8 The Developing Countries

Changing Attitudes toward Trade Policy

From the 1970s onward, a great many of the developing countries revised their attitudes toward trade policy, altering the nature of their participation in multilateral trade cooperation. What lay behind this change was a more pervasive shift in general economic policies. Governments began to place greater reliance on private markets and to move away from direct state management of economic activity.[1] As part of this shift, reforms in trade policy were widespread in the 1980s and 1990s. Many countries both substituted tariffs for quantitative import restrictions and unilaterally reduced their tariffs. They also relaxed restrictions on the inflow of foreign capital for direct investment.

For developing countries in general, a consequence of the shift in trade policy was their heightened interest in the operation of the multilateral trade regime. It was symptomatic of the change that the solidarity the developing countries (the Group of Seventy-Seven) had shown in United Nations forums in the 1970s in their call for the New International Economic Order quietly evaporated in the early 1980s. Intergovernmental arrangements for the management of international trade were no longer the preferred solution. As I will discuss in chapter 9, the developing countries initially expressed opposition to the launching of the Uruguay Round in 1986, but once it was underway, many developing countries soon assumed a very active role in the negotiations. Moreover, numerous countries previously not willing to become members of GATT now sought to accede to the agreement.

All this indicated a growing recognition among governments of the value that greater integration into the world market system held for their own economies. It would, however, be a gross error to see it as an ideological victory for the free trade doctrine. Most

countries were far from adopting free trade as their goal. Tariffs had formerly often been at very high levels, and the use of nontariff barriers at the border, most notably import licensing, had been widespread; reducing tariff and nontariff barriers, even substantially, by no means meant abandoning protectionist practices. Moreover, most countries, though lowering their trade barriers, retained numerous internal laws, regulations, and administrative practices that allowed them to differentiate between domestic and foreign producers or investors. Trade policies were no longer so inward-looking, but they were generally cautious in their embrace of more open markets.

REASONS FOR THE SHIFT IN POLICIES

When we look for the reasons behind the shift toward more open trade policies, we are forcefully reminded how closely these policies are integrated with broader economic policies. A weakness of the specialization that exists among commentators and researchers is that trade policy is often discussed as an issue that is to be decided on its own merits. The truth is, however, that its main contours and general direction emerge from broader decisions about economic policy as a whole.

This fact makes it easier to understand why the shift in trade policies, though varying among countries in timing and extent, occurred so widely. Most developing countries–and certainly all the semi-industrialized countries–experienced a similar change toward more market-oriented policies within the same ten to fifteen years. The common characteristics were twofold. First, the shift was preceded by a generation or two of slowly accumulating dissatisfaction with existing state-oriented policies, mainly because the unintended consequences of these policies were proving increasingly unacceptable. Second, the shift was almost everywhere precipitated by a crisis–brought on by external or internal events–that caused a sharp deterioration in economic conditions and opened the way for drastic policy revision.

The Origins of State-Directed Policies

It helps to recall that in the years before the 1970s, a familiar characteristic of economic policy almost everywhere–in the industri-

ally more established countries as well as in the developing world—was that a significant role was assigned to government in directing or regulating economic activity. This was true no matter whether governments leaned toward the right or the left in their ideologies. It was partly a reaction to the disastrous experience of the 1930s, which was widely interpreted to have had its roots in the failure of unregulated market capitalism. The skill with which the Western governments marshaled their economies to fight the Second World War and managed the transition to peacetime production only reinforced the belief in the effectiveness of state management.

These experiences were shared by the developing countries. During the 1930s, the slump in primary commodity markets and the collapse of capital markets left most members of political circles with a deep mistrust of the international market economy and a desire to seek to insulate their countries from it. It strengthened the conviction of such socialist leaders as Pandit Nehru of India or, later, Julius Nyerere of Tanzania that they had to find a third way for their societies that was neither capitalist nor communist.

But the earlier postwar policies of developing countries were not only a response to recent economic history. Also motivating their leaders and elites was a new spirit of nationalism, not only in the countries that had gained their independence after the Second World War, but also in the older, independent nations of Latin America and elsewhere. It became a matter of national self-respect for such countries to assert their economic, as well as their political, sovereignty. Almost everywhere, governments insisted on full command over their own natural resources; they nationalized foreign-owned industries, such as banking, utilities, or mines; and they established new manufacturing industries owned by the state or by private nationals. The political classes in developing countries not only wanted to see the modernization of their economies and the lessening of their galling state of dependence on the Western industrial countries; they also wanted their own nationals to be both the agents and the beneficiaries of the modernization. For some, the way forward was through central planning and the establishment of state-owned enterprises to spear-

head the modernization of their economies; the private sector and foreign capital were, at best, reluctantly tolerated. For others, state direction was more a mix of state-owned enterprises and an array of policy measures designed specifically to support new, nationally owned private enterprises. Almost everywhere, inward-looking trade polices that gave protection to national enterprises and did little to enhance trade links with other countries were seen as an integral part of these strategies. Though the nationalist pride that infused these strategies was often carried to excess or was abused to favor politically influential cliques, it is doubtful that the spread of industrialization around the globe would have taken place as rapidly in its absence.

