Programme, comprising GDP growth as well as other components, shows that the per capita GDP component and others strongly correlate (Priewe, 2015). Per capita GDP, counted in PPP dollars, might be, at first glance, the more appropriate measure for assessing real incomes,³ although the data are not very reliable due to different consumption baskets; moreover, PPP-based income data only exist for few years, meaning that time series cannot sensibly be used. Therefore, in the following we use constant 2005 dollars to measure and compare incomes. We only consider rough performance indicators, due to space limitations. For more detailed analyses, see Priewe (2015).

Comparing annual per capita GDP growth, there are stunning differences between the main

regions in the “South”: sub-Saharan Africa grew on average by only 0.2 per cent per annum during the 1980–2012 period, with higher growth during 2000–2012 and negative growth in the lost 1980s and 1990s. Latin America accomplished overall 1.0 per cent growth during 1980–2012, in contrast to South Asia, mainly India, with 3.9 per cent and East Asia, driven by China and neighbouring countries, with 7.0 per cent (table 5). Growth acceleration in the 2000s in all regions, especially in Africa, was backed by improved barter terms of trade in many countries (e.g. *TDR 2013*: 50).

Comparing the per capita GDP growth ranking of 40 medium and large developing countries and transition economies (defined here as having a population above 20 million) shows that 11 countries grew more slowly from 1990 until 2013 than the OECD high-income country group, while 29 grew faster, most prominently China, Viet Nam and India (data are not available for five countries in this group) (see chart 4). Ranks 12 and after are occupied by Uganda and some other African countries, whereas Brazil, the Russian Federation and South Africa rank low while

Table 5
AVERAGE ANNUAL GROWTH OF PER CAPITA GDP, SELECTED COUNTRY GROUPS, 1980–2013
(Per cent)

	1980–1990	1990–2000	2000–2013	1980–2013	1990–2013
East Asia and Pacific	6.0	6.7	7.9	7.0	7.4
Europe and Central Asia	1.9	-0.7	3.8	1.9	1.8
Latin America and the Caribbean	-0.7	1.4	1.9	1.0	1.7
Sub-Saharan Africa	-1.3	-0.7	2.2	0.2	0.9
South Asia	3.1	3.3	5.1	3.9	4.3
Middle East and North Africa	-0.1	1.5	2.2	1.3	1.9

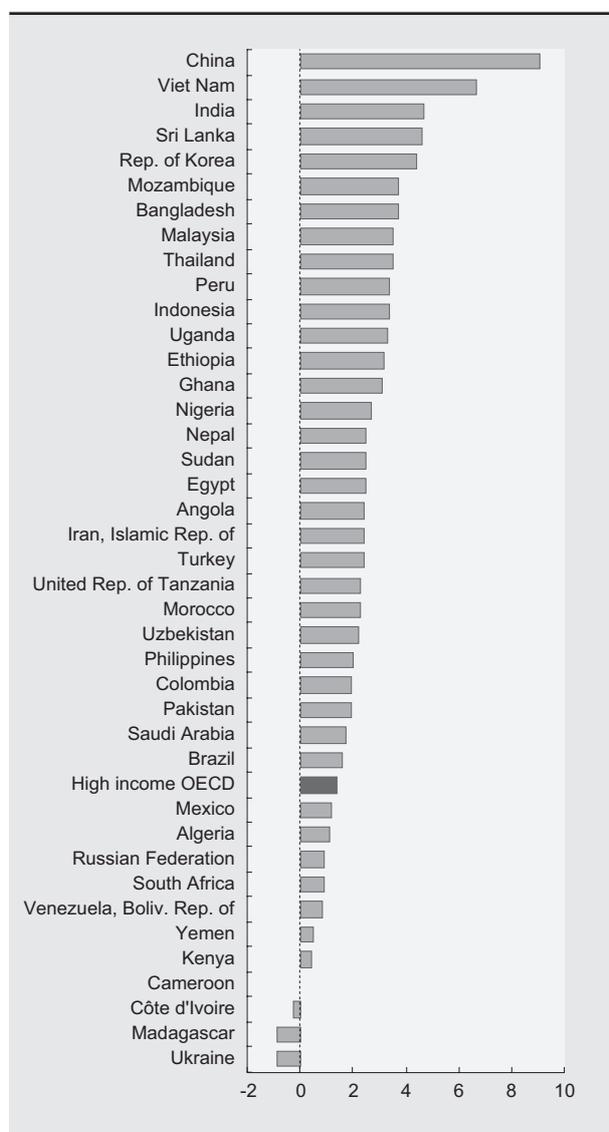
Source: Author's calculations, based on World Bank, *World Development Indicators* database.

Note: Data only include low- and middle-income countries, except for the world. Calculations are based on constant 2005 dollars.

Chart 4

PER CAPITA GDP GROWTH, SELECTED MEDIUM AND LARGE DEVELOPING COUNTRIES AND TRANSITION ECONOMIES, 1990–2013

(Per cent of GDP)



Source: Author's calculations, based on World Bank, *World Development Indicators* database.

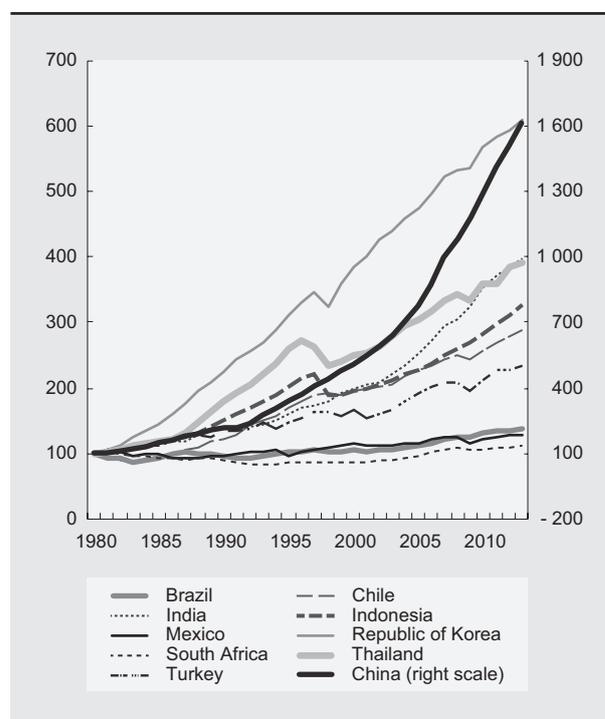
Note: Medium and large developing countries refer to economies with more than 20 million people in 2013. The following medium and large developing countries are not reported because GDP per capita data for 2013 was available: Afghanistan, Argentina, Democratic Republic of the Congo, Iraq, Democratic People's Republic of Korea, Myanmar, and Syrian Arab Republic. For comparison, the average of the high income OECD economies is also reported.

Mexico, the Bolivarian Republic of Venezuela and Kenya join the group of poor performers. It becomes evident that the top runner group mainly comprises Asian countries that more or less continuously

Chart 5

PER CAPITA GDP, SELECTED DEVELOPING ECONOMIES, 1980–2013

(Index numbers, 2000 = 100)



Source: Author's calculations, based on World Bank, *World Development Indicators* database.

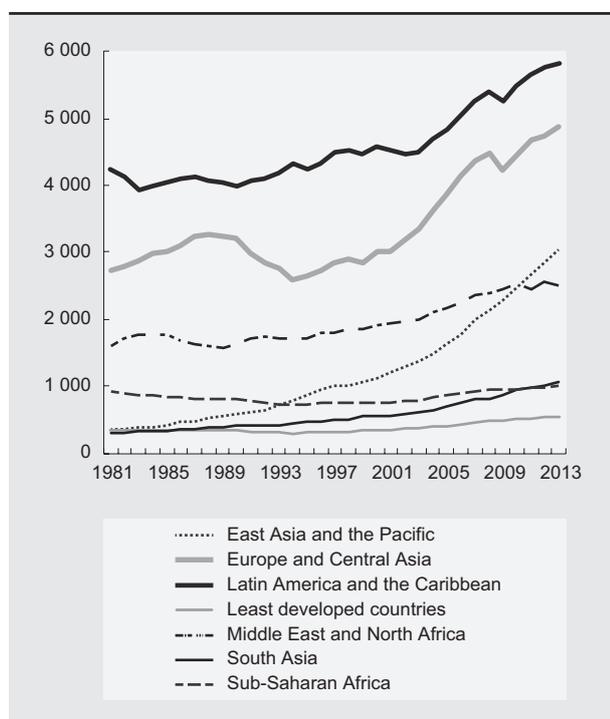
performed well, whereas a few African countries only picked up after the turn of the millennium (e.g. Commission on Growth and Development, 2008).

Looking at the long period from 1980 until 2013 for selected developing economies (chart 5), we see China's outstanding growth, clearly beating the Republic of Korea and all others. However, China follows a growth track similar to the Republic of Korea, Taiwan Province of China and Hong Kong (China), which started 10 to 20 years earlier. From this perspective, China has a speed similar to the first "Tiger" generation of catching-up countries in Asia. By contrast, Brazil, Mexico and South Africa have not gained so much since 1980. Here, we clearly see the diversity of growth and development. Success is not necessarily accomplished by maximising growth, but rather by continuous growth without severe and long-lasting setbacks.

Despite high growth in Asia, the *level* of per capita GDP achieved in Latin America is almost twice as high compared to East Asia, as well as six times higher than in sub-Saharan Africa (chart 6).⁴

Chart 6

PER CAPITA GDP, SELECTED DEVELOPING REGIONS, 1981–2013
(Constant 2005 dollars)



Source: Author's calculations, based on World Bank, *World Development Indicators* database.

One of the basic reasons for higher growth in Asia is the degree of monetization of the economies, measured roughly by the domestic credit to GDP ratio (see table 6). Broad money and credit largely grow in tandem. In all regions analysed, credit picked up relative to GDP. In 2012 East Asia had reached the level of high-income OECD countries of 1990, although this may have driven their credit volume relative to GDP in some countries into an excessive dimension after 2000. The strong credit growth within a bank-centred financial system backed the financing of investment dynamics and thus avoided dependence on foreign finance.

Credit growth and fixed investment-to-GDP ratios (see tables 6 and 7) show the same hierarchy across regions. East Asia invested on average almost twice as much of GDP in fixed capital compared to sub-Saharan Africa and Latin America, and South Asia remarkably more so than the latter. This reflects the strong role of fixed investment for growth and embodied technical progress when complemented with human capital formation (e.g. Commission on Growth and Development, 2008).

Table 6

DOMESTIC CREDIT PROVIDED BY THE FINANCIAL SECTOR, SELECTED COUNTRY GROUPS, 1990–2012
(Per cent of GDP)

	1990	2000	2012
East Asia and Pacific	76.3	110.9	141.5
Europe and Central Asia	51.7 ^a	34.1	64.3
Latin America and the Caribbean	58.0	42.3	71.7
Middle East and North Africa	74.4	61.3	31.5 ^b
Sub-Saharan Africa	55.3	67.8	66.4
South Asia	47.6	48.4	71.1
South Asia	47.6	48.4	71.1
High income OECD	141.3	179.2	213.1

Source: Author's calculations, based on World Bank, *World Development Indicators* database.

Note: Data only include low- and middle-income countries, except for the high-income OECD group.

a Data refer to 1992.

b Data refer to 2010.

Table 7

GROSS CAPITAL FORMATION IN LMICs, SELECTED COUNTRY GROUPS, 1990–2013
(Per cent of GDP)

	1990–1999	2000–2013
East Asia and Pacific	36.7	38.9
South Asia	23.1	29.8
Middle East and North Africa	27.0	26.6
Least developed countries	19.4	23.3
Europe and Central Asia	23.7	22.0
Latin America and the Caribbean	19.5	20.2
Sub-Saharan Africa	16.4	18.4

Source: Author's calculations, based on World Bank, *World Development Indicators* database.

Note: Data only refer to the average of 153 low- and middle-income countries.

The majority of developing countries, and especially the smaller and less developed ones, struggle with high current account deficits. Of the 153 LMICs listed in the World Economic Outlook Database from the IMF (2014), 113 faced current account deficits on average during the 2000–2013 period, whereby 70 countries (46 per cent of all LMICs listed) had deficits higher than 5 per cent of GDP and 22 up

to 5 per cent. The median deficit was -7.0 per cent of GDP, in most cases far beyond sustainability. 39 countries had surpluses, headed by top oil exporters. Despite conspicuously higher growth in the 2000s, the current account deficits were on average smaller in the 1990s, with a median deficit of 4.9 per cent and 124 countries in deficit. The reasons for the increased deficit in the 2000s are, among others, the increased imports dependent on higher growth, as well as higher energy prices.

Not all chronic current account deficits had dragged growth. Some countries still follow the “*growth cum debt*” strategy, which largely failed in so many countries, and especially in Latin America. A number of African countries have fared quite well regarding GDP growth in the last decade, with high inflows of foreign aid, partially spent more productively than in earlier periods, especially in Ethiopia and to a lesser extent in Uganda, with a rising investment-to-GDP ratio. However, their high growth does not seem sustainable unless they remain on the drip of donors and remittances from emigrants for long or even forever.

Our brief overview of a few key economic indicators unequivocally shows the distinct differences between Asian countries, despite all the differences between China, India and others on the one hand and sub-Saharan Africa and Latin America

and the Caribbean on the other, and despite the latter’s marked difference in the level of development. China is not as unique as it might appear, since the country sails in the same class as Japan, Hong Kong (China), Singapore, Taiwan Province of China and the Republic of Korea previously did. Within Latin America, Chile, a copper-heavy economy, striving with little success to overcome its monoculture, is the spearhead of enduring growth since the 1990s, while Brazil and Argentina accelerated in the 2000s, until growth petered out recently. Whether the few fast growing African economies can sustain their speed in the future is questionable, not least due to a huge backlog in industrialization and the fact that commodity prices will not rise forever.

In the rough picture that we have painted, we have neglected income distribution, among many other indicators. The high level of income and wealth inequality in Latin America has been somewhat reduced in the 2000s, whereas it strongly increased in many Asian countries, particularly in China, as well as in sub-Saharan Africa, facing commodity windfall profits; however, Asia comes from a much lower level of inequality than in Latin America whereas sub-Saharan Africa could reduce inequality until 1990 clearly below Latin America’s level, apart from South Africa and Namibia (see *TDR 2012*: 51; data apply for unweighted averages in personal income distribution).

IV. Conclusions

While few governments or policy-making elites have clear explicit development strategies, many have explicit or tacit ideas on the proper economic rationale for their future development, often provided by various economic advisers within and outside the country. Our short review of the original “Washington Consensus” and even more so the neoliberal interpretation that followed has shown that these visions are far too narrow, neglect important points, especially active macroeconomic policies, have no sound theoretical base or are rooted in abstract neoclassical thinking that does not stand up to the challenges of reality. The successful developing countries *de facto* do not follow this line and rank relatively poorly on the “Fraser Economic Freedom

Index”. Similar applies to the “good governance” approach to development; even if the indicators were clear and unbiased, they cannot be achieved quickly (and could not be in the history of now developed countries) and thus they are more a result of development rather than precondition. Moreover, many countries develop consummately in many aspects with low indicator values, even for corruption and rule of law. Nonetheless, the latter deserve strong ethical and distributional appreciation.

Regarding the old debates on inward or outward development, export orientation and import substitution do not show a black and white divide in either theory or reality; rather, countries have implemented

both. Indeed, it is the prudence of the mix that counts for growth and development. Export promotion in the often-propelled sense of export-led growth, with preferences for exporters regardless *what* is exported, is neither in line with the experience of advanced countries that seek systematically new comparative economic advantages, nor with the reality of successful emerging economies. At least for the larger developing countries, a thorough export orientation requires a strong commitment to industrialization, fully in line with the ideas of the pioneers of development economics. Almost all middle-income countries are nowadays more industrialized than high-income OECD countries; the latter have embarked more strongly on high-value services as inputs to industrial exporters or increasingly to direct high-value service exports. Developmental strategies primarily focusing on agricultural and mineral commodities may flourish in times of commodity price hikes, but hardly in the long run, and they are at risk to infection by Dutch disease, which over-appreciates the currency and hampers net exports of goods that are not subject to price booms. Hence, industrial policies are required to promote non-traditional exports and prudent import substitutions; moreover, a focus on few sectors is unavoidable for small economies, while macroeconomic policies are largely less efficiently applicable.

The orthodox development strategies neglect macroeconomic policies, as they narrow the latter to the goal of achieving price stability, mainly with tight monetary and fiscal policy. Instead, money, interest and exchange rates are not neutral for the growth of output and employment, neither in the short nor the long run. Strong dynamics of domestic aggregate demand matters and can be fired by growth-enhancing macroeconomic policies, not only for short-term stimulus to overcome recessions. Macroeconomic policies comprise a package of seven policies that can be blended according to the conditions and constraints in specific countries. This not only requires respective policies, but also focused institution building, for instance, for the management of the balance of payments, exchange rate management, wage bargaining or income redistribution, aside from establishing a central bank committed to more than price stability and capable of cooperating with other institutions.

The brief overview of basic macroeconomic performance indicators shows a distinct competitive advantage for East and South Asian countries, led by the giant economies of China and India. They

strongly liberalized their economies in select areas in the past decades, but in a gradualist approach and in key aspects. They refrained from taking the full-fledged free-market-road of strong macroeconomic policies, maintaining capital inflow and outflow controls to some extent, as well as the usage of some kind of industrial policies. Financial sector development is a backbone for both economies, much more so in China compared to India, with the former having maintained State-ownership in commercial banking and a number of important sectors.

In sub-Saharan Africa and many Latin American economies, a higher degree of liberalising goods, labour and financial markets has taken place, with little success in the 1980s and 1990s but growth acceleration in the 2000s, mainly caused by commodity price booms that reversed the trend of terms of trade. In Africa, the hesitation to embark on industrialization beyond mining continues, while in Latin America deindustrialization has occurred since the early 1980s regarding manufacturing. The challenge of finding a development pattern with continuous growth, resilience to inflation and financial crises and growth enabling macroeconomic conditions, especially pertaining to competitive exchange rates and low real interest rates, is still awaiting a sound policy response.

The lessons that can be learnt from emerging Asian countries have not found a full echo in Latin America, let alone Africa. If both China and India as well as their neighbours embarked on full liberalization, they would most likely jeopardize the factors that have led them to where they are now. In particular, the Indian sub-continent seems to have reached a critical juncture.

Our tour d'horizon on development strategies has left out three increasingly important aspects that lie beyond this analysis, namely: the rising inequality of income and wealth, as well as the difficulties in reducing inequalities once they have reached high levels; environmental issues; and the necessity of more global governance in the face of rapidly increasing globalization of trade, finance, labour and pollution. Limited global governance makes developing countries very vulnerable to negative external shocks. They would be forced to limit their exposure to global markets when their policy space shrinks to an extent that render governments impotent in coping with the ensuing problems, while emerging democracies would be impeded.

Notes

- 1 According to the WDI, for the 1960–2012 period, Argentina reached a peak – in terms of value added of manufacturing as a share of GDP – of 41 per cent in 1966, compared to 21.7 per cent in 2012. Brazil reached 34.0 per cent in 1982 compared to 13.3 per cent in 2012. Mexico reached 28.8 per cent in 1987, compared to 18.3 per cent in 2012. Chile reached 29.9 per cent in 1974, compared to 14.1 per cent in 2012. India reached 17.3 per cent in 1979 and stood at 13.5 per cent in 2012.
- 2 A similar approach regarding developed countries is used by Herr and Kazandziska (2011).
- 3 This notion could be questioned: lower prices of non-tradable goods and services imply lower income for their producers, regarding the purchase of tradables. These households often have to live, mostly partially, in subsistence.
- 4 Counted in current dollars, Latin America ranks first with \$9,617, with Chile as the top runner, East Asia ranks second with \$5,690, followed by sub-Saharan Africa with \$1,701 and South Asia bringing up the rear with only \$1,409, and the 49 least developed countries at \$863. All the data refer to 2013 (World Bank, 2014).

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RESTORING THE DEVELOPMENT DIMENSION OF BRETTON WOODS

Eric Helleiner

Abstract

The slow pace of the post-2008 global financial reform is encouraging growing discontent among policymakers from emerging market and developing economies who lament the continuing dominance of the Bretton Woods institutions by Northern powers and the inadequate attention given to their developmental priorities in multilateral financial reforms. Questions are increasingly raised about whether their time might be better spent constructing alternative institutional arrangements to the Bretton Woods system. As the future of the Bretton Woods institutions comes into question, it is worthwhile recalling their original purpose. The initial Bretton Woods negotiations are often described as an Anglo-American affair in which developing countries played little role and the development issues were largely ignored. However, the Bretton Woods architects included officials from many poorer countries and international development goals were explicitly prioritized in the design of the post-war international financial order. Remembering this original development content of Bretton Woods may be politically very useful for reformers seeking to construct a more development-friendly global financial system today.

Introduction

Many analysts anticipated that the 2008 global financial crisis would generate very substantial reforms to global financial governance (see references in Helleiner, 2014a). To date, however, reforms have been more incremental than transformative, generating growing frustration in many quarters. Discontent is particularly strong among many policymakers and analysts in emerging market and developing economies (EMDEs) who lament the continuing dominance of the Bretton Woods (BW) institutions by Northern powers and the inadequate attention given to their developmental priorities in multilateral financial reforms. These frustrations are generating support for initiatives to create alternatives to the BW institutions, such as the New Development

Bank (NDB) and Contingent Reserve Arrangement (CRA) between Brazil, the Russian Federation, India, China and South Africa (referred to as BRICS).

As the future of the BW institutions comes into question, this chapter argues that it is worthwhile recalling their original purpose. The BW negotiations are often described as an Anglo-American affair in which developing countries played little role and the development issues were largely ignored. This portrayal fosters pessimism about the prospects for reform today by suggesting that the design of the BW system was development-unfriendly from the very start. In fact, however, this history story is quite inaccurate, given that the BW architects included

officials from many poorer countries and international development goals were explicitly prioritized in the design of the post-war international financial order. Indeed, the BW negotiations pioneered the idea of constructing a multilateral economic order to support

the development aspirations of poorer countries. Resurrecting this original development content of BW may be politically very useful for those reformers seeking to strengthen international development goals within global financial governance at present.

