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approach to development: learning the  
right lessons from development  
experience**

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**'Openness' and the 'Market Friendly' Approach to Development:  
Learning the Right Lessons from Development Experience**

**1. INTRODUCTION**

Two principal analytical and practical policy issues in economic development today are:

a) the degree and kind of openness to the world economy a developing country should seek;

b) what should the government do, or not do, in order to promote fast economic and industrial development.

These questions are controversial and have therefore been the subject of an important debate, not least in the pages of this Journal. In view of its direct policy involvement in developing countries around the globe, the World Bank has been a major participant in this debate. In a large number of studies and reports,<sup>1</sup> World Bank economists have provided detailed analyses of these questions. Specifically, they have argued that the best way to achieve economic growth for developing countries is to be highly open to the world economy and to seek a close integration with it. On the second issue, they have suggested a relatively limited role for the state, encapsulated in the concept of a

'market-friendly' approach to development.

The importance of the World Bank analyses and conclusions on these subjects for economic policy hardly needs any emphasis. However, these analyses are also significant for another reason: since the beginning of this decade, Bank economists have departed significantly from the extreme free market neoclassical perspectives which often characterised their contributions in the 1980s. In that sense, the Bank's views on these questions today probably represent the professional mainstream.

The main purpose of this paper is to carry forward the recent debate<sup>ii</sup> between the World Bank and the heterodox or 'revisionist' economists, which centres around the analysis of the development experience of the economically highly successful East Asian countries. It will be suggested here that this debate has already made considerable progress and has led to a degree of convergence between the two schools on a range of analytical and empirical issues, though, as will soon become evident below, not yet on policy. This paper aims to carry this process further by identifying and commenting on the most important issues which still remain in contention.

The paper will, inter alia, outline an alternative framework for examining the question of openness, which leads to a rather different policy conclusion than that above. It will be argued here that, in contrast to the recommendations of the

Bretton Wood institutions, developing countries should actively seek 'strategic' rather than 'close' integration with the international economy. Further, the paper will suggest that government needs to have a far bigger role in economic activity than is envisaged in the 'market-friendly' approach. It is contended that in mixed economy countries with reasonably effective states, the government should pursue a dynamic industrial policy to bring about the desired structural transformations in the economy as speedily as possible, to achieve fast economic growth. These, it is argued, are the correct lessons to be learnt from the East Asian economic record.

Taking into account previous contributions to the debate, the paper concentrates on the following specific issues:

(a) the question of the effectiveness of industrial policy; (b) the issue of 'openness'; (c) the nature of competition in domestic markets and (d) the relationship between technology policy, industrial policy and international competitiveness. Particular attention will be paid here to the theoretical underpinnings of the World Bank analyses of these issues. Specifically, the neglect of the role of 'demand' in such analyses will be highlighted. This, it will be shown, leads to incorrect interpretations of the East Asian development record at key stages of the Bank's argument. For space reasons, and also to sharpen the debate, the empirical analysis will be confined here to Japan and South Korea - two of the most important exemplar countries. It will be shown that a proper consideration of the role of the balance of payments

constraint and of demand leads to a rather different interpretation of the experience of these economies from that provided by World Bank economists.

## **2. THE MARKET-FRIENDLY APPROACH TO DEVELOPMENT: THE BANK'S THESIS**

The concept of the 'market friendly' strategy of development was put forward in the World Bank's seminal 1991 Report: *The Challenge of Development*. [World Bank, (1991), hereafter referred to as the 1991 Report]. Representing the synthesis of what the World Bank economists have learnt from forty years of development experience, the starting point for the 1991 Report was the question: why during the last four decades some developing countries were successful in the sense of substantially raising their per capita incomes whilst others were not? The central analytical argument is that economic growth is determined essentially by the growth of total factor productivity (TFP) of capital and labour. The Report's analysis came to the conclusion that the more open an economy, the greater the degree of competition and the higher its investment in education, the greater would be its growth of TFP and hence its overall economic growth. Although the significance of international economic factors was recognised, a major argument of the Report was that domestic policy matters far more for raising per capita incomes than world economic conditions.

With respect to economic policy, the Report concluded that:

"Economic theory and practical experience suggest that

(government) interventions are likely to help provided they are market-friendly" (p. 5). In order for 'market-friendly' not to be a mere tautology, the Report, to its credit, defined the concept fairly precisely in the following terms:

- a. *Intervene reluctantly.* Let markets work unless it is demonstrably better to step in... [It] is usually a mistake for the state to carry out physical production, or to protect the domestic production of a good that can be imported more cheaply and whose local production offers few spillover benefits.
- b. *Apply checks and balances.* Put interventions continually to the discipline of international and domestic markets.
- c. *Intervene openly.* Make interventions simple, transparent and subject to rules rather than official discretion.

Overall, the state's role in economic development in this 'market-friendly' approach is regarded as being important but best limited to providing the social, legal and economic infrastructure, to creating a suitable climate for private enterprise, but also, significantly, to ensure a high level and appropriate composition of human capital formation. Even this limited role for the state is, nevertheless, an advance over the earlier neoclassical thinking which enjoined governments simply to avoid distortions, provide a stable macroeconomic environment and a reliable legal framework.

Both the neoclassical and the 'market friendly' analyses have encountered serious intellectual difficulties since neither can satisfactorily explain the outstanding success of East Asian economies. Revisionist authors, such as Boltho(1985a), Amsden(1989) and Wade(1990) have pointed out that in countries like Japan, South Korea and Taiwan, the government has played a leading and a heavily interventionist role in the course of their economic development.

