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*Export Promoting Trade Strategy:
Issues and Evidence*

Jagdish N. Bhagwati
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EXPORT PROMOTING TRADE STRATEGY:

ISSUES AND EVIDENCE

by

Jagdish N. Bhagwati

October 1986

The author is the Arthur Lehman Professor of Economics, Columbia University, and Consultant, World Bank.

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Abstract

This paper evaluates new hesitations in adopting an export promoting (EP) trade strategy. It reviews past experience with trade strategies. It also distinguishes between the old export pessimism and the new export pessimism. The former was based on an (unwarranted) assessment of "natural" or market forces. The latter, by contrast, reflects "man-made" protectionism. Hence, an EP policy remains the preferred option provided developing countries forcefully join with the developed countries in strategies to contain protectionist threats and to preserve and expand an open trading system.

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Export Promoting Trade Strategy:
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Jagdish N. Bhagwati

I. Introduction

The question of the wisdom of adopting an export promoting trade strategy has a habit of recurring in the developing countries.

Development economics was born in an atmosphere of export pessimism at the end of the Second World War. However, the remarkable success of the few economies that pursued "export promoting" (i.e., EP) policies, in defiance of prescriptions for "import substituting" (i.e., IS) policies that the pessimism inspired, swung the weight of academic opinion behind the EP strategy by the late 1960s. Aiding this process were numerous academic findings from research projects around the world which probed these EP successes, and equally the failures of the IS countries. 1/

However, the debt crisis of the 1980s, the sluggish world economy and the continuing depression of primary product prices have revived export pessimism afresh. It is time again therefore to examine the old and new arguments which question the wisdom of the EP strategy.

After the Introduction, Section II briefly reviews the early postwar arguments in support of the misguided export pessimism. Section III states

1/ The chief studies were directed by Little, Scitovsky, and Scott (1970) at the Organization for Economic Cooperation and Development (OECD), Balassa (1971) at the World Bank, Bhagwati (1978) and Krueger (1978) at the National Bureau of Economic Research (NBER) in the United States and Donges (1976) at the Kiel Institute in Germany. Complementing and overlapping each other, these studies represent a massive analysis of the central question that has preoccupied development economists from the very beginning of the discipline.

the precise content of an EP strategy, sorting out some of the confusion that bedevils much of the current debate. Section IV considers a few salient lessons that have emerged in the studies on the advantages of the EP strategy, focusing on those that are particularly pertinent today. Section V then examines several new sources of skepticism concerning export promoting trade policies. The contrasts between the old (postwar) pessimism and the new pessimism prevalent today are then exploited briefly in Section VI to draw a central policy lesson for the developing countries, especially in regard to the forthcoming Multilateral Trade Negotiations (MTN). 2/

II. The First Export Pessimism

It is well known that export pessimism characterized the thinking of most influential development economists and policymakers in the developing countries after the Second World War.

The most articulate proponents of the pessimist school of thought were the two great pioneers of development economics: Raul Prebisch (see Prebisch 1952 and 1984) and Ragnar Nurkse (see Nurkse 1959). Interestingly, however, their diagnoses had significant differences.

Prebisch considered the terms of trade of primary products, then the chief exports of developing countries, to be secularly declining. Left to themselves, producers in the developing countries would have then responded to this (exogenous) secular price shift by industrializing: evidently, government intervention in the shape of either (trade tariff) protection or

2/ Among other reviews which complement this paper, the reader may consult Behrman (1984), Bhagwati and Srinivasan (1979), Findlay (1984), and Srinivasan (1986a and 1986b).

(domestic subsidy) promotion was unnecessary and unjustified in this instance. By contrast, Nurkse's export pessimism related to the notion that the absorptive capacity of foreign markets was low and that they simply could not accommodate imports from developing countries on a sufficient scale as developing countries accelerated their development. Therefore, export pessimism explicitly meant "elasticity" pessimism; and, as all students of international economics will immediately recognize, the case for government intervention then follows. ^{3/} Nurkse, therefore, advocated what he called a policy of "balanced growth".

Paradoxically, however, Nurkse (1953) was mindful of the costs of indiscriminate protectionism, having also written about the collapse of the world trading system during the 1930s. That "balanced growth" meant government incentives to assist industrialization appears therefore to have been a prescription that Nurkse combined uneasily with caveats about protection. By contrast, Prebisch's brand of pessimism did not justify protectionism but was nevertheless widely used by his followers to do so in Latin America.

The export pessimism of these influential economists, in any event, was cast in the mold of "natural" forces and phenomena that the developing countries faced. Nurkse, for instance, wrote about increasing economy in the use of raw materials and a shift further from natural to synthetic materials, both dampening the demand for developing countries' exports over time.

^{3/} In technical jargon, we have here the classic case for an optimal tariff since the terms of trade vary with the level of trade.

Developing countries could do nothing to change these conditions at the source, just as one cannot do anything about bad weather. But their policies had to adjust to these conditions, just as one can buy an umbrella against the rain. (By contrast, as I note below, the second export pessimism of the 1980s is rooted in protectionist threats, which can indeed be addressed at the source and hence has critically different implications for developing country policies.)

The export pessimism following the Second World War was to prove unjustified by the unfolding reality.

(i) World trade did not merely grow rapidly during the 1950s and 1960s, it grew even faster than world income. In fact, the growth rates in both output and trade were unprecedented for such sustained periods (see Table 1).

(ii) Within the aggregate performance, the economies that shifted quickly to an EP strategy (as defined more formally below) experienced substantial improvements in their export performance. This is particularly the case for the four Far Eastern economies: Hong Kong, Singapore, South Korea, and Taiwan but by no means confined to them. In fact, the dramatic rise in these economies' share of trade in GDP over this period made them "jump off" the Chenery-type regression lines for trade-to-GDP ratios and per capita incomes in a dramatic fashion. If anything, these regressions show a falling trade-to-GDP ratio as per capita income rises, whereas these

Table 1: Postwar Growth Rates of World Output and Trade

	World Output (annual growth rate)	World Trade (annual growth rate)
1953-63	4.3	6.1
1963-73	5.1	8.9
1973-83	2.5	2.8

Source: Hufbauer and Schott (1985), Table A-1, p. 97.

successful exporters showed a spectacular rise in their trade shares as their per capita incomes grew rapidly. 4/

Clearly, history has sided with economists such as Cairncross (1962) and Krueger (1961) who had been among the foremost critics in raising doubts about export pessimism.

While the evidence of successful trade expansion buried export pessimism decisively, the economic analysis underlying the reasons that Nurkse and others had advanced in support of such pessimism was also to prove enlightening. It also has a bearing on the dissection of the resurgent, second export pessimism prevalent today.

Thus, Nurkse had embraced Robertson's classic phrase: trade as "an engine of growth". This established a rather strong and direct link in the export pessimists' minds between external conditions and internal expansion. In a classic throwback to this form of argumentation, Arthur Lewis (1980) argued more recently in a much-quoted passage: 5/

"The growth rate of world trade in primary products over the period of 1873 to 1913 was 0.87 times the growth rate of industrial production in the developed countries; and just about the same relationship, about 0.87, also ruled in the two decades to 1973... We need no elaborate statistical proof that trade depends on prosperity in the industrial countries". (p. 556)

4/ In fact, this shows how dangerous it can be to use such regressions, with little underlying rationales, for predictive purposes. I have considered this issue at great length in Bhagwati (1985a, Part II).

5/ Cf. Riedel (1984), who analyzes this argument fully in a splendid article. Also of importance is the classic examination of the issue by Kravis (1970).

But, it is evident from several analyses, 6/ the latest being by Riedel (1984), that such stable relationships (which suggest the exclusive dominance of "demand" in determining trade performance) simply cannot be extracted from the export experience of developing countries in the postwar period. Indeed, the export performance of these (and indeed other) countries must be explained by domestic incentives (or "supply") more than by external (or "demand") conditions. It is worth restating the main arguments supporting this conclusion.

(i) While Lewis addresses the linkage between developed country incomes and developing country exports of primary products, Riedel (1984, Table 4) shows that even this aggregate developing country relationship is not stable. The stability, in turn, obviously cannot be maintained for individual developing countries.

(ii) Again, it is important to note that the postwar period has seen a dramatic shift in the export composition of developing countries towards manufactures. Developing country exports of manufactures grew three-fold over the 1955-78 period, representing one-fourth of overall exports. Manufactures are now close in magnitude to the other nonfuel exports such as food, minerals, and agricultural raw materials. Of course, the successful exporters of the postwar period dominate this shift. But their experience, based on domestic policies, precisely proves the point that one goes seriously wrong if one assesses trade potential by mechanical linkages to developing country income expansion.