The Movement toward More Market-Oriented Policies

By the 1970s and 1980s, however, circumstances were substantially different. For one thing, cumulative economic and social changes were becoming apparent. The transformation from peasant or semisubsistence societies to commercial, urbanized economies had begun in a few countries before the Second World War, but it gathered momentum throughout Asia and Latin America in the latter half of the twentieth century (see table 5). The industrializa-

TABLE 5. Urban Population as Percentage of Total Population, Selected Developing Countries, 1965 and 1995

	Percent of Total Population	
Country	1965	1995
Brazil	50	76
Chile	72	85
China	18	26
Colombia	52	71
Egypt	41	44
India	19	28
Iran	39	58
Korea, Republic of	34	76
Mexico	54	74

Source: United Nations 1980, 1997.

Note: The definitions of urban population vary according to national censuses. In some cases, the years on record differ slightly from the years shown here; for example, for Brazil, the data shown under 1995 are for 1991.

tion that had been going on for several decades changed a number of developing countries into semi-industrialized economies by the early 1980s. With the economic change emerged increasingly influential social groups of businessmen and middle-class professionals. Moreover, a new generation, with a different experience behind it, was taking the place of the earlier postwar leaders and opinion makers. This shift was exemplified, for example, in changing attitudes toward foreign direct investment, where extreme nationalist sensitivities were gradually moderated by greater pragmatism.

It is of immediate relevance for trade policy, too, that industrialization was altering the pattern of comparative advantage within countries, whether or not they pursued inward-looking policies. Not a few countries had left behind the days when they were very largely producers and exporters of primary products. As I noted in chapter 1, the share of manufactures in total exports rose for a great many developing countries between 1965 and 1985; in some countries, the proportion had become substantial, amounting to 30 percent or more (see table 3, in chap. 1). It would certainly not be true to say that this was invariably a spin-off from domestic industrialization. For many of the smaller countries, the rising exports largely reflected their success in attracting foreign capital to take advantage of their low wage costs and to manufacture for export. But for larger countries, rising exports of manufactures were also an outgrowth of a diversified industrial base primarily rooted in the domestic market.

Accompanying the decades of industrialization was an accumulating skepticism in many countries about the capacity of government to oversee effectively the current activities and the investment decisions of productive enterprises, whether publicly or privately owned. Particularly in countries that relied on extensive and detailed licensing and controls, the burden on governments in managing the many markets for goods and services proved increasingly onerous as the economies became more complex. Inefficiencies and inequities multiplied, as did the opportunities for evasion or corruption. Moreover, since state licensing protected established private enterprises from competition, the incentive to improve efficiency through cost reductions—

or, still more important, through innovations–was dampened. State-owned enterprises, in particular, revealed major flaws inherent in their close ties to the political authorities. The management of their operations and their investment decisions were almost inescapably subject to political interference, and they were accordingly prone to disregard commercial discipline in the conduct of their business. Managements lacked the incentive to improve efficiency, since it was more rewarding to cultivate political allies in government. If the enterprises ran losses, as they often did, they received support from public revenue. They were consequently often a major reason for the chronic budget deficits of central government.

Such sources of dissatisfaction found champions in the growing school of economists–identified as liberal economists in Europe and as neoclassicists in North America–who presented a powerful critique of the limitations of state intervention. In the industrially more established countries, they found sympathetic ears in new governments, such as those of President Reagan and Prime Minister Thatcher. In the world of development policies, there was a comparable, if more gradual and diffuse, reassessment of the effectiveness of past state-oriented policies.[2] There was, moreover, the experience of South Korea and Taiwan that was widely quoted as evidence that faster economic growth and more open trade polices were interrelated. (This experience is discussed more fully later in this chapter.) Finally, though it occurred long after the skepticism had gained momentum, the abandonment of central state planning by the former Soviet Union and other Eastern European countries was a late confirmation that extensive state ownership and control could become a large obstacle to economic growth.