This intellectual challenge was taken up by World Bank (1993), the East Asia Miracle study (hereafter referred to as the Miracle Study), which has produced a new analysis of the economic development of the high performing Asian economies (HPAEs) including Japan. This study fully acknowledges the facts of enormous government economic interventions in most spheres in these countries, much as documented by the revisionist school.

However, the Study goes on to suggest that such interventions, particularly in the sphere of industrial policy, had in general a limited effect. Some of these worked for some of the time in a few countries, but overall they were neither necessary nor sufficient for the extraordinary success of these countries. Thus,

the Study:

"What are the main factors that contributed to the HPAE's superior allocation of physical and human capital to high yielding investments and their ability to catch up technologically? Mainly, the answer lies in fundamentally sound, market oriented policies. Labour markets were allowed to work. Financial markets ... generally had low distortions and limited subsidies compared with other developing economies. Import substitution was ... quickly accompanied by the promotion of exports. ... the result was limited differences between international relative prices and domestic relative prices in the HPAE's. Market forces and competitive pressures guided resources into activities that were consistent with comparative advantage ...". (Page 325).

In other words, the final policy conclusion is still to reassert the 'market friendly' strategy of development - developing countries are recommended to seek their comparative advantage, to 'get their prices right' and to have free markets as far as possible.

### **3. THE TOTAL FACTOR PRODUCTIVITY (TFP) APPROACH TO ECONOMIC GROWTH**

The theoretical foundation of the World Bank analyses is the TFP approach to economic growth. It is suggested that inter-country and inter-temporal variations in growth rates are caused by variations in total factor productivity of capital and labour.

Changes in the latter variable are thought to be determined mainly by economic policy - the degree of openness of an economy, the extent of competition in the product and factor markets, and investment in physical and human capital (education), particularly the latter. The underlying chain of causation is that competition and education promote technical progress, and therefore TFP growth



and hence economic expansion. "Free mobility of people, capital, and technology" and "free entry and exit of firms" are regarded as being particularly conducive to the spread of knowledge and technical change.

Now at a theoretical level, there are several well-known objections to the causal model underlying the TFP approach to economic growth. The model assumes for example full employment of resources and perfect competition, none of which obtain in the real world. Moreover, it is a wholly supply-side model which ignores altogether the role of demand factors.<sup>iii</sup> The latter, as we shall see below, is a critical weakness which creates serious difficulties for the Bank's analyses of the East Asian as well as other economies.

With respect to empirical evidence, even a cursory consideration of the data presented by Bank economists themselves in the 1991 Report (table 2.2 on page 43) reveals the serious limitations of the TFP approach. The table provides figures for the growth of GDP, capital and labour inputs and TFP, separately for each of the sub-periods, 1960-73 and 1973-87, for each of the five developing regions as well as for a group of 68 developing economies; in addition, it also provides similar information for each of the four leading industrial economies. These data show that in every region, and for each country or group of countries shown in the table except South Asia (ie. in nine out of ten observations), the rate of growth of TFP fell substantially during 1973-87, compared with 1960-73. For example, TFP growth fell in

East Asian developing economies from 2.6 percent p.a. in the first period to 1.3 percent p.a. in the second period; in Latin America, the corresponding figures were 1.3 percent p.a. and -0.4 percent p.a.; for the group of 68 developing economies, the TFP growth fell from 1.3 percent to -0.2 percent over the two periods. However, in South Asia - notably the only region which registered a trend increase in its GDP growth between the two periods - TFP growth rose from zero in 1960-73 to 1.2 percent p.a. during 1973-87.

In terms of the causal model underlying the World Bank analysis, this almost universal fall in TFP growth in the recent period would be due to policy mismanagement - low rates of technical progress caused by distortions, lack of competition, lack of integration with the world economy, etc. The evidence, however, is not compatible with such an analysis, since as Bank economists themselves note there has actually been more competition, greater integration of the world economy, less distortions in most developing countries in the latter period (particularly in the 1980s) than in the former.

These facts are much more in accord with an alternative theoretical model which would suggest that the fall in the world and the national economic growth rates in the post-1973 period was responsible for the decline in the rate of growth of productivity in most regions (Verdoorn's Law).<sup>iv</sup> The decline in world economic growth after 1973, in terms of this model, was due to a lower rate of growth of world and national demand caused by a whole range

of factors (e.g. the collapse of the Bretton Woods system, the growth of real wages in a number of industrial countries outstripping productivity growth in the wake of the first oil shock) connected with the fall of the Golden Age of development of the OECD economies.<sup>v</sup>

#### **4. EFFICACY OF INDUSTRIAL POLICY: CONCEPTUAL ISSUES**

The TFP approach is prominently used in the World Bank economists critique of the industrial policy thesis of the revisionist economists. One of their most controversial findings is what may be called, by analogy to Lucas's well known theorem<sup>vi</sup>, the industrial policy ineffectiveness doctrine. Bank economists assert that contrary to popular perceptions, rigorous quantitative analysis shows that these policies were largely ineffective in the East Asian countries. The clear implication is that if industrial policies could not succeed in these countries with their highly efficient bureaucracies, ipso facto these would be inappropriate for the rest of the developing world which is not blessed with such high quality administrative assets.

In examining this 'ineffectiveness doctrine', there are two prior conceptual issues which require attention: what is industrial policy?; how should the "success" or otherwise of such a policy be assessed?