6/ See again the results cited in the synthesis volumes of the research projects listed in footnote 1.

The most compelling aggregate statistics in fact are that during the prosperous 1960s developing countries' exports of manufactures grew nearly twice as fast as the developed countries' incomes. The expansion of developing countries' trade over the 1950s and 1960s occurred in the context of an environment where protection in the developed countries was diminishing sharply as a consequence of first the elimination of quotas, and then the reduction in tariffs. Even during the troubled 1970s, developing countries' exports of manufactures grew more than four times as rapidly as the developed countries' income. 7/

The only key question that has remained at issue, therefore, is what has been called the "fallacy of composition"--can all, or most, developing countries become successful exporters simultaneously? Or, focusing on the successful Asian exporters, the question may be put wittily: can the Asian export model be successfully exported to all? The suspicion still lingers that the success of a few was built on the failure of the many, and that if all had shifted to the EP strategy, none would have fared well.

There are two distinct sources of this worry. The first presumes that markets would not be able to absorb all of the exports that would materialize if developing countries shifted to an EP strategy. The second argues that while the markets could be found, they would be closed by protectionist measures, provoked by the import penetration and outcries of market disruption. The second source is the major cause of export pessimism today, while the first source was the one that afflicted the earlier wave of

7/ Cf. Riedel's (1984) discussion of this finding in Table 4.

export pessimism. I now examine the former argument, and defer discussion of the latter.

First, as I shall argue more fully below, the fear that world trade would have to grow by leaps and bounds if most developing countries pursued an EP strategy is wholly unwarranted. For, as in Cline (1982), this fear follows from trying to put all countries on the curve, however adjusted, for the Asian exporters with very high ratios of trade to national income. The pursuit of an EP strategy, as discussed in Section III, simply amounts however to the adoption of a structure of incentives which does not discriminate against exports in favor of the home market. This does not imply that the resulting increases in trade-to-income ratios will be necessarily as dramatic as in the Far Eastern case. To infer otherwise is simply a nonsequitur.

Second, the share of developing countries in the markets for manufactures in most developed countries has been, and continues to be, relatively small. In the aggregate, the share of manufactured exports from developing countries in the consumption of manufactures in the developed countries runs even today at little more than 5 percent. "Absorptive capacity" purely in the market sense, therefore, is not prima facie a plausible source of worry.

Third, a chief lesson of the postwar experience is that policymakers who seek to forecast exports typically tend to understate export potential by understating the absorptive capacity of import markets. This comes largely from having to focus on "known" exports and partly from downward estimation biases when price elasticities for such exports are econometrically measured. Experience underlines the enormous capacity of wholly unforeseen markets to develop when incentives exist to make profits; and "miscellaneous

exports" often represent the source of spectacular gains when the bias against exports, typical of IS regimes, is removed on a sustained basis.

Fourth, trade economists have increasingly appreciated the potential for intra-industry specialization as trade opportunities are provided and seized. The experience of the European Communities (EC), where the progressive dismantling of trade barriers within the EC led to increased mutual trade in similar products rather than to massive reductions in scale of output in industry groups within industrial member states, has only underlined this lesson. 8/ There is no reason therefore to doubt that such intra-industry trade in manufactures among developing countries and between them and the developed countries can also develop significantly, difficult as it is to forecast with plausible numbers.

Finally, if we reckon also with the potential for intra-developing country trade (where again policies can change to permit its increase), and the possibility of opening (again by policy) new sectors such as agriculture and services to freer trade, then the export possibilities are even more abundant than the preceding arguments indicate.

Export pessimism, if traced to market forces as in the postwar period, is then unwarranted. If, however, it is traced to policies (that is, to protectionism) as is the case today, this is a different matter which I turn to later.

8/ There is a substantial empirical literature on this subject, with important contributions by Balassa, Grubel, and Lloyd. In addition, recent theoretical work by Dixit, Lancaster, Krugman, Helpman, and others has provided the analytical explanation for such intra-industry trade.

Therefore, while the postwar export pessimism was unjustified, it did provide a key rationale for the widespread adoption of inward looking or IS trade policies in many developing countries. The export promoting strategy was shortchanged, in consequence.

There were other contributory factors in this outcome as well. Thus, trade restrictions were adopted to protect the industries that had grown up in Latin America during the Second World War which had provided artificial inducement to set up domestic capacities to produce interrupted supplies from traditional, competitive suppliers abroad. ^{9/} Then, there was a reluctance to devalue which, combined with high rates of inflation, implied that these developing countries had continuously overvalued exchange rates which amounted to a de facto IS trade policy (as explained in the Appendix). ^{10/}

III. Export Promoting Trade Strategy: What Is It?

What exactly is meant by an export promoting trade strategy? Unless we are clear on that critical question, we cannot properly debate the merits of the strategy and its alternatives. Clarification of the question is therefore important, especially as the everyday usage of this phrase evokes many different notions that are wholly unrelated.

The definitions of EP and IS that are most widely accepted, and indeed the ones proposed and used by the sophisticated international economists who have long studied these matters theoretically and empirically, relate to incentives. The incentive-related definition states that a country

^{9/} I am indebted to Vittorio Corbo for pointing this out to me.

^{10/} Cf. the comment on Prebisch in Bhagwati (1985a).

is following the IS strategy if the effective exchange rate for the country's exports (EER_x) is less than for its imports (EER_m). These effective exchange rates measure the incentives to export and import-substitute respectively. Thus, EER_x would include, for a peso currency country, not just the pesos earned at parity from a unit dollar worth of export, but also any export subsidy, tax credits, special credits, etc. Similarly, EER_m would add to the parity any import duty, import premia resulting from quantitative restrictions (QRs) and other charges. If then a dollar worth of exports fetches altogether 100 pesos, whereas a dollar worth of imports fetches 130 pesos, when these adjustments have been made, the incentive structure implies $EER_x < EER_m$. This constitutes a "bias against exports", a phrase which seems to have come independently into use in Bhagwati (1968), Little, Scitovsky, and Scott (1970), and Balassa (1971). This is also the hallmark of the IS strategy: it creates a net incentive to import substitute relative to what international prices dictate.

Suppose, however, that EER_m yields 100 pesos per dollar worth of imports, while EER_x is also 100 pesos. Then, the home market sales will give a producer as much as exporting will: the incentive structure then implies $EER_x = EER_m$. Thus bias against exports will have been eliminated. This is defined as the EP strategy.

These definitions of EP and IS strategies are by now in common usage. But they do raise a question: how do we christen the case where $EER_x > EER_m$? Where the effective exchange rate is more favorable for exports than for imports, should we not call that EP instead of the one where $EER_x \approx EER_m$ as the above definitions do, and instead call the case

with $EER_x \approx EER_m$ simply the trade-neutral or bias-free strategy? 11/ Perhaps that might have been the ideal way to do it. But the EP strategy came to be defined as the one with bias-free incentives simply because the empirical studies of the four Far Eastern economies, particularly in the NBER project, strongly suggested that these successful outward-oriented developers were in fact closer to neutrality than to a positive bias in favor of exports, by and large. 12/ Also, the sequencing of trade regimes, one in which the EP countries went from an IS strategy to a neutral strategy which eliminated the bias against exports, helped the researchers to define EP strategy in terms of neutrality. Given therefore the now common usage of these terms, I have suggested recently the following terminology that does least violence to what has been the practice to date: 13/

IS Strategy: $EER_x < EER_m$

EP Strategy: $EER_x \approx EER_m$

Ultra-EP Strategy: $EER_x > EER_m$

These definitions clearly relate to average incentives. On the other hand, it is obvious that, within EP for instance, some activities may be import substituting in the sense that their EER_m exceeds the average EER_x . Thus, the pursuit of either the EP or the ultra-EP strategy does not preclude import substituting in selected sectors. This is, in fact, true for most of

11/ Sometimes EP has even been considered loosely to include the case where $EER_x > EER_m$, as in the more discursive argumentation in Krueger (1980). However, this is not the common parlance.

12/ This is confirmed for South Korea in a more recent analysis by Nam (1986).