I. Growing discontent

Officials from EMDEs have many reasons to be dissatisfied with the content of post-2008 global financial reforms to date. One such reason is the slow pace of efforts to enhance their influence within the BW institutions. At their first summit in November 2008, the G20 leaders noted that “emerging and developing economies, including the poorest countries, should have greater voice and representation” in the International Monetary Fund (IMF) and World Bank (quoted in Helleiner, 2014a: 37). Reforms were agreed two years later, involving a shift in approximately six per cent of voting shares to EMDEs and a reduction by two members of European representation on the IMF Executive Board to make room for more emerging market and developing country representatives. However, the Congress of the United States has since delayed approval of the new reforms (Helleiner, 2014a: 50–51).

EMDEs have also been frustrated by inadequate efforts to strengthen a “global financial safety net” that could address their special needs for short-term balance of payments support. Indeed, the G20 leaders dramatically increased the size of the IMF resources from \$250 billion to \$750 billion during their April 2009 summit, in order to help countries cope with balance of payments shocks in the wake of the 2008 financial crisis. Yet, few EMDE countries took advantage of the IMF enlarged lending capacity to borrow from the institution in the following months. A central reason was the ongoing concern about the IMF record during the 1997–98 Asian crisis, when its loan conditionality was widely criticized for being overly intrusive, neoliberal and excessively influenced by the policy goals of the United States. Since 2008, the IMF has made some efforts to address the stigma associated with its borrowing by creating new facilities and streamlining conditionality. Nonetheless, potential borrowers remain understandably wary, particularly as the shift in the

content of conditionality in IMF crisis lending has been uneven and the IMF governance reforms remain stalled (Helleiner, 2014a).

Frustration with the IMF as a source of balance of payments finance encouraged discussion in 2010 within the G20 of mechanisms to try to institutionalize and expand the conditionality-free bilateral swaps arrangements that the Federal Reserve of the United States (thereafter Fed) had extended during the financial crisis. Four EMDE countries – Brazil, Mexico, the Republic of Korea and Singapore – received Fed swaps of \$30 billion in October 2008, which were important in boosting confidence at the time, particularly in the Republic of Korea, which drew extensively on its swap. When the Fed let its crisis-era swaps expire in February 2010, the Government of the Republic of Korea – then chair of the G20 – proposed the creation of a multilateral swap arrangement that would make permanent the swap arrangements created in the crisis, as well as extending them to a wider group of emerging market countries by embedding them within the G20 framework (Helleiner, 2014a).

However, this proposal was resisted by officials of the United States, who preferred swaps to be bilateral and extended on a discretionary basis to minimize the burdens and responsibilities that might be placed on the Fed (Helleiner, 2014a: 45–47). As the now-released minutes of the Federal Open Market Committee (2008: 11, 16, 29–30, 35) make clear, the Fed’s resistance to lending to a wider group of countries had also been apparent at the height of the crisis, when its officials had explicitly decided that most Southern countries were not considered deserving of swaps, even including important G20 members such as India, Indonesia and South Africa. The reluctance of the United States to institutionalize swaps with EMDE countries was subsequently confirmed

in October 2013 when the Fed only chose to make swap arrangements permanent with the central banks of Canada, England, Europe, Japan and Switzerland.

Such developments have encouraged EMDEs to search out alternative mechanisms to insulate themselves from balance of payments crises. In 2014, the BRICS announced the creation of the CRA, a \$100 billion swap arrangement among themselves (whereby 30 per cent of the funds can be accessed without an IMF programme). Many EMDE Governments have also turned to self-insurance by unilaterally building up national foreign exchange reserves. In addition, there has been a proliferation of bilateral swap arrangements among EMDEs, particularly involving China. Regional swap arrangements have also been strengthened, most notably in East Asia, where members of the Chiang Mai Initiative transformed their network of bilateral swaps into a self-managed multilateral fund that opened in March 2010 with \$120 billion. This Chiang Mai Initiative Multilateralism was subsequently doubled to \$240 billion in June 2012 and the portion of its funds available without an IMF programme was increased from 20 to 30 per cent (rising to 40 per cent in 2014) (Helleiner, 2014a: 47).

The same centrifugal pressures can be seen in the world of long-term international development finance. In the wake of the 2008 crisis, the G20 leaders boosted the resources of a number of multilateral development banks, including that of the World Bank, which experienced its first general capital increase in over twenty years. However, many officials from EMDEs still perceive these initiatives as quite inadequate to meet their development needs and they remain frustrated by enduring G7 influence in the World Bank and other multilateral development banks. Reflecting these sentiments, the BRICS countries committed in 2014 to create a new institution, the NDB, devoted to long-term development lending, particularly for infrastructure projects. It was established with an initial capital of \$50 billion, with the idea that this will rise to \$100 billion. China is also promoting the creation of a large Asian Infrastructure Investment Bank with initial capital of \$100 billion, not much smaller than the existing Asian Development Bank (whose capital is \$165 billion) and World Bank (\$223 billion) (Leahy and Harding, 2014). The importance of the World Bank lending role has also been increasingly challenged by the growing bilateral official lending of countries such as China and Brazil.

North-South tensions also characterized post-2008 international discussions about the role that capital controls could play in preserving national policy space. These tensions were already on display at the time of the late-1990s Asian crisis, when a number of Southern officials expressed concerns about speculative capital flows while Northern policymakers – particularly officials of the United States – strongly defended the virtues of financial liberalization. In the wake of the financial crisis, many EMDE Governments became bolder in arguing that controls on excessive capital inflows and outflows might need to play a larger role in their policy toolbox. The political salience of the issue was heightened by the fact that dramatic monetary easing in the leading economic powers encouraged large capital outflows to many Southern countries, threatening to generate financial bubbles and drive up exchange rates in those countries (Gallagher, 2014).

In October 2011, a compromise was reached on this issue through an ambiguous statement issued by G20 financial officials. While the statement noted that “there is no one-size-fits-all approach or rigid definition of conditions for the use of capital flow management measures”, it also outlined the long-term goal of putting in place conditions “that allow members to reap the benefits of free capital movements” (quoted in Helleiner, 2014a: 120–121). This G20 statement subsequently helped to inform a new “institutional view” of the IMF on the issue, which was announced in late 2012 to help inform its surveillance activities. The document noted that “there is no presumption that full liberalization is an appropriate goal for all countries at all times” and it endorsed the use of “capital flow management measures” to contain inflow surges or disruptive outflows. At the same time, it stressed the need for these measures to be temporary and noted that “careful liberalization of capital flows can provide significant benefits, which countries could usefully work toward realizing over the long run” (quoted in Helleiner, 2014a: 121). EMDE officials from countries such as Brazil who had played a leading role pressing for change were left dissatisfied, complaining that the IMF position remained far too cautious and pro-liberalization (Helleiner, 2014a: 121).

Frustration has also been evident about the lack of attention in the post-2008 global financial reforms concerning the need for a sovereign debt restructuring mechanism (SDRM) at the international level. After the East Asian crisis and 2001 Argentine default,

the first deputy managing director of the IMF Anne Krueger proposed the establishment of a SDRM, arguing that its absence was a “gaping hole” in the international financial architecture. **While her proposal generated enormous debate, it was ultimately shelved in the face of opposition, most notably from the United States (Helleiner, 2009).** The importance of the issue was once again highlighted after 2008 by sovereign debt crises in the eurozone and elsewhere, as well as by the continuing efforts of vulture funds to disrupt existing debt restructuring deals (most notably in the Argentine case). Reflecting the new interest in the idea, the United Nations General Assembly adopted a resolution for the first time in September 2014 that called for a “multilateral legal framework for sovereign debt restructuring processes”. The resolution was proposed by Argentina and fully backed by

the G77, although it was met with opposition in the United States and some other G7 countries, whose support would be important for a substantial initiative of this kind to move forward (Muchhala, 2014).

Such developments have left many EMDE officials pessimistic about the prospects for substantial change to the BW system. Questions are increasingly raised about whether transformative reforms of the system are possible, as well as whether time may be better spent constructing alternative institutional arrangements such as the CRA and NDB. This pessimistic perspective about the prospects for reform is often reinforced by histories of the BW system, which argue that its design was unfriendly to developing countries and development issues from the very start.

II. American goals for Bretton Woods

Is this pessimism deserved? Its historical foundations certainly warrant questioning. Many histories of the BW negotiations depict them as an Anglo-American affair in which development issues were largely ignored. However, recent research has shown that this perspective on the origins of BW is inaccurate. Far from being development-unfriendly, the BW system was originally designed with the promotion of international development as one of its core goals (Helleiner, 2014b).

Policymakers of the United States were particularly keen on this goal. From the very start of their planning of the post-war international economic order, American officials made it very clear that international development issues would be prioritized. Even before the United States entered the war, the President Franklin Roosevelt committed in his famous “four freedoms” speech of January 1941 that the post-war world should provide “freedom from want” for people “everywhere in the world” (quoted in Helleiner, 2014b: 120). As historian Elizabeth Borgwardt (2005) has argued, Roosevelt’s vision was part of his bold attempt at this time to “internationalize the New Deal”. Just as his New Deal had promised greater economic security to Americans, Roosevelt now saw bolstering the standards of living in poorer regions of the world as a crucial foundation for

post-war international peace and prosperity. The commitment to promote “freedom from want” worldwide was subsequently enshrined in the Atlantic Charter that Roosevelt and British Prime Minister Winston Churchill announced in August 1941, as a statement of their combined vision of the post-war world.

When Harry Dexter White – who was an ardent New Dealer – drew up his initial drafts of the IMF and International Bank for Reconstruction and Development (IBRD) in early 1942, he made explicit reference to these international development goals. White’s interest in international development was hardly surprising, given that he had already been a very strong advocate within the Government of the United States of initiatives to promote Latin America development since the late-1930s as part of the Roosevelt administration’s Good Neighbor policy towards the region. These initiatives represented the first-ever foreign assistance programmes of the United States to promote development and they were not only driven by New Deal values, but also by the geopolitical goal of offsetting the German influence in Latin America. White had been particularly supportive of this new aspect of the Good Neighbor policy and Latin American industrialization which, he argued was essential if the region’s standards of living were to be raised (Helleiner, 2014b).

A number of features of White's initial plans drew directly upon his Latin American experience. The first was the IBRD's mandate to mobilize long-term development lending. This feature was highly novel, given that no public international financial institution had ever been created with the purpose of supporting long-term development loans to poorer countries. Interestingly, White's idea built on a United States-Latin American initiative of 1939–1940 to construct an Inter-American Bank (IAB) with this precise mandate in the Americas. White had taken the lead role in drafting the IAB, which he had empowered to support Latin American development through direct lending and by guaranteeing private lending to the region. While the IAB was never established (because the Congress of the United States did not approve it), White imported these features of his IAB plan into the initial IBRD proposal in early 1942 (Helleiner, 2014b).

White's proposal to create an international fund offering short-term lending for balance of payments purposes also grew directly out of his previous experience of pioneering bilateral loans of this kind of the United States to Latin American countries. On his initiative, the Exchange Stabilization Fund of the United States had begun to extend these loans in 1936. These were particularly useful to Latin American countries whose dependence on commodity exports left them vulnerable to unexpected seasonal fluctuations and price swings. White's colleagues noted that his initial draft of the IMF (which he initially called a "Stabilization Fund") simply multilateralized that policy and they emphasized how the Fund's role would be particularly helpful for Latin American countries addressing these balance of payments difficulties (Helleiner, 2014b: 110).

White also expressed support in his initial drafts for efforts to curtail capital flight from poorer countries (or what he called "the steady drain of capital from a country that needs the capital but is unable for one reason or another to offer sufficient monetary return to keep its capital at home", quoted in Helleiner, 2014b: 110). Once again, this concern had emerged out of his work in Latin America. During the drafting of the IAB and some financial advisory work in Cuba in 1941–1942, White and other officials of the United States had become interested in how some Latin American countries were afflicted by large volumes of capital flight to New York. In the IAB discussions, they had explicitly designed the institution to recycle that flight capital by accepting private

deposits and lending the funds back for development purposes to the Latin American country from which they had originated (Helleiner, 2014b: 67–68).

Perhaps because that specific proposal had generated much opposition in the New York financial community, White did not resurrect it in his initial BW plans. Nonetheless, he continued to promote the idea of a cooperative approach to tackling the problem of flight capital. Under the proposed Fund's charter, White included a provision that all member countries would undertake commitments to help enforce each other's controls by agreeing "(a) not to accept or permit deposits or investments from any member country except with the permission of that country, and (b) to make available to the Government of any member country at its request all property in form of deposits, investments, securities, safety deposit vault contents, of the nationals of member countries" (quoted in Helleiner, 2014b: 111). In subsequent drafts, he also added the idea that countries receiving capital flows would commit to sharing information about those flows with the sending countries. White argued – as did Keynes at the time – that countries experiencing illegal outflows of capital would have a greater chance of making their controls effective with these kinds of international assistance.

White's Latin American experience also encouraged him to assign a role for both the Fund and Bank to help facilitate international debt restructuring. During the 1930s, many Latin American countries that had defaulted on external loans and efforts to settle these loans became a major irritant in United States-Latin American relations throughout the decade. Like Roosevelt and other New Dealers, White had little sympathy for New York creditors who were seen to have engaged in irresponsible and fraudulent lending practices to the region during the 1920s. In his initial drafts of the BW plans, White gave his proposed Fund a formal role in settling international debts through "compulsory arbitration". He also inserted a provision into his proposed IBRD that allowed it to lend to a country in default on external debts if that country had accepted the recommendations of a Bank-appointed committee for settling the outstanding debts "irrespective of whether the bondholders did or did not" (quoted in Helleiner, 2014b: 112).

Finally, in his initial drafts, White also referred to two trade issues with international development significance that had emerged from out of the context

of the United States-Latin American relations. The first was international commodity price stabilization. As part of efforts to assist Latin American countries, the United States had signalled its support in mid-1940 for the development of commodity agreements that would help to stabilize prices of major Latin American exports, with the first such agreement – the Inter-American Coffee Agreement – established later that year. In a March 1942 draft of the IBRD, White reiterated this idea, proposing that the Bank could “organize and finance an International Commodity Stabilization Corporation for the purpose of stabilizing the price of important commodities” (quoted in Helleiner, 2014b: 112–113).

In his initial drafts of the Fund, White also went out of his way to signal his support for poorer countries’ use of infant industry tariffs, a support he had already expressed in the Latin American context. He argued that the belief that trade liberalization would generate rising standards of living in poor countries made the mistake of assuming “that a country chiefly agricultural in its economy has as many economic, political and social advantages as a country whose economy is chiefly industrial, or a country which has a balanced economy.” He added: “[i]t assumes that there are no gains to be achieved by diversification of output. It grossly underestimates the extent to which a country can virtually lift itself by its bootstraps in one generation if it is willing to pay the price. The view further overlooks the very important fact that political relationships among countries being what they are vital considerations exist in the shaping of the economic structure of a country other than that of producing goods with the least labor” (quoted in Helleiner, 2014b: 113).

Taken together, these provisions in White’s initial drafts outlined a highly innovative vision for a multilateral economic framework that was supportive of the economic development of poorer countries. Never before had a global framework of this kind been put forward for international negotiation. White’s specific proposals drew directly from experiments in the regional inter-American context that had arisen out from the politics of United States-Latin American relations in the late-1930s and early-1940s. Inspired by New Deal values, White and others in the Roosevelt administration now proposed to expand these experiments on a worldwide scale as a key foundation of the post-war international financial order.

As White’s proposals were subsequently refined in internal discussions in the United States in 1942–1944, some of his ambitious ideas were eliminated or watered down, often with an eye to what might be eventually acceptable to the Congress (particularly after the Republican gains in the autumn 1942 elections). While the IMF and IBRD’s lending roles remained, White’s proposals concerning debt restructuring, commodity price stabilization and infant industry protection were eliminated (in the latter case, because the BW negotiations were meant to focus on finance rather than trade). Mandatory international cooperation to enforce capital controls was also replaced with a provision simply permitting such cooperation among countries (Helleiner, 2014b: 115–117). However, to offset the latter change, White strengthened the right of all countries to employ capital controls – even on a permanent basis – without obtaining permission from the Fund.

Policymakers in the United States considered the endorsement of the use of both capital controls and adjustable exchange rates in the Fund’s final articles of agreement to be important in bolstering the policy space of Southern Governments to promote their countries’ rapid economic development (Helleiner, 2014b). Support for this kind of “development-oriented” policy space was particularly evident during and in the immediate wake of the BW negotiations, when American officials advised countries that had attended BW – such as Ethiopia, Guatemala, Paraguay and the Philippines – to undertake domestic monetary reforms that were designed to strengthen the capacity of public authorities to pursue development goals. These reforms not only included the creation of new central banks, national currencies and mechanisms for public authorities to finance development objectives, but also domestic legislation that incorporated the Fund’s provisions for exchange rate adjustments and capital controls. While BW established a new multilateral framework that was supportive of State-led development strategies, these financial advisers of the United States helped to build domestic institutional capacity to enable these strategies to be pursued (Helleiner, 2014b.).

At the BW conference itself, officials of the United States continued to stress their commitment to the idea that the post-war international financial order must be supportive of international development. White’s boss, the Treasury Secretary Henry Morgenthau, used his welcoming address to speak

of the importance of establishing “a satisfactory standard of living for all the people of all the countries on this earth”. As he put it, “Prosperity, like peace, is indivisible. We cannot afford to have it scattered here or there among the fortunate or to enjoy it at the expense of others. Poverty, wherever it exists, is menacing to us all and undermines the well-being of each of us”. The last sentence was reminiscent of the wording in a statement that the International Labour Organization (ILO) had endorsed a meeting two months earlier, claiming that “poverty anywhere constitutes a danger to prosperity everywhere”. At the end of the ILO meeting, Roosevelt went out of his way to praise that statement, noting that “this principle is a guide to all of our international economic deliberations” and citing his concern to bring greater prosperity to poor regions of the world that he had visited, such as the Gambia (quotes from Helleiner, 2014b: 122).

In a high profile article in *Foreign Affairs* in early 1945, Morgenthau (1945: 190) reiterated

that the BW framework was designed to serve not only developed countries’ preferences, but also less developed countries’ objectives of raising levels of industrialization and standards of living. As he put it:

Unless some framework which will make the desires of both sets of countries mutually compatible is established, economic and monetary conflicts between the less and more developed countries will almost certainly ensue. Nothing would be more menacing to have than to have the less developed countries, comprising more than half the population of the world, ranged in economic battle against the less populous but industrially more advanced nations of the west. The Bretton Woods approach is based on the realization that it is to the economic and political advantage of countries such as India and China, and also of countries such as England and the United States, that the industrialization and betterment of living conditions in the former be achieved with the aid and encouragement of the latter.

III. Inclusive multilateralism and North-South dialogue

One final way in which policymakers of the United States supported international development goals was through their backing of a very inclusive form of multilateralism that gave poorer countries more of a voice in international financial affairs. From the very start, Roosevelt and his officials favoured establishing public international financial institutions whose membership would be open to all the United and Associated Nations (“Associated” nations referred to countries that had broken diplomatic relations with the Axis powers but had not joined the United Nations). They were also strongly committed to what John and Richard Toye (2004: 18) call “*procedural* multilateralism”, in which all the United and Associated Nations would have an opportunity to contribute to the design of the post-war international financial order. White and other officials of the United States engaged in extensive consultations with other countries in 1943–1944, culminating with the BW conference itself, to which they invited 43 other Governments. Well over half

of those Governments were from poorer regions of the world, including nineteen from Latin America alone, while their total delegates outnumbered those representing rich countries (Helleiner, 2014b: 14). The fact that the conference operated formally on the principle of one-government-one-vote reinforced the influence of poorer countries (although many issues were settled at the meeting without formal voting).

Officials from Latin America, China (which brought the second largest delegation to the conference) and India (whose delegation was divided equally between British and Indian officials, due to its colonial status at the time) were particularly active in the conference discussions. All of them very vocally highlighted how they saw the BW negotiations as an opportunity to construct a development-friendly international financial regime that was supportive of their State-led efforts to raising standards of living and levels of industrialization. Unsurprisingly, they were very supportive of the IBRD’s proposed

development mandate. They ensured that the Bank's formal purposes included "the encouragement of the development of productive facilities and resources in less developed countries" (Helleiner, 2014b: 163). They also successfully lobbied at the conference to include wording that ensured development loans would be given equitable consideration vis-à-vis reconstruction loans in the Bank's operations. The Mexican official who led this initiative made the case in language very similar to that of the officials of the United States: "development must prevail if we are to sustain and increase real income everywhere" (quoted in Helleiner, 2014b: 164).

Southern officials also pressed for the IMF's lending provisions to be designed in a manner that was supportive of their countries' distinctive balance of payments challenges. Owing to the frequent fluctuations in their balances of payments caused by commodity exports, many Latin American officials had been very supportive of White's initial plans for the Fund. As one Brazilian official had put it, the proposed Fund would mean that his country no longer had to hold such large gold reserves, the conservation of which "has been onerous, since it may be likened to an insurance maintained exclusively by the insured" (quoted in Helleiner, 2014b: 166). At the BW conference, Latin American delegates subsequently played a key role in backing the inclusion of a "waiver" clause in the IMF's articles of agreement that allowed the Fund to override normal restrictions on its lending in situations that took into consideration the "periodic or exceptional circumstances" of the countries requesting the waiver. Latin American officials (and others) saw this clause as explicitly designed to serve the interests of commodity-exporting countries that faced larger balance of payments fluctuations (Helleiner, 2014b: 166–168).

In discussions before and during the conference, Southern delegates also highlighted their support for

international provisions such as adjustable exchange rates and capital controls (including cooperative controls) on the grounds that these would help to protect their policy space to pursue activist domestic policies designed to promote development (Helleiner, 2014b: 170–172, 255–256). Some Southern officials also tried to resurrect White's initial proposals for development-friendly trade provisions. For example, there were calls at the conference to pay greater attention to the need for infant industry protection in poor countries (Helleiner, 2014b: 170, 253). Latin American proposals at the BW conference also called for an international conference to be held to establish a new international organization to promote commodity price stabilization. Pressure arising from these latter proposals led to the passage of a resolution at BW recommending that Governments seek agreement on ways and means to "bring about the orderly marketing of staple commodities at prices fair to the producer and consumer alike" (quoted in Helleiner, 2014b: 170).