**(a) What is Industrial Policy?**

Governments in almost all market economy countries intervene to a greater or a smaller degree in the operation of their industries. For example, even the US government, normally regarded as non-interventionist, in fact, intervenes in industry through a variety of measures, such as anti-trust laws, industrial standards, pollution regulations, labour laws. However, most people would agree that despite such extensive interventions, the US does not have an 'industrial policy', while Japan and East Asian countries do.

What makes Japanese interventions into an 'industrial policy' is that in Japan, such interventions are generally coordinated and viewed as a coherent whole, and the government has a strategic view of the country's industrial development in relation to the world economy. In this sense South Korea, and other East Asian countries also have an industrial policy. Japan's strategic view in the 1950s and 60s was eloquently expressed by Vice Minister Ojimi of MITI as follows:

The MITI 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 viewpoint, these are precisely the industries where income elasticity of demand is high, technological progress is rapid, and labour productivity rises fast. [OECD, 1972].

At the end of World War II, the bulk of Japanese exports consisted of textiles and light manufactured goods. In the view of Ojimi and his colleagues at MITI although such an economic structure may have conformed to the theory of comparative advantage (Japan being a labour-surplus economy at the time), it was not capable of raising in the long run the Japanese standard of living to European or American levels. One interpretation of Ojimi's argument above would be that the purpose of the Japanese industrial policy was no more than to pursue the country's dynamic comparative advantage, but to do that as quickly as possible. The other non-neoclassical interpretation, which does not necessarily exclude the previous one, is that the purpose of the industrial policy was to guide the market, to deliberately create a competitive advantage in areas where world demand was likely to rise rapidly and in which it would, therefore, be in Japan's long term interest to specialise. As Magziner and Hout (1980) note: "On balance, Japan's industrial policy has been anticipating rather than reacting to international competitive evolution".

Support for the non-neoclassical interpretation is provided by the fact that although in the 1950s and 1960s, MITI's structural programme could be justified in orthodox terms by the infant industry argument, these structural policies have continued, albeit in an attenuated form, right up to the present day. MITI continues to provide blueprints and to seek wide business and

social agreement towards its future structural visions for the evolution of the Japanese economy, as the world competitive situation and Japan's role in the world economy changes.<sup>vii</sup>

### **(b) Assessment of Industrial Policy**

How does one assess the success of an industrial policy like that of Japan? It is not a straightforward question since one needs a credible counter-factual - what would have happened in the absence of industrial policy? Would Japanese industrial production still have grown by nearly 13 percent a year between 1953 to 1973, its GNP by nearly 10 percent and its share in world exports of manufactures change by a huge 10 percentage points? Boltho(1985a).

One way to answer this kind of question in the absence of a controlled experiment would be to compare the performance of countries which were in other relevant ways similar to Japan, but which did not have an industrial policy like that of Japan. This after all is the broad methodology underlying the 1991 Report which compares the experiences of different countries to find out why some were successful and others were not. A closer analogy would be the studies which assess the success of the Bank's structural adjustment program by comparing countries which did have such programmes with those which did not. There are of course well recognised problems with such comparisons: to be able to provide satisfactory evidence on the issue the two groups of countries

should be as similar as possible in all other ways.

Similarly, a second way of assessing the success of Japanese industrial policy would be to compare the country's post-war economic record under an industrial policy, with its own performance in the pre-war period when it was not pursuing such policies. A third method of assessment would be to examine the policy in terms of the goals which the country may have set for itself. In the Japanese case, during the high growth period 1950-73, a critical proximate goal of MITI's was to ensure a current account balance at as high a growth rate as possible. In other words, the balance of payments was seen as the main constraint on fast economic growth in this period. (Shinhara,1982; Tsuru,1993). The government pursued this objective by a wide range of measures including inter alia a policy of extensive import controls, together with the promotion of exports of certain key industries, which changed over time.

Boltho (1985a, 1985b) assesses the Japanese industrial policy on these criteria and concludes that the policy was successful. Boltho's analysis is complemented by Magziner and Hout's (1980) detailed and careful evidence based on case studies of several specific industries. These strongly suggest that the industrial policies were successful in propelling the targeted industries into pre-eminence in international competition. So how do World Bank economists conclude that industrial policy in countries like Japan or South Korea was ineffective?

## 5. THE INDUSTRIAL POLICY INEFFECTIVENESS DOCTRINE

The first reason for this negative assessment is that Bank economists have a very narrow definition of industrial policy, considering it only as a policy to upgrade industrial structure.<sup>viii</sup>

Industrial policy is not viewed as a whole in all its various aspects. They also depart, without adequate justification, from the standard methodology above for assessing the effectiveness of industrial policy. Instead, they adopt a so-called functional approach to examine three types of government interventions: (a) directed credit, (b) export promotion, and (c) structural policy, and conclude that whereas (a) and (b) were successful, (c) was not.

However, these policies cannot properly be judged individually since (a) and (b), as well as other policies such as extensive import protection for the whole economy (and not just the favoured sectors), were closely connected with (c). All three, combined with other relevant policies should therefore be assessed together. To recall the analogy with the Bank's own structural adjustment programs, the Bank's procedure in the present case amounts to an assessment of a single component of the structural adjustment programs such as say devaluation, without reference to the interconnections with the rest of the program. This is not to say that it is not an interesting and a legitimate exercise to consider the effectiveness of a single component of a structural



adjustment program or of industrial policy. However, to do that its links with the other components must be explicitly recognised. It also requires a much more elaborate counter-factual exercise e.g. simulation of a macro-econometric model, first with the structural adjustment programme, and then with one in which the component under reference is not considered.