13/ The strategies have been illustrated in terms of the simplified two-goods model of traditional trade theory in Figure 1 in the Appendix.

the successful Far Eastern developers. Nor does this fact render meaningless therefore the distinction among the different trade strategies, as is sometimes contended. As I have argued elsewhere (Bhagwati, 1986c):

"We also need to remember always that the average EER_x and EER_m can and do conceal very substantial variations among different exports and among different imports. In view of this fact, I have long emphasized the need to distinguish between the questions of the degree of import substitution and the pattern of import substitution. Thus, within the broad aggregates of an EP country case, there may well be activities that are being import-substituted (i.e., their EER_m exceeds the average EER_x). Indeed there often are. But one should not jump to the erroneous conclusion that there is therefore no way to think of EP versus IS and that the distinction is an artificial one--any more than one would refuse to acknowledge that the Sahara is a desert, whereas Sri Lanka is not, simply because there are some oases." (p. 93)

Nor should one equate the EP strategy with the absence of government intervention, as is often done by proponents of the IS strategy and sometimes by advocates of the EP strategy as well. It is true that a laissez-faire policy would satisfy the requirement that $EER_x = EER_m$. On the other hand, this is not a necessary condition for this outcome. In fact, the Far Eastern economies (with the exception of Hong Kong) and others that have come close to the EP strategy, have been characterized by considerable government activity in the economic system. In my judgment, such intervention can be of great value, and almost certainly has been so, in making the EP strategy work successfully. This is because credibility of commitment on the part of governments is necessary to induce investors to take decisions that reflect the inducements offered by the policy framework. By publicly supporting the outward oriented strategy, by even bending in some cases towards ultra-export promotion, and by gearing the credit institutions to supporting export activities in an overt fashion, governments in these countries appear to have established the necessary confidence that their commitment to the EP strategy

is serious, thus inducing firms to undertake costly investments and programs to take advantage of the EP strategy. The laissez-faire model does not quite capture this aspect of the problem since its proponents implicitly assume that the policy of laissez-faire will be accepted at face value. But neither the establishment nor the continuation of laissez-faire is a realistic assumption since governments, except in the models of Friedman and Bakunin, fail to abstain or self-destruct; they will find invariably something, indeed much, to do. Therefore, explicit commitment to an activist, supportive role in pursuit of the EP strategy would appear to constitute a definite advantage in reaping its benefits.

Some other caveats are also in order.

(i) Development economists such as Chenery and his many associates have used the terminology of IS and EP in a wholly different fashion. They have typically used identities to decompose observed growth of output in an industry or the economy into components attributable to export promotion, import substitution and other categories. ^{14/} Quite aside from the fact that such decompositions are, except under singular circumstances, statistical descriptions without analytical significance, they also have no relationship to the incentives-related definitions of trade strategy that have been set out here. Unfortunately, this distinction occasionally gets confused in popular discussions, especially as economists sometimes deploy both usages simultaneously (i.e., Balassa, 1983).

^{14/} C.f., Chenery, Shishido, and Watanabe (1962) for one such decomposition. For an analytical synthesis and evaluation of alternative measures of import substitution, see Desai (1979).

(ii) Next, the incentives-defined EP strategy has to be distinguished from the traditional concept of "export-led" growth with which it is again confused repeatedly. The latter relates to a situation where external growth, due to income effects centered on a country's exports, generates income expansion attributable to direct gains from trade and indirect beneficial effects. The notion of "export-led" growth is thus closer in spirit to the notion that underlay Nurkse's and Lewis' pessimism that was dissected earlier. On the other hand, it is evident that the incentives-related EP definition has literally nothing to do with such beneficial external phenomena. Whether the success of an EP strategy, defined in terms of freedom from bias against exports, requires the presence of a beneficial external environment is of course a separate issue which has already been addressed above and will be treated again in Section V which focuses on the revived export pessimism.

(iii) Finally, it is worth stressing that the concept of EP or outward orientation relates to trade incentives (as defined by either trade policies directly or by domestic policies which impact on trade or by exchange rate policies which have consequences for trade) but does not imply that the EP strategy countries must be equally outward oriented in regard to their policies concerning foreign investment. As it happens, the four Far Eastern economies have generally been more favorable in their treatment of foreign investors than the IS countries, though the historic growth of Japan, presumably as an EP country, was characterized by far more control on the entry of foreign investment. Logically and empirically, the two types of outward orientation, in trade and in foreign investment, are therefore distinct phenomena though whether one can exist efficiently without the other

is an important question that has been raised in the literature and is surrounded by far more controversy than the question of the desirability of an EP strategy in trade.

IV. Why Does an Export Promoting Trade Strategy Aid Successful Development?

With the EP strategy defined in terms of the incentive structure, the substantive conclusion that has emerged from the major research projects listed earlier is that the EP countries have done remarkably well in terms of their economic performance. Paradoxically, the successful countries in development have therefore turned out to be those that followed this strategy but had no one rooting for their success when development efforts were being initiated in the early 1950s. Here, as elsewhere, history has turned up surprises.

In evaluating this outcome, we have to distinguish between two questions: (i) why should the EP strategy have been helpful in accelerating economic development; and (ii) could the acceleration have been caused by factors other than the EP strategy? Prior to both questions, however, it is useful to review the evidence on the relationship between EP strategy and economic performance.

A. The Evidence

(i) The serious evidence on the successful impact of the EP strategy on economic performance, as measured by an improved growth rate, has to be found in the country studies of the research projects on trade and development (listed earlier). Among these, the most compelling evidence is in the analyses in the NBER project where the EP strategy was carefully defined and

transitions to it from an IS strategy by various Phases were systematically investigated. 15/

(ii) There is also much cited evidence that relates largely to associations between growth rates of exports and growth rates of income, as in the work of Michaely (1977) who used data for 1950-73 for 41 countries, and the further extension of this type of work by Balassa (1978) and Feder (1983). 16/

Complementing this approach is the altogether different statistical formulation in Michalopoulos and Jay (1973). This study takes a very different approach to the problem by using exports as an argument in estimating an economy-wide production function from aggregate output and factor-use data. Using data for 39 countries this study argued that exports are an independent input into national income. 17/

Both these Michaely-Balassa-Feder and Michalopoulos-Jay variety of findings, however, do not bear directly on the question whether the EP strategy is productive in terms of more growth. For, the incentive-related EP strategy, which nearly all of these authors would embrace as the appropriate definition and concept to deploy, is not the one used to examine the question of income or growth performance. It is necessary to go behind the scenes and

15/ See, in particular, the synthesis volumes by Bhagwati (1978) and Krueger (1978).

16/ Krueger's (1978) synthesis volume also contains similar cross-country regressions for the ten semi-industrialized countries in the NBER project. See the extensive review in Lal and Rajapatirana (1986).

17/ Balassa's (1978) re-estimation of Michaely-type regressions also incorporates the Michalopoulos-Jay approach, thus combining the two different methodologies under one rubric.

identify whether the superior export growth rates (or higher export magnitudes) belong to the EP countries.

This is particularly worrisome since high growth rates of exports may have been caused by high growth rates of output (which, in turn, may have resulted from other exogenous factors such as a higher savings effort), rather than the other way around. Thus, if IS does not parametrically reduce trade greatly, it is conceivable that this reverse causation could lead the rapidly expanding countries, whether EP or IS, to show higher export growth rates than less rapidly expanding economies, whether EP or IS.

Hence, while these cross-country regressions are certainly interesting, valuable, and suggestive, they cannot be considered compelling on the issue in question. By contrast, the detailed country studies are indeed methodologically superior and more persuasive. And, as noted already, they do indicate the superiority of the EP strategy.

B. Reasons

The reasons why the IS strategy has been generally dominated by the EP strategy, and why the countries that rapidly made the transition from the former to the latter have done better, have preoccupied economists since these findings came to light. The following hypotheses have been advanced, based on the usual mix of analytical insights, casual empiricism, and econometric evidence.

(i) Resource Allocation Efficiency: The first set of reasons relies on the fact that the EP strategy brings incentives for domestic resource allocation closer to international opportunity costs and hence, as international economists recognize, closer to what will generally produce efficient outcomes.

This is true, not merely in the sense that there is no bias against exports and in favor of the home market (i.e., $EER_x \approx EER_m$) under the EP strategy, whereas often the researchers have observed a substantial excess of EER_m over EER_x in the IS countries. It is also valid in the sense that the IS countries seem to have generally had a chaotic dispersion of EERs among the different activities within the broader categories of export and import-competing activities as well. That is, the degree of IS goes far and the pattern of IS reflects widely divergent incentives. By contrast, the EP strategy does better on both degree (since $EER_x \approx EER_m$) and on pattern.

The interesting further question relates to why the degree gets outsized and the pattern also goes wrong under IS. The answer seems to lie in the way in which IS is often practiced and in the constraints that surround EP. Thus IS could, in principle, be contained to modest excess of EER_m over EER_x . But typically IS arises in the context of overvalued exchange rates and associated exchange controls. So, there is no way in which the excess of domestic over foreign prices is being tracked by government agencies in most cases, and the excesses of EER_m over EER_x simply go unnoticed. The nontransparency is fatal. By contrast, EP typically tends to constrain itself to rough equality, and ultra-EP also seems to be moderate in practice, because policy-induced excesses of EER_x over EER_m would require subsidization that is constrained by budgetary problems.