THE TIMING OF THE SHIFT

Dissatisfaction with existing policies alone does not explain the timing or the extent of the shift in policies in individual countries. Some sort of crisis–usually in the form of deteriorating economic conditions–was needed to evoke a strong response from political leaders. Sometimes, the politicians' response was not reform at all; it was a further tightening or extension of existing policies. But

in the climate of growing skepticism about past state policies, political leaders in many countries had both the opportunity and the incentive (or at least the legitimizing rationale) to break with past policies and set out in new directions. External pressures also played a significant role in bringing about the change. Faced with balance-of-payments crises, numerous countries had to negotiate emergency loans from the International Monetary Fund (IMF), the World Bank, and other official sources; they found themselves under heavy pressure not only to adopt orthodox stabilization measures but also to agree to programs of market-oriented reforms, including more open trade policies. However, while the power of the external agencies was considerable, the primary condition of sustained reforms was the changing internal climate of political opinion that made them acceptable.

Dramatic Change in Some Latin American Countries

More often than not, the precipitating crisis had its origin in external economic relations. But it was sometimes of a purely domestic character. Chile was among the first and the most radical in its reforms, which occurred after General Pinochet overthrew the Allende government in 1973 and established an authoritarian regime. For most Latin American governments, however, reform came in the aftermath of the commercial debt crisis that broke in the early 1980s.

In Mexico, policy reforms took place in response to a complex of forces–long-term structural changes in the economy affecting the balance of political interests, changing ideas about the role of the state, and the trigger of an economic crisis. The policy shift had its origins both in the debt crisis of 1982 and in a growing business and middle class dissatisfied with state policies. (Among the dissatisfied were the owners of private export-oriented businesses that had been strengthened both by devaluations and by the establishment of duty-free zones–the maquiladora–along the U.S. border.) During the presidency of Hurtado de la Madrid from 1982 to 1988, the dissatisfied found an outlet in a new, right-wing party that was a breakaway for the Partido Revolucionario Institucional (PRI), the party that had governed Mexico since its revolution. At the same time, the Hurtado administration, partly

as a result of its pursuit of orthodox stabilization policies, had lost popular support among wage earners, and another breakaway group formed a leftist party. The PRI, which had both working links with private enterprise and populist roots in labor and the peasantry, was forced to make a choice between these wings, and it moved toward support for business.

Some steps were taken toward a more market-oriented approach. A number of state enterprises were privatized. In trade policy, import licensing was replaced by a system of general tariffs, and in 1986, Mexico, deciding to give up its long-standing freedom to set trade barriers as it saw fit, submitted an application for accession to GATT. It thus accepted that its trade policy would thereafter be constrained by international norms and rules.

When President Salinas, a Harvard-trained economist, took office in Mexico in 1988, he continued the reform of policies along more market-oriented lines. Moreover, Mexico actively set about cementing its new economic strategy by forging very close trade and financial ties with the United States and Canada. It did so by stating its desire to join with these countries in the North American Free Trade Agreement (NAFTA). The shift in trade policy was evidently only one component—albeit a major one—in a larger political and economic strategy to enhance the confidence of the business community, to encourage foreign investment, and to rely more heavily on private enterprise for future growth.

In Argentina, it took more than the debt crisis to create the political conditions that brought about a shift in the direction of policy. More than once since the early 1970s, Argentina had attempted trade reforms but had reversed its reforms when economic conditions deteriorated. In the years succeeding the debt crisis, the country was overwhelmed by bouts of severe inflation in conditions of economic stagnation. Following the election in 1988 of President Menem, who drew his support from the labor-oriented Justicialista Party, capital flight caused the exchange rate to plummet, and inflation reached a new pitch. By early 1990, prices were rising at an annual rate of more than 20,000 percent. Faced with a traumatic threat to social cohesion, the president appointed a new economics minister, Domingo Cavallo (another

Harvard-trained economist). To stabilize the currency, the government established a currency board, fixing the value of the peso in dollars and allowing the central bank to create money only against gold or foreign exchange. This was accompanied by other stabilization measures and by a radical program of privatization of state enterprises, extensive deregulation, and trade reforms. Such a radical program proved politically feasible only because it was preceded by years of economic decline, by growing popular despair over an ever more bloated and inefficient state sector, and by an encounter with hyperinflation. Similarly, in Brazil, years of recurrent inflationary bouts culminated in hyperinflation and a radical monetary reform to stabilize the currency. But Brazil's market-oriented and trade reforms were more modulated.