However, Bank economists have not carried out such research. The interconnections between different aspects of industrial policy in countries like Japan or Korea have either not been examined at all or as shown below, not correctly interpreted. Nevertheless, within their own terms, the Bank's industrial policy ineffectiveness doctrine rests on two empirical propositions: (a) That the industrial structure which emerged in industrial policy economies like Japan and South Korea was not all that different from what it would have been had these countries not pursued an industrial policy (ie. that the observed industrial structure was ex-post market conforming and accorded with the changing relative factor intensities and prices). (b) That the TFP growth of the industrial policy favoured sectors was no different from that of the unfavoured sectors.

As tests of the ineffectiveness of industrial policy, even in this narrow sense, (a) and (b) are inadequate. To illustrate, suppose we take the neoclassical interpretation of Vice-Minister Ojimi's rationale for Japan's industrial policy noted earlier. On this interpretation, all that MITI was doing was pursuing Japan's

dynamic comparative advantage, helping create an industrial structure to accord with it. However, it was attempting to do so in as short a time as possible. The resulting industrial structure would of course in equilibrium be market conforming. So that even if it were true that the market forces, left to themselves, may have generated the same kind of industrial structure, it may have taken a much longer time to do so and hence resulted in a much lower rate of economic growth. Bank economists do not address this crucial issue of the speed of adjustment at all.

The problem with test (b) is that it overlooks the effects of industrial policy on a country's balance of payments and its long term rate of growth of domestic demand. By confining their attention only to the supply side effects of productivity growth and technical change, as predicated by the TFP approach, Bank economists hypothesise that 'spillovers' of these activities will be confined only to the favoured sectors or their close sub-sectors within the two digit industrial classification which they have analysed. However, to the extent that industrial policy helps to relieve the balance of payments constraint, most sectors will benefit from higher rates of growth of production and hence productivity (by Verdoorn's Law) and not just the favoured sectors. In other words, the spillovers will be almost universal.

Thus test (b) cannot discriminate between industrial policy and non-industrial policy states. To do that, one needs to look also at the costs and benefits of industrial policy interventions in

terms of their relaxing the balance of payments constraint in the short and the long run. More specifically, it would require inter alia, an examination of the contribution of the favoured sectors to the growth of exports or to the reduction in the growth of imports over time.

It is the failure to consider such factors which leads Bank economists to conclude that South Korea's Heavy and Chemical industry (HCI) drive in the 1970s was unsuccessful, while revisionist economists suggest that it was a success. The reason for these conflicting judgements is that Bank economists do not consider its benefits to the long term trajectory of the balance of payments and hence to overall economic growth. Amsden(1989) points out that the mainstay of Korea's celebrated export success in the 1980s was precisely these HCI industries.<sup>ix</sup>

Parenthetically, a related point which is relevant here is that Bank economists ignore the fact that in Korea the industrial policy favoured sectors were not just the high capital intensity sectors but importantly these included textiles (precisely because of its contribution to the balance of payments) for most of the period. (see Chang, forthcoming). However, the Korean government knew, as did the Japanese before them, that howsoever successful a country may be in the export of textiles, to have sustained fast overall rates of growth of exports over time, it needs to regularly add new export products to the list. Hence the need to continuously upgrade the industrial and export structure of the economy, albeit,

if it pleases the Bank, in accordance with the country's changing dynamic comparative advantage. However, it will be appreciated that the factor proportions Heckscher-Ohlin theory does not yield any precise predictions where a country's dynamic comparative advantage lies as it accumulates capital and skills. The theory predicts a movement towards skill intensive exports but does not specify which ones. In Japan and Korea, the government selected and nurtured those industries where it thought the country did, or should (in the non-neoclassical interpretation) have a dynamic comparative advantage.

Bank economists seem to be unaware of an ironic implication of their analysis. If despite heavy government intervention, the Japanese and the Korean industrial structures still conformed to these countries' dynamic comparative advantage, a reasonable inference must be that on average the government was correctly able to 'pick the winners'! Hence, at this level of analysis, in Bank economists own terms, the Japanese or the Korean industrial policies should be regarded as a success.

To sum up, the above discussion indicates that Bank economists arrive at their industrial policy ineffectiveness doctrine by (a) considering industrial policy in a very narrow sense; (b) by ignoring its multi-faceted character and the important linkages between its different components; and (c) even within their own terms by using inappropriate tests for assessing the success or otherwise of industrial policy. The first of their tests is not

valid because it does not consider the critical issue of the speed of adjustment to a country's dynamic comparative advantage; the second is marred by the fact that it abstracts from the effects of industrial policy on the balance of payments constraint and hence on overall demand - issues which are salient in the real world of imperfect or incomplete markets in semi-industrial economies. The TFP model, with its assumptions of full utilisation of resources and perfect competition, which Bank economists use is inappropriate for such analysis.

## **6. OPENNESS: 'CLOSE' VERSUS 'STRATEGIC' INTEGRATION WITH THE WORLD ECONOMY**

### **(a) Degrees of Openness of the East Asian Economies**

The virtues of openness, international competition, close integration with the world economy, are stressed in several Bank publications (see in particular the 1991 Report). Evidence suggests, however, that these virtues were not in fact practised by either Japan or Korea.