In these ways, the BW negotiations represented the first substantial North-South multilateral dialogue on international development issues. At the end of the conference, Southern policymakers applauded the fact that the final agreements supported their development aspirations. As Chintaman Deshmukh, governor of the Reserve Bank of India, told an audience in India after the conference: "[w]e all now apparently subscribe to the belief that poverty and plenty are infectious, in the international as well as in the national field, and that we cannot hope to keep our own side of the garden pretty if our neighbour's is full of weeds" (quoted in Helleiner, 2014b: 254). The commitment to building a development-friendly international financial regime also found support among policymakers from other rich countries involved in the BW negotiations, such as Australia, Canada, the Netherlands and the United Kingdom (Helleiner, 2014b).

IV. The fate of the development content of Bretton Woods

Given this history, it is striking that so many scholars and policymakers have overlooked the international development content of BW. However, such neglect is more understandable once it is recognized that this content was dramatically watered down right after the war by changing priorities of the United States, particularly with the onset of the Cold War. This is not the place to analyse how and why officials of the United States withdrew their backing for the international development vision of BW so quickly. Nonetheless, the consequence of the changed policy of the United States was important, resulting in the fact that the “actually-existing” BW system was much less supportive of Southern development aspirations than the original BW vision had been (Helleiner, 2014b: 260–268).

This undermining of the BW development framework generated the result ominously predicted by Morgenthau in 1945: growing conflicts between North and South in international economic diplomacy. These conflicts escalated particularly after the wave of decolonisation in the 1950s and 1960s, and by the early-1970s Southern policymakers were demanding an entire New International Economic Order that would better support their development goals. At the time, the proposal was generally portrayed as a challenge to the BW system. Yet, many of its specific demands simply resurrected – usually unknowingly – ideas put forward at the time of the construction of the original BW international development vision, ranging from proposals for development assistance to commodity price stabilization schemes (Helleiner, 2014b: 268–276).

The same is true of many of the demands of EMDEs today. As noted above, officials of EMDEs

are often quite critical of the BW system. However, the BW architects pioneered specific proposals for promoting international development that EMDEs continue to see as crucially important today: public international long-term development finance, short-term international lending for balance of payments support, multilateral support for capital controls and national policy space, SDRMs, and inclusive multilateral governance practices. The BW architects also included many policymakers from today’s EMDEs. Indeed, some of the key countries’ pushing for global financial reforms today – such as Brazil, China, and India – were among the most active of the poorer countries that helped to shape the international development content of the original BW agreements.

Recalling the original development content of BW helps to correct the historical misconception that the BW system was development-unfriendly from its very beginnings. This correction may be particularly useful for those seeking to bolster the prominence of international development goals within contemporary global financial governance. Rather than challenging BW norms, reforms with this goal can be accurately recast as those that resurrect and more fully realize the vision of the founders of the post-war international financial order. Indeed, a very strong case can be made that the future of the multilateral order established in 1944 depends on the fate of such reforms. If they are embraced, that multilateral order will likely be rejuvenated in the current context where EMDEs are gaining global economic influence. On the other hand, if these reforms fail, Morgenthau’s 1945 predictions are likely to be realized once again, resulting in an increasingly conflictual and fragmented global financial system.

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THE MIDDLE-INCOME TRAP AND EAST ASIAN MIRACLE LESSONS*

Veerayooth Kanchoochat

Abstract

The “middle-income trap” has recently become a powerful catchword in the international development community. Nonetheless, despite using the same phrase, the existing literature considerably varies. The objective of this chapter is twofold. First, it provides a classification of this burgeoning area of research. Based upon differences in theoretical underpinnings and policy implications, the literature is categorized into three groups: (i) getting education and institutions right; (ii) changing export compositions through comparative advantage; and (iii) industrial upgrading through State intervention. Second, the chapter examines the validity of these three bodies of literature through the East Asian development experience. Deduced from the successful catching-up of the Republic of Korea, Singapore and Taiwan Province of China, structural transformation rather than education and institutions is a key driver of long-term growth. While changing a country’s productive structure often goes against static comparative advantage, industrial and technology policies require clear yardsticks and compatible macroeconomic measures. The chapter also suggests conceptual grounds for future policymaking and research agendas to make the debate more relevant to today’s developing countries.

Introduction

The term “middle-income trap” (MIT) is a recent powerful catchword in the international development community, becoming widespread shortly after being coined by Gill and Kharas (2007) in their *East Asian Renaissance* report. The status of middle-income countries is defined by the World Bank as those who had a GNI per capita between \$1,036 and \$12,615 in 2012.¹ From 101 middle-income economies in 1960, only 13 economies managed to reach the high-income level in 2008, namely Equatorial Guinea, Greece, Hong Kong (China), Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, the Republic

of Korea, Singapore, Spain and Taiwan Province of China (World Bank, 2013). Given that the lion’s share of them has been stuck in the same income category for over half a century, this has attracted attention from academics and policymakers to explore whether there is such a thing as a “trap” that deters these middle-income countries from moving forward.

However, there is neither apparent nor growing consensus in the literature. Despite using the same phrase, the MIT literature considerably varies in the cases studied, the research methods employed, the

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underlying causes of the trap asserted and the policies suggested. To make this issue more tractable and particularly pertinent to today's developing countries, this chapter has two objectives: first, it provides one of the earliest attempts at categorizing this burgeoning area of research; and second, it examines the validity of each strand of MIT literature through the catching-up experience of East Asia.

The following discussion is organized into five sections. Section I elaborates upon the three variations within the literature. Based upon the differing theoretical assumptions and solutions provided, the existing works on the MIT can be categorized into three groups, labelled by their policy stances: (i) getting education and institutions right; (ii) changing export composition through comparative advantage; and (iii) industrial upgrading through State intervention. The three succeeding sections examine each of these three bodies through the East Asian development experience. Section II discusses why the focus on education and institutions cannot guarantee successful catching-up unless it is particularly designed to support the country's industrial targets. Section III examines the role of structural transformation and export in long-term economic development, enquiring whether East Asia has succeeded by following its comparative advantage. Section IV revisits the

State-centred approach to the MIT and discusses various recipes for industrial and macroeconomic policies pursued in East Asia. Section V summarizes policy lessons and suggests certain conceptual grounds for future policymaking and research agendas.

It is worth noting that by East Asia, this chapter means the policy lessons learned, mainly – yet not exclusively – from the first-tier newly industrializing economies (NIEs), namely the Republic of Korea, Singapore and Taiwan Province of China.² These lessons are based upon their experience during the catching-up period, approximately between the 1960s and the 1980s, as this is most relevant to the debate concerning the transition from middle- to high-income levels. While East Asia has usually been at the centre of the contemporary debate over economic development, as symbolized in the World Bank's *East Asian Miracle* report (1993), it has surprisingly been missing from the current MIT debate. Of course, today's middle-income countries differ in their characters and situations, economically, socially and politically. Although we cannot make a sweeping generalization, the lessons from East Asia warrant detailed discussion because among the only 13 countries who could escape from the MIT as mentioned above, East Asia comprises the major group of those non-European countries without natural resource wealth.

I. Three approaches to the middle-income trap³

Generally speaking, the term MIT refers to the situation in which countries have failed to grow further into a high-income level despite attaining middle-income status for certain periods. Nonetheless, there is no accepted definition of the MIT. One group of literature sees the trap as “growth slowdowns”; for example, Eichengreen et al. (2013) define MIT countries as those who had undergone average GDP growth of at least 3.5 per cent for several years and subsequently stepped down by at least 2 per cent between successive seven-year periods (in the same vein are Felipe et al., 2012; Aiyar et al., 2013). Another group puts the MIT into the broader debate concerning the economic “catching up” of developing countries in relation to such developed countries as the United States or Japan (e.g. Lin and Rosenblatt, 2012; Lee, 2013).

The MIT literature is even more diverse when analysing the causes of the trap and proposing policy solutions. According to their differences in the analytical approach to, and the solution for, the MIT, they can be classified into three groups, namely: (i) getting education and institutions right; (ii) changing export composition through comparative advantage; and (iii) industrial upgrading through State intervention. While none of the existing MIT studies deny the importance of education, institutions and exports, each work differs in its emphasis placed upon the *fundamental causes* of the MIT, as well as the extent to which *the State* should be involved in remedying the problems (functional, facilitating, or proactive). Indeed, both are the criteria that I used for this categorization.

A. Getting education and institutions right

The first strand is distinctive in terms of its principal focus on the causal mechanisms of education and institutions. It considers inadequate quality of education and institutions as the main causes that impede middle-income countries from sustainable economic growth. In terms of policy suggestions, this strand prefers the role of the State to be kept to a *minimum*, particularly when comparing with the other two strands. For example, Aiyar et al. (2013) conducted a comprehensive study through probit regressions covering 138 countries from 1955 to 2009. Defined as strong rule of law, small government and light regulation, high-quality institutions are among significant factors that prevent growth slowdowns in middle-income countries. In terms of policy suggestions, this and related studies maintain that the State should concentrate on the so-called functional intervention by making the right incentive systems for private sectors, investing more in education and institution building (e.g. Jimenez et al., 2012; Jitsuchon, 2012; Tran, 2013; Aiyar et al., 2013).

B. Changing export composition through comparative advantage

Rather than education and institutions, the second and third strands are more concerned with the country's structural transformation. Specifically, they point to a country's *export composition* as being particularly critical to its catching-up success and failure. For example, Felipe et al. (2012) argue that successful catching-up is found in those with a "diversified, sophisticated, and non-standard level export basket". Put differently, while the Republic of Korea was able to gain comparative advantage in a significant number of sophisticated products, Malaysia and the Philippines were only able to gain comparative advantage in electronics. From their perspective, countries have fallen into the MIT because they have inadequate capabilities to produce and export higher-technology products. The disparity between these two groups lies in the role the State should play in solving the exports problem.

The second strand has reservations about State intervention. While policy suggestions vary within this group, they generally prefer the State to function as no more than a *facilitator* who supports a country's transformation towards higher value-added exports. Whereas some works recommend that developing countries should pay attention to their export compositions, they offer no clear instruction concerning how the State can achieve this (e.g. Felipe et al., 2012; Eichengreen et al., 2013). Another work within this strand goes further and maintains that the State should play a facilitating role by supporting sectors in accordance with the country's current comparative advantage. For example, Lin and Treichel (2012: 48) assert that: "To achieve dynamic growth, a developing country should develop industries according to its comparative advantage, which is determined by the country's endowment structure, and tap into the potential advantages of backwardness in industrial upgrading."

C. Industrial upgrading through State intervention

Similar to the second group, the third strand of MIT literature emphasizes exports and production structures. Nevertheless, it explicitly supports the active role of the State in acquiring indigenous technology for latecomers, even against the country's comparative advantage when necessary. Put otherwise, for this group, comparative advantage is not a matter of concern, and especially comparative advantage in trade determined by initial endowment conditions. This group makes it clear that the MIT problem is mostly about the inappropriate or insufficient role of the State in enhancing the country's capabilities to produce and export higher-technology products. As a result, the State should be proactive, paying close attention to capability accumulation and industrial upgrading (e.g. Ohno 2009; Paus, 2012; Lee, 2013).

In summary, those who used the term MIT hold different underlying assumptions about the trap, thereby deriving a different set of policy suggestions. In the subsequent sections, we examine each strand through the catching-up experience of East Asian NIEs.

II. Education and institutions as magic bullets?

While the first strand of MIT literature considers education and institutions as holding the key to reaching a higher-income level, the East Asian experience tells us that neither guarantees successful catching-up. In order to contribute significantly to economic growth, education and institutions need to be closely linked with specific industrial targets.

A. Education needs to link with industrial targets

In contrast to conventional wisdom, a number of cross-country studies find that the relationships between education and economic growth are weak (Benhabib and Spiegel, 1994; Pritchett, 2001) or take place in the opposite direction, namely from economic growth to a higher quality and quantity of education (Bils and Klenow, 2000). When comparing East and Southeast Asia, it was found that the literacy rates and average years of schooling of the first-tier NIEs were below those of the Philippines in 1960.⁴ Even as late as 1994, the average years of schooling of Indonesia, Malaysia and Singapore were still lower than that of the Philippines (Collins and Bosworth, 1996). However, the Philippines is the least successful catching-up country among them.

Why might this be the case? The reason is that despite having value on its own, much of the knowledge gained in education is not necessarily relevant for productivity enhancement, not only because many subjects have almost no impact on most workers' productivity (such as literature, history, and philosophy), but also because education tends to promote individual betterment to a greater extent than national prosperity (Chang, 2010: 189). The causal link from (more or higher quality) education to (higher, more continuous) growth is indirect at best, and requires many more things in the causal process. To ensure that education contributes substantially to economic growth, educational policy has to be tailored to support the national development strategy, rather than simply increasing literacy rates, average years of schooling or even gross tertiary enrolment.

For example, in Singapore, the human resource system was restructured in 1981 when the country decided to shift from import-substitution to export-oriented industrialization. The new system was aimed

at specific industrial goals and not only encompassed improving formal education, but also upgrading the abilities of the existing workforce in the industry through training and vocational education (for the Skills Development Fund, see Kuruvilla, 1996). By contrast, while Thailand and the Philippines were able to create educated workers, their university–industry linkages have been porous and neglected, which in turn has impeded the utilization of labour forces and hampered the economic development of both countries (Yusuf and Nabeshima, 2010).

B. Growth-enhancing governance is more relevant than “good governance”

While no one would reject the contribution of institutions to economic development, the question about which kind of institutions matter remains debatable. In this regard, the existing MIT literature is influenced by the so-called “good governance” institutions meant for minimizing the role of the State, as well as rent-seeking activities. According to Aiyar et al. (2013), better institutional quality is meant to comprise less government ownership of enterprises, lower income tax rates, fewer regulatory restrictions on the sale of real property, as well as fewer trade taxes and non-tariff trade barriers.

However, methodologically speaking, the argument for “good governance” institutions is based upon flawed research methodology, as in fact many of the explanatory variables in empirical research are not really institutions (e.g. tax rates and trade barriers). However, in theory, institutions are supposed to be something more fundamental and deeply rooted, providing the basic scaffolding for human interactions, such as constitutions or widely held norms. Even assuming away the problematic use of such proxies, cross-country regressions are poor tools to determine which particular institutions are necessary for a country to develop, because we still lack good aggregate measures of complex institutions or an understanding of how these institutions interact with specific country characteristics (Shirley, 2008).

More importantly, from an empirical perspective, the first-tier NIEs were able catch up with advanced economies despite their institutions being highly deficient by modern standards, in such areas

as democracy, bureaucracy and judiciary, property rights, western-style corporate governance and financial institutions (Chang, 2002). In the Republic of Korea, for example, rent-seeking was rife throughout the high-growth period under the Park Chung Hee regime. The assumption that rents and rent-seeking are always counter-productive and thus should be eliminated at all costs is problematic because there are different types of rent. For example, the Schumpeterian rents, or the above-average profit that

the firm earns due to innovation, are vital to ensure sustained efficiency and growth. The implication is that it is the way in which rents have been created and managed holds greater relevance for consequent economic performance (see Khan and Jomo, 2000; Kang, 2002). Specific to the task of escaping from the MIT, growth-enhancing institutions, namely those that focus on the country's structural transformation and export compositions, are more relevant than good governance ones.

III. Structural transformation through comparative advantage?

Beyond education and good governance institutions, the second strand of MIT literature emphasizes structural transformation, export composition and comparative advantage. First, it revives the old tradition of development economics by reaffirming that *structural transformation* is the key to sustaining economic growth. Second, it has shifted the focus from export expansion to *export composition* as a prime indicator of structural transformation. Third, it renews the concept of *comparative advantage* as a guideline for a developing country to follow. The experience of East Asia is supportive of the first two statements, yet is at odds with the third one.

A. Long-term economic development requires structural transformation

To begin with, the definition of “development” has always been subject to controversial debate. The current UNDP human development index may underscore the non-income dimensions of human welfare, such as health and gender equality. However, another group of development economists has tried to draw academic attention back to the “old school” cannon in the tradition of, inter alia, Arthur Lewis, Simon Kuznets and Nicholas Kaldor. Before the rise of neo-liberalism in the 1980s, there was a general consensus that development is largely about the transformation of the productive structure. Emphasis is placed on manufacturing as the source of national prosperity because it offers greater returns to scale and spillovers from learning and productivity potential (e.g. Rodrik, 2007; Cimoli et al., 2009; UNIDO, 2013). In human history, only a few countries have

achieved high-income status without industrializing, and merely because they were endowed with an extraordinary abundance of natural resources.

This “productionist” tradition of development is based upon the world history of industrialization. Among the catching-up economies, Latin America remained the most industrialized region until 1975, while Africa has been the least industrialized region. However, the most transformative change took place in Asia, whose manufacturing continuously surged throughout the last half of the century, particularly from 1965 to 1980. Moreover, by 2010, the three most successful economies in East Asia, namely China, the Republic of Korea and Taiwan Province of China, together accounted for approximately one-fifth of world manufacturing's value-added share and world manufactures trade (UNIDO, 2013).

In short, since the Industrial Revolution, long-term growth has required a country's structural transformation in which resources are transferred to higher-value-added sectors (i.e. from agriculture to industries and services), production is diversified continuously and labour productivity is significantly increased. The successful catching-up of first-tier NIEs also results from such transformation, albeit in a faster and more intense manner than any other developing region (Szirmai, 2012).

In addition to reviving the old definition of development, the second body of MIT literature brings a fresh empirical insight by shifting the focus from export expansion to export composition as the crucial determinant of sustainable structural transformation.

Export expansion alone is not sufficient for sustaining growth. What separates export-led industrialization in Latin America and East Asia is export composition. The study by Palma (2009) finds that between the 1960s and the 1990s, Latin American countries' capacity to move into the "high-tech" products was much lower than that of the East Asian ones.⁵ Although Latin American countries managed to reach East Asian levels of market penetration in OECD markets (matching export expansion) in the 1990s, they only did so in their traditional export products, while NIEs were able to increase remarkably the share of high-tech products in their exports to the same markets (different export composition). In sum, exports can be used as both a development tool and a test of a country's success (see also Hausmann et al., 2007).

B. Changing export compositions usually goes against comparative advantage

However, the extent to which the role of the State is needed in changing the country's export composition remains controversial. Although overly deviating from comparative advantages might be damaging, it is almost impossible for a backward economy to accumulate capabilities in new industries without defying comparative advantage and actually entering the industry before it has the "right"

factor endowments. Theoretically speaking, the concept of comparative advantage, which underlies Justin Lin's policy advice, is based upon *unrealistic* assumptions, including: (i) the "no" conditions, such as no externalities; no increasing returns to scale; no factor mobility between countries; no technological change; and (ii) the "necessary" conditions, such as the perfect competition in all markets in both countries (Fine and Waeyenberge, 2013). Empirically, high-speed structural transformation in first-tier NIEs was a result of various mixtures of proactive State intervention aimed at upgrading their industrial structures. For example, the Republic of Korea set up the State-owned steel mill, POSCO, and initiated the Heavy and Chemical Industrialization (HCI) programme, which promoted shipbuilding, automobiles and machinery in the early 1970s when its per capita income was only 5.5 per cent that of the United States. Given that per capita income has been used as a proxy to compare capital abundance between the United States and the Republic of Korea, the latter should have specialized in labour-intensive sectors such as the apparel industry rather than the HCI programme (see detailed discussion in Lin and Chang, 2009). Of course, changing export composition and going against comparative advantage can do more harm than good if industrial and technology policies are not well implemented, which is an issue to which we now turn.⁶

IV. Industrial policy without yardsticks and macroeconomic stability?

The third strand of MIT literature gives strong weight to industrial and technology policy. Although the East Asian experience seems to concur with this view, the Achilles heel of this approach is its lesser emphasis on the pragmatic guidelines on effective State intervention and, more importantly, macroeconomic policymaking (e.g. Ohno, 2009; Lee, 2013). This section discusses the carrot-and-stick ingredients of industrial policy, as well as the macroeconomic measurements pursued by the first-tier NIEs.

A. East Asian policies entailed variation in carrot-and-stick incentives

Despite the East Asian experience always representing a strong case for the proponents of industrial

policy, detailed analysis of how the first-tier NIEs succeeded in operation is usually missing. The fruits of such policy vary considerably across time and space. In general, the first-tier NIEs used *export performance* and the *discrepancy* between domestic costs and international prices to guide subsequent government policies for the targeted industries. The role of exports is underestimated by both sides of the industrial policy debate: while its proponents do not fully appreciate how critical exports are to the success of industrial policy, its opponents do not recognize that selective industrial policy is required for local firms to be capable of competing in global markets (Chang, 2011).

At the micro level, the Republic of Korea and Taiwan Province of China ran a tight ship and took

punitive actions whenever necessary. In Taiwan Province of China, the recipients of policy support were threatened with a penalty if the prescription was not followed. Control instruments included quantitative import restrictions and export licensing, foreign investment screening, approval for capital goods imports for new plants, no private borrowing of foreign funds and restrictions on entry to certain sectors. Likewise, the Republic of Korea strongly deployed the tight performance monitoring system, set by industry associations in concert with the Government. Its punitive measures included the withdrawal of subsidized credit and import licences, income tax audits, while even prison sentences could be put in place for some serious issues. Moreover, the Korean State usually set up State-owned enterprises to accomplish the tasks that private firms could not be forced to undertake. Singapore is less punitive than the Republic of Korea and Taiwan Province of China, given its FDI-led strategy. However, firms would only be granted potential rewards when their activities matched the country's specific targets at a given time (see Amsden, 1989; Wade, 1990; Lall, 2004).

The intensity of the carrot-and-stick measures outlined above is in marked contrast with the industrial policymaking of other State-led economies. For example, in Malaysia, technology transfer did not involve any *ex post* monitoring and appraisal, while the *ex ante* screening was poorly managed, as exemplified in the case of Proton, the "national car" project. Despite having been granted substantial protection through high tariffs and excise duties since 1983, Proton has yet to develop engine-manufacturing capability because the Malaysian Government has had no rigorous mechanisms to monitor and improve performance to adjust tariffs downwards according to levels of efficiency (Doraisami and Rasiah, 2001). Political factors aside,⁷ the lack of effective carrot-and-stick incentives warrants close attention, as it draws a fine line between successful and failed catching-up.