In the same way, the pattern of EER_m can be terribly chaotic because exchange controls and QRs on trade will typically generate differential premia and hence differential degrees of implied protection of thousands of import-competing activities, all of which are simply the side consequence of the administrative decisions on exchange allocations. By contrast, the EP

strategy will rely more on unifying exchange rates which avoid these problems and, when relying on export subsidization, will be handled both with necessary transparency and with budgetary constraints that would then prevent IS-type spectacular dispersions in resulting EERs.

(ii) Directly-Unproductive Profit-Seeking (DUP) and Rent-Seeking Activities: Yet another important aspect of the difference between EP and IS strategies, once we recognize that IS regimes have typically arisen in the context of exchange rate overvaluation and associated controls on foreign exchange and trade, is that this kind of regime is more likely to trigger what economic theorists now call DUP (Bhagwati, 1982b) and rent-seeking activities (Krueger, 1974). These activities divert resources from productive use into unproductive but profitable activities designed to earn profits (or income) by lobbying to change policies or to evade them or to seek the revenue and rents they generate. 18/

With IS policies typically conducted within the framework of quantitative allocation systems, the diversion of entrepreneurial energies and real resources into such DUP activities tends to add to the conventionally measured losses from the high degree and chaotic pattern of IS. 19/

It must be admitted that while economists have now begun to make attempts at estimating these costs, they are nowhere near arriving at

18/ See Bhagwati and Srinivasan (1983, Chapter 30) for a taxonomy of such lobbying activities.

19/ The Appendix explains the manner in which the conventional cost of protection, from distorted production decisions resulting from the protection, is augmented by adding the cost of tariff-seeking lobbying when the protective tariff is the result of such lobbying. Costs of other kinds of lobbying, including the effects of DUP activities such as illegal trade (i.e., tariff evasion), can be similarly illustrated.

plausible estimates simply because it is not yet possible to estimate realistically the production functions for returns to different kinds of lobbying. But, as Harrod once remarked, arguments that cannot be quantified are not necessarily unimportant in economics; and the losses arising from DUP and rent-seeking activities seem presently to illustrate his observation. 20/

(iii) Foreign Investment: If IS regimes have tended to use domestic resources inefficiently in the ways that were just outlined, the same applies to the use of foreign resources.

This is perhaps self-evident. But substantial theoretical work by Bhagwati (1973), Brecher and Diaz-Alejandro (1977), Uzawa (1969), Hamada (1974), and others has established that foreign investment which comes in over QRs and tariffs--the so-called "tariff-jumping" investment--is capable of immiserizing the recipient country under conditions that seem uncannily close to the conditions in the IS countries in the postwar decades. These conditions require capital flows into capital intensive sectors in the protected activities. It is thus plausible that, if these inflows were not actually harmful, the social returns on them were at least low compared to what they would be in the EP countries where the inflows were not tariff-

20/ Krueger's (1974) classic article contains estimates of rent-seeking costs, that is, costs arising from resources spent in chasing premia or rents on quantitative restrictions. But these are exceptionally high estimates because they are based on the assumption that rents result in an equivalent loss of resources in equilibrium (the so-called one-on-one postulate in rent-seeking theory). Recently, computable-general-equilibrium modellers such as Whalley, Robinson, de Melo, and others have begun to incorporate such DUP and rent-seeking activities into their models and calculations, so that progress can be expected at some future date in assessing the magnitude of such costs in a plausible fashion. Cf. Dervis, de Melo, and Robinson (1981) and Grais, de Melo, and Urata (1986).

jumping but rather aimed at world markets, in line with the EP strategy of the recipient countries.

In addition, I have hypothesized (Bhagwati, 1978 and 1986a) that, ceteris paribus, foreign investments into IS countries will be self-limiting in the long run because they are aimed at the home market and therefore constrained by it. If so, and there seems to be some preliminary evidence in support of this hypothesis in ongoing econometric analysis, 21/ then IS countries would have been handicapped also by the lower amount of foreign investment flows and not just by their lower social productivity compared to the EP countries.

(iv) "Grey Area" Dynamic Effects: While the arguments so far provide ample satisfaction to those who seek to understand why the EP strategy does so well, dissatisfaction has continued to be expressed that these are arguments of static efficiency and that "dynamic" factors such as savings and innovations may well be favorable under IS.

Of course, if what we are seeking to explain is the relative success of the EP countries with growth, this counter-argumentation makes little sense since, even if it were true, the favorable effects from these "grey area" sources of dynamic efficiency would have been outweighed in practice by the static-efficiency aspects. The fact remains, however, that in the NBER project which was the only one to address these questions in some fashion, the results were simply not clearcut on the issue, providing support to neither

21/ See the discussion in Balasubramanian (1984) and in Bhagwati (1986a). In private communication, Balasubramanian has provided further results on this hypothesis.

the school that maintains that IS does better on these questions nor to the EP proponents who sometimes propose the opposite in their enthusiasm. 22/

(a) Thus, it is simply impossible to claim that IS regimes enable a country to save more or less than EP regimes: the evidence in the NBER project, for instance, went both ways. 23/

(b) Nor does it seem possible to maintain that EP or IS regimes are necessarily more innovative. It is possible to argue that EP regimes may lead to more competition and less sheltered markets and hence more innovation. But equally, Schumpeterian arguments suggest that the opposite might also be true.

The little empirical evidence that was available in the NBER project did not point in either direction. Since then, however, a few studies have appeared which suggest that the EP strategy may encourage greater innovation. Thus, Krueger and Tuncer (1980) have examined the 18 Turkish manufacturing industries during the 1963-76 period. They found that periods of low productivity growth roughly occurred during periods when foreign exchange controls were particularly restrictive and hence the IS strategy was being accentuated. The overall rate of productivity growth was also low throughout the period Turkey pursued an IS strategy.

Again, in an analysis of productivity change in Korea, Turkey, Yugoslavia, and Japan, Nishimizu and Robinson (1984) argue that if growth is decomposed into that due to "domestic demand expansion", "export expansion",

22/ See, in particular, the extensive analysis of this question in the NBER synthesis volume by Bhagwati (1978) where some chapters are specifically addressed to summarizing and evaluating these kinds of arguments with the aid of the findings in the ten country studies as also extraneous evidence and argumentation on these subjects.

23/ See Bhagwati (1978, Chapter 8).

and "import substitution", the inter-industrial variation in factor productivity growth reflects (except for Japan) the relative roles of export expansion and import substitution, the former causing a positive impact and the latter a negative one. This careful and painstaking research is certainly suggestive. However, as the authors recognize, export expansion may have been caused by productivity change rather than the other way around, the regressions begging the issue of causality.

(c) What about economies of scale? Theoretically, the EP success should be increased because world markets are certainly larger than just home markets. But, systematic evidence is not yet available on this question. For instance, evidence is lacking to date indicating whether firms which turn to export markets are characterized by greater scale of output than those firms which do not.

(d) Finally, in the matter of X-efficiency, it is again plausible that firms under IS regimes should find themselves more frequently in sheltered and monopolistic environments than under EP regimes; in fact, a great deal of such evidence is available from the country studies in the several research projects discussed. X-efficiency therefore ought to be greater under the EP regime. However, as is well known, this is a notoriously grey area where measurement has often turned out to be elusive.

While the latter two arguments for the success of the EP strategy are therefore plausible, empirical support for them is not available. The former two arguments are a mixed bag, providing less than a compelling case for showing that EP is necessarily better on their account than IS.

C. Growth and Other Objectives

A final word is necessary on the superior economic performance of the EP strategy. Much like the die-hard monetarists who keep shifting their definitions of money as necessary in order to keep their faith, the proponents of IS have tended to shift their objections as required by the state of the art.

When it became evident that the EP strategy yielded higher growth, and that the static versus dynamic efficiency arguments were not persuasive and probably went in favor of the EP strategy, the IS die-hards shifted ground. They took to arguing that the objective of development was not growth but the elimination of poverty or increasing employment; and that EP might be better for growth but was worse for these other objectives. This was part of a larger argument that became fashionable during the 1970s in certain development circles: that growth had been the objective of development to date, that the objective was wrong, and that the true objective of poverty amelioration was ill-served by development efforts directed at growth, and in fact growth even harmed (in certain formulations of such critics) the poor.

Of course, in theory, economists can prove anything if they are smart enough. Conflicts among different objectives can be readily demonstrated in well-defined, suitably-chosen models. What was novel, however, was the assertion that the empirical experience of the 1950s and 1960s had shown that growth did not impact on poverty and that it had even harmed it. These views, however, have not stood the test of detailed scrutiny.