To illustrate, the Japanese economy operated under rigorous import controls, whether formal or informal, throughout the 1950s and 1960s. As late as 1978, the total imports of manufactured goods into Japan was only 2.4 percent of GDP. The corresponding figures for manufactured imports for the UK and other leading European countries were at that time of the order of 14 or 15 per cent of GDP. Between 1950 and 1970, the Japanese domestic capital markets

were highly regulated and completely shut off from the world capital markets. Only the government and its agencies were able to borrow from or lend abroad. Foreign direct investment was strictly controlled. Foreign firms were prohibited either by legal or administrative means from acquiring a majority ownership in Japanese corporations.

With respect to the questions of exchange rates and distortions, the Japanese Government maintained exchange controls and kept a steady nominal exchange rate with respect to the U.S. dollar over almost the whole of the period of that country's most rapid growth (1950-73). Purchasing power parity calculations by Sachs (1987), using Japanese and U.S. price indices, show a 60 percent real appreciation of the exchange rate between 1950 and 1970.

Thus, despite the strong export orientation of the Japanese economy, it was far from being open or closely integrated with the world economy. The stories of Taiwan and South Korea, subject to certain modifications, also point in the same general direction.[see further Amsden(1989) and Wade(1990)].

#### **(b) Protection and Export Promotion: Alternative Interpretations**

What was the role of this high degree of protection in the East Asian economies? The Bank economists acknowledge the facts of this protective regime but essentially argue that this was generally a negative influence which was kept in bounds only by the government

pursuit of export targets and export contests.

This interpretation has serious short-comings. First, as noted earlier, generalised protection was one of the mechanisms used by the Japanese and the Korean governments to alleviate the balance of payments constraint. Secondly, and equally significantly, there are both analytical and empirical reasons for the view that protection played an important, positive role in promoting technical change, productivity growth and exports in these countries. To appreciate how protection worked at a microeconomic level, consider the specific case of the celebrated Japanese car industry. Magaziner and Hout (1980) point out that "government intervention in this industry was characterized by three major goals: discouragement of foreign capital in the Japanese industry and protection against car imports, attempts to bring about rationalization of production, and assistance with overseas marketing and distribution expenditure" (p. 55). The government imposed comprehensive import controls and adopted a variety of measures to discourage foreign investment in the car industry. (see also below). Quotas and tariffs were used to protect the industry; the former were applied throughout the mid-1960s, and prohibitively high tariffs till the mid-1970s. Moreover, "the government controlled all foreign licensing agreements. To make technology agreements more attractive to the licensor, it guaranteed the remittance of royalties from Japan. The policy stipulated, however, that continued remittances would be guaranteed only if 90 percent of the licensed parts were produced

in Japan within five years" - about as powerful a domestic content arrangement as one can get.

More generally, protection provided the Japanese companies with a captive home market leading to high profits which enabled the firms to undertake higher rates of investment, to learn by doing and to improve the quality of their products. These profits in the protected internal market, which were further enhanced by restrictions on domestic competition (see Section VII), not only made possible higher rates of investment but also greatly aided exports. Yamamura (1988) shows how these protective policies gave the Japanese firm 'a strategic as well as a cost advantage' over foreign competitors. In other words protection, export promotion and performance standards were very much complementary policies.

#### **(i) Foreign Direct Investment**

An important feature of both the Japanese and the Korean industrial policy has been the discouragement of foreign direct investment (FDI). Available statistics indicate that among developing countries, Korea was second only to India in its low reliance on FDI inflows. Foreign capital stocks totalled just 2.3 per cent of GNP in 1987 in Korea, above the 0.5 per cent estimate for India, but far below the levels of 5.3 per cent for Taiwan, 17 per cent for Hong Kong, a massive 87 per cent for Singapore, 10 per cent for Brazil and 14 per cent for Mexico. UN (1993). In the view of the World Bank economists, this discouragement was a self-imposed handicap which was compensated for only by the fact



that both countries remained open to foreign technology through licensing and other means. This raises the question that if the Japanese and the Korean governments were as efficient and flexible in their economic policy as the Bank economists themselves suggest (to account for their long term overall economic success), how is it they have persisted with this apparently wrong-headed approach for so long?

An alternative interpretation is that the approach was perhaps not so wrong-headed. It was 'functional' within the context of the overall industrial policies which the two countries were pursuing. First, it would have been difficult for MITI or for the Korean authorities to use 'administrative guidance' to the same degree with the foreign firms as they were able to do with the domestic ones. Secondly, as UN(1993) emphasises, there is a link between the national ownership of the large Korean firms (Chaebols) and their levels of investment in research and development. Korea has, in relative terms, by far the largest expenditure on R and D among developing countries: 1.9 percent of GNP in 1988, compared with 1.2 percent in Taiwan (1988), 0.9 percent for India (1986) and Singapore (1987), 0.5 percent for Argentina (1988), 0.6 percent in Mexico (1984) and 0.4 percent in Brazil (1985). The country's performance in this area outstrips that of many developed countries (eg. Belgium, 1.7 per cent in 1987), but is of course still below that of industrial super powers, (Japan and Germany each at 2.8 percent in 1987).

Thirdly, Freeman (1989) stresses another important advantage of the policy of mainly rejecting foreign investment as a means of technology transfer. This, he argues, automatically places on the enterprise, the full responsibility for assimilating imported technology. This is far more likely to lead to "total system improvements than the 'turn-key plant' mode of import or the foreign subsidiary mode".

