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Do Outward – Oriented Policies Really Favour Growth?

A critical look at the World Development Report 1987

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The World Development Report 1987 was prepared by a team of economists led by Sarath Rajapatirana and his paper on "Industrialisation and Foreign Trade", which we carried in our November issue, contains much of the substance of the Report. L.K.Jha a leading official figure in India's commerce and planning setup and most recently Chairman of India's Commission on Economic Efficiency, Productivity and Exports has disagreed with some of these views and takes a critical look at the Report in this note; while Rajapatirana replies.

People interested in the problems of developing countries look forward to the annual publication of the *World Development Report* by the World Bank with great expectation. The special feature of the 1987 Report, the tenth in the series, is that it tries in Chapter 5 to argue that the trade orientation of developing countries has been the principal factor influencing their industrial performance. To prove this point, it classifies 41 developing economies according to the orientation of their trade strategy over 1963–73 and over 1973–85. At one extreme are the countries whose policies are said to be strongly outward-oriented, while at the other end are those described as strongly inward-oriented. In between, there are two other groupings—moderately outward-oriented and moderately inward-oriented. The Report compares the macroeconomic performance of these four groups, focusing attention on their average annual percentage growth in real GDP, both overall and in per capita terms, as well as other yardsticks of economic performance, such as gross domestic savings, incremental capital/output ratio, average annual rate of inflation, and the growth of manufactured exports. The broad conclusion drawn from these comparisons is that the more outward-oriented their trade policies, the better was the performance of developing countries.

A careful analysis of the methodology employed in coming to this conclusion gives rise to serious misgivings. Is it seriously contended that a policy which paid large dividends to island economies in whose national income foreign trade made such a large contribution would prove equally useful in continental economies such as Brazil and India? One wonders why some other island economies, such as Fiji, Seychelles, Jamaica, Trinidad, Mauritius, and Bermuda have not been included in the study. Further, is the inclusion of the Republic of Korea among the outward-looking economies fully justified, considering that the country's trade policies went through many phases, some more restrictive than others? In any event, the regulatory and developmental role of the State in various fields, particularly technological research, and the kind of political and economic support from the United States, among other things, have also unquestionably helped in the spectacular growth of Korea. Nor has its record of performance been equally satisfactory all the time. At one stage, the annual rate of inflation was as high as 40 percent. Indeed, there are a wide range of factors, differing from country to country, which influence the developmental potential and performance of each. Therefore, a generalization of the sort made in the Report by looking at the average—and not at individual performance—of different countries, carefully selected and grouped, and correlating it with their trade policies, can be very misleading.

Of the many factors influencing the growth performance of a country, some are immutable, such as natural resource endowment. Some, such as population growth, are amenable to change over a long period of time, through sociological rather than economic policies. Others include the nature of political relations with developed countries whose cooperation can be particularly helpful in providing resources, technology, and markets for the developing country's industry. Then again, while external investment usually comes into export-oriented industries in island economies with a small domestic market, in a large continental economy, it is the size of the domestic market and the rate at which it is expanding that attracts foreign investment. In turn, foreign investors want to be assured of a measure of shelter from competition, both external and internal.

Then there are special factors which are part of the national psyche. The absence of a tradition of entrepreneurship, for example, often leaves an otherwise promising economy in a state of poverty. Often restrictive trade policies which help minimize risks act as a corrective to it.

An objective study of the impact of outward- or inward-orientation of an economy on its industrial growth could have been better made by comparing the performance of the *same* economy at different periods of time, under different trade orientations. The results of such a study might well have led to very different conclusions. For example, in the case of India under British rule, the economy was open. There were no inhibitions about allowing private foreign investment in industry. Import tariffs were low. Yet, the rate of industrial growth in that period was very low. It was during World War II, when imports were severely curtailed as a result of short supply and shipping difficulties, that there was the first real spurt in the rate of industrial growth. This gained further momentum after independence. The experience of many other colonies, before and after independence, would tell a somewhat similar tale.

Yet another way of making an objective evaluation of the impact of trade policies on the pace of industrial development would be to look at the historical experience of developed countries. Was the emergence of the United States as the leading industrial economy the result of outward-oriented trade policies or of other factors? Then, again, what about Japan? A 1972 OECD study, *The Industrial Policy of Japan*, has a very different story to tell. It says:

"Should Japan have entrusted its future, according to the theory of comparative advantage, to these industries [toys or other miscellaneous merchandise and low-quality textile products] characterized by intensive use of labour? That would perhaps be a rational choice for a country with a small population of 5 to 10 million. But Japan has a large population. If the Japanese economy had adopted the simple doctrine of free trade and had chosen to specialize in this kind of industry, it would almost permanently have been unable to break away from the Asian pattern of stagnation and poverty, and would have remained the weakest link in the free world, thereby becoming a problem area in the Far East.

"The Ministry of International Trade and Industry decided to establish in Japan industries which require intensive employment of capital and technology, industries that in consideration of comparative cost of production should be the most inappropriate for Japan, industries such as steel, oil refining, petro-chemicals, automobiles, aircraft, industrial machinery of all sorts, and electronics including electronic computers. From a short-run, static viewpoint, encouragement of such industries would seem to conflict with economic rationalism. But, from a long-range point of view, these are precisely the industries where income elasticity of demand is high,

technological progress is rapid, and labour productivity rises fast. It was clear that without these industries it would be difficult to employ a population of 100 million and raise their standard of living to that of Europe and America with light industries alone; whether right or wrong, Japan had to have these heavy and chemical industries."