B. Macroeconomic stability matters, but in unconventional ways

Another shortcoming of the proponents of proactive State intervention is the downplaying of macroeconomic policy in relation to industrial upgrading. East Asia reminds us that the stability of macroeconomy was instrumental in gearing a country

towards successful catching-up. However, it is worth noting that for the first-tier NIEs, macroeconomic policies were considered part of, and subordinated to, the overriding goal of structural transformation and enhancing export performance.

In the Republic of Korea, fiscal and monetary policies were employed to sustain a high level of investment by creating an expansionary environment, even through inflationary measures if necessary (Chang, 1993). During the 1960s and 1970s, annual per capita income in the Republic of Korea was growing at 9.5 per cent, in parallel with an average inflation rate of around 15.5 per cent (Jeon, 1995). Overall, the majority of financial resources were directed towards targeted sectors. The Republic of Korea ran budget deficits to finance government investment or re-lend to private sectors. Fiscal support by the government to favoured firms and industries was far greater than officially shown in budget expenditures (Haggard et al. 1994). One of the most important means was "policy loans", which accounted for 57.9 per cent of total bank loans made approximately between 1962 and 1987 (Heo, 2001). Monetary policies were also used to manage credit allocation in the targeted industries and increase household savings. Real deposit interest rates were increased to raise the low national saving rate, thus helping to close the saving gap. To control resource allocation, the government repossessed a major portion of equity shares of nationwide commercial banks in 1961 and exercised tight control over the lending activities of these institutions until the early 1980s (Dornbusch et al., 1987).

Macroeconomic policy in Taiwan Province of China may be more "conventional" than that of the Republic of Korea. Throughout its catching-up period, Taiwan Province of China attained surplus budgeting, high real interest rates, low money supply and stable foreign exchange rates (Auty, 1997). Nonetheless, during the high-growth period of 9.7 per cent from 1960 to 1979, Taiwan Province of China still had an average inflation rate of 7.2 per cent (Jeon, 1995). The balance of priority between macroeconomic stability and industrial upgrading was readjusted at times. When confronting external shocks, the top priority was placed on macroeconomic stability, although once the economy was stabilized growth would return to the top of the agenda. For example, whenever export growth slowed down, Taiwan Province of China's central bank would lower the rediscount rate on export loans to stimulate investment. Despite a

relatively restrictive monetary policy, the economy had a significant informal, unregulated financial sector, which has been a major supplier of funds for small- and medium-sized firms. Private enterprises in Taiwan Province of China borrowed up to 34 per cent of annual funds for investment and operations from the informal financial sector in the 1964–1991 period (Lin et al., 1996).

At a glance, Singapore's macroeconomic policy seems the most conservative among these first-tier NIEs, with low inflation, high savings and investment and small government expenditures. It had an inflation rate of only 4.3 per cent between 1965 and 1979, while growing at 10.2 per cent on average (Jeon, 1995). However, these conventional figures were only made possible because the island State engineered the “unconventional” tools to encourage industrial investment. For one thing, the use of government budget surplus is a misleading indicator of Singapore's fiscal stance as it rules out the gigantic resources spent by the State-owned enterprises, known as the government-linked companies (GLCs). On the one hand, these GLCs hold *majority shares* in a wide range of areas, including Singapore Airlines, telecommunications, financial services, energy and natural resources, transport, shipping, semiconductors, health care, and engineering. As a result, the public sector share of gross fixed capital formation in Singapore was 35.6 per cent in the 1960s, 26.7 per cent in the 1970s and 30.3 per cent in the 1980s, which were even much higher than in Taiwan Province of China and the Republic of Korea (Shin, 2005). Singapore often used these GLCs to

pump-prime the economy whenever there was any sign of economic downturn. Furthermore, profits from GLCs were used to subsidize deficits in government priority areas like housing, which kept up the effective demand (Chowdhury, 2008).

On the other hand, the major source of Singapore's public sector investment stems from the country's compulsory social security scheme that forces every employee to save, named the Central Provident Fund (CPF). Between 1974 and 1985, government savings rose from 23 to 67 per cent of gross national savings. The CPF provided a ready and non-inflationary source of finance for government spending, including fiscal incentives for foreign investors, with lower than market interest rates (Huff, 1999). Together, the use of GLCs and the CPF functioned as an “automatic stabilizer for inflation” in Singapore. Meanwhile, certain monetary policies have been utilized to restrict short-term capital flows; for example, withholding tax on interest earned by non-residents and preventing banks from making Singapore dollar loans to non-residents or residents for use outside Singapore (Chowdhury, 2008).

In summary, although macroeconomic stability was a necessity, it should be defined in a broader way as part of national development strategy, rather than a narrow, unfounded focus on single-digit inflation and budget balancing. To the greatest extent possible, macroeconomic policy should focus on the variables of ultimate concern, such as efficiency, growth and equity, rather than an intermediate variable like inflation (see Herr and Prieue, 2006; Stiglitz et al., 2006).

V. The middle-income trap: Future research agenda

This chapter has explored the growing body of literature on the MIT, providing reflections and policy lessons drawn from the catching-up experience of the Republic of Korea, Singapore and Taiwan Province of China, the so-called first-tier NIEs. First, with some oversimplification, I classified the existing MIT literature into three groups, labelled by their policy statements, namely: (i) getting education and institutions right; (ii) changing export composition through comparative advantage; and (iii) industrial upgrading through State intervention. Although the

factors studied and policy suggested overlap across those works who used the term MIT, they differ in their emphasis on the factors that engendered the “trap”, as well as the extent to which the State should play a role, which are the main benchmarks that I have used for this classification.

The chapter subsequently examined each of the above three strands in relation to the East Asian development experience. Regarding the first strand, I argued that education and good governance institutions cannot

guarantee successful catching-up; rather, both have to be designed to tailor specific industrial targets of the country at that time, as exemplified in East Asian economies. If the subject matter is about long-term economic growth, transforming the productive structure and export compositions of a country should be at the centre of policymaking, as the second MIT strand suggested. If anything, these East Asian economies have achieved the fastest industrialization in human history. However, in doing so, the role of the State rather goes beyond a comparative-advantage-following strategy, with this theory heavily relying on unrealistic assumptions. Of course, moving against comparative advantage demands well-designed industrial and technology policies. The third strand of literature, which advocates proactive State intervention, typically underestimates the nitty-gritty details of incentives needed for industrial upgrading, as well as the compatible macroeconomic policies required to maintain economic stability.

To make the future debate on the MIT more relevant to, and policy advice more realistic for, today's developing countries, the chapter ends with two conceptual grounds for policymaking and one crucial research agenda.

To begin with, we should have reached a consensus that industrial policy can work – although it can also fail – before moving on to the productive debate. In other words, both God and the devil of industrial policy are in the details. In doing so, two conceptual points should give grounds for policymaking. First, industrial and technology policymaking should be posited on the same level as other types of policymaking, whether education, health or social policies, in the sense that it will certainly be confronted with problems and difficulties in terms of implementation. However, the tasks of policymakers are to minimize such problems and maximize the benefits through processes of policy evaluation and refinement. Second, targeting should not imply

an automatic negative connotation. The debate over “functional” versus “selective” intervention is almost meaningless at the operational level. Those who support functional intervention of the State may draw the line of intervention at education, R&D and infrastructure that benefits all industries equally. Nonetheless, almost all interventions in reality *inevitably* favour some sectors and actors over others, and thus have discriminatory effects that amount to targeting (Rodrik, 2008; Chang 2011).⁸ Accordingly, designing a systemic selective policy *ex ante* should be a more productive and accountable enterprise than deploying it with blind prejudice.

Nevertheless, one of the crucial yet under-researched areas in the field concerns the potential *criteria for effective targeting*. Although targeting is almost inevitable, we still lack a set of well-developed measures to be employed by developing countries. Among recent studies in this thread is Lee (2013), which argues that leapfrogging is more likely to take place in the sectors characterized by rapid technological change. Lee argues that the success of the Republic of Korea and Taiwan Province of China is largely due to their overarching strategy towards “short-cycle”, technology-based sectors.⁹ Short-cycle technologies mean that the sector not only has less reliance on existing technologies but also has a greater opportunity for the continued emergence of new technologies. For example, the Republic of Korea's catching-up with Japan in high-definition TVs would not have been successful if in the 1980s Korean electronics companies had not targeted the emerging digital technology-based products more aggressively than Japanese companies, which decided to continue manufacturing the then-dominant analogue products. In summary, to distil useful policy lessons, an exploration into criteria for targeting such as Lee's technological cycle time should be one of the crucial themes of future MIT research (also in this vein are Hausmann et al., 2011; Lin and Treichel 2011).

Notes

- 1 According to the country's GNI per capita in 2012, countries have been classified as follows: low income, \$1,035 or less; lower-middle income, \$1,036–\$4,085; upper-middle income, \$4,086–\$12,615; and high income, \$12,616 or more. Note that the World Bank measures and categories have been repeatedly adjusted.
- 2 Hong Kong (China) is dropped from my discussion, as it is the only economy in East Asia that has been prosperous mainly due to free trade and a *laissez-faire* industrial policy. However, Hong Kong (China) had never been an independent State. As a British colony from the mid-19th century until 1997, it was used as a platform for Britain's financial and trading interests in Asia. It has subsequently become China's financial and trading centre.
- 3 It is worth noting that my review here is limited to those that explicitly use the term "middle-income trap". Seemingly related works, such as those on middle-income countries or the East Asian development, are not included if they have not used that specific term.
- 4 In 1960, the Philippines had a literacy rate of 72 per cent, while it was 71 per cent for the Republic of Korea, 68 per cent for Thailand, 54 per cent for Taiwan Province of China and 53 per cent for Malaysia (Sarel, 1996).
- 5 High-tech products are defined as products with high R&D content (see Palma, 2009).
- 6 How the role of globalization and the changing patterns of international trade have affected the path of structural transformation is discussed at greater length by Yang in the volume *Development Strategies – Country Studies in Comparison*.
- 7 Nonetheless, the deeper causes of second-tier NIEs' mediocre catching-up lie in their political and institutional deficiencies; for example, the Philippines' oligarchic structure (see Hamilton-Hart and Jomo, 2003).
- 8 For example, granting R&D subsidies implicitly favours R&D-intensive high-tech sectors. Building railways (rather than roads) implicitly favours the steel industry (over the auto industry). Among a few policies that could be regarded as "general" are basic education and health care (Chang, 2011).
- 9 Lee (2013) measures the cycle time of technologies by the mean citation lag, which is the time difference between the application year of the citing patent and that of the cited patents.

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THE ROLE OF INDUSTRIAL POLICY IN DEVELOPING COUNTRIES

Robert H. Wade

Abstract

The voices raised against “industrial policy” in the economics profession have long achieved a choral force. However, historical evidence suggests that the public authorities of virtually all of the small number of non-western economies that achieved “developed” economic status in the past two centuries have used industrial policy to impart directional thrust aimed at catching up with western economies. Since the 2007–2008 financial crash and ensuing long slump, minds have become somewhat more open to this evidence as the realization dawns that western countries themselves have to restructure their production structure beyond the limits of “let the market decide”.

This chapter argues that the classic developmental State is only viable today for a very small number of countries with large domestic markets. However, a variant of the developmental State can still be viable. The chapter spells out necessary features of the encompassing political settlement and the industrial policy agency itself. It ends on the note that developing country policy makers should be cautious about accepting mainstream economists’ blanket negatives about industrial policy.

Introduction

The voices gathered against “industrial policy” in the economics profession have long achieved a choral force. For Nobel laureate Gary Becker, “the best industrial policy is none at all” (1985). For John Williamson, crystallizer of the Washington Consensus about appropriate development policy, “little in the record of industrial policy suggests that the state is very good at ‘picking winners’” (2012: 10). For Lawrence Summers, former chief economist of the World Bank, Treasury Secretary of the United States, presently professor of economics at Harvard, government “is a crappy VC [venture capitalist]” (quoted in Nocera 2011). For *The Economist* magazine, “the government has a terrible record of picking winners” (2011).

For William Easterly, ex-World Bank economist and currently professor of economics at New York University, “[t]he track record of dictators picking winners is very poor, so why are we so sure that this factor contributed to the success of the Gang of Four [East Asian tigers]?” (2009: 129). An interviewer pressed him on how he reconciled his faith in free markets with evidence that the typical developing country had better economic performance in the 1960s and 1970s, when governments intervened more, compared to later, when governments intervened less: “It is a bit of a *mystery* why they did well ... the growth had a lot of *mystery* for me ... It is *mysterious* to those who advocate hands-off markets.” (Easterly, 2002: 91, emphasis added).

By this time, Easterly had been analysing development issues for 21 years, most of them in the World Bank.

In short, the choral force says that “industrial policy” is “government picking winners”; and everyone knows that governments cannot pick winners.

However, since the Great Western Recession starting in 2007–2008, industrial policy has enjoyed something of a renaissance. Prominent development economists (including Ha-Joon Chang, Ricardo Hausmann, Justin Yifu Lin, Mariana Mazzucato, Dani Rodrik and Joseph Stiglitz) write about it in at least partly positive terms, with their arguments eliciting a more respectful response within policy circles than before. Lin’s advocacy is significant, because he was chief economist and senior vice president at the World Bank from 2008 to 2012, which gave him an institutional platform for disseminating ideas. The Organisation for Economic Co-operation and Development (OECD) published a flagship report with “industrial policies” in the title, *Perspectives on Global Development 2013: Industrial Policies in a Changing World* (2013). UNCTAD and the ILO published *Transforming Economies: Making Industrial Policy Work for Growth, Jobs and Development* (2014, edited by Salazar-Xirinachs et al.). The United Nations Industrial Development Organization (UNIDO) now makes “inclusive and sustainable industrial development” its banner headline and organizes industrial policy promotion events. Mariana Mazzucato’s *The Entrepreneurial State: Debunking Public vs. Private Sector Myths* (2013) became a widely reviewed best-seller, translated into six European languages so far and top of Amazon’s “economic policy” list for six months, with sales of around 10 000 (as of mid-2014).

This chapter begins by summarising reasons for the recent – apparent – re-legitimation of industrial policy in section one. Section two discusses the scope today for a developmental State à la France, Japan, the Republic of Korea, Taiwan Province of China and Brazil of the post-war decades. Section three outlines a recent debate about how a government should identify priority industries or products, particularly concerning the extent to which it should only target activities *within* the economy’s current comparative advantage. Section four turns to organizational issues: the political and organizational features that make for high capacity to implement industrial policy at the level of State-society relations and the level of particular agencies. Section five concludes on the

future of industrial policy, with some suggestions and cautions for developing country policymakers.

Before proceeding, it is necessary to raise three points about the larger context of industrial policy. First, the past two centuries since the Industrial Revolution show, on the one hand, a dramatic Great Escape from lives that were “nasty, brutish and short”, borrowing Thomas Hobbes’ phrase (Deaton, 2013). On the other hand, the number of *non-western* economies that have become developed in the two centuries since the Industrial Revolution is less than ten, even stretching the categories of “non-western”, “economies” and “developed”. The list plausibly includes Japan, the Russian Federation, Taiwan Province of China, the Republic of Korea, Hong Kong (China), Singapore, Israel and maybe Mauritius. Such a low total suggests that strong forces operating at the level of the world economy hold “developing” countries back, analogous to gravity, and that the vast “development industry” created since the Second World War can hardly be classed a success. The non-western success stories had or have two conditions in common: first, external State enemies capable of conquering the territory; and second, a public authority imparting more directional thrust than is consistent with neoclassical development prescriptions (with Hong Kong (China) being a partial exception to the second condition).

This finding should induce caution about accepting the Washington Consensus agenda for developing countries (privatize-free trade-deregulate-no industrial policy), even though, according to John Williamson, it reflects the beliefs of “all serious economists”.

Second, industrial policy – understood as targeted efforts to change the production structure of an economy in order to accelerate economic development, so it should more accurately be called “production transformation policy” – is an “inner wheel” whose effects depend on “outer wheels” of macroeconomic conditions and underlying political settlements.

Macroeconomic conditions refer especially to the exchange rate. Standard comparative advantage theory assumes that when economies specialize and trade on the basis of comparative advantage (produce and export products whose opportunity costs are lower compared to other products that might be produced in the same economy and import the rest of the consumption bundle), welfare will be maximized and trading economies will all gain from trade. The freer

the trade, the greater the welfare gains, compared to no trade. The theory assumes that trade is balanced, with no payments surpluses or deficits, although the mechanisms of balance are unclear. A cousin of the standard theory (the purchasing power parity theory of exchange rates) says that the balance comes from the exchange rate moving to ensure that the price of a good in two countries is the same when expressed in a common currency. This means that producers in the relatively most efficient country will specialize in the good and others will import it. Accordingly, the exchange rate adjusts to reflect relative cost differences, which signal the appropriate specialization.

However, this is a fanciful picture of how exchange rates move in the real world. They not only move in response to trade flows but also in response to (often much greater) volatile capital flows, and can go in quite the wrong direction for balancing trade flows – and for helping a country’s emerging industries to compete internationally (see Frenkel and Rapetti chapter, this volume). The exchange rate is commonly as important a determinant of growth and the structure of production and trade as the dense array of international trade and investment rules. However, the literature on how to do industrial policy tends – wrongly – to treat the exchange rate as belonging to another policy realm.

Political settlements, the second kind of “outer wheel”, refer to institutional balances between the State, business and labour, as well as between rival parties or groups contending for control of the State. Political settlements affect the extent to which “business”, “politicians”, “police”, “judges” and “Church” are unconstrained in their (collusive) control over society, the extent of “rule by law” rather than “rule of law”, the extent to which labour movements limit the power of business and the extent to which the State ties industrial policy assistance to performance conditions. Political settlements affect wages, income distribution and domestic demand, as well as the State’s ability to raise broad-based taxes and use the revenues for financing public goods, as distinct from private goods or goods with which to keep others out of power.

The third contextual factor is limits to growth, especially environmental limits. Any discussion of the economic growth and catch-up of developing countries has to acknowledge that endless growth on a finite planet is impossible – short of revolutionary changes in technology.

For the most part, this essay takes these points as given and focuses on debates around industrial policy more narrowly construed.

I. The return of industrial policy?

Let us consider why industrial policy is currently receiving attention in the spirit of how to do it better rather than how to do it less. There are several reasons.

First, the Great Recession and median income stagnation in the western world (more than six years old at the time of writing) has dented the widespread confidence in the idea that “free markets” and “small States” are best for all.

Second, recent research shows that – contrary to widespread understanding – the Government of the United States has been vigorously undertaking a form of selective industrial policy for several decades, especially since the 1990s. Agencies such as the Defence Advanced Research Project Agency,

National Institutes of Health, National Institute of Standards and Technology and the Central Intelligence Agency have taken the initiative to create and steer knowledge-pooling networks, linking (a) firms that otherwise compete with each other, (b) sources of finance and (c) universities, public labs and private labs. This form of industrial policy of the United States has escaped public attention, partly because there is no superordinate “industrial policy agency” akin to Japan’s Ministry of International Trade and Industry (MITI) in the post-war decades, as well as because the agencies have tried to keep their network-building and direction-setting programmes below the radar of conservative public attention (Wade, 2014b; Mazzucato, 2013; Lind, 2012; Block and Keller, 2011; Schrank and Whitford, 2009).

The contradiction between the fact of vigorous industrial policy in the United States – where State agencies are active in helping to pick (or more accurately, make) winners – and the general understanding that the United States does not do industrial policy prompts the quip that the most successful United States industrial policy is to persuade the world that the United States does not do industrial policy.

A third reason for the recent attention to industrial policy is the dramatic fall in the growth rates of “emerging economies” after 2010, which dented confidence that their high growth rates from 2003 to 2010 would be sustained long into the future, powering a catch-up to developed countries. The fall in emerging economy growth rates is another fact that helps to open minds to the potential for industrial policy to spur production diversification and upgrading. In the new situation, people devote more attention to the previously little noticed trend: in the period from 1980 to the early-2000s, the majority of middle-income countries in Latin America, sub-Saharan Africa, Middle East and North Africa and South Asia *fell behind the West* in relative average income, whereas more of them had raised their per capita incomes relative to the capitalist core in 1960–1980, during the era of supposedly bad “import-substituting industrialization” (Wade, 2003a; 2014a). The later falling behind occurred while many of these economies were under “structural adjustment programmes” of the World Bank and similar organizations, whose content derives from the Washington Consensus. After the 2008 Crash, people became more willing to notice evidence that structural adjustment and Lawrence Summers’ “three -ations” (privatization, stabilization, liberalization) were not so favourable a foundation for development as they had been led to believe.

Fourth, there is accumulating evidence that many upper middle-income countries that might be first in line to graduate to developed economy status are stuck in a “middle-income trap” (see Kanchoochat chapter, this volume). While this has become a popular phrase, it hides an important distinction between a middle-income trap and a middle capabilities trap. Even when a middle-income country converges upwards in income (thanks to high prices for commodity exports), it may be stuck in a capabilities trap. For example, its non-natural-resource-based firms may find that – with the exchange rate buoyed up by the commodity exports – they cannot compete with firms producing standardized products in lower-wage countries, as well as being unable to compete with

firms producing more technology-intensive goods and services in higher-wage countries (Paus, 2012; 2014).

The notion that much of Latin America might be stuck in the capabilities trap is suggested by the dramatic fall in the region’s ratio of regional manufacturing value-added to regional GDP, from 26 per cent in 1980 to 16 per cent in 2009 (East Asia’s equivalent figure is over 30 per cent) (World Bank, 2014). Chinese- and German-made intermediate and final goods were in evidence everywhere at Brazil’s World Cup venues in June–July 2014.

Some evidence suggests that even the South-East Asian economies are no longer advancing in high value-added manufacturing activities. True, Malaysia, Thailand, and Indonesia experienced deep structural change out of natural resources and into manufacturing after the mid-1970s, especially in electronics, electrical engineering, textiles and autos, building up production and management skills to match the productivity levels of developed countries in standardized products. No other developing countries beyond North-East Asia have experienced such growth of manufacturing capacities.