**(ii) Price Distortions**

Bank economists in their econometric analyses in recent publications use a quantitative measure of openness - the degree to which the relative domestic prices in an economy differ from international relative prices. On that measure, it turns out that both Japan and Korea were among the least open economies. Relative prices in these countries were more distorted than in Brazil, India, Mexico, Pakistan and Venezuela, often held up by the Bretton Woods institutions as prime examples of countries which do not 'get the prices right'.

**(c) The Optimal Degree of Openness and Strategic Integration with  
the World Economy**

To sum up, the experience of Japan and Korea comprehensively contradicts the central theses of many World Bank Reports that, the more open the economy, the closer its integration with the global economy, the faster would be its rate of growth. During

their periods of rapid growth, instead of a deep or unconditional integration with the world economy, these countries evidently sought what might be called 'strategic' integration, i.e. they integrated upto the point that it was in their interest to do so as to promote national economic growth. If (as stated in the 1991 Report) the purpose of Bank economists was to find out why countries like Japan have been so successful in economic development during the last forty years, they have clearly been using the wrong paradigm for examining Japanese economic history.

The basic problem is that the underlying assumptions of this paradigm are greatly at variance with the real world of static and dynamic economies of scale, learning by doing, and imperfect competition. In such a world, even neoclassical analysis now accepts that the optimal degree of openness for a country is not "close" integration with the global economy through free trade.<sup>x</sup>

In that case, what is the optimal degree of openness for the economy? This extremely important policy question however is not seriously addressed by the orthodox theory.<sup>xi</sup>

Chakravarty and Singh (1988) provide an alternative theoretical perspective for considering this issue. To put it briefly, they argue that "openness" is a multi-dimensional concept; apart from trade, a country can be "open" or not so open with respect to financial and capital markets, in relation to technology, science, culture, education, inward and outward migration. Moreover a country can choose to be open in some directions [say trade] but not so open in others such as foreign direct investment or financial

markets. Their analysis suggests that there is no unique optimum form or degree of openness which holds true for all countries at all times. A number of factors affect the desirable nature of openness: the world configuration, the past history of the economy, its state of development, among others. The timing and sequence of opening are also critical. They point out that there may be serious irreversible losses if the wrong kind of openness is attempted or the timing and sequence are incorrect. The East Asian experience of "strategic" rather than "close" integration with the world economy makes perfect sense within this kind of theoretical framework.

Such a framework can also explain why for the second tier of South East Asian NICs - Malaysia, Thailand, Indonesia - the optimal degree of openness is different than it was for the East Asian countries. As noted earlier, in the South-East Asian economies, foreign direct investment has played a far more important role than it did in Japan or South Korea. As a consequence of the fast development of the East Asian countries, the second tier NICs are faced with a different historical situation. This makes it advantageous for them to attract industries which are no longer economic in the first tier countries because of the growth of their real wages - as suggested by the so called "flying geese" model of Asian economic development.

It should be emphasised that this model and the associated intra-regional pattern of trade and investment in Asia is itself in part a product of the industrial policy in Japan, Korea and

other countries. Unlike many other advanced countries which try to protect declining industries, the Japanese practice a 'positive' industrial policy of encouraging structural change by assisting the replacement of old industries by the new. This, however, involves an orderly rundown of the older industries (see next section), including inter-alia their transfer to less developed countries in the region. (Okimoto, 1989)

Consequently, Felix (1994) suggests that East Asian foreign direct investment in the region has been structurally more conducive to sustaining backward linkage development in the participant economies than has been the case of foreign direct investment in Latin America. He ascribes this to the fact that the East Asian intra-regional pattern has evolved along a dynamic comparative advantage path dominated by cost minimising trade and investment. The Latin American pattern, he suggests, has been shaped largely by mercantilist market access rather than by cost minimising objectives. As a result, it is more vulnerable to disruptive shifts of trading advantages deriving from changes in the marketing and financial strategies of foreign firms.

## **7. COMPETITION IN THE DOMESTIC MARKETS**

World Bank economists have traditionally stressed the merits of competition in the domestic product, capital and labour markets. However, the practice of the successful East Asian countries in this respect also has been rather different. As in relation

to the question of integration with the world economy, Japan and Korea appear to have taken the view that from the dynamic perspective of promoting investment and technical change, the optimal degree of competition is not perfect or maximum competition. The governments in these countries have therefore managed or guided competition in a purposeful manner: it has both been encouraged, but notably also restricted in a number of ways.

#### **(a) Collusion and Competition in Japan**

To illustrate, it is useful to reflect on some of the blatant restrictions which were imposed by the Japanese Government in the 1950s and 1960s on domestic product market competition. To meet its myriad goals which continually changed in the light of economic circumstances facing the country, MITI encouraged a variety of cartel arrangements in a wide range of industries – export and import cartels, cartels to combat depression or excessive competition, rationalization cartels, etc. According to Caves and Uekusa (1976), in the 1960s, cartels accounted for 78.1 percent of the value of shipments in textiles; 64.8 percent in clothing; 50.0 percent in non-ferrous metals; 47 percent in printing and publishing; 41.2 percent in stone, clay and glass; 34.5 percent in steel products, and 37.2 percent in food products. Although these cartels functioned for only limited periods of time and there was wide variation in their effectiveness, Caves and Uekusa observed that "their mere presence in such broad stretches of the manufacturing sector attests to their importance." (page 147).