Turning once again to the area covered by the 1987 *World Development Report*, a careful study of the data presented can lead to very different conclusions from those drawn in it. Thus, Figure 5.3 on page 86 furnishes information on the performance of individual countries with different trade orientation over 1963–73 and 1973–85. A closer study of the information presented shows that the rate of increase of real GNP per capita for Bangladesh jumped up from about *minus* 2 percent in the first period to above 4 percent in the second period. Likewise, for India, the rate went up from a little above zero to just below 4 percent. Against this, the corresponding rate in Singapore and the Republic of Korea registered a fall of 2 percent or more per annum. Considering that the rate of population growth in Bangladesh and India was so much higher—a very important point when assessing per capita growth rates—surely their performance cannot be judged to be too poor, even though they pursued inward-looking policies.

Similarly, the average annual percentage growth of "real manufacturing value-added" shot up from near zero to about 10 percent in the case of Bangladesh, and from around 3 percent to around 7 percent in the case of India. The percentage rate of growth in "employment in manufacturing" between the two periods went up in the case of Bangladesh and India, while it recorded a sharp decline in the case of the Republic of Korea, Singapore, and Hong Kong.

Another point which emerges from a study of the Report's data on the performance of individual countries is that Pakistan's rate of per capita income growth was higher between 1963 and 1973, when it was classified as strongly inward-oriented, than between 1973 and 1985, when it had moved into the category of moderately inward-oriented. In "real manufacturing value added" too, Pakistan did not improve its performance by going in for more liberalized policies. Moreover, "employment in manufacturing" in Pakistan, which showed an average annual growth of around 2 percent over 1963–73, had a growth rate of *minus* 3 percent over 1973–84.

Thus, the data presented in the WDR could well be used to argue that most of the poorer people of the earth have fared better with inward-looking trade policies. This is not the conclusion reached by the authors of the *World Development Report 1987*.

Rejoinder:

Sarath Rajapatirana, leader of the World Bank team that produced the World Development Report 1987, *replies:*

As Mr. Jha states, many factors influence the growth performance of a country. Indeed, the first paragraph of the Report states precisely that. The discussion in Chapter 5 concentrated on the relationship between trade strategies and economic performance. It was based upon evidence from 41 developing economies that the better performance of outward-oriented economies is the result of trade and industrial policies that do not discriminate between production for the domestic market and exports nor between domestic and foreign goods. These policies lead to neutral incentives. Conversely, countries that actively discriminate against foreign trade, by giving greater incentives to production for the domestic market, forgo the benefits of efficiency, permit poor macroeconomic policies to persist without correction, and incur costs associated with rent-seeking by those in economic activities protected by quotas.

From his detailed comments, it appears that Mr. Jha either may not have read the Report in its entirety or that he has misinterpreted some of the data contained in it. I shall, however, attempt to answer each of his major points, in the order that he raises them:

- *Can we compare island with continental economies? Whether a country is an island or a continental economy has no relevance to the definitions of outward- or inward-oriented trade strategies. These definitions relate to the structure of incentives. A continental economy could have a small share of foreign trade in its national income and still reap the benefits of neutral incentives. We did not include the island economies that Mr. Jha cites because we did not have adequate data on their trade regimes and economic performance to match those of the other countries in our sample.*

- *India may well have had an open economy and even neutral incentives under British rule. But the fact that it did not grow rapidly cannot be ascribed to the neutral incentives. These incentives would have led to efficiency but could not have made up for low investment, poor literacy, or lack of technology.*

- *In discussing the Republic of Korea, Mr. Jha implies that outward-orientation is equivalent to free trade. This is not correct. In our sample, Korea is classified as outward-oriented because it provides nearly neutral incentives for the domestic and foreign market. Providing incentives to some domestic industries does not conflict with outward orientation.*

- *Contrary to Mr. Jha's assertion that our sample countries were "carefully selected and grouped," the group was not at all pre-selected. These were the developing countries on which sufficient data were available. The two categories—strongly outward-oriented and strongly inward-oriented—correlate respectively with relatively good and poor performance. No clear relationship emerged for those in the "moderate" groupings. Our conclusions were based on the robust results of the strongly outward- and inward-oriented economies in the sample.*

- *The reason we did not devote extensive discussion to the performance of individual countries with different trade policy orientations over time is that we did not wish to repeat the findings of numerous other studies, cited in the Report itself and elsewhere, of individual country experiences. See, for example, Little, Scitovsky and Scott (1970), Juergen Donges (1976), Bhagwati (1978), and Krueger (1978). Those findings show that, over time, countries that move toward neutral incentives improve their economic performance. The sample used by our Report, which is 3–4 times larger than each of the sets of countries analyzed in these studies, confirms their findings.*

- *On Japan, Mr. Jha quotes a 15-year-old OECD study. First, at the risk of repetition, one must not equate free trade with outward-orientation. Second, more recent OECD studies (e.g.,* Costs and Benefits of Protection, *1985, Paris) acknowledge the high costs of protection.*

- *Finally, Mr. Jha attempts to reinterpret our data in analyzing Figure 5.3 of the Report. He may have misread the bar charts. Each vertical bar covers the range of individual country performances for each group of countries. The location of the country name on the chart does not indicate its position on the scale. Bangladesh, for example, did not reach a 4 percent growth rate in per capita GNP over 1973–85, as stated by Mr. Jha. It was within the range that peaked at 2 percent, as clearly marked by the vertical bar in the chart. Similarly, for the growth rate of real manufacturing value added, Bangladesh and India increased by 7.5 percent and 4.6 percent respectively over 1973–85,* not *by 10 percent and 7 percent, as Mr. Jha states.*

- *Contrary to Mr. Jha's interpretation of our data, Pakistan's per capita income was not higher under inward-orientation. Again, he appears to have misread the bar chart. Even if his point were correct, it does not demonstrate that high growth is associated with inward orientation. It is well known that countries may be able to grow faster with increased protection, but they cannot sustain such growth over time.*