Nonetheless, in contrast to Taiwan Province of China and the Republic of Korea at the equivalent stage of development, not even the wealthiest – Malaysia – has built an indigenous capacity to design, innovate and commercialize into new and more profitable sectors, while few firms have created even regional brand names. All of them remain heavily dependent on subsidiaries of multinational corporations (TNCs) for their higher-tech manufacturing exports. Most importantly, backward links from TNC operations into the domestic economy are thin, with the result that domestic value-added in manufacturing remains low.

Indeed, as China advances – dense backward links from TNC operations to domestically-owned firms, including firms operating in lower-wage western China – it is leap-frogging the South-East Asian economies, putting them under even stronger competitive pressure (see Yang in volume 2 of this publication).

A recent study of Malaysia finds that real wages declined in 2002–2008, while the average skill intensity of production also declined. It concludes:

Malaysian industry appears to be *sliding down* the technological slope, and the incentives for

workers to improve their skills are weakening... technological capabilities are relatively static (and may even be declining)... industrial competitiveness is marking time (Yusuf and Nabeshima, 2009: 26, emphasis added).

Worried about being caught in the middle-income or capabilities trap, Governments of middle-

income countries have become more willing to challenge the long-standing argument of mainstream economics and the World Bank, namely that “the best industrial policy is none at all.”

The above circumstances and evidence have helped to make discussion of industrial policy partially respectable.

II. The developmental State Mark II

The classic developmental State focused on developing the capacities of *indigenous firms across a broad range of major global industries*, capable of acting as first-tier suppliers to TNCs and even competing head-to-head with them. Today, only a few economies with very large internal markets – China, India and Brazil most obviously – have this as an option. High entry barriers in the face of existing TNC dominance and neoclassically-inspired trade and investment rules make such an objective non-viable for most (Pirie, 2013).

However, if the developmental State Mark I (where the capitalist State leads the creation of a diversified and autonomous industrial base) is now only viable for very large developing countries, this is not the end of the story; rather, there is scope for developmental State Mark II.

First, World Trade Organization (WTO) rules are more constraining for some policy instruments than for others: more constraining for tariffs, quantitative restrictions, local content requirements; medium constraining for government procurement, intellectual property, export subsidies in agriculture; and least constraining for devaluations, investment incentives, trade finance and export taxes, for example.

Second, the State can act more – or less – strategically in attracting selected portions of global value chains into its territory. It can bargain hard with a TNC to maximize the transfer of skills into the heads of citizens, or it can let the corporation decide by itself how many citizens to employ in which stages of which operations. Throughout the fast catch-up phase, the public authorities of the Republic of Korea and Taiwan Province of China bargained hard with

incoming TNCs, in a way that public authorities in many other developing countries (Chile and Hong Kong (China), for two) did not.¹ Indeed, some studies argue that policymakers in the Republic of Korea and Taiwan Province of China continue to practice activist industrial policy, even as they keep their interventions much more covert than in the past.²

In other words, the leaders of a State may buy into the prevailing liberal ideology that they can best promote development by improving the institutional and physical framework for markets, in the hope that, *having made a level playing field in line with the World Bank's criteria (as in its Doing Business reports), the players will turn up to play*. Accordingly, private profit-seeking investors – domestic and foreign – responding to incremental price signals, will diversify and upgrade production sufficiently to keep incomes rising. Alternatively, the leaders of the State can use the remaining room for policy manoeuvre to promote non-incremental jumps in the product and technology space, in the spirit of developmental State Mark II. In countries as varied as Argentina, Nigeria, Thailand and the United Kingdom, State leaders *could* still today undertake entrepreneurial roles,³ even accepting that anything like the developmental States of East Asia of the post-war decades – building up indigenously-controlled major industrial sectors in cars, chemicals, petrochemicals and electronics – is unlikely (Wade, 1990; 2003a; 2003b).

Indeed, new evidence suggests that since 2008 and the long slump, many developed and developing country States – whatever they say – have moved further away from “level playing field” policies and intensified *policy selectivity* by sector, location and ownership. This is the finding of Vinod Aggarwal and

Simon Evenett (2010), who draw upon the Global Trade Alert data set for the United States, major EU countries, Argentina, Brazil China, India and others. Much of the resulting “industrial policy” (although generally not called that) is directed at “green” products and processes, which softens neoclassical censure (albeit not as much as “military” does). States have generally avoided tariffs and quantitative restrictions (which, as noted, are in the “more constrained” category of WTO rules). They have employed modes subject to “medium” or “low” WTO restraint, such as public procurement, discriminatory subsidies and bailouts (“murky protection”).

In short, the quantum of industrial policy has gone up since 2008, especially for green investments. WTO rules have affected the *composition* of industrial policy instruments, rather than curbing the *quantum*.

The developmental State Mark II is all the more important for the many middle-income countries

that find themselves in the squeeze described earlier, where their producers cannot compete with low-wage countries in standard goods and do not have capabilities to compete in exports of skill- and knowledge-intensive goods and services. China’s position as the workshop of the world across a wide range of manufactured products (more accurately, the assembly workshop of the world, drawing upon parts and components produced elsewhere, particularly in regional value chains spanning East and South-East Asia) intensifies the squeeze on others. Across swathes of manufacturing, China has enjoyed absolute – not just relative – cost advantages over producers elsewhere, while its exports have been knocking out manufacturing employment in both middle- and high-income countries. The idea that governments should hew to neoclassical principles in response to this competitive squeeze and limit themselves to investing in the basic ingredients of State fiscal and legal capacity, as well as leaving the outcome to the Invisible Hand mechanism, is – to put it politely – debatable.

III. “New structural economics” and industrial policy

Justin Yifu Lin, chief economist at the World Bank from 2008 to 2012, is a leading proponent of “new structural economics”. He argues, first, that market prices give signals for *incremental* change, but can block larger economic diversification and innovation. Second, governments can usefully push or incentivize firms to diversify and upgrade their production, giving more encouragement to some activities ahead of others. Third, government efforts should remain within the economy’s *existing* comparative advantage, because firms operating within existing comparative advantage are more likely to attain and sustain private profitability (and not depend on continued government support). Fourth, comparative advantage itself will evolve over time as endowments change. Accordingly, investing in line with today’s comparative advantage alters tomorrow’s endowment structure, which alters tomorrow’s comparative advantage and permits sustainable (because privately profitable) production diversification and upgrading relative to today.

The underlying image is of a vast, continuously improving Toyota-style production system in which different products have different growth potential and opportunities and constraints are identified *as they emerge over time*. Learning and self-discovery by actors – private and public – are central.

Lin calls his approach the “comparative-advantage-following” strategy, in contrast to the “comparative-advantage-defying” strategy. He spells out five operational steps for a specific country (Lin, 2010; 2012):

- (1) Government identifies a list of goods and services produced over the previous two decades in dynamically growing countries with similar endowment structures and average GDP 100 per cent higher.
- (2) Among the resulting list, government gives priority to those products that some domestic

private firms have already started to produce, and helps remove obstacles to their growth and upgrading. For products not locally produced, government could adopt specific measures to attract firms in higher-income countries to invest in these industries.

- (3) Government should pay attention to private enterprises' independent discoveries of successful products that are not included in the list, as well as providing support to scale up those industries.
- (4) In developing countries with poor infrastructure and unfriendly business environment, government can invest in industrial parks or export processing zones and make improvements to attract domestic private firms and/or foreign firms willing to invest in the targeted industries.
- (5) Government should give limited incentives for domestic firms or foreign investors that work within the list of products in step (1) to compensate them for the *public* knowledge created by their private investments.

Lin stresses that targeted public support must be confined to activities *within* the economy's existing comparative advantage. This is a useful defence against the standard accusation that any sectorally targeted support amounts to "government picking winners". However, he has been reluctant to identify criteria for distinguishing investments within and without the economy's existing comparative advantage.

For example, the Cambridge University-based economist Ha-Joon Chang, born in the Republic of Korea, emphasizes more than Lin that what an economy produces today determines the skill and comparative advantage of tomorrow – an effect that is external to private decision making and "undersupplied" if resource allocation is left to private agents.

Chang argues that Japan's push into steel, autos, ships and the like in the late-1950s and early-1960s, when its per capita income was only 19 per cent that of the United States (1961, at market exchange rates), was beyond its existing comparative advantage. The same applies for the Republic of Korea's push into heavy and chemical industries in the late-1960s, when its per capita income was only 6 per cent that of the United States, as well as its push into semiconductors in 1983, when its per capita income was still only 14 per cent that of the United States.

On the face of it, these combinations of products and relative average income suggest that Japan and the Republic of Korea invested heavily in products far above their existing comparative advantage (for example, far above the products being produced in countries with average income twice theirs at the time, in line with Lin's step one).

Lin replied that these moves were indeed *within* the country's comparative advantage at the time. In the Republic of Korea, POSCO, the giant State-owned steel company established in 1968 against strong World Bank advice, which soon became the most efficient maker of basic steel products in the world: "[B]uilt upon the success of development in garments, wigs, footwear, and other labour-intensive industries..., [the Republic of] Korea accumulated capital and the capital intensity of its endowment structure increased. From the perspective of the comparative-advantage-following strategy, the upgrading of a few firms into more capital-intensive industries became a necessity".

Lin continued: "Industries such as steel production and shipbuilding were among the most advanced industries globally in the nineteenth century, but by the mid-twentieth century they no longer held this leading-edge position... Investments in these mature industries required a large amount of capital, compared with traditional labour-intensive industries, but their capital intensities were much lower than in the emergent industries. It is therefore not surprising that, with some government support for overcoming the difficulty of mobilising a large amount of capital in an economy with an underdeveloped financial sector, these industries are viable in an economy that have achieved or are approaching lower-middle-income status" (Lin and Chang, 2009: 499).

However, Lin's argument smacks of tautology: the fact that Japan and the Republic of Korea succeeded in the given industries means that those industries with those technologies *must have been* within their existing comparative advantage. More generally, the principle that industrial policy should remain within existing comparative advantage seems to advise a Stone-Age economy trading with an information and communication technology economy to continue specialising in the production of stone-intensive products as though this is the optimal equilibrium (Salazar-Xirinachs and Nubler, 2010; Wade 2014c).

The debate between Lin and Chang leaves unmentioned a surprising fact: we know little about how East Asian industrial policymakers – in Japan and Taiwan Province of China from the 1950s, the Republic of Korea from the 1960s – went about identifying priority sectors or priority firms and changing support for the targeted industries and firms over time.

My own research on East Asian industrial policy identified two modes of targeted public support (Wade, 1990; 2003a): first, “government leadership”, where the government allocates public resources to industries where the private sector is not willing to invest on its own; and second, “government followership”, where the government comes in to underwrite *some* of the bets that the private sector has already made or would be prepared to make on its own. An example of followership is the work of Taiwan Province of China’s Industrial Development Bureau in its role as an industrial extension service (parallel to an agricultural extension service). Its employees (about 150 by the early-1980s, mostly engineers) visited factories up and down the country at frequent intervals, and among other things kept nudging owners and managers to rearrange the production line, buy a new kind of machine tool, upgrade quality, diversify products, link up with subsidiaries of TNCs producing in Taiwan Province of China and hunt out export markets. They kept a close eye on parts and components being imported by big foreign firms or firms of Taiwan Province of China, and looked for promising opportunities to “persuade” big firms to switch their sources of supply from imports

to domestic producers, without having to take too great a hit in price or quality. They regarded import replacement and export promotion as “two wings of the same bird”. Of course, the same bureau was also involved in promoting the “big lump” investments in upstream sectors, as were apex bodies like the Council for Economic Planning and Development and the Science and Technology Advisory Board.

Over time in any one sector, one can trace periods of “leadership” and “followership” in various sequences, as well as the default mode of no targeted support at all. In terms of this distinction, “followership” is close to Lin’s advocacy of government support for activities within the economy’s current comparative advantage, while “leadership” is close to Chang’s advocacy of public support for investments beyond current comparative advantage. We can think of government “leadership” as like “stretching” comparative advantage, in an analogy with a rubber membrane.

What is missing from their arguments is the point just made, namely that over time in any one sector one should see movement between the three modes; for example, an initial period of “government leadership” in one sector may give way to more limited support for private sector initiatives (“followership”) and then to no targeted support. Moreover, what is missing from Lin, but not from Chang, is the recognition that trade protection may be a justified instrument of followership and leadership, especially where State fiscal capacity to raise broad-based taxes is relatively low.

IV. Political and organizational determinants of industrial policy

The literature tends to concentrate on what the State should do, using which instruments, whereas it tends to leave unexamined the determinants of State effectiveness (Devlin and Moguillansky, 2011, is a useful exception). We can think of these at two levels: first, the macro level of State-society relations and the political settlements behind them referred to earlier; and second, the more micro level of State agencies, in particular, industrial policy agencies.

A. State-society relations

In terms of the first, a State executive has a broad choice between (a) building generic State capacity (fiscal, legal, bureaucratic, military) or (b) building specific State capacity to redistribute resources to itself and its group at the expense of would-be incumbents, using legal subterfuge, repression or violence to exclude opponents. Where the State lacks

experience of constitutional constraints and democratic accountability, electoral victors are more likely to follow the second route and adopt winners-take-all strategies, shutting out the opposition and governing as they see fit. Few States of this kind have been able to mount effective industrial policies. Most of the exceptions (China is one) have sustained enough State discipline to provide public goods (as well as redistributive goods) because they see themselves facing powerful external enemies, whose existence induces internal solidarity and acquiescence. On the other hand, where the State operates in conjunction with a cohesive capitalist class, the prospects for effective industrial policy are considerably improved.

The short answer to why the East Asian capitalist developmental States took the form they did is that (a) their societies faced external State-based enemies capable of overwhelming the whole society, and (b) the owners and managers of capital faced episodes of labour militancy early on. The famed “embedded autonomy” of the East Asian developmental State came out of co-determination between external military threats, State fiscal, legal and bureaucratic capacity, as well as State constraints on capital and especially labour (Evans, 1995).

B. Making effective industrial policy bureaucracies

The Politics of Public Sector Performance: Pockets of Excellence in Developing Countries, edited by Michael Roll (2014), uses an inductive approach to identify characteristics of State agencies that distinguish themselves from the surrounding bureaucratic swamp by being effective in carrying out their mission. The case studies range across Brazil (the National Development Bank), Nigeria (National Agency for Food and Drug Administration and Control), Surinam (State Oil Company), mainland China before 1949 (Sino-Foreign Salt Inspectorate), Taiwan Province of China after 1949 (Joint Commission for Rural Reconstruction) and State-owned enterprises in rentier States. From these case studies, Roll induces several necessary (but not sufficient) conditions for “pockets of effectiveness”.

The first condition is a strong head of government (or a small, coherent elite), which has strong commitment to particular tasks – like industrial diversification and upgrading – being done effectively.

His or her motives may be defence against external enemies, national prestige or international prestige.

Second, the head of government breaks with normal – patronage – appointment criteria, possibly against a lot of elite opposition. Instead, criteria for appointment to top positions in the agency emphasize technical qualifications, proven leadership and proven incorruptibility. The agency director or chief executive officer (CEO) comes from *outside* the inner elite and is connected to it through “weak ties”. This makes the CEO less vulnerable to the *insider’s dilemma*: the insider head of an agency is under pressure to allocate jobs, contracts and other public resources to other members of the elite network, or risk their own career and effectiveness from insider attacks; but stuffing the agency with officials recruited on patronage networks is likely to render the agency ineffective, which can also risk the CEO’s career.

Therefore, prior to the appointment, the tie between the CEO-to-be and the president is a weak one; they usually do not know each other well, because the candidate comes from outside the inner elite. However, once selected, the third necessary condition – the link between the CEO and the president – must become a *strong* one, because the CEO heavily depends on the president’s support to defend him/her against the established elite’s attacks. However, the link to the rest of the elite remains *weak*.

Fourth, the strong tie to the head of government helps to secure the necessary bureaucratic autonomy – necessary because the agency will often conflict with politicians and firms with contrary interests (e.g. firms wanting continued protection despite non-performance). However, autonomy does not mean separation or no contact, and it is not fixed and based on law. Paradoxically, *autonomy depends on political connections and is inherently relational*. Agency managers must constantly manipulate their external environment to secure their autonomy, using connections to politicians, corporations, unions and other powerful entities.

Fifth, the director must be free to appoint members to the management teams and select staff who are committed to the mission (“principled agents”), most of whom come from outside political elite networks (some from private companies or overseas). Salaries and benefits are higher than in the regular civil service. However, the ethos of the agency is such

that performance does not mainly depend on extrinsic incentives (money); rather, staff work conscientiously mainly due to *intrinsic* incentives, because they see their job as meaningful for national development. Intrinsic motivation helps agency effectiveness because it reduces the director's costs of controlling staff. In the language of principal-agent analysis, it reduces the principal's cost of controlling agents.

Sixth, an agency that aims to be a “pocket of effectiveness” in a bureaucratic swamp must change

internal and external expectations of the agency's *modus operandi*. The key instruments are (1) standardization of procedures (for example, procedures for project appraisals and project decisions) and (2) regular evaluations of agency performance. In relations with the outside, the standardization of procedures enhances predictability for clients and reduces the incentives for bribes. In relations within the agency, standardization raises staff confidence in the information they receive from others, rendering it unnecessary for them to check it for themselves.

V. The future of industrial policy

Many advanced and developing countries are worried about the erosion of manufacturing in the face of Chinese competition, many middle-income countries are worried about being stuck in the middle-income trap, many lower-income countries are worried about being stuck as commodity exporters, running faster to stand still, while many governments – developed and developing – are trying to target investment in “green” industries.

These trends have helped to rekindle a broad interest in industrial policy, and national strategy more generally, in developing countries. The arrival of China as a major “aid” donor and foreign investor in Africa, Latin America, and other parts of the developing world has forced recognition in host governments that if they are not to repeat their earlier failure to set the terms of engagement with western “aid” and foreign investment, they must formulate national development strategies and ensure that Chinese investment meets their own development agenda, rather than just China's.

Several prominent development economists have started to make the academic field bubble. Some of the recent writing suggests flaws in the earlier evidence used to discredit sectoral industrial policy, drawing attention to previously neglected soft-meso forms of industrial policy (such as the United States form described earlier). Other development specialists have focused on the important question of how to constrain politicians and officials to provide services (including industrial policy) that meet a national interest test rather than a sectarian interest test (Besley and Persson, 2011).

Some middle-income countries' governments draw inspiration from East Asian experience and have been trying to use their growing voice in multilateral development banks to change norms in favour of doing industrial policy better, rather than simply less (Wade, 2011).

It is often said that the rules of the international economic order constitute a significant constraint on effective industrial policy; indeed, it is true that WTO rules make a large part of East Asia's earlier development interventions actionable or illegal (Wade, 2003b). Here, however, the neglected distinction between hard and soft industrial policy – or leadership and followership – is important, because most of what the WTO makes actionable or illegal is towards the hard end of the spectrum (protection, subsidies, quantitative import restrictions and the like).

Developing country governments should exploit this policy space, even as they try to modify the larger framework of rules to allow more use of harder measures. They should recognize that although the East Asian, French and Brazilian developmental State of the post-war decades is not a viable option today (except perhaps in a few of the largest developing countries), this is not the end of the story; rather, scope remains for the developmental State Mark II.

However, we should not underestimate the forces arranged against any more positive role of government. Economics as a discipline has failed to produce positive theories that match the pervasive role of the State in most economies, as distinct from theories (such as those of James Buchanan and

George Stigler) that show the State as self-serving and predatory, while the same theories give private firms a largely free pass. The failure reflects an ideological idea of the good society embedded in the DNA of the neoclassical discipline, in which the government's appropriate role is to protect free markets and "fix" occasional market failure when the Invisible Hand does not produce satisfactory results. The operating procedures and loan conditions of western-run organizations like the World Bank institutionalize the idea of the free market as the optimal resource allocation mechanism.

Indeed, efforts to promote the idea of industrial policy in international organizations have encountered strong resistance from within the staff, as well as from member States. When Justin Yifu Lin was chief economist of the World Bank, only one vice president showed an interest in trying to put his ideas on industrial policy into modest practice, in the form of several pilot projects under the name "Competitive Industries program". For all that Lin insisted on the orthodoxy of his approach (industrial policy should only assist activities within the economy's existing comparative advantage, not stretch it), Lin himself admits that during his time as chief economist less than 10 per cent of World Bank economists were sympathetic to his arguments (personal communication, 2010). Under Lin's successor, the chief economist's complex "is mainly run these days by a Director of Development Policy who strongly opposes any form of active government strategy" (personal communication, July 2014). In the operations complex, the new Senior Director most relevant to continuing the Competitive Industries programme closed it down on the grounds that "she understands industrial policy only as the failed import-substitution

policies implemented in Latin America in the 1960s". Therefore, post-Lin, the World Bank has played little part in the new interest in industrial policy.

In the case of the OECD and its *Perspectives on Global Development 2013: Industrial Policies in a Changing World*, several of the staff of seven delegated to produce the report made it clear that they doubted the wisdom of industrial policy. Senior OECD managers kept asking, "are we really sure the OECD should endorse industrial policy?" (personal communication, 2013).

As for UNIDO, its big push for Inclusive and Sustainable Industrial Development is a kind of gamble for resurrection. As big western States have terminated or are terminating their membership of UNIDO, it faces a budget crisis and appointed a Chinese national as director-general in 2013 in the hope that China will be able to elicit more buy-in from developing countries and avoid staff cuts (such as those in UNDP, where about 20 per cent of its 5,000 staff have recently been made redundant). Industrial policy is the substance around which the organization is trying to elicit this buy-in from developing countries, even at the risk of further alienating western States that continue to say that industrial policy is a bad idea.

In short, developing country policymakers should be cautious about accepting economists' negative judgements about industrial policy, and doubly cautious about accepting politicians' negative judgements of the kind made by the former German Chancellor Helmut Schmidt, referring to national exercises in foresight, "people who have visions should see a doctor".

Notes

- 1 Enos and Park (1988) report that in the 1970s, when the public authorities of the Republic of Korea, Chile and Hong Kong (China) ordered the same ethylene plant from Dow Chemicals, the Republic of Korea pressed Dow much harder to employ nationals across the several stages of the project; and the ratio of nationals to regular Dow employees increased in each of the two subsequent plants the Republic of Korea ordered from Dow. This case fits a motto heard in the Republic of Korea “we never learn anything twice” (Wade, 1982).
- 2 See Chu (2009), who argues: “In seeking to attain its development goals, the Korean state articulates visions and deploys public resources to structure the market and shape innovation”.
- 3 While even a State like the United Kingdom *could* undertake an entrepreneurial role, the December 2013 report of its House of Commons liaison committee about the future of the civil service identified a fundamental problem in the pervasive “belief in incremental change versus long-term vision” (Jenkins, 2013).