The evidence simply does not support the views that growth was desired per se, that poverty elimination was not the stated objective which was pursued by means which included as a key element the acceleration of

growth rates to "pull up" the poor into gainful employment, and that growth on a sustained basis has not helped the poor. These orthodoxies are no longer regarded as plausible, as I have argued at length elsewhere. 24/

In regard to the narrower question at hand, that is, whether the EP strategy procures efficiency and growth but impacts adversely on poverty and employment, evidence has now been gathered extensively in a sequel NBER project, directed by Krueger (1982). Essentially, she and her associates document how the investment allocation under EP require the expansion of labor-intensive activities since developing country exports are typically labor intensive. Therefore, ceteris paribus, they encourage the use of labor and hence employment and hence, in countries which typically have underemployed labor, also the alleviation of poverty.

Moreover, after more than two decades of successful growth in the EP countries, especially in the four Far Eastern economies, it has become easier for economists to contemplate and comprehend the effects of compound rates and the advantages of being on rapid escalators. Even if it had been true that the EP strategy yielded currently lower employment or lower real wages, the rapid growth rates would overwhelm these disadvantages in the long run which can be simply one generation.

It would appear therefore that both the employment-intensive nature of EP growth in developing countries and the higher growth rates in the EP countries have provided a massive antidote to the poverty and underemployment that afflicted these countries at the start of their development process.

24/ See Bhagwati (1985d) for a detailed review of these questions, drawing on a substantial body of evidence.

V. The Second Export Pessimism

These lessons were important. Many developing countries learnt them the hard way: by following IS policies too long and seeing the fortunate few pursuing the EP strategy do much better. Perhaps learning by others' doing and one's own undoing is the most common form of education!

But just as these lessons were widely accepted, and a "new orthodoxy" in their favor was established, a new wave of export pessimism arrived on the scene. This second export pessimism, which is paradoxically both more serious and more tractable in principle, tends to undermine the desired shift to the EP strategy in the developing countries.

As is often the case, there are two different sets of factors generating this pessimism: (i) the objective events such as the slowing down of the world economy since the 1970s and the resurgence of powerful protectionist sentiments in the developed countries; and (ii) new intellectual and academic arguments supportive of inward-looking trade policies in the developing countries. The two are not entirely unrelated since theory, especially international trade theory, does not grow in a vacuum. But they can be dealt with sequentially nonetheless.

A. Protectionism

In essence, the second export pessimism rests on the view that, whatever the market-defined absorptive capacity for the exports of the developing countries, the politics of protectionism in the developed countries (which still constitute the chief markets of developing country exports) is such that the exports from developing countries face serious and crippling constraints that make the pursuit of an EP strategy (with $EER_x \approx EER_m$) inefficient, if not positively foolish.

If this assessment is correct in its empirical premises, then of course the IS strategy is more appropriate. For, the constraints on exports, if effectively binding, constitute a historically accepted basis for a country turning inward in its trade policy. The argument collapses only insofar as one can argue that the protectionist threat is not as serious as it appears or that, even though it is serious, there are policy options such as multilateral efforts at containing the threat effectively that therefore ought to be undertaken while one pursues the EP strategy. As it happens, a case can be made in support of both these responses.

B. How Serious is the Protectionist Threat?

In assessing the extent to which the protectionist threat must be taken seriously, one may first make the prudential statement that it should never be regarded lightly. Sectional interests have always provided the political momentum through Congresses and Parliaments to protectionist responses to import competition. On the other hand, the postwar history of trade barriers shows the important role that Executives have played in upholding the national interest, broadly served by freer trade and specialization. Vigilance in containing protection has always been necessary. The real question is: has the threat become sufficiently more serious so that the developing countries ought to turn away from embracing the EP strategy?

(i) First, a few facts need to be noted. As Table 1 briefly indicates, trade expansion has certainly slowed down considerably since the 1970s. But even then, world trade has grown faster than world income over the 1970-83 period. More compelling is the fact that the developing countries' exports of manufactures to the developed countries have grown almost twice as fast as the exports of these countries to one another, showing even during the

1970s a growth rate of over 8 percent annually. This has happened during a period when nontariff barriers (NTBs) such as voluntary export restraints (VERs) began to proliferate to the chagrin of everyone embracing the national interest, and during a period when the OECD countries showed sluggish growth rates and increased rates of unemployment.

That exports from the developing countries continued to grow in this fashion was first highlighted by Hughes and Krueger (1984) who thought that it was a puzzle since protectionist threats had been felt to be translated into a large amount of actual protection already. This puzzle has stimulated Baldwin (1982 and 1985) into developing an interesting thesis: that protection is far less effective than one thinks simply because there are many ways in which exporting countries can "get around" it in continuing to increase their export earnings. Thus, Baldwin has written (1985):

"Consider the response of exporting firms to the imposition of tighter foreign restrictions on imports of a particular product. One immediate response will be to try to ship the product in a form which is not covered by the restriction... One case involves coats with removable sleeves. By importing sleeves unattached, the rest of the coat comes in as a vest, thereby qualifying for more favorable tariff treatment." (p. 110)

"The use of substitute components is another common way of getting around import restrictions. The quotas on imports of sugar into the United States only apply to pure sugar, defined as 100 percent sucrose. Foreign exporters are avoiding the quotas by shipping sugar products consisting mainly of sucrose, but also containing a sugar substitute, for example dextrose... At one time, exporters of running shoes to the United States avoided the high tariff on rubber footwear by using leather for most of the upper portion of the shoes, thereby qualifying for duty treatment as leather shoes." (p. 110)

Yoffie (1983) has also recently examined the VERs on footwear and textiles from a political scientist's perspective and found that the dynamic exporting economies such as South Korea and Taiwan have embraced them with considerable ingenuity, much like what Baldwin has documented and argued, to continue expanding their exports significantly.

There is also a more subtle factor at play here which relates to why VERs, which represent the method by which imports have been sought to be cut in many recent NTB actions, may have provided the mechanism by which the Executives interested in maintaining freer trade despite mounting protectionism may have succeeded in keeping trade expanding. VERs are, in that view, a "porous" form of protection that is deliberately preferred because of this nontransparent porousness. I have argued recently (Bhagwati, 1986b) that in industries such as footwear, two characteristics seem to hold that lend support to this "porous-protection" model as an explanation for why protection is ineffective: (a) undifferentiated products (i.e., cheaper varieties of garments and footwear) make it easy to "transship", that is, to cheat on rules of origin, passing off products of a country restricted by VERs as products of countries not covered by VERs; and (b) low start-up costs and therefore small recoupment horizons apply in shifting investment and hence products to adjacent third countries that are not covered by VERs, so that an exporting country can get around (admittedly at some cost) the VERs by "investment-shunting" to sources unaffected by VERs. This type of strategy allows the exporter to recover his investment costs since it is usually some time before the VERs get around to covering these alternative sources (or VERs are eliminated as the political pressure subsides (as was the case with US footwear). 25/

In both ways, therefore, VERs in these types of industries can yield an "as-if-free-trade" solution for the exporting countries that are afflicted

25/ The investment-shunting need occur only insofar as it is necessary to meet value-added rules of origin, of course, making the cost of profiting from this porousness even less than otherwise.

by the VERs. These countries can continue to profit from their comparative advantage by effectively exploiting, legally (through investment-shunting) and illegally (through transshipments), the fact that VERs leave "third countries" out whereas importing-country tariffs and quotas do not. 26/

But the question then arises: why would the protecting importing countries prefer this "porous protection"? Does it not imply that the market-disrupted industry fails to be protected as it would under a corresponding import trade restraint? Indeed it does. But that is precisely its attractiveness.

If Executives want free trade in the national interest whereas legislatures respond to the sectoral interests--definitely the "stylized" description of the "two-headed" democracies in the United States and the United Kingdom--then it can be argued that Executives will prefer to use a porous form of protection which, while assuring freer market access, will nonetheless manage to appear as a concession to the political demands for protection from the legislature or from their constituencies. Undoubtedly, these protectionist groups and their congressional spokesmen will eventually complain about continuing imports. But then the Executive can always cite its VER actions, promise to look into complaints and perhaps bring other countries

26/ Of course, the VERs in this instance represent only a partial and suboptimal approximation to the free trade solution which remains the desirable but infeasible alternative.

into the VER net, and continue to obfuscate and buy time without effectively protecting. 27/

(ii) If the foregoing arguments suggest that Executives have been clever enough, both in exporting and importing countries, in keeping markets much more open than the casual reading of the newspapers would suggest, there are also additional pro-freer-trade forces that have now emerged in the world economy which need to be considered in making a reasonable assessment of the prospects for increased protectionist measures.