However, these restraints on competition are only a part of the story. An equally significant part is MITI's strong encouragement of vigorous domestic oligopolistic rivalry and international competitiveness. In general, whether competition was promoted or restricted depended on the industry and its life-cycle: in young industries, during the developmental phase, the government discouraged competition; when these industries became technologically mature, competition was allowed to flourish. Later, when industries are in competitive decline, the government again discourages competition and, as noted earlier, attempts to bring about an orderly rationalization of the industry (Okimoto, 1989).

Yamamura (1988) provides a useful dynamic model to show how the Japanese competition policy was an integral part of the country's industrial policy. During the rapid growth phase of Japanese development in the 1950s and 1960s, in the key industries which were receiving its attention, MITI essentially organized an "investment race" among large oligopolistic firms in which exports and international market share were significant performance goals.

As in the real world markets are always incomplete, such a race without a coordinator could lead to ruinous competition, price wars and excess capacity, inhibiting the inducement to invest.

In the Japanese economic miracle, MITI provided this crucial coordinating role and orchestrated the dynamic combination of collusion and competition which characterizes Japanese industrial

policy. Yamamura notes that what MITI did was to 'guide' the firms to invest in such a way that each large firm in a market expanded its productive capacity roughly in proportion to its current market share – no firm was to make an investment so large that it would destabilize the market. The policy was effective in encouraging competition for the market share (thus preserving the essential competitiveness of the industrial markets) while reducing the risk of losses due to excessive investment. Thus, it promoted the aggressive expansion of capacity necessary to increase productive efficiency.

**(b) Large Firms and Domestic Competition in Korea**

Turning to Korea, that country also did not follow a policy of maximum domestic competition or unfettered market-determined entry or exit of firms. The Korean government, if anything, went one step further than the Japanese in actively helping to create large conglomerates, promoting mergers, and directing entry and exit of firms according to the requirements of technological scale economies and world demand conditions. The result is that Korea's manufacturing industry displays one of the highest levels of market concentration anywhere. The top 50 chaebols accounted for 15 percent of the country's GDP in 1990. Among the largest 500 industrial companies in the world in 1990, there were eleven Korean firms, the same number as Switzerland. UN(1993) observes in relation to the Korean industrial structure:  
"Such a structure is the deliberate creation of the Government, which utilised a highly interventionist strategy to push industry into large-scale, complex technologically demanding



activities while simultaneously restricting FDI inflows tightly to promote national ownership. It was deemed necessary to create enterprises of large size and diversity, to undertake the risk inherent in launching in high-technology, high-skill activities that would remain competitive in world markets.

Nevertheless, there is ample evidence that the big business groups still exhibited highly rivalrous behaviour (Kim, 1992). This was because under rapid growth conditions, as well as the rules of the game which the state had established, there was neither the incentive nor the ability for big business to collude. The Korean government went out of its way to insure that big business did not collude, by allocating subsidies only in exchange for strict performance standards (Amsden, 1989). After 1975 inter-group competition in Korea heated-up as each chaebol, or diversified business group, tried to qualify for generous subsidies to establish a general trading company by meeting government performance standards regarding minimum export volume and the number of export products (Cho, 1987)

### **(c) An Assessment**

There has been a major advance in the Bank's thinking about the role of free markets and competition in economic development. Implicitly rejecting the view embodied in many previous documents and specifically in the 1991 Report that, "Competitive markets are the best way yet found for efficiently organising the production and distribution of goods and services", the Bank's recent seminal publication (the Miracle Study) accepts the need

for cooperation as well as competition to achieve fast economic growth. Specifically in relation to Japan, South Korea and Taiwan, Bank economists acknowledge the positive role of cooperation (or restrictions on competition) in order to correct what they call "the coordination failures", which particularly characterise industrialising country product and capital markets. In this analysis, a much larger role of the government as a referee to mediate these cooperative arrangements is explicitly recognised.

Thus, intellectually, Bank economists accept the revisionist argument that the governments in these East Asian countries guided the market and controlled the competitive process, and that this guidance was conducive to their fast growth.

Nevertheless, after this giant conceptual step forward for the Bank economists, in their policy recommendations to other developing countries, they retreat to their earlier perspective of free and competitive markets. The main argument made for this reversal is that other countries do not have the institutional capacity to successfully implement the required combination of competition and cooperation .

## **8. INDUSTRIAL POLICY, NATIONAL TECHNOLOGICAL SYSTEM AND INTERNATIONAL COMPETITIVENESS**

In addition to protection, domestic competition policy another measures already discussed above, another important component of

industrial policy in the exemplar East Asian countries has been a national strategy for technological development. The World Bank reports invariably stress the importance of primary and secondary education for achieving economic growth. However, they do not pay sufficient attention to tertiary education and to the technological infrastructure both human and physical which late industrialisers require to catch-up with the advanced countries. Yet, it is precisely in these areas that the East Asian countries have excelled, which in turn has played a major role in enhancing their international competitiveness and their outstanding export success.

A national system of technological advancement was first advocated by Friedrich List in the first half of the 19th century to enable Germany to catch up with Great Britain. Although "catch up" was much easier then than it is for today's developing countries, many of List's insights continue to remain valid.<sup>xii</sup> Following the end of World War II, the Japanese adopted a national technological system which spans the government, the firms, the universities, and indeed, the society as a whole. Freeman(1989) identifies following to be the principal elements of this national techno-economic strategy.