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THE REAL EXCHANGE RATE AS A TARGET OF MACROECONOMIC POLICY

*Roberto Frenkel and Martín Rapetti**

Abstract

In recent years, several authors have argued that developing countries should aim to target a stable and competitive real exchange rate (SCRER) to foster economic growth. A growing body of empirical research gives support to this claim. Although more theoretical work is needed, some ideas from development theory can help to explain the empirical findings. For instance, if modern tradable activities display some form of increasing returns to scale, market forces alone would deliver a set of relative prices to render capital accumulation in these activities suboptimal. This chapter supports the view that developing countries could target SCRER as part of a development strategy that promotes the expansion of modern tradable activities. We review the empirical findings, discuss the channels through which a SCRER can stimulate economic growth and describe the policies needed to pursue a strategy based on a SCRER.

Introduction

In recent years, the idea that a stable and competitive real exchange rate (SCRER) can foster economic growth in developing countries has gained much attention, with a growing body of research having provided persuasive evidence indicating that undervaluation of the currency – a high real exchange rate (RER) level – is positively associated with higher economic growth. Moreover, research has also documented that RER volatility negatively affects growth. Based on this and other more episodic evidence, some economists and analysts have started to advocate that developing countries should target a SCRER as part of their development strategy.

The aim of this chapter is to take stock of the work – including ours – that has addressed different

aspects of the SCRER strategy for development, focusing on what we consider the three main issues. First, we review in section I the empirical literature finding evidence that SCRER is positively associated with economic growth. Second, we discuss the mechanisms that could explain such an association and their supporting evidence or lack of it. In section II, we explore the theoretical and practical aspects of macroeconomic management in a framework that targets a SCRER while attaining full employment, low inflation and balance of payments sustainability. We conclude the chapter in section III with some final remarks.

Before moving on, some definitions are in order. We define the exchange rate as the domestic price of

* The authors thank Emiliano Libman for his comments on the chapter.

a foreign currency. Consequently, a rise (fall) in the nominal/real exchange rate implies a nominal/real depreciation (appreciation) of the domestic currency. The RER is the relative price between tradables and non-tradables. A competitive RER level is one that is above its equilibrium level.¹ We generally refer

to a competitive RER level as the level at which the modern tradable sector of a developing economy reaches a risk-adjusted profit rate equal to that of the same sector in a developed economy.² We use competitive or high RER and undervalued domestic currency indistinctively throughout this chapter.

I. SCRER and economic performance³

The relationship between the RER, real wages and output usually generates some confusion. On the one hand, it is commonly accepted that real currency depreciation has a negative impact on output level in the short run. A standard Keynesian/Structuralist interpretation is that real depreciation redistributes income against wage earners, who have a large propensity to spend, and thus it contracts aggregate demand and output levels. Another common mechanism is the negative balance sheet effect of devaluation when debts are issued in foreign currency. On the other hand, the proposition that we develop in this chapter claims that a stable and competitive level of the RER – through mechanisms discussed below – has a positive effect on the rate of growth of output and real wages in the medium run.⁴

The two propositions are not contradictory: the former refers to the *short-run* effects of a *change* in the RER on output *level*, and the latter to the *medium-run* effects of the *level* (and stability) of the RER on the *rate of change* of output (i.e., economic growth). While there is a good deal of evidence supporting the first proposition,⁵ the second one is more controversial. Below, we review a recent body of research that supports the second proposition and the mechanisms involved.

A. Empirical evidence

Most empirical work analysing the association between RER levels and economic growth has been conducted through growth regressions, finding substantial evidence that competitive and stable RER levels tend to be associated with higher GDP per capita growth rates. The association appears robust to changes in the estimation technique – cross-section OLS, panel data (fixed and random effects), dynamic

panel data (GMM), non-linear panels and panel cointegration techniques –, the number of control variables and the data sources for both the dependent and independent variables.

An interesting result is that the RER-growth association seems to be especially strong in developing countries. Rodrik (2008) tests whether there is any significant difference between developed and developing countries. He uses a fixed-effects model for a panel of up to 184 countries between 1950 and 2004 and defines developing countries as those with a GDP per capita less than \$6,000 in constant dollars of 2005. He finds that the positive relationship between RER competitiveness and economic growth is stronger and more significant for developing than developed countries. Rapetti et al. (2012) replicate Rodrik's work and show that if the threshold is selected from anywhere in the \$9,000–\$15,000 range, the estimated effect of RER competitiveness on developed countries' growth is similar to that estimated for developing countries. Given the fragility of Rodrik's result, they investigate the issue in more detail by developing a series of alternative developed/developing countries splits and conducting different empirical strategies, finding that the effect of currency undervaluation on growth is indeed larger and more robust for developing economies. Extending the analysis for a substantially longer period, Di Nino et al. (2011) also find supporting evidence that the relationship is strong for developing countries and weak for advanced countries in both the pre- and post-World War II period (1861–1939 vs. 1950–2009). Other studies, like Cottani et al. (1990), Dollar (1992) and Gala (2008), focus exclusively on developing countries and find similar evidence of the positive effect of RER competitiveness on growth.

Since most of studies have used RER misalignment indexes as measures of RER levels, a valid

concern is whether the results are driven by cases of RER overvaluation decelerating economic growth. Put differently, the positive relationship between RER levels and growth rates may result from low RER levels decelerating growth, which also implies a positive association between RER levels and growth rates. Nonetheless, several studies have explicitly addressed this concern.

Razin and Collins (1999) use a pooled sample of 93 developed and developing countries over 16 to 18 year periods since 1975, finding that currency overvaluation hurts and undervaluation favours growth, although the effect of overvaluation appears stronger. Aguirre and Calderón (2005) find that the estimated coefficients of their RER misalignment indexes are larger for cases of overvaluation than those of undervaluation; but here, again, the positive effect of undervaluation on growth is both statistically and economically significant. Rodrik (2008) finds that overvaluation hurts growth and undervaluation favours growth and reports no significant difference in terms of the size of each effect. Rapetti et al. (2012) find similar results to Rodrik's, although the effect of overvaluation is slightly higher in absolute terms than that of undervaluation. Bereau et al. (2012) use panel non-linear techniques – i.e. a Panel Smooth Transition Regression model – to capture whether there are asymmetries between RER undervaluation and overvaluation. They find robust evidence that undervaluation accelerates and overvaluation decelerates growth, with a similar strength.

Other studies have tested whether the RER-growth association is robust to measurement errors in the dependent and independent variable. MacDonald and Vieira (2010) construct seven different indexes of RER misalignment and use them alternatively on the right-hand side of the growth regressions. They find a significant and positive correlation between RER competitiveness and economic growth, which is stronger for developing and emerging countries. Razmi et al. (2012) use the rate of investment growth as the dependent variable, finding a strong positive association with RER levels.

Many empirical studies have used Penn World Tables (PWT) data for the dependent variable (i.e. GDP per capita growth). Johnson et al. (2009) show that GDP estimates vary substantially across different versions of the PWT and that the results of many published studies employing PWT growth rates – especially those using higher frequency – are fragile when changing from

older to newer versions of the PWT. Libman (2014) address this issue by using growth rates from data sources other than the PWT, such as International Financial Statistics, World Development Indicators and Maddison Historical Statistics and finds that the positive RER-growth association holds.

Other studies have used different empirical strategies, like case and episode studies or historical analyses and also found supporting evidence that SCRERs favour economic growth. Hausmann et al. (2005) identify and analyse determinants of 'growth episodes' in the latter half of the twentieth century, finding that adjustments of RER towards more competitive levels tend to precede sustained growth spurts. Frenkel and Rapetti (2012) carry out a historical analysis of exchange rate regimes and economic performance in Latin America and find that countries have tended to grow faster when macroeconomic policies aimed to maintain SCRERs. Regarding the role of RER stability, Cottani et al. (1990), Eichengreen (2008) and Rapetti et al. (2012) have found supportive evidence that RER volatility is negatively associated with GDP growth.

B. Mechanisms

Research has established a robust positive association between RER levels and economic growth. Although there might be some room for debate, it seems widely accepted that the causality runs from RER levels to economic growth. Every-day experience shows that governments use a variety of instruments – including exchange rate, monetary, fiscal, incomes and capital management policies – to manage the level and stability of the RER with real objectives. Thus, the relevant question is not about causality but rather the mechanism explaining why undervalued (overvalued) RER levels would favour (hurt) economic growth. Below, we discuss the mechanisms that we consider more plausible.

One such mechanism focuses on the effects of capital movements on the RER and the probability of crisis. An extreme form of this mechanism arises as a result of currency overvaluation caused by massive capital inflows, which eventually leads to currency, financial and debt crises with a long-lasting negative impact on growth. Indeed, a number of developing countries – mostly in Latin America – have experienced this type of boom-and-bust episodes.⁶ Many of these episodes began with the implementation of

macroeconomic programmes that combined fixed or semi-fixed exchange rates, liberalized current and capital accounts and the deregulation of domestic financial markets. In a first phase, the combination of these elements stimulated capital inflows that appreciated the domestic currency in real terms, expanded economic activity and induced current account deficits. In many cases, a consumption boom ensued without a rise in the investment rate. Even when investment increased, the overvaluation of the currency favoured investment in non-tradable activities with little increase in the export capacity required to repay foreign debt.

In a second phase, the excessive external borrowing raised concerns about the sustainability of the fixed exchange rate regimes and triggered speculative attacks against the domestic currencies, whereby the effect of capital outflows was typically contractionary. The domestic banking systems – which had currency mismatch between dollarized liabilities and assets in domestic currency – faced liquidity problems and went bankrupt in many cases, exacerbating the negative impact on economic activity. In cases in which the collapse of the financial system was severe and the foreign (private and public) debt burden was very high, the crises had long-lasting effects on economic growth. Clear examples of these dynamics are the stabilization programmes based on active crawling pegs (the so-called *tablitas*) in Argentina, Chile and Uruguay during the late-1970s, which ended up in severe debt crises that crippled growth during the ‘lost decade’ of the 1980s. Other stabilization programmes leading to crises occurred during the 1990s in Mexico (1994–1995), Brazil (1998–1999), Argentina (2001–2002) and Uruguay (2002). Taylor (1998) suggests that this kind of cyclical dynamics was also observed in the South East Asian crises of 1997–1998, while Bagnai (2012), Cesaratto (2012) and Frenkel (2013) argue similarly concerning the current crisis in the southern European countries.

Historical records are supportive of this mechanism for the case of currency overvaluation and low or negative growth via the effects of crises, with more recent experience in emerging market accounting for the positive association observed between high/competitive RERs and faster growth. Several authors have indicated that undervalued currency help to stabilize long-term growth by limiting external debt accumulation and avoiding contractionary effects of sudden stops (Prasad et al., 2007). Competitive RERs typically generate current account surpluses and facilitate

foreign exchange (FX) reserve accumulation, which in turn operate as an insurance against international financial instability and sudden stops. Recent research supports this view, with Aizenman and Lee (2007) finding evidence suggesting that international reserve accumulation in emerging markets has been carried out as a self-insurance strategy to protect the economy from sudden stops. Polterovich and Popov (2003) and Levi Yeyati et al. (2013) find a positive correlation between FX reserve accumulation and RER levels, as well as between reserve accumulation and economic growth. Similarly, Prasad et al. (2007) find that current account balances are highly and positively associated with both undervalued currencies and economic growth.

The mechanism discussed above highlights that international capital markets operate with many imperfections that can jeopardize long-term economic performance, particularly in developing countries. Consequently, these countries need to establish safe linkages with international markets to minimize their reliance on foreign savings and the probability of crises. It is important to note that this refers to the composition of savings. A higher RER helps to reduce the domestic absorption of tradables while promoting the domestic production of tradables, thus lowering *foreign* saving. At the same time, a higher RER level implies a transfer of income from workers to firms via the decline in real wages generated by the rise in tradable prices. If workers have a lower propensity to save than firms, the redistribution would result in higher *domestic* savings. The effect of a higher RER level on *aggregate* savings would be determined by the effect of these two. While evidence concerning the complete effect is not entirely clear, it seems to suggest that RER levels and aggregate saving rates are positively associated.

In our view, the strongest mechanism is one that rests on the key role that “modern” tradable activities play in the process of economic development. Essentially, this mechanism perceives economic development as a process characterized by a rapid and intense structural transformation from low-productivity to high-productivity activities that are largely tradable. While “modern” tradables have traditionally been associated with manufactures, there is now recognition that some services (e.g., software) and knowledge-intensive agricultural activities (e.g., seed production) are also part of this group. The tradable-led growth channel can be seen as comprising three broad elements:

- (i) Modern tradable activities are intrinsically more productive or operate under some sort of increasing returns to scale.⁷
- (ii) Given this trait, the reallocation of (current and future) resources to these activities – i.e. structural change – accelerates GDP per capita growth.
- (iii) Accumulation in these activities depends on their profitability, which in turn depends on the level of the RER. Rapid capital accumulation requires a sufficiently competitive (high) RER to compensate for the market failures caused by the increasing returns.

A large number of specific mechanisms have been advanced with this general logic. In an influential article, Rodrik (2008) indicates that modern tradable activities are disproportionately affected by market and institutional failures. Using an endogenous growth model, he shows that the resulting misallocation of resources towards non-tradables leads to slower economic growth, whereby a high RER can be a second-best policy that compensates for the market and institutional failures, improves tradable profitability and accelerates economic growth.

Of course, Rodrik is not the first to emphasise the important interplay between RER levels and market failures in economic development. Learning externalities, for instance, imply that infant industries in the tradable sector can benefit from temporary protection against foreign competition via a transitory trade policy or currency undervaluation (Ros, 2013). Similarly, temporary currency overvaluation can lead to de-industrialization and lower growth – as in the Dutch disease case – when tradable firms' production is subject to some form of increasing returns to scale (e.g. Krugman, 1987, and Ros and Skott, 1998). The opposite case – transitory currency undervaluation – can spur a virtuous dynamics of structural change and economic development (Rapetti, 2013). Models of export-led growth and modern trade theory have emphasized positive externalities that are not equally prevalent in non-export activities; therefore, policies reallocating resources to export industries – like a SCRRER policy – promote higher growth (e.g. de Melo and Robinson, 1992).

Another mechanism emphasizes that the lack of FX may constrain economic growth in

developing countries. This idea has a long tradition in the United Nations Economic Commission for Latin America and the Caribbean (CEPAL) structuralist economics (Ocampo, 2014) and the balance-of-payments-constrained growth literature initiated by Thirwall (1979). However, it remains a matter of debate whether the RER can help to alleviate the FX constrain and favour growth. Under the “elasticity pessimism” view of the old structuralists, the level of the RER was unimportant. A similar view emerges from the Thirwall-type of models. In such settings, long-run growth is demand constrained, i.e. constrained by foreign *demand* of domestic tradables (i.e. exports). The level of the RER is neutral on growth dynamics because only a continuous real depreciation can foster growth via substitution effects on a given rate of foreign demand growth.

These pessimistic views overlook the possibility that the FX constraint on growth may depend on supply-side factors. As emphasized above, the RER is a key determinant of tradable profitability and thus capital accumulation: in other words, the level of RER is a key determinant of the long-run *supply* of domestic tradables. If foreign demand for (at least) some tradables is large at a given international price (i.e., highly or perfectly elastic), then a higher RER level would increase exports, relax the FX constraint and accelerate growth. Thus, the point under dispute is to what extent export growth depends on foreign demand growth *vis-à-vis* domestic tradable firms' ability to profitably expand their supply at the given international prices. Indeed, this has recently become an area of intense debate in certain circles.⁸ Evidence seems to side with the view that the level of the RER does play an important role in the behaviour of tradable supply and thus in relaxing the FX constraint on growth.

For instance, Freund and Pierola (2012) detect 92 episodes of sustained manufacturing export growth and show that they tend to be preceded by real currency undervaluations. Their findings suggest that high RERs help entry into new exports products and new markets (i.e. extensive margin) in developing countries. Colacelli (2010) also finds strong evidence that the extensive margin of trade is very responsive to RER changes. Cimoli et al. (2013) work with a panel of 111 countries over 1962–2008, finding that higher RERs favour export diversification. In turn, exports diversification is associated with an upgrading in the technological intensity of exports and higher economic growth. McMillan

and Rodrik (2011) use a panel data of nine sectors in 38 countries over the period 1990–2005 and find that level of the RER favours structural change in favour of modern tradables and the flow of labour from low-productivity to high-productivity tradable activities. Similarly, Eichengreen (2008) works with a panel of 28 industries for 40 emerging market countries covering the period 1985–2003, finding that higher and more stable RER levels favour tradable employment growth.

To summarize, there are both sensible explanations and a significant amount of evidence to believe that stable and competitive RER levels favour economic growth in developing countries. A SCRER appears to be growth-enhancing because it: (a) minimizes the risks of currency and financial crises and sudden stops; (b) relaxes the FX constraint on sustained economic growth; and more importantly, (c) stimulates modern tradable activities that are key for economic development.

II. SCRER management

From the strict perspective of conventional economic theory, managing a relative price – like the RER – sounds like a heresy. Because speeds of price adjustment vary from market to market and therefore some prices are stickier than others, conventional economic theory could concede that managing a relative price would only be possible in the short run. However, if deviations from equilibrium are only transitory, what would the purpose of such an objective be?

Economists know that the real world is substantially more complex than any abstract representation of it and that policy making requires some degree of eclecticism. This pervades the conduct of macroeconomic policy. For instance, it is widely recognized that nominal exchange rates – like the price of any other financial asset – are highly volatile and frequently follow long swings. Thus, conventional wisdom on macroeconomic policy suggests that central banks should curb RER movements that are not associated with changes in economic fundamentals. Most central banks in developing countries – where exchange rate volatility is high – follow this recipe. They conduct *sui generis* inflation-targeting regimes in which exchange rates are managed through interventions in the FX market that seek to avoid this kind of non-fundamental volatility.⁹

A SCRER strategy challenges this view because its goal is not to manage the RER to avoid short-run misalignments, but rather to keep it competitive in the medium run. As discussed in the previous section, a central assumption is that modern tradables operate under some form of increasing returns, thus making their expansion favourable for economic

growth. Economic theory establishes that multiple equilibria arise in the presence of increasing returns to scale. Targeting a SCRER can thus be conceived as a strategy seeking to move the economy from one equilibrium to another. Because some of the gains from investing are difficult to internalize by the firms under normal conditions, an RER higher than equilibrium gives proper incentives to invest. Sustained capital accumulation in the modern tradable sector puts the economy on a trajectory towards a better equilibrium, in which the size of this sector is significantly larger. However, if incentives are weak and volatile, capital accumulation may not follow. RER competitiveness thus has to be sufficiently stable and durable to induce investment, which may likely require managing the RER beyond the short run.

Targeting a SCRER beyond the short run is a strategy that has a long-run goal – i.e. to accelerate growth – but needs to be compatible with the conventional short-run goals of macroeconomic policy. In other words, macroeconomic policy under this regime needs to keep the RER stable and competitive while achieving full employment, low inflation (i.e. internal equilibrium) and current account sustainability (i.e. external balance). Addressing all these issues simultaneously is not an easy task; rather, it requires the coordination of several policies.

A. SCRER and external equilibrium

Attaining external equilibrium under a SCRER regime is probably the least controversial aspect. As discussed in section I, a SCRER strategy tends to be associated with current account surpluses or low

deficits and the accumulation of international reserves by the central bank, because it stimulates the supply of and limits the demand for tradables. Countries are in a stronger position to deal with negative external shocks and reduce the chances of sudden stops of capital inflows. Moreover, a SCRER strategy makes it very unlikely that the economy follows unsustainable trajectories regarding its international assets position. The most likely case is that the country would reduce its net foreign debt or increase its net asset position.

If anything, the concerns relate to whether accumulating foreign assets is *optimal*. While textbook treatments consider sustained current account deficits and surpluses as cases of external imbalances, this characterization misses an important distinction. A sustained current account deficit implies that domestic agents are continuously issuing foreign debt. In turn, a sustained current account surplus implies that domestic agents are postponing spending indefinitely. In the first case, the behaviour is probably desirable but unsustainable. One would like to consume beyond their means, but the problem is to find someone willing to finance such behaviour. In the second case, the behaviour is sustainable but arguably suboptimal. One can sustainably finance someone else's spending; rather, the issue is whether there is a reason to do so.

In the case of a country following a SCRER strategy, it may be desirable to accumulate foreign assets – and therefore finance other countries' spending – if the country manages to reach a higher level of development by doing so. The discussions about the “global imbalance” have never pointed to China's inability to maintain its current account surplus, but rather whether the United States could keep running current account deficits or the potential bubbles that such financing could cause on the United States and European financial markets. These considerations relate to the important issue of the global consequences of conducting a SCRER strategy, but are unrelated to specifics concerning how such a strategy is conducted at the national level.

B. SCRER and internal equilibrium¹⁰

Internal equilibrium – full employment with low inflation – is usually tackled through monetary policy. In the case of a SCRER strategy, the central bank needs to manage the nominal exchange rate to achieve the targeted SCRER, as well as the interest rate to regulate the liquidity and influence the pace

of aggregate demand. This immediately brings in the well-known policy trilemma, establishing that it is impossible for a central bank to simultaneously control the exchange rate and the interest rate in an economy open to capital flows.

One way to avoid such difficulties is to use controls on capital inflows. Several countries have successfully used this instrument. Evidence appears to suggest that capital controls reduce the share of short-term inflows and lower exchange rate volatility. Many scholars highlight the benefits of capital management techniques for macroeconomic management, especially in developing countries (Gallagher et al., 2012). Even the IMF, who had fiercely opposed them in the past, now perceives a role for them in the macroeconomic policy toolkit (IMF, 2010). Despite their increasing acceptance within the profession, it seems uncontroversial that they constitute an imperfect instrument to isolate domestic financial markets from the international capital market. If a central bank wants to use monetary and exchange rate policies simultaneously, it would surely need additional instruments.