I believe that the international political economy has changed dramatically in the last two decades to generate new and influential actors that are supportive of freer world trade.

A fairly common complaint on the part of analysts of the political economy has been the asymmetry of pressure groups in the tariff-making process. The beneficiaries of protection are often concentrated whereas its victims tend to be either diffused (as is the case with final consumers) or are unable to recognize the losses they incur as when protection indirectly affects exports and hence hurts those engaged in producing exportables. 28/

27/ This "two-headed" version of governments is, of course, what underlies the Feenstra-Bhagwati (1982) model of the efficient tariff. There, the model postulates that one branch of the government (pursuing special interests) interacts with a protectionist lobby to enact a political-economy tariff. Then, another branch of the government (pursuing the national interest) uses the revenue generated by this tariff to bribe the lobby into accepting a less harmful tariff that nonetheless leaves it as well off as under the political-economy tariff. When this model was presented to a scientific conference in 1978, the general reaction was that the model had a "schizophrenic" two-headed government! Traditional trade theory is so often modelled in terms of a monolithic government that what was obviously a realistic innovation was regarded as a bizarre feature of the model.

28/ See for example, Olson (1971), Finger (1982), and Mayer (1985).

Direct foreign investment (DFI) and the growing maze of globalized production have changed this equation perceptibly. When DFI is undertaken, not for tariff-jumping in locally-sheltered markets, but for exports to the home country or to third markets as is increasingly the case, protectionism threatens clearly the investments so made and tends to galvanize these influential multinationals into lobbying to keep markets open.

For example, it was noticeable that when the US semiconductor suppliers recently gathered to discuss anti-dumping legal action against Japanese producers of memory microchips known as EPROMS (or erasable programmable read-only memories), noticeably absent were Motorola Inc. and Texas Instruments Inc. who produce semiconductors in Japan and expect to be shipping some back to the United States. 29/

Almost certainly a main reason why US protectionism has not translated into a disastrous Smoot-Hawley scenario, despite high unemployment levels and the seriously "overvalued" dollar (in the Dutch-Disease sense), is that few congressmen have constituencies where DFI has not created such pro-trade, anti-protectionist presence, muddying waters where protectionists would have otherwise sailed with great ease. The "spider's web" or "spaghetti-bowl" phenomenon resulting from DFI that criss-crosses the world economy has thus been a stabilizing force in favor of holding the protectionists at bay.

29/ See the report by Miller (1985) in the Wall Street Journal.

It is not just the DFI in place that provides these trade-reinforcing political pressures. 30/ As I have often argued (1982a and 1986a), the response to import competition has been diluted by the possibility of using international factor mobility as a policy response. Thus, the possibility of undertaking DFI when faced with import competition also provides an alternative to a protectionist response. Since this is the capitalist response, rather than that of labor which would "lose jobs abroad", the defusion of protectionist threat that is implied here works by breaking and hence weakening the customary alliance between both pressure groups within an industry in their protectionist lobbying, a relationship with which Magee has made us long familiar.

Interestingly, labor today seems also to have caught onto this game and is not averse to using threats of protection to induce DFI from foreign competitors instead. The United Auto Workers labor union in the United States appears to have so helped induce Japanese investments in the car industry. This is, in fact, quite a generic phenomenon where DFI is undertaken by the Japanese exporting firms to "buy off" the local pressure groups of firms and/or unions who can, and often do, threaten legislative pressures for tariffs to close the import markets. This type of induced DFI has been christened by me as "quid pro quo DFI" (Bhagwati, 1985c) and appears to be a

30/ Of relevance here is the work of Helleiner (1977) and others. These authors, and most recently Lavergne and Helleiner (1985), have argued that multinationals have become active agents exercising political pressure in favor of free trade, and the structure of trade barriers has been related to patterns of DFI in some of these studies. Their work, however, does not extend to the potential DFI effects in favor of freer trade (through DFI becoming an alternative response to import competition) that is discussed in Bhagwati (1982b and 1986a) and in the text.

growing phenomenon 31/ (certainly on the part of Japanese firms), representing a new and alternative form of response to import competition than provided by old fashioned tariff-making. 32/

In short, both actual DFI (through the "spaghetti-bowl" effect) and potential DFI (outward by domestic capital and quid pro quo inward by foreign capital) are powerful forces that are influencing the political economy of tariff-making in favor of an open economy. They surely provide some counterweight to the gloom that the protectionist noises generate today.

(iii) But all these arguments could collapse under the weight of the contention that if many countries were indeed to shift to the EP strategy, whether through conversion to the view or through conditionality such as that envisaged under the Baker Plan put forth by US Treasury Secretary James Baker III in 1985, the pressures to close markets would multiply owing to the magnitude of the absorption of exports that this would imply for the developed countries.

This takes us back partly to the Cline (1982) estimates and the several refutations of his line of pessimism that were set out in Section II earlier. 33/ But it remains true that, even if the estimates in Cline are not

31/ In fact, MITI (Ministry of International Trade and Industry) of Japan has recently completed a survey of Japanese DFI abroad and found that a large fraction of the respondents cited reasons of the quid pro quo variety to explain their investment decisions. I am indebted to Professor Shishido of the International University of Japan for this reference.

32/ See the theoretical modelling of such quid pro quo DFI in Bhagwati, Brecher, Dinopoulos, and Srinivasan (1987) and in Bhagwati and Dinopoulos (1986), the former using perfectly competitive structure and the latter using monopoly and duopoly structures instead.

33/ See also the excellent critique offered by Ranis (1985), which is an added corrective to the Cline approach and conclusions.

to be taken seriously, the addition of any kind of trade pressure in a significant degree could touch off a wider range of sectoral, safeguard moves in the developed countries in the present climate. It is indeed possible to argue that (i) Cline-type estimates are not plausible and exaggerate what would happen; (ii) there is a great deal of absorptive capacity in the market sense in the world economy which can readily handle improved export performance resulting from the shift of many developing countries to the EP mode of organizing trade; and (iii) there are powerful new forces in the international political economy that may make the protectionist bark worse than the protectionist bite. Nonetheless, the danger of protectionism does remain acute, especially in the present macroeconomic situation of sluggish growth and continuing trade deficit in the United States. The US Executive's capacity to hold the line against protectionism has been significantly eroded by the neglect of fiscal deficits and a serious underestimate of the upsurge in the congressional sentiment in favor of protection and fair trade that would ensue from such failures and the massive adjustments they would impose on the trade sector. The US Executive is much more conscious of its earlier neglects and of their consequences for protectionism; but the fragility of the situation requires serious attention to other policy instruments such as the proposed Multinational Trade Negotiations (MTN), as discussed below.

An important consequence of the second wave of export pessimism, which is based on this protectionist threat rather than on the belief in market-determined forces that limit export prospects, is that developing countries can join in the process of trying to contain this threat and thereby change the very prospects for their trade. In turn, therefore, this suggests that they join hands with the developed countries in efforts such as the MTN

to contain the threat to the world trading system and to keep markets open to expanding trade levels. Shifting to the IS strategy, therefore, based on export pessimism reflecting protectionist sentiments simply makes no sense from an economic viewpoint unless the developing countries are convinced that protectionism is here to stay and will be translated into actuality no matter what is done--an assumption that seems to be wholly unwarranted in light of the discussion earlier in this Section. A far more sensible policy approach seems rather to be to join with the Executives of countries that support freer trade initiatives, among them certainly the United States, in containing the protectionist sentiments via strategies such as entering into trade negotiations.

C. New Arguments for the IS Strategy

It may then be useful to address some new intellectual defenses of the IS strategy that have recently emerged in the academic literature. ^{34/}

(i) Labor Market Imperfections: In recent articles, especially Fields (1984), it has been argued that the EP strategy is not appropriate when there are excessively high wages in the economy and that EP countries such as Jamaica have done badly by ignoring this caveat.

Now, the theoretical literature on market imperfections and optimal policy that emerged in the postwar period, with the independent contributions

^{34/} In the following, I select for treatment only the most important such arguments, given the central theme of this paper. For a more comprehensive review of recent arguments for protection, including those applying to developed countries--as in Kaldor's (1966) argument for protection to prevent British deindustrialization or Seabury's (1983) advocacy of protection to prevent American deindustrialization for defense reasons--see my analyses in Bhagwati (1985c, 1985e, and 1986c). For a different emphasis, more skeptical of anti-protectist arguments and EP strategy, see Streeten (1982).

by Meade (1951) and Bhagwati and Ramaswami (1963) setting off the spectacular growth of the subject during the 1960s, has shown that factor market imperfections are best addressed by domestic, rather than trade, taxes and subsidies. ^{35/} However, it is indeed true that the second-best policy measures in such a case could be trade tariffs and subsidies, as the case may be.