More Restrained Reforms in India and Elsewhere

India was another country where many people expressed dissatisfaction with state-oriented management of the economy for many years but had little effect on policy. Since its independence in 1947, India had pursued the modernization and industrialization of its economy through an extensive system of state management and planning that tightly controlled the activities, especially the investment, of the private sector. As part of this system, tariffs were kept high, import licensing was severe, and foreign direct investment was restricted. Some tentative steps were taken toward liberalization in 1977 after the Janata Party defeated the long-ruling Congress Party, and further steps were taken in the 1980s. But it was not until 1991 that a major shift in direction first took place. Again, the occasion was a sharply deteriorating economic situation that demanded a strong policy response. In the 1980s, political competition had driven state spending up sharply, fiscal deficits had grown, and the trade deficit had widened. When the Persian Gulf War caused oil prices to escalate, India came close to defaulting on its external debt. The new reformist government of Narasimha Rao came to power in 1991, and an IMF-backed stabilization program was linked with major reforms in the management of the economy. Numerous regulations that controlled economic activity in the private sector were swept

away, and market incentives were given freer play in determining business decisions. As part of these reforms, import licensing was sharply curtailed, tariffs were reduced, and sectors previously closed to foreign investment were opened up (see Haggard 1995, 106). Further, though cautious, reforms took place in the course of the 1990s.

In numerous countries, the shift in direction, though real, was restrained. Countries with long social democratic traditions, such as Costa Rica and Uruguay, exhibited less dissatisfaction with past policies than some of their larger neighbors, and their reforms were accordingly less dramatic. In other countries, major segments of the established business community put up strong resistance to trade liberalization. In the Philippines, which also suffered badly from the aftermath of the debt crisis in the early 1980s, liberalization measures introduced by the government of President Aquino received general support; they struck at the Marcos regime's highly selective and egregious use of state powers to favor family and friends. However, the business community did not want to dispense with state support and protection, so the economic liberalization moved forward very slowly.

The Special Case of Sub-Saharan Africa

Trade reforms were also widely introduced in African countries in the 1980s and 1990s. But in the countries south of the Sahara, the motivation did not stem from dissatisfaction with excessive state management of industrialization. The subregion includes many low-income countries whose economies were still moving out of a precapitalist phase and whose commercial sectors were predominantly engaged in primary production. Severe economic difficulties in the 1980s compelled many of these countries to seek emergency assistance from the IMF, the World Bank, and other official agencies, and the countries effected market-oriented reforms largely in response to pressures from these bodies. Through these reforms, tariffs and other barriers to imports were widely reduced. In the case of these countries, however, the argument that greater openness would enhance the competitive efficiency of domestic industry and promote industrial exports did not apply, since the countries lacked the established manu-

facturing sectors. In fact, without a comparable depreciation of exchange rates, imports rose strongly, and in quite a number of countries, the share of manufacturing in total domestic production declined.

THE MIX OF OUTWARD ORIENTATION AND PROTECTION

In their unilateral trade reforms, most developing countries moved toward a more outward-oriented stance.[3] It was a stance similar to that long pursued by the group of East Asian countries known as the "Four Tigers"–South Korea, Taiwan, Hong Kong, and Singapore–which, at least until the 1997 financial crisis, had achieved remarkably high rates of economic and export growth.

South Korea and Taiwan, in particular, have been famous for the dramatic growth in their exports of manufactures since the 1960s.[4] This growth was the consequence of deliberate policy choices made around the early 1960s, when both countries faced the combination of acute trade deficits and the cessation of foreign aid to finance them. At that time, both decided to follow the example of their more advanced neighbor, Japan, and pursue a strategy of export-oriented, industrial growth. Relying mainly on private enterprise (but not on foreign direct investment), they accomplished their aim through industrial policies that did not entail detailed planning and control but were nonetheless strongly interventionist. As part of these polices, care was taken to ensure that production was oriented toward exports. This meant that when all the measures available to government were taken together–tariffs, subsidies, the exchange rate, fiscal and credit policies–their net effect on the system of incentives facing private enterprise was to favor exports. Several other East Asian countries (e.g., Malaysia, Thailand, and Indonesia) set foot on the same path in later years, though they differed in the particular ways in which their governments influenced the business communities.

The export orientation of policies did not mean that these countries eschewed trade protection as an instrument in the promotion of their industrialization. South Korea and Taiwan actively pursued industrial strategies to foster the development of new industries. Like Japan, these countries had decided that

industries with a comparative advantage in international trade should not simply be allowed to emerge from the existing pattern of production and costs; that would have condemned them to specialize in labor-intensive, low-technology products. The policy was to create a comparative advantage in higher-value industries by encouraging the establishment and growth of new industries that would move the country up the technological scale. Since the two countries differed considerably in their forms of industrial organization—with large-scale *chaebols* (conglomerates) dominating industry in South Korea and with small-scale and medium-sized firms being the pattern in Taiwan—their particular ways of carrying out their industrial policies were often dissimilar. But for both countries, the protection of new industries was one important instrument for realizing their aim.