Sterilized FX interventions can be useful in this regard. In a situation of excess supply of FX at the targeted exchange rate – a likely scenario in a country following a SCRER strategy that runs a current account surplus or a small deficit – the central bank can control both the prevailing exchange and the interest rate. It can purchase all the excess supply of international currency in the FX market and sterilize the monetary effect of such an intervention through issuing bonds in the money market. The central bank has two instruments available to achieve its two targets: intervention in the FX market to control the exchange rate and the sterilization in the money market to control the interest rate. Accordingly, Tinbergen's maxim is fulfilled.

A fully sterilized intervention in a situation of excess supply of international currency at the targeted exchange rate can be considered a policy implemented in two steps. First, the central bank's intervention in the FX market generates a monetary expansion. The resulting situation would show a higher amount of monetary base, the same amount of domestic bonds and an interest rate lower than the initial one. In the second step, the sterilization fully compensates for the change in the private portfolio that took place in the first step, whereby the central bank absorbs the increment of the monetary base

and issues an amount of domestic assets equal to the initial excess demand for domestic assets (the excess supply of international currency), returning the domestic interest rate to its previous level.

Note that the excess supply of international currency at the targeted exchange rate is tantamount to an excess demand of domestic assets. If the central bank can supply such an asset, the trilemma would be invalid.¹¹ Certainly, in a situation of excess demand of FX at the targeted exchange rate, the predictions of the trilemma continue to be valid. The central bank's capacity to intervene in such a situation is limited by its stock of international reserves. However, there is no symmetry between situations of excess demand and excess supply of FX: while the trilemma is valid in the first case, it is not true in the second. The asymmetry lies in the fact that in the first case, sterilization is constrained by a fixed stock (i.e. FX reserves), while in the second, sterilization may be carried out indefinitely due to an accommodating stock (i.e. the central bank's bonds). The central bank's ability to issue bonds but not FX reserves is the key difference. It seems that this conclusion is not generally acknowledged because the literature discussing monetary autonomy and exchange regimes rarely considers situations of excess supply of FX.

Even if circumventing the trilemma is feasible in cases of excess supply of foreign currency, one may wonder about the sustainability of such a strategy. This depends on the potential cost that the central bank faces when performing these operations. At a given targeted exchange rate, a sustained policy of fully sterilized interventions implies no change in the central bank's net worth. The asset side of its balance sheet increases by the increment of FX reserves and the liability side by the bonds issued to sterilize, with both magnitudes initially of equal value. The cost depends on the yield of the FX reserves compared to the interest rate that the sterilising bonds pay. Since FX reserves are typically allocated in low risk assets – e.g. United States bonds – the yield of FX reserves are likely to be lower than the bonds interest rate (Rodrik, 2006). However, note that the full cost of the operation also depends on the capital gains or losses associated with the variation of the exchange rate in time: if it depreciates (appreciates), the yield of FX reserves increases (diminishes) by the rate of depreciation. Note that if the central bank follows some sort of uncovered interest parity rule¹² to manage the exchange rate – devaluing by a rate equal to the difference between the interest rate that

the central bank's bonds pay and the one paid for the international reserves – the marginal cost of sterilization would be nil (Bofinger and Wollmershäuser, 2003). However, even if the marginal cost is positive, the policy may be financially sustainable. This would depend on the whole asset and liability structure of the central bank's balance sheet and the corresponding yields. Frenkel (2008) analyses sustainability conditions for sterilized FX interventions considering reasonable balance sheet structures, concluding that they are sustainable as long as the interest rate of monetary policy is “moderate”, which critically depends on sovereign and currency risk premia.

Sterilized FX intervention may be sustainable even if it generates a net positive cost to the central bank. This would imply that the Treasury has to finance the central bank's deficit, whereby this decision would depend on a cost-benefit analysis of the strategy. If the costs of the sterilized interventions on which the SCRER strategy is based are low compared to the benefits in terms of structural change and development, then it may worth financing them. As John Williamson (1996: 30) pointed out regarding the cost of sterilization in Chile's SCRER policy during the 1990s: “[if paying 1-1.5 per cent of GDP] is the price of preserving a model that works, it would be cheap”.

Despite the arguments developed thus far, it is possible that under certain conditions the interest rate required to attain internal equilibrium would be too high to make sterilization financially sustainable. Capital regulations could help in this scenario, but it is also imaginable that inflows would find ways to at least partially circumvent them. These considerations highlight the fact that financial integration with international markets makes monetary policy not completely independent. For this reason, fiscal policy also needs to play a role in the management of aggregate demand under a SCRER framework. Given that most public spending items and taxes are rigid and their modification typically requires legislative treatment, authorities need to develop some fiscal instrument that is sufficiently flexible to help monetary policy to conduct counter-cyclical policy. Indeed, some countries have successfully developed counter-cyclical fiscal funds that play such a role.

Managing aggregate demand under a SCRER strategy thus requires the coordination of policies, including exchange rate, monetary, capital account and fiscal policies. If correctly coordinated, macroeconomic policy can properly respond to shocks and

manage aggregate demand to attain internal equilibrium. However, it is important to bear in mind that a SCRER strategy can have an inflationary bias even if macroeconomic policy is adequately coordinated. A competitive or high RER implies that real wages – or more specifically, wages in terms of tradable prices – are lower than they could be if the RER were at equilibrium. Thus, even if aggregate demand is not generating inflationary pressures in the goods markets, inflation may still accelerate due to wage inflation pressures arising from workers' perception that wages are too low. Wage aspirations are not only influenced by the degree of unemployment, but also by history, social norms and institutions.

Thus, keeping a RER competitive beyond the short run may ultimately depend on developing some mechanism that makes workers' wage aspirations compatible with modern tradable sector's profitability. Authorities would need to convince workers and their leaders that their cooperation in terms of prudent wage aspirations are not only beneficial for modern tradable activities, but also workers themselves, because under cooperation real wages would be higher in the medium run. Social agreements between governments, firms and workers linking real wages to productivity in key tradable activities may thus be an important element in a successful competitive RER strategy for development.¹³

III. Conclusions

Today's mainstream approach to macroeconomic policy is to conduct inflation-targeting regimes with the dominant goal of a low and stable inflation rate. Additionally, exchange rates are managed through FX interventions seeking to avoid short-run volatility that is unassociated with economic fundamentals. A common result of this kind of approach has been RERs that are volatile and domestic currency is overvalued, which may represent an obstacle for long-run growth.

In this chapter, we have made the case for an alternative approach, suggesting that attaining standard

macro-policy objectives while targeting a SCRER is viable. The proposed scheme is certainly more complex than a standard inflation-targeting framework because it adds an additional target to macroeconomic policy, namely the RER. However, evidence persuasively suggests that SCRERs tend to foster economic growth and development. Therefore, developing countries should evaluate the possibility of adopting this development-friendly approach to macroeconomic policy.

Notes

- 1 Equilibrium RER is a concept that generates no few confusions and debates. For simplicity, we define it here as the one at which the economy is at macroeconomic equilibrium (i.e. full employment with low inflation and external balance). It depends on deep economic fundamentals (e.g. productivity), exogenous variables (e.g. international interest rate) and policy variables (e.g. public spending).
- 2 See Bresser-Pereira (2010) for a similar definition.
- 3 This part draws on Rapetti (2014).
- 4 While we do not discuss the association between RER levels and employment here, there is evidence suggesting that SCRERs tend to make growth more labour-intensive. See Frenkel and Ros (2006) and Damill and Frenkel (2012).
- 5 See, for instance, Razmi (2007) for a theoretical and empirical discussion and the references therein.
- 6 Frenkel (1983) analyses and formalizes this kind of dynamics. English readers can check Frenkel (2003) and Frenkel and Rapetti (2009).
- 7 This is a main characteristic emphasized by the pioneers of development economics such as Rosenstein-Rodan (1943) and Hirschman (1958).
- 8 See, for instance, Razmi (2013), Cimoli et al. (2013) and Marques Ribeiro et al. (2014).
- 9 See, for instance, the analysis of Chang (2008) for the case of Latin American inflation targeters.
- 10 This section draws on Frenkel (2007), Frenkel (2008), Frenkel and Rapetti (2008) and Rapetti (2013).
- 11 Except for special circumstances, public debt instruments – including those issued by the central bank – are the least risky assets in a developing economy. The interest rate of such instruments set the floor of the other interest rates in the economy. In fact, this is the very basis for conducting monetary policy via an interest rate set by the central bank. Thus, unless there is an institutional constraint, central banks should be able to offer such an asset and perform sterilization operations.
- 12 UIP stands for uncovered interest parity, which states that portfolio decisions should lead to domestic interest rate being equal to the sum of foreign interest rate and the expected rate of exchange rate variation.
- 13 In commodity-exporting countries, such an agreement could be complemented with special taxes on rents, whereby the proceeds are used to finance social transfers that function as indirect wages.

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DEFENDING DEVELOPMENT SOVEREIGNTY: THE CASE FOR INDUSTRIAL POLICY AND FINANCIAL REGULATION IN THE TRADING REGIME

Rachel Denae Thrasher and Kevin P. Gallagher

Abstract

As nation States and development experts contemplate renewing commitments for global development goals, it is imperative that countries have the national-level flexibility to meet those goals. It is equally imperative that emerging market and developing economies pursuing sustainable and inclusive growth are able to meet their global economic governance commitments. This chapter focuses on the expanding trade regime. While the benefits and economic rationale for gradual liberalization of trade in goods is well-founded, global barriers to goods trade are at an all-time low. Therefore, a new “trade” policy has evolved, seeking to liberalize all perceived impediments to global commerce – reaching into the realms of financial regulation, innovation policy and a range of domestic regulations that promote public welfare. This chapter argues that there is a fine line between what may be perceived as “protectionism” by actors seeking further market access and the legitimate deployment of domestic regulation for sustainable and inclusive growth on the part of emerging market and developing economies. Global and regional trade rulemaking will need to preserve nation States’ ability to deploy country-specific policy for development.

I. Crisis-era protectionism and the expanding trade regime

Following the Great Depression and World War II, the global economic consensus reflected the need for countries to direct and stimulate their economies, while also drastically lowering traditional barriers to trade in goods. The Bretton Woods regime, referring to the triad of the International Monetary Fund (IMF), the World Bank and the General Agreement on Tariffs and Trade (GATT), aimed at globalizing trade while leaving “plenty of space for governments to respond to social and economic needs at home” (Rodrik, 2011: 69). Where the two aims – globalization and domestic policy needs – clashed, national interests dominated.

Out of the success of the Bretton Woods regime came an even greater push for global trade liberalization. Tariffs had been brought low and global trade

flows had exploded. As a result, the gains from liberalizing trade in goods slowed down. Indeed, full global trade liberalization in goods is now estimated to yield a one-time increase in GDP of less than one per cent (Ackerman and Gallagher, 2008). Thus, market actors now seek increased market access in other areas – including services, investment and intellectual property – in an effort to expand exports and market share. Combined with the desire for greater market access, a philosophical shift toward suspicion of government intervention in the market led to a set of beliefs now called the Washington Consensus. The creation of the World Trade Organization (WTO), with its increased market access commitments and more enforceable dispute settlement procedures, reflected and reinforced the prevailing view that

broader and deeper liberalization beyond tariffs and quotas in goods was the best way to promote growth worldwide.

Circumstances changed again in the wake of the Global Financial Crisis and the resulting Great Recession. The Washington Consensus view of the 1990s is becoming a minority view in many capitals across the world, as well as the halls of academia. The growth success stories of China and other East Asian nations on the one hand, and the fact that the global financial crisis was due to problems in the West on the other, have generated a widespread questioning of the Washington Consensus (Moreno-Brid, 2013).

In terms of financial stability, many countries across the world – regardless of their income level – have been re-regulating the financial sector in an attempt to prevent and mitigate the next financial crisis. In emerging market and developing economies (EMDE), there has been a renewed effort to regulate foreign financial flows that can be de-stabilizing for long-run development prospects. Moreover, to the surprise of many, the IMF has endorsed the use of such cross-border financial regulations in some circumstances (IMF, 2013). This thinking has also permeated the World Bank (Ju et al., 2011; Lin and Treichel, 2012).

Perhaps more stark than the IMF and World Bank endorsement of regulating the capital account is the embracing of industrial policy in the advanced countries. David Cameron, Prime Minister of the United Kingdom, urged the staff of the Foreign Office to “develop [their] global comparative advantage” and create a “modern industrial strategy”.¹ In response to what was perceived as the “increasingly aggressive industrial policies of America, Britain, China and France”,² Japan has promised similar policies to support domestic manufacturing (Moreno-Brid, 2013). Indeed, the majority of all such measures introduced in the past five years have come from already-industrialized countries and emerging economies in the Group of Twenty (G20) (Evenett, 2013a). Of course, EMDE have been pioneers of industrial policy over the past decade and many – such as those discussed below – are at the forefront in current times.³

Dani Rodrik posits a “political trilemma” in which nations are divided between pursuits of democracy, national self-determination and economic globalization. He argues that a nation “cannot simultaneously pursue” all three at once (Rodrik, 2011).

In practice, one of the three gives way to the others. Furthermore, choosing which interests should prevail is not always a straightforward decision. Thus, despite a growing consensus in favour of domestic policy interests, some market actors have pushed against this, electing to favour economic globalization instead.

There is a growing concern, for example, that policies introduced at the onset of the Financial Crisis may have “morphed into another, potentially longer-lasting, form of discrimination against foreign commercial interests” (Evenett, 2013b: 148). Simon Evenett argues that despite the importance of prioritizing economic growth, employment and financial sector management, “the harm done by beggar-thy-neighbor policies should not be overlooked” (Evenett, 2013a: 1). Evenett and others are rightly concerned that a rise in protectionist policies like those during the Great Depression could slow a global economic recovery and at considerable cost (Kindleberger, 1986). Globally, governments have pledged not to repeat such mistakes in their public commitments at global bodies such as the G20. Nevertheless, there remains a concern that market distortions could act to cover up domestic competitive deficiencies rather than forcing governments and the markets to fix them (Evenett, 2013a).

Evenett argues that WTO disciplines have not done much to keep countries from resorting to protectionism; rather, it has only “altered the composition” of that protectionism (Evenett, 2013a: 7). Since the crisis, global growth has continued at a slow and uneven pace. If these unregulated measures are used as substitutions for – or disguised versions of – older forms of protectionism, Evenett and others argue that the global trade regime should at least have a method for phasing these policies out over time. Otherwise, the policies initially introduced for legitimate reasons may be used in the long term to “discriminate against foreign goods, companies, workers and investors” (Baldwin and Evenett, 2009: 4).

“Murky” or “soft” protectionism are the most commonly used terms for these technically legal measures that are not yet directly governed by the WTO or other trade rules. Attempts to measure this type of “protectionism” suggest that 60 per cent of the trade-distorting measures put in place since 2012 are non-traditional, i.e. not tariffs or trade defence mechanisms (Evenett, 2013c). Such measures have included health and safety regulations, stimulus packages that direct spending domestically, government

subsidies limited to local manufacturers, bank bailouts, industrial and innovation policies, as well as many other ways to boost the domestic market while not running afoul of the international trade laws.

There is an additional concern about investment-related protectionism that specifically targets policy related to foreign direct investment as well as cross-border financial regulations. In an article published shortly after the crisis, Claude Barfield made a plea that measures blocking foreign investment are just as significant as trade measures and called on United States of America President Barack Obama to lead an effort to prevent such protectionism (Barfield, 2009). Between 2009 and 2012, the Organisation for Economic Co-operation and Development (OECD) – long a supporter of the deregulation of investment markets – and the United Nations Conference on Trade and Development (UNCTAD) issued nine reports to the G20, calling for a restraint on investment-related measures restricting the flow of capital and companies across borders, and continue to do so (OECD, 2013a).

Some proponents of this view uphold the WTO as the best option for creating and enforcing global economic commitments to keep this kind of protectionism at bay (OECD, 2013a). Others argue that the WTO is not structured to place these kinds of restraints on member nations, but rather that the initiative to continue global commercial liberalization should come from the individual nations (Evenett, 2013b). Reflecting the latter argument to some degree, governments worldwide are pushing for additional market access commitments outside of the purview of the WTO. The Transatlantic Trade and Investment Partnership (TTIP) on one side and the Trans-Pacific Partnership (TPP) on the other are each attempting to secure commitments in services, investment, intellectual property and financial services worldwide. Plurilateral negotiations for the Trade in Services Agreement (TISA) have begun between governments in favour of further liberalization in services sectors. Therefore, the global trend in trade and investment agreements seems to reflect the concern over crisis-era protectionism, pushing for ever-broader and deeper economic globalization.

II. The soft foundations of soft protectionism

The emerging narrative around “soft” and “murky” protectionism rests on relatively weak foundations and thus it should be examined with scrutiny. The economic case for expanding the trade and investment regime to include measures that regulate for financial stability and industrial diversification is fairly limited. Economic theory surrounding the liberalization of investment flows is quite weak, likewise the empirical evidence. Those nations that liberalize the free flow of capital (both foreign direct investment (FDI) and financial flows) have not been correlated with strong growth and have been more susceptible to financial crises. Moreover, those nations that regulate foreign capital flows have done so in an effective manner. In addition, economic theory has long shown that EMDE should deploy certain regulations on trade to correct for market failures and generate long-run dynamic comparative advantages. The empirical evidence shows that those nations that steer trade in this manner have developed more than those that have not. Furthermore, almost all conventional models of trade liberalization have

shown that the benefits of further liberalization are relatively small.

Jeanne et al. (2012) conduct a sweeping “meta-regression” of the entire literature, including 2,340 regression results, finding little correlation between capital account liberalization and economic growth. They conclude: “the international community should not seek to promote totally free trade in assets – even over the long run – because (as we show in this book) *free capital mobility seems to have little benefit in terms of long run growth* and because there is a good case to be made for prudential and non-distortive capital controls” (Jeanne et al., 2012: 5). There is also considerable work demonstrating that capital account liberalization is associated with a higher probability of financial crises. Reinhart and Rogoff (2010) show that, since 1800, capital mobility has been associated with banking crises. Indeed, the most recent research has shown that capital market liberalization is only associated with growth in nations that have reached a certain institutional threshold: a threshold that

most developing nations are yet to achieve (Kose et al., 2009; Jeanne et al., 2012). This is partly due to the fact that the need for external investment is not the binding constraint for some developing country growth trajectories, but rather the lack of investment demand. This constraint can be accentuated through foreign capital flows because such flows appreciate the real exchange rate, thus reducing the competitiveness of goods and reducing private sector willingness to invest (Rodrik and Subramanian, 2009).

There is an even older and deeper tradition in economics that industrial policy can also be optimal (see Wade, 1990; Amsden, 2001; Chang, 2002; Rodrik, 2007). For EMDE, what matters most in the longer run is not static comparative advantage at any one moment in time, but rather the ongoing pattern of dynamic comparative advantage: the ability to follow one success with another, to repeatedly build on one industry by launching another. Since the process of technology development is characterized by increasing returns, many models will have multiple equilibria. It is easy to specify a model in which the choice between multiple equilibria is not uniquely determined by history; rather, it becomes possible for public policy to determine which equilibrium will occur (Krugman, 1991). If the multiple equilibria in such a model include high-tech, high-growth paths as well as traditional, low-growth futures, then public policy may make all the difference in development. Four key market failures plague nations seeking to catch up to the developed world: coordination externalities, information externalities, dynamism and technological change and human capital formation. By definition, diversification can mean the creation of whole new industries in an economy and sometimes may require linking new industry to necessary intermediate goods markets, labour markets, roads and ports and final product markets (Rodrik, 2007).

Of course, many policies to provide public goods for the welfare of the public stand on the strongest economic grounds. Pigou (1920) long established that in cases where private and social costs diverge, taxes or subsidies that internalize externalities can lead to significant welfare gains. Regulations on food safety and security, environmental policy, alternative energy and beyond all fall into this category. Most economists prefer price-based interventions to correct for market failures such as taxes or subsidies. However, under conditions of significant uncertainty and high damage costs (such as in climate change and chemical substances with

lethal impacts) at the tails of a distribution there is a stronger justification for outright bans and quantitative restrictions (Weitzman, 1974).

With the right accountability policy in place, it has been shown that those nations that have deployed capital account regulations and industrial policies have been among the best growth performers of the past centuries: Europe, the United States, Japan, the Republic of Korea, Taiwan Province of China and, more recently, China. Moreover, it has been shown that trade liberalization is not correlated with economic growth in ex-post econometric analyses (Rodrik, 2007). Even in the theoretically-driven computable general equilibrium models, a high estimate for full global trade liberalization would give a one-time boost in global output of 0.27 per cent (Ackerman and Gallagher, 2008).

Juxtaposed with the relatively minor benefits of the further liberalization of trade and investment, the costs of further deregulating the global economy in the name of “murky protectionism” are significant. Moreover, while many countries pay lip service to the expanding and deepening trade regime, their domestic policy tells a different story. Opponents of “murky protectionism” are gathering extensive data on policies employed all over the world that place restraints on trade. While many of the measures that are seen as impediments to trade have some justification, a number of measures that are well justified and key to an effective development strategy have been targeted as soft or murky protectionism. As table 1 demonstrates, many of the measures targeted aim at financial stability, industrial development and public welfare. Some involve domestic regulations, like United States of America and European Union environmental regimes, some involve direct government subsidies to support certain industries, while others use government procurement policy for the same purpose.