There are two other problems with Fields' argument. First, he does not establish that countries such as Jamaica have in fact been following the EP strategy in the incentive-related sense that is relevant. As it happens, Jamaica certainly has not and, in fact, has for long periods been in the IS mode instead. This confusion of concepts and hence conclusions is however, it should be noted, not confined to Fields' analysis but afflicts even the proponents of EP strategy in some cases. Second, it is not at all clear from Fields that the high wages constitute a market imperfection in the sense required for departure from unified exchange rates in the form of the IS strategy.

In my view, wages are relevant in a different sense that is macro-theoretic rather than micro-theoretic as Fields suggests. If overall wages are "too high", that can only mean that somehow they, and therefore the price level as well, are out of line with the exchange rate. That is, the country is suffering from overvaluation. In short, if that is so, we have already seen that the country is pursuing an IS strategy, whether it intends to or not. Therefore, a country simply cannot hold on to any EP strategy if it

^{35/} The entire theory has been synthesized in Bhagwati (1971) and there is also a splendid short treatment by Srinivasan (1987) in his entry on distortions for The New Palgrave.

continues to experience excessive wages. The successful pursuit of EP, on a sustained basis so that investors respond to the incentives that EP defines, thus requires a sound macro policy as its foundation. Sound macro policies may then also bring, in turn, their own other rewards that supplement those that follow from the EP strategy.

(ii) Satisficing Theory of IS: An interesting thesis has been proposed by the political scientist Ruggie (1983), which seems to argue that the advantage of an EP strategy cannot be enjoyed by many developing countries because they simply do not possess the flexibility of resource movements and the necessary political capacities to negotiate such flexibilities that the pursuit of EP requires. I would call this therefore the "satisficing" theory of the IS strategy: developing countries in this predicament must make do without the gains from trade and efficiency improvements that EP strategy brings.

This is a difficult argument to judge since, even if it were valid within its premises, I do not find it compelling if such political constraints are equated with the fact of being less developed economically. In fact, given the lack of democratic structures with pressure group politics and attendant constraints on economic action by the government, it is doubtful whether developing countries are not the ones at advantage in this matter!

Again, is it clear that tensions and distributional conflicts are necessarily more difficult under an EP strategy? An IS strategy, while insulating the economy relatively from external disturbances, may create yet more tensions and conflicts if the resulting stultification of income expansion accentuates the zero-sum nature of other policy options in the system. The correct statement of the Ruggie thesis would then seem to be

that, in the pursuit of any development strategy, the compatibility of it with the political structure and resilience of the country needs to be considered. And this caveat needs to be addressed not only to the EP-strategy proponents.

(iii) Coping with External Instability: A similar economic concern has been that, while EP may be better under steady-state conditions, it exposes the economy to the downside in the world economy and makes it more vulnerable to instability.

Of course, the downside effects have to be set off against the upside effects. When this is done, it is not evident that countries pursuing EP strategies are necessarily worse off. As it happens, even the downside experience of EP-strategy countries during the post oil shock years seems to have been more favorable than the experience of the IS-strategy countries, according to statistical analysis by Balassa (1983 and 1984). The reason seems to have been their greater capacity to deal with external adversity by using export expansion more successfully and thus avoiding import contraction to adapt to the world slowdown.

VI. Conclusion

Export promotion policies emerge with success from the detailed scrutiny offered in this paper. Equally important is the fact that their successful adoption will indeed require collaborative and intense efforts to ensure that the protectionist threat, recently escalating, is not allowed to break out into actual protection on a massive scale.

It will therefore require some patience and understanding, not merely on the part of the developed countries, but also on the part of the developing

countries as they meet to negotiate trade demands and concessions over the forthcoming trade talks.

The forthcoming Multilateral Trade Negotiations offer the only reasonable prospect for maintaining a momentum in favor of a freer world trading system. Failure in pursuing them successfully, in a spirit of accommodation and mutual understanding of constraints and needs, will only undermine what seems like the best mechanism for containing the protectionist threat.

Appendix

Theoretical Clarification of Key Concepts

I. Definitions of Export Promoting (EP), Import Substituting (IS), and Ultra-Export Promoting (Ultra-EP) Trade Strategies

Figure 1 illustrates, in the two-good model, the definitions of alternative trade strategies.

AB is the country's production possibility curve. With given international prices P^*S , equilibrium production would be reached at P^* under unified exchange rates which ensure that the relative goods prices domestically are equal to P^*S . Therefore, at P^* , we have $EER_x = EER_m$, where EER refers to the effective exchange rate. This is defined as the EP strategy.

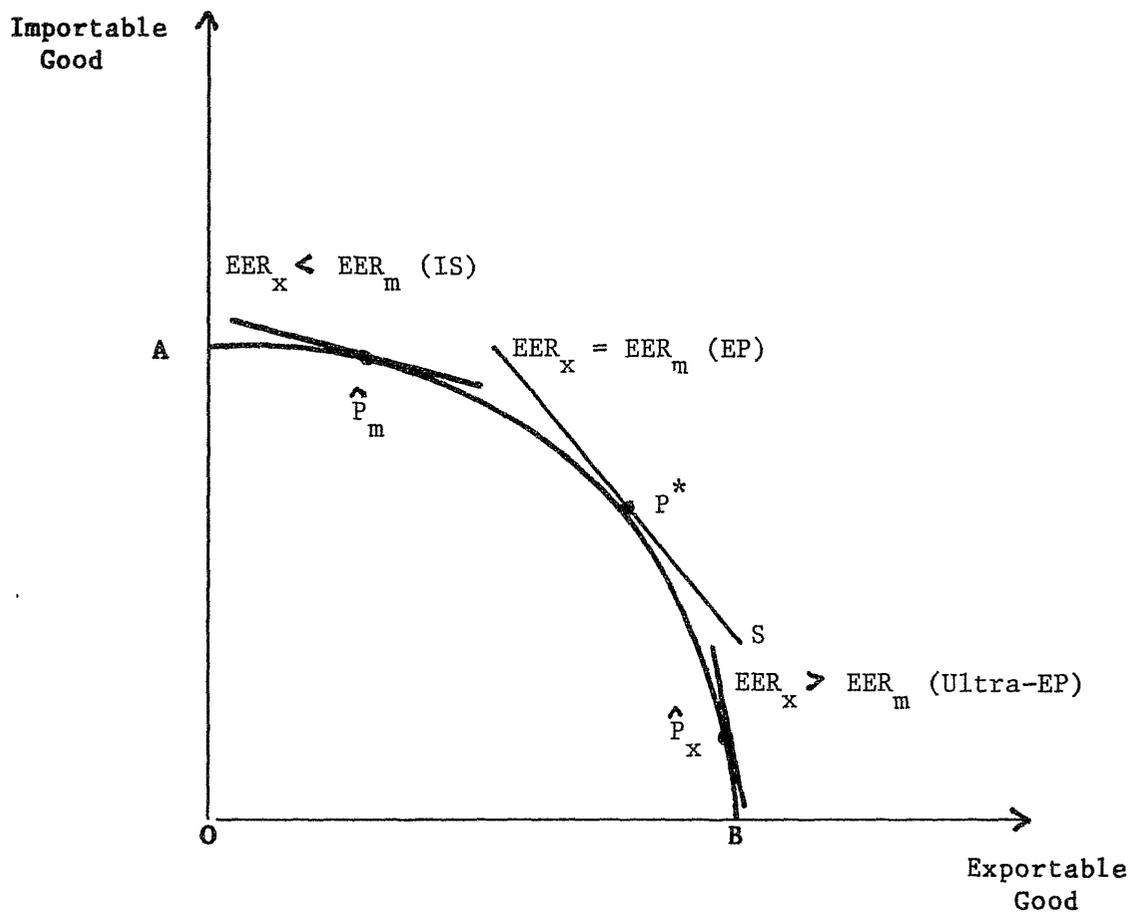
When the incentive to produce the import-competing good exceeds that to produce the exportable good, due to say a tariff or overvalued exchange rates (as shown below), production shifts to \hat{P}_m . Here, $EER_x < EER_m$. This is the IS strategy.

If the biased incentive goes in the other direction, the relative incentives imply $EER_x > EER_m$ and production shifts to the right of P^* , to say \hat{P}_x . This is defined as the ultra-EP strategy.

II. Overvalued Exchange Rate and IS Strategy

An overvalued exchange rate will imply the pursuit of the IS strategy. Figure 2 demonstrates this via the standard supply and demand diagram for foreign exchange.