In South Korea and Taiwan, protection was practiced within the context of an export-oriented strategy, with a sensitivity to the effects of protection on domestic costs—a sensitivity not evident in countries pursuing more inward-looking policies. The costs of industries that might supply inputs to the export sector had to be internationally competitive. Protection was thus granted to industries on a conditional basis; the new industries were expected to bring down their costs to international levels within a reasonable period of time. Thus, over the long term, protection went hand in hand with export promotion in fulfilling the policy of sustained, export-oriented economic growth.

The trade policies of South Korea and Taiwan underwent significant reforms in the 1980s and 1990s. To some degree, the pressure for reform came from within; as the export sector had grown, so had the ties of many enterprises and individuals to a prosperous foreign trade, and they became advocates for a more liberal trade policy. Another reason for reform in these countries was quite different from the experience of most other developing countries. It sprang from the success that South Korea and Taiwan had in the 1970s and 1980s in expanding their exports to the industrially more established countries. This success had evoked, on numerous occasions, a protectionist response from the industrially more established countries. Action was repeatedly taken to restrict imports of specific manufactures through the negotiation

of voluntary export restraints or by other means. In the 1980s, when U.S. trade policy shifted in emphasis from the imposition of unilateral import restrictions to gaining greater access to the markets of other countries, South Korea and Taiwan came under a new kind of pressure, namely, to ease access to their domestic markets. Threatened with action under Section 301 of the U.S. trade law, Taiwan made tariff cuts in the late 1980s. More protectionist, South Korea initiated a five-year program of reductions in trade barriers in 1984, followed by a second five-year program. By 1994, South Korea's average tariff rate was down to below 8 percent, and more than 90 percent of its rates were bound (see Haggard 1995, 51).

The governments of South Korea and Taiwan took a pragmatic approach to their trade policies, seeking, in a very dynamic situation, to maintain a balance between different aims. On the one hand, it was essential to deal diplomatically with the industrially more established countries whose markets were so important for their exports; unilateral concessions were the price of safeguarding that access. On the other hand, if an industrial policy was still to be pursued, some leeway had to be retained to protect particular industries or services. The dilemma was made even more acute in the 1990s when the industrially more established countries—particularly the United States—pressed for the opening up of financial markets to their financial services firms and for the dismantling of external capital controls. The issue had consequences not simply for the domestic financial industry but, more broadly, for the stability of currencies and for levels of economic activity at home (as the financial crisis of 1997 demonstrated). Stated more generally, South Korea and Taiwan paid a price for their success as exporters: they were expected increasingly to adjust their trade policies to the norms and standards to which the industrially more established countries themselves conformed in their own trade relations.

THE SHIFT IN POLICIES AND MULTILATERAL COOPERATION

In the years between the ends of the Tokyo and Uruguay Rounds, the governments of a great many developing countries chose to intervene less in private markets and to allow more busi-

ness decisions to be made in response to the free play of market forces. As part of this shift, they moved in varying degrees toward a greater opening of their markets to foreign goods, services, and capital, thus accepting closer integration in the world economy. It was generally expected that exports, particularly of manufactures, would come to play a more dynamic role in the growth of their domestic economies.

This shift in broad strategy placed the issue of access to the markets of other countries higher on the agenda of national trade policies and heightened the interest in the Uruguay Round. In contrast to earlier decades, when most developing countries argued that they should be granted access to the markets of the industrially more established countries on a nonreciprocal basis, developing countries began to accept that concessions in the reduction of their trade barriers was often a condition of securing the market access that they wanted. In fact, some of the most successful countries found that the tables had been turned completely; in response to bilateral pressures, they were making nonreciprocal concessions to the industrially more established countries.

The vulnerability of the weaker, developing countries to bilateral pressures was an added reason for their heightening interest in a regime of internationally agreed norms and rules. In dealing with the industrially more established countries, most developing countries were only too well aware of their own weakness in bilateral negotiations. A multilateral trade regime with norms and rules that at least constrained, if not eliminated, the opportunistic behavior of the more powerful countries was distinctly attractive to them. The price was that each country's own trade behavior became subject to the same constraints. Most developing countries began to judge the price to be worthwhile.