Nations must have the policy space to put measures such as these in place under the right conditions. Table 1 lays out important policies for financial stability, industrial development and public welfare that have been singled out as protectionist. The justification for such policies is much stronger than the justification to de-regulate for private gain. However, new proposals at the WTO as well as under regional and bilateral arrangements from industrialized countries are increasingly critical of such measures in the name of soft protectionism. This is very concerning

Table 1
THE NEW PROTECTIONISM? COUNTRY EXAMPLES

<i>Purpose of measure</i>	<i>Country examples</i>
<i>Financial stability</i>	<p>India: Reserve Bank of India prohibits Indian banks from engaging in proprietary trading in currency futures</p> <p>Australia: 2013–2014 budget specifies new “thin-capitalization” ratios for non-resident multinational corporations</p> <p>Brazil: Extends programme for sustaining investment to capital goods in 2014, including local content requirements for subsidized credits from the Brazilian Development Bank (BNDES)</p> <p>Brazil: Tax on financial operations (IOF tax) – allowing the Government to raise and lower taxes on capital flows to stabilise the economy</p> <p>Republic of Korea: Lowered the ratio of banks foreign exchange derivatives to equity</p>
<i>Industrial development</i>	<p>Canada: Government subsidies for R&D provided through a new technology demonstration programme</p> <p>Viet Nam: Restricted bidding by foreign firms on public procurement tenders except where domestic bidders cannot provide the necessary services</p> <p>Brazil: Preferential treatment of local construction products in public procurement process</p> <p>Viet Nam: Increased import duties for certain mineral resources (from 30 to 40 per cent)</p> <p>Russian Federation: State guarantees export sales for companies with 30 per cent local sourcing/content</p> <p>Indonesia: Franchise law requiring 80 per cent of inputs to be sourced locally</p> <p>India: Local content requirements extended to private telecommunications firms</p> <p>Ghana: Local content requirements in the petrol industry</p>
<i>Public health and welfare</i>	<p>European Union: Fuel quality directive; maximum residue levels of pesticides</p> <p>United States: Denial of entry to goods not complying with energy conservation and labeling standards</p> <p>China and Japan: import restrictions on beef due to bovine spongiform encephalopathy (BSE)</p> <p>China: Financial aid provided for purchasing new energy vehicles (including electric and hybrid vehicles)</p>

Source: Global Trade Alert (2014) and OECD (2013a).

for those EMDE working to “catch up” and stimulate sustainable and inclusive growth in their economies. In the following section, we compare bilateral and regional trade agreements with disciplines under the

WTO to determine the extent to which the various regimes constrain policy space for member nations, as well as what this means for countries negotiating new agreements.

III. The threat to financial stability and industrial development policies

As we have discussed above, developing and developed countries alike have historically had a wide range of policy tools available to respond to market failures and direct their economies. Today, the variety and number of those tools are shrinking. This section focuses on specific policy tools that remain in use under the current global trade regime.

We find that while the WTO permits a fair amount of flexibility outside of traditional trade policy, other agreements making up the global trade regime are not so open to government “creativity” in guiding trade and investment for development. Bilateral and regional agreements widely vary in the policy space that they permit, depending on which countries are involved, their geographic proximity and whether there is a large development gap between them, among other factors. Bilateral agreements between developing nations (South-South agreements) tend to provide ample space to all parties to promote development and rarely delve deep enough to bind a country’s “behind the border” activities (regulation, taxation, environmental measures).

By contrast, bilateral agreements between the European Union or the United States of America and a developing country tend to restrict policy space both more broadly and deeply. As we discuss in more detail below, trade and investment agreements in which the United States of America is a partner attempt to keep countries from imposing *any* new restriction that could interfere with trade or investment flows. United States of America agreements prohibit export incentives, forbid local labour, technology transfer and research and development requirements for foreign investors and have mechanisms in which foreign companies (private sector) can sue the host country if regulations interfere with their investment. The United States of America model reflects the current global trend to broaden and deepen global commerce commitments through bilateral and regional agreements.

Table 2 provides an illustrative list of policy tools that countries have employed (and still do!) in an effort to promote financial stability, industrial development and public welfare. The table indicates whether these measures are prohibited under the indicated trade regimes. In the next pages, we explore how differences in agreement breadth and depth

affect the policy flexibility that countries enjoy within the global trading system.

There are a few things to note about the chart above. First, where provisions are prohibited under both the WTO and bilateral regimes, differences in enforcement and exceptions leave room under the former that is not there under the latter. Second, South-South agreements are far from uniform with respect to these measures. Furthermore, the arrangements may act as special protection from developed world competition by keeping tariffs among members low while keeping external tariffs high. Likewise, even North-South agreements are not all the same (despite being considerably more uniform). For example, European Union agreements tend to vary based upon the treaty partner, leaving more policy space available to lesser developed countries.

Table 2
ILLUSTRATIVE TOOL BOX:
PROHIBITED MEASURES

<i>Measure Types</i>	<i>WTO</i>	<i>North-South trade agreements</i>	<i>South-South trade agreements</i>
Tariff rate flexibility		•	•
Import bans, licensing	•	•	
Tax-based export incentives		•	
Performance requirements	•	•	
Capital controls		•	
Domestic environmental/health regulations			
Public procurement preferences		•	

Source: Thrasher and Gallagher (2010).

A. Tariffs

Tariffs have long been the preferred trade barriers under the global trade regime because they are easy to measure, transparent to apply and straightforward to liberalize progressively over time. Employed carefully, countries can raise and lower tariffs to protect nascent industries until they are ready to face global competition. Under the WTO, countries

Table 3

ILLUSTRATIVE TARIFF COMPARISON: IRON AND NON-ALLOY STEEL BARS AND RODS (2012 HS06 721310)
(Per cent)

Country/agreement	WTO binding	Regional/bilateral applied tariff	MFN applied rate (avg) (2012)
Brazil (MERCOSUR)	35.0	0.0	12.0
Chile (European Union-Chile)	25.0	0.0	6.0 (2011)
Mexico (NAFTA)	35.0	0.0	11.5
Guatemala (DR-CAFTA)	20.0	4.5 ^a	15.0
Malaysia (ATIGA)	Unbound	0.0	5.0
South Africa (European Union-South Africa)	15.0	0.0	5.0 (2013)
Viet Nam (ATIGA)	21.7	5.0	15.0

Source: WTO Current Schedules.

^a Guatemalan tariffs were scheduled to be eliminated as of 1 January 2014. Since the latest data available was from 2012, it is possible that the 4.5 per cent duty has now been eliminated.

often bind their tariff rates far above their applied rates, leaving room for such measures. By contrast, bilateral and regional agreements have tended to demand lower tariff bindings.

Many countries have taken advantage of the WTO flexibilities and with some success. In Viet Nam, this method has been used to great effect to stabilize energy prices and protect various key industries, even as a member of the ASEAN trade in goods agreement (ATIGA). The chart below indicates that Malaysia has reserved an entire classification of goods from WTO binding, presumably as a way of protecting the automotive industry. Likewise, Brazil has leaned on tariff rate flexibilities to protect industries facing impossible competition from Asia. Table 3 provides an example of one particular line of goods, comparing bound and applied rates for iron and non-alloy steel bars and rods (WTO Current Schedules).

This chart highlights some interesting trends. First, in every instance, whether North-South or South-South, the regional or bilateral tariffs are much lower than the bound tariff levels at the WTO. Also in every instance, the countries in question have average rates above their bilateral bindings, indicating that they take advantage of tariff rate flexibilities with respect to trade partners outside of their bilateral arrangements. Second, as mentioned above, low or non-existent tariffs in the South-South arrangements may actually protect industries from competition rather than exposing them. This is the case in both

MERCOSUR⁴ (with a common external tariff) and ATIGA (without one). They allow developing nations to work together to build up nascent industries within the region without competition from the developed world. Finally, it is important to note that the 0.0 per cent applied tariffs represent all kinds of different arrangements. Where the European Union and United States of America might provide 12–14 years for the elimination of some tariffs, other product duties were eliminated immediately (compare European Union-South Africa⁵ and NAFTA⁶ with European Union-Chile⁷).

B. Import licensing and bans

Despite being disfavoured except under dire circumstances, import licensing and bans have been historically used to protect domestic industry and stabilize economies. Actual quantitative restrictions (quotas) and import bans are generally prohibited under the WTO, except to address food shortages and balance of payments difficulties or enforce certain local standards and regulations (GATT Arts. XI, XII). Import licensing programmes are more widely used, although they are heavily regulated in the WTO Import Licensing Agreement to promote transparency.

Outside of the WTO, the availability of these measures widely varies. Treaties with the European Union generally mimic WTO exceptions but can vary

with the treaty partner; for instance, European Union-Chile prohibits both quotas and import licensing, while European Union-South Africa only mentions quotas (European Union-Chile Art. 76, European Union-South Africa Art. 19). Both agreements leave some space for exceptional circumstances (European Union-Chile Art. 93 (shortages), European Union-South Africa Art. 24 (safeguards)). Treaties where the United States of America is a partner increasingly shrink the same kind of room for exceptional circumstances. Only one of six treaty partners under the Dominican Republic-Central American Free Trade Agreement⁸ (DR-CAFTA) retained a shortages exception, while most recent agreements have eliminated the exception for balance of payments (see United States of America agreements with Colombia,⁹ Peru¹⁰ and Singapore;¹¹ DR-CAFTA Annex 3.2(F)). If the United States of America model carries the day in the current TPP negotiations, it could have very real consequences for the developing countries involved. For example, both Viet Nam and Malaysia have ongoing programmes of import licensing to control imports in certain sectors. Viet Nam's automatic licensing programme is limited to steel products as of 2012 (WTO, 2013). Malaysia, on the other hand, maintains an extensive set of border measures including import permitting and quotas to protect its highly prized auto industry (United States Trade Representative, 2013).

C. Tax-based export incentives

Tax-based export incentives have also played a key role in making global trade work for development. In fact, this may be an area where there remains the most flexibility in promoting development locally. Taking the form of duty drawbacks, tax deferrals, exemptions and deductions, these measures can promote a healthy trade balance and enable local industry to compete globally (Mai, 2004). Under the WTO's Agreement on Trade-Related Investment Measures (TRIMs), tax-based advantages limiting import purchases to a value related to exports of local products would violate the general pillar of national treatment under the WTO. However, as exports have long been considered a key vehicle for economic growth, broad-based tax incentives that encourage exports are generally accepted. This sharply contrasts more direct subsidy programmes prohibited by the Subsidies and Countervailing Measures (SCM) Agreement.

While most bilateral regimes follow the example of the WTO in this respect, certain United States of America agreements almost universally prohibit such incentives. Under NAFTA and United States-Chile,¹² for example, member States may not provide drawbacks or tax deferrals on condition that goods are exported or used as material for another exported good (Art. 303; Art. 3.8). Once again, if the TPP reflects this approach, it could directly affect developing country members.

Viet Nam has moved away from explicit export performance-based tax incentives since entering the WTO. However, it continues to indirectly support domestic industry through tax incentives for corporate or land use taxes (WTO, 2013). Malaysia relies on a complex tariff, tax, quota and credit system to support its national car companies. The National Automotive Policy gives tax exemptions to exporters based upon a percentage of domestic value-added. Concurrently, taxes on primary goods export have increased linkages within the auto industry and the economy more generally (United States Trade Representative, 2013). Following a United States of America model, these countries will face far more restrictions on their domestic tax laws.

D. Performance requirements

Performance requirements are highly scrutinized under the global trade regime. The TRIMs of the WTO prohibits any measures that violate national treatment (Article III) or the general obligation to eliminate quantitative restrictions (Article XI). It subsequently lays out an illustrative list of prohibited measures in its annex. Under TRIMs, countries may not require that foreign investors achieve a certain level of domestic content in their goods or prefer domestic producers or products in their production process. They may not limit foreign investors' imports in relation to their local production or export levels. Moreover, they may not require investors to acquire foreign exchange only through export and they may not demand that investors sell a certain amount of their product within the domestic market. Furthermore, WTO members may not create incentives by requiring any of the above as a condition for receiving economic advantages.

Once again, United States of America agreements tack on several "plus" provisions that place

additional limits on government policymakers. In addition to WTO disciplines, United States of America agreements forbid technology and knowledge transfer requirements and management nationality pre-requisites (NAFTA Art. 1106, DR-CAFTA 10.9). Nonetheless, even members of United States of America agreements may continue to provide advantages to companies that “locate production, supply a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory” (NAFTA Art. 1106, DR-CAFTA 10.9). Certain other measures such as local infrastructure investment, directed credit and administrative guidance for multinational corporations lay beyond the scope of these investment provisions, making them available to all countries that have the capacity to impose and enforce them.

Despite their high level of scrutiny today, performance requirements have commonly been used with tax incentives to funnel FDI into favoured or essential industries for economic development. Both Malaysia and Viet Nam openly used local content, labour and capital, as well as domestic location and export performance requirements to promote industrial development (WTO, 2013, Fuangkajonsak, 2006). Malaysia has had to eliminate explicit performance requirements since joining the WTO, although it retains some more subtle measures connecting financial benefits to local value-added and local content (United States Trade Representative, 2013).

A key difference between the multilateral trade and investment regime and the United States of America model of investment provisions appears in the dispute resolution process. Unlike the WTO State-to-State dispute settlement (or other State-to-State arbitration processes in most trade agreements, both North and South), *investment* disputes under the United States of America model allow private investors to sue States in a private arbitration forum. Although the TPP has yet to agree on a full draft of the proposed agreement, leaked drafts of the investment chapter indicate that investor-State dispute resolution may be included (Citizens Trade Campaign, 2012). NAFTA is the only agreement in force long enough to have a history of investor-State disputes and since then a few agreements have attempted to clarify certain treaty standards (Van Harten, 2009). Nonetheless, countries like Malaysia and Viet Nam could likely experience regulatory chill due to NAFTA’s arbitration history and the threat of expensive lawsuits.

E. Financial regulation

Financial regulation is another tool that countries have used to promote development and stabilize their financial environment. Brazil’s Tax on Financial Operations (IOF tax) introduced at the outset of the 2008 financial crisis provides one example, as does tax of the Republic of Korea on foreign exchange derivatives. Indeed, similar regulations have been put in place by India, Indonesia, Taiwan Province of China, Uruguay and numerous other nations in the wake of the crisis (Global Trade Alert, 2014; OECD, 2013a).

However, restrictions on foreign capital flows are generally disfavoured within modern trade agreement models. The WTO as well as all North-South trade agreements prohibit international transfer and payment restrictions presumptively. Nonetheless, under the WTO, capital flows are treated under the General Agreement on Trade in Services, which employs a positive-list approach to binding measures, whereby countries select which sectors and industries they want to bind under the agreement. By contrast, United States of America trade agreements – as well as more recent European Union agreements (European Union-CARIFORUM)¹³ – apply a negative list approach to investment protection, where liberalization is the rule rather than the exception.

The WTO rules provide an exception in the case of “serious balance of payments and external financial difficulties” (General Agreement on Trade in Services Art. XII). This exception is mirrored in most – if not all – bilateral and regional agreements. While this protects in emergency situations, it would be better if countries could employ capital controls preemptively to avoid financial instability and crisis.

F. Public welfare and “green” measures

Public welfare and “green” measures may be directed at the quality of certain products or the effects of their production. While these measures have been used less frequently in the developing world, with increasing awareness of the cross-border effects of health and environmental problems, they are becoming more prevalent. The European Union restricts the pesticide residue level on imported agriculture, based upon a concern that such pesticides will cause harmful health effects. Both China and Japan placed restrictions on imported beef due to fear of

the bovine spongiform encephalopathy, which can be fatal to humans. As carbon-based energy sources start to dwindle, many countries are realizing the importance of developing national green energy projects. Thus, environmental measures are used to protect the environment as well as domestic industry. Feed-in tariffs in Europe and targeted subsidies in China have helped countries like Germany, Spain and China itself to gain global comparative advantages in low carbon-renewable energy while increasing up the value chain.

The somewhat conflicting relationship between trade and the environment is far from new, whereby all modern global, regional and bilateral agreements make some mention of promoting sustainable resource development and environmental protection. NAFTA was the first trade agreement to include environmental provisions as a part of the agreement, and the trend continues to date (Gallagher, 2009). At the WTO, the Commission on Trade and the Environment has the ongoing concern of considering questions of environmental protection in global trade. Nonetheless, those concerned with “murky” protectionism identify environmental measures as suspect alongside policies protecting domestic industries and firms (Global Trade Alert, 2014). Under NAFTA investor-State disputes, all three countries’ foreign firms have challenged environmental laws in their host States as measures “tantamount to expropriation” (Gallagher, 2009). Environmental protection is quickly becoming a widely accepted global norm that may eclipse the concern for fully free trade. However, it seems important to recognize the tension between trade and environmental interests, as the expanded trade regime blurs the lines between domestic and global regulation.

G. Public procurement

Public procurement remains an area in which most countries retain plenty of flexibility to promote their domestic policy goals. Procurement measures have been used historically – as well as recently – to protect vulnerable people groups, favour domestic industries and show support for environmental and social concerns. In much of Europe, public

procurement is an accepted tool for reaching public welfare and environmental goals. Through procurement policies, Viet Nam actively prefers local suppliers and discourages imports where domestic inputs can be produced (WTO, 2013). Malaysia public procurement in favour of its indigenous people group continues to respond to the historical race tensions that exist in the country (United States Trade Representative, 2013). Brazil, alongside its MERCOSUR partners, stands out as having initiated a pilot programme of sustainable public procurement, promoting environmental sustainability through their tender policies (Instituto Argentino de Desarrollo Sostenible, 2008).

Such measures currently remain beyond the scope of the global trade rules, at least as they apply to all members. The Government Procurement Agreement (GPA) in the WTO only has 15 members, whereas most countries are reluctant to subject their government spending to global scrutiny. As with many types of measures, European Union treatment of public procurement depends on the treaty partner. European Union-South Africa simply mentions liberalization as a future goal and European Union-Chile contains a comprehensive chapter governing procurement within the parties. United States of America agreements are more uniform, as with many other areas, containing chapters that put in place rules for the valuation and awarding of government contracts (NAFTA Ch. 10, DR-CAFTA Ch. 9). Interestingly, even some South-South agreements have begun to incorporate public procurement provisions.

MERCOSUR countries signed the Protocol of Mercosur Public Bids for Tender in 2006, under which countries commit to non-discrimination on a sector-by-sector basis in goods, services and public works. As noted above, each of our case studies has extensively relied on public procurement for national development aims. Within the newest negotiations, it is unclear whether the United States of America and the European Union will push for greater market access in government procurement. Both are signatories to the GPA of the WTO, although its membership remains limited. However, it is clear that broader and deeper trade rules in this area could bind government hands more tightly than most of the world would like.

IV. Alternatives for emerging market and developing countries

The terms “soft”, “murky” and “investment protectionism” emerge from the view that trade liberalization should extend beyond trade in goods into areas traditionally not seen as part of trade policy. The intellectual foundations of these concepts, as well as the empirical record of what happens when regulations in these areas are stripped, are weak. Targeted government regulation has been part and parcel of growth and inclusive development for over a century. Nevertheless, powerful interests in the West have been expanding the mandates of trade and investment treaties to include measures on financial stability and industrial policy in particular.

By examining some key policies employed by developing and developed countries alike, we show that the United States of America model of trade agreements (and to some degree also European Union agreements) more severely constrain nations from deploying adequate industrial strategies. Drawing on this analysis, it appears that North-South free trade agreements should be considered with great caution for nations looking to expand or devise industrial development strategies. EMDE are also urged to develop new model treaties (as Brazil and South Africa are) that steer closer to the South-South model prioritizing development-oriented trade and investment.

Many countries are already working to this end, albeit in different ways. At the WTO, a coalition of EMDE has been successful in resisting industrialized country proposals to expand the mandate of the WTO. During the early days of the Doha Round, there was a push by the advanced countries to include (further) investment measures, government procurement, competition policies and other measures now repackaged as “protectionist”, although these coalitions were able to hold the debate to look at distortions in agricultural and manufacturing markets. On a more proactive level, EMDE have proposed a “product basket approach” to manufacturing tariff reductions, although movement on such proposals

has stalled as the Doha Round is at a near standstill. Somewhat analogous to the “box” approach in the WTO Agreement on Agriculture, nations could put certain sectors in a “basket” that could have higher tariffs as long as they are balanced by further reductions in other baskets of countries.

Some countries have simply avoided new treaties that may further restrict their existing policies, with Brazil being one example here. The country underwent a major inter-governmental assessment and concluded that the most beneficial approach would be to focus on multilateral trade negotiations at the WTO. It has not ratified bilateral investment treaties or trade agreements beyond the MERCOSUR agreement. Other countries are working on South-South trade or investment agreements that have a starkly different model. For instance, the ASEAN +6 treaty only deals with goods trade and some services; it includes FDI but not other financial flows, has special and differentiated treatment for poorer nations and does not feature investor-State dispute resolution. A group of countries is trying to come up with new language and rules for North-South treaties. Chile and other nations are proposing safeguards for financial stability in the TPP Agreement. Other countries, such as South Africa, are carefully withdrawing from their bilateral investment treaties and offering to re-negotiate them to balance them with national development priorities (Haftel and Thompson, 2014). Finally, other countries are simply walking away from their existing commitments, such as Argentina, the Bolivarian Republic of Venezuela and the Plurinational State of Bolivia (Gaillard, 2008; Lavopa et al., 2013).

The path taken will need to cater to each country’s specific circumstances. Given that we live in one of the most open periods in global economic history, rather than searching for new barriers to deregulate, nations need to work to design the appropriate national policies to thrive in a globalizing world.

Notes

- 1 *The Telegraph*, Speech by David Cameron at Lord Mayor's Banquet. 12 November 2012.
- 2 *The Economist*, The global revival of industrial policy: picking winners, saving losers. 5 August 2010.
- 3 For more on the role of industrial policies for development, see the contribution of Robert Wade to this volume.
- 4 Available at: <http://www.sice.oas.org/trade/mrcsr/mrcsrtoc.asp>.
- 5 Available at: http://eur-lex.europa.eu/resource.html?uri=cellar:df28bbd2-29f1-4cea-86ab-81d81c47903b.0004.02/DOC_3&format=PDF.
- 6 Available at: <https://www.nafta-sec-alena.org/Home/Legal-Texts/North-American-Free-Trade-Agreement>.
- 7 Available at: http://trade.ec.europa.eu/doclib/docs/2004/november/tradoc_111620.pdf.
- 8 Available at: <https://ustr.gov/trade-agreements/free-trade-agreements/cafta-dr-dominican-republic-central-america-fta/final-text>.
- 9 Available at: <https://ustr.gov/trade-agreements/free-trade-agreements/colombia-fta/final-text>.
- 10 Available at: <https://ustr.gov/trade-agreements/free-trade-agreements/peru-tpa/final-text>.
- 11 Available at: <https://ustr.gov/trade-agreements/free-trade-agreements/singapore-fta/final-text>.
- 12 Available at: <https://ustr.gov/trade-agreements/free-trade-agreements/chile-fta/final-text>.
- 13 Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:289:0003:1955:EN:PDF>.

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