Figure 1: Alternative Trade Strategies



If the exchange rate is adjusted to clear the market, at S , then $EER_x = EER_m$ because an identical parity applies to both export and import transactions. But consider now an overvalued exchange rate with exchange controls in place. Under these circumstances the overvalued exchange rate γ_x leads to OW foreign exchange being earned, corresponding to R on the SS curve. This foreign exchange will then be rationed through controls to users, fetching a market-determined price which exceeds γ_x . That price is determined by Q on the DD curve, with γ_m representing then the price corresponding to quantity OW . Evidently then, $(\gamma_m - \gamma_x)/\gamma_x$ represents the rate of premium that scarce foreign exchange enjoys in this overvalued-exchange-rate system.

It is also evident that $\gamma_x = EER_x$ and $\gamma_m = EER_m$ and therefore $EER_x < EER_m$ by the magnitude of the premium on rationed foreign exchange. The overvalued exchange rate therefore implies the pursuit of an IS strategy, whether it is intended to or not.

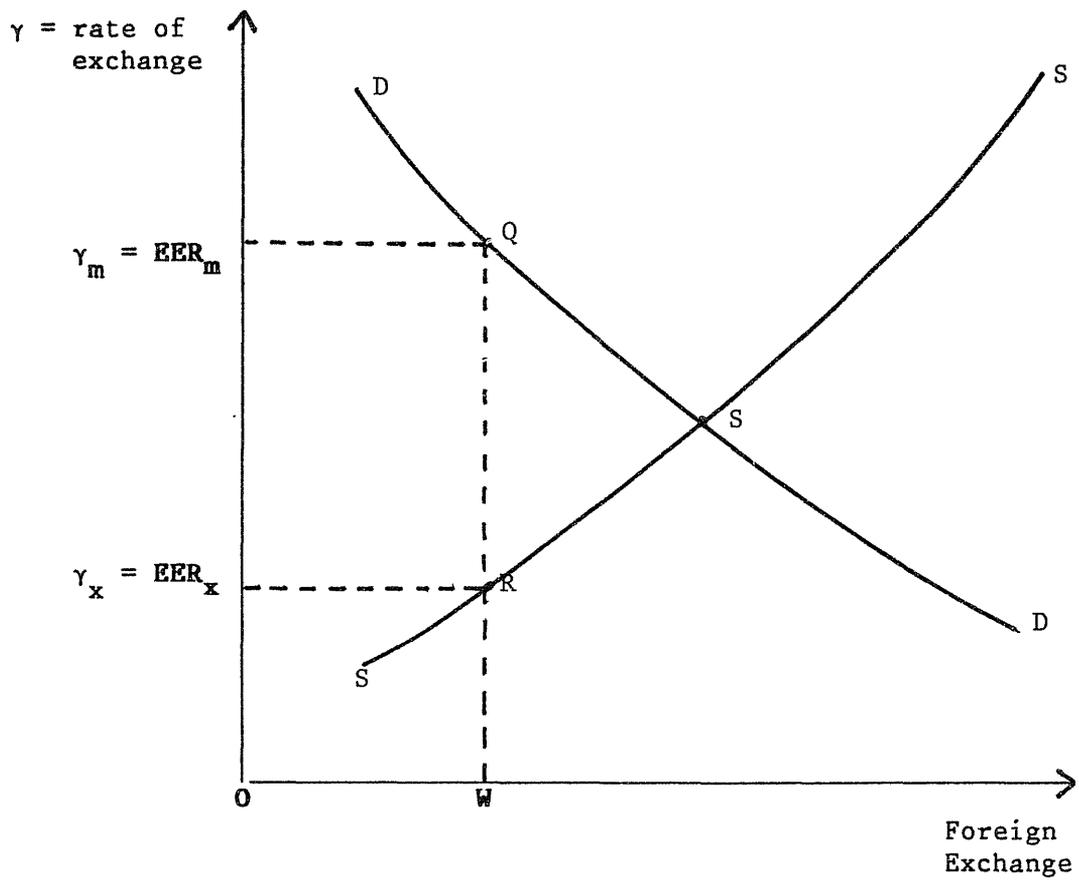
III. The Cost of Protection with Tariff-Seeking

The new theory of directly-unproductive profit-seeking (DUP) and rent-seeking activities, which incorporates lobbying and related policy-triggered and policy-influencing activities into formal economic theorizing, is illustrated in Figure 3 by reference to the phenomenon of tariff-seeking lobbying.

AB is the production possibility curve if there is no tariff-seeking activity. If, as in conventional analysis, we assume an exogenously specified tariff, equilibrium production shifts to \hat{P} (where, of course, $EER_x < EER_m$).

Suppose now that this very tariff is instead arrived at by lobbying which uses up real resources, diverting these resources from being

Figure 2: Overvalued Exchange Rate and the IS Strategy



productively employed in producing the two goods. Then, the resources which are available to produce the two goods in this endogenous-tariff, or equivalently tariff-seeking, equilibrium can be hypothetically seen to result in a "net-of-tariff-seeking" production possibility curve A_1B_1 at \hat{P} .

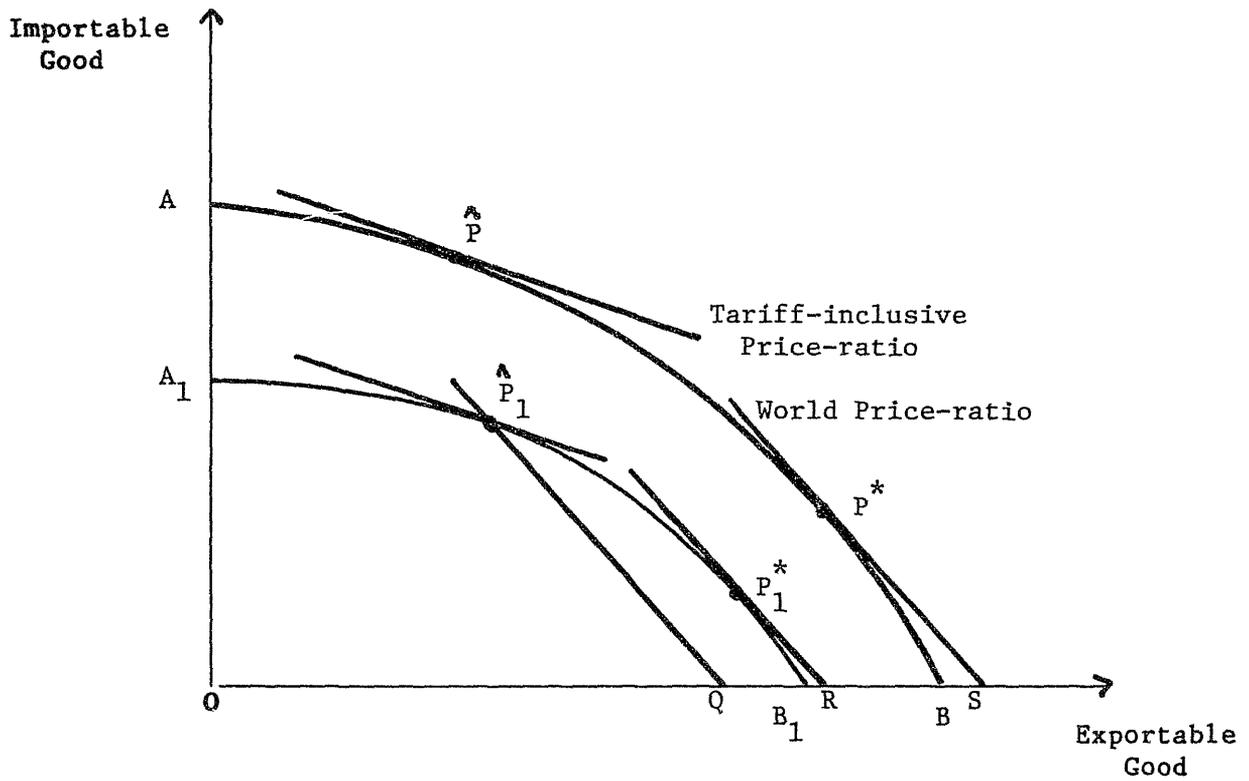
The total cost of protection then is evidently QS, measured in the conventional equivalent-variation fashion. By putting the given world price ratio tangent to AB at P^* , we can then decompose this total cost of protection as follows:

$$QS = QR + RS$$

where QR is the conventional cost of protection (but measured along the net curve AB) and RS is the additional cost of tariff-seeking (representing the cost of diverting resources from productive use to tariff-seeking lobbying). 1/

1/ For the original analysis of this problem, see Bhagwati (1980). Further discussion of the question can be found in Bhagwati, Brecher, and Srinivasan (1984).

Figure 3: Cost of Protection with Tariff-Seeking



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