- a. The ability to design and redesign entire production processes, whether in shipbuilding, machine tools or any other industry.
- b. The capacity at national, government level to pursue an

integration strategy which brings together the best available resources from universities, government, research institutions, private or public industry to solve the most important design and development problems.

c. The development of an educational and training system which goes beyond the German level in two respects. First, in the absolute numbers of young people acquiring higher levels of education, specially in science and engineering. Second, in the scale and quality of industrial training which is carried out at enterprise level.

d. The policy of eschewing, as noted earlier, foreign investment as a principal means of technology transfer.

e. The emergence of a far more flexible and decentralised management system, permitting both greater horizontal integration of design, development and production and more rapid response to change.

f. Close co-operation between the central government and Keiretsu (large conglomerate groupings in Japanese industries) in identifying future technological trajectories, and taking joint initiatives, to adopt these to enhance the country's prospective competitiveness.

It is notable that many Asian countries including, Korea, Taiwan and currently China have been consciously following the Japanese model and building their own national technological systems in the light of their resources and requirements. It is also striking that several of these countries now have a higher annual output

of graduate engineers per hundred thousand of population than Japan. These countries are thus trying to outdo Japan in this respect, just as Japan outstripped the United States.

Freeman(1989) calls attention to the fact that the third country in the world to introduce and export 256K memory chips after Japan and USA was not an advanced industrial country but South Korea. It took that country less than thirty years, starting from a position of barely any industry at all, to become a significant player in the world electronics industry.

None of the above is to under-estimate the formidable problems which the late industrialisers face just to keep in step with the fast pace of technological change in the world economy, let alone to catch up. Lall (1994) and others have pointed to the formidable technological and other barriers to entry<sup>xiii</sup> in the world markets which LDC firms face. To meet these technological challenges, developing countries require a continuing build-up of national technological capability through an integrated system in the ways outlined above. It is an incremental and long-term process requiring concerted national effort in which the government necessarily plays a leading direct, as well as a crucial coordinating role. Without such effort, countries like Korea or Taiwan would not have been able to hold their share of world manufacturing exports, let alone greatly increase them as they have so successfully done over the last two decades or more.

The World Bank emphasis on early education would not appear to be an adequate means of enhancing the international industrial competitiveness of semi-industrial countries. To compete in the world industrial economy, it is also essential to have higher educational institutions, scientists, technologists and engineers. It is useful in this context to go back to the earlier discussion of changing factor proportions and its implications for comparative advantage and structural changes in the economy. The changing factor proportions (in the sense of human capital and skill formation) over time in the East Asian countries, was clearly not simply an outcome of 'natural market forces' as per capita income rose. Rather these developments were very much guided by the visible hand of the government in terms of its national priorities.

## **9. CONCLUSION**

As detailed in the previous pages, there has been considerable progress in the debate between heterodox and World Bank economists concerning the outstandingly successful development experience of East Asian economies like Japan or Korea. There is now general agreement that governments in these countries intervened heavily in all spheres of the economy in order to achieve rapid economic growth and fast industrialisation. It is also common ground that during the course of their development these countries did not have free and flexible internal or external product and capital markets. Although these countries were export oriented, they

eschewed close integration with the international economy in terms of imports, foreign direct investment or capital flows. The governments of these countries also controlled and guided the competitive process in the domestic product and capital markets through a highly effective combination of inter-firm cooperation and oligopolistic competition.

There are, of course, still important areas of disagreement - particularly in relation to the industrial policy ineffectiveness doctrine of the World Bank economists. Nevertheless, on the whole, there is now much less disagreement on the analytical and empirical issues than on policy. A main reason for the policy differences is the belief of Bank economists that other countries do not have the institutional capacity to implement the optimum degree of competition and openness which the exemplar East Asian countries achieved. How valid is this view?

The important point to note here is that the Japanese model was itself imitated by the Koreans and by the Taiwanese. When Korea decided to embark on the Japanese model in the 1960s, as World Bank economists themselves admit, that country did not have the necessary institutional capacity. The Korean bureaucracy at the time was incompetent and corrupt, as indeed was the case with the Kuomintang bureaucracy when it arrived in Taiwan from mainland China. Yet these countries were able to create the right kind of bureaucracy and the other necessary institutions required for implementing the Japanese model. If these institutions can be

created by Korea and Taiwan, and later on by Malaysia or Indonesia, surely it must be possible to establish them in many other countries elsewhere as well? In the end therefore, this analysis raises the following question: if in view of the ubiquitous coordination failures in the less developed economies, state- directed industrialisation on the Japanese or Korean pattern is the first best policy for achieving fast economic growth, should the World Bank not concern itself more with the institutional imitation and innovation of the kind outlined above, than with prescribing market-friendliness or close integration with the world economy (which these countries did not practice)?



i. The World Bank's annual World Development Reports are useful sources for the analysis of these issues. However, for reasons given in section II, the two most important documents in this context are World Bank (1991, 1993). The latter are seminal works which provide a comprehensive account of Bank economists' thinking on these and other development problems and their conclusions on public policy. These are therefore the specific documents this paper draws upon in all references made to the Bank's analyses.

ii. See the commentaries in this Journal by Amsden et al (1994) on World Bank (1993).

iii. There is an enormous literature on the subject. For a lucid analysis of the relevant issues under discussion here, see Nelson [1981].

iv. The classic references here are Verdoorn (1949) and Kaldor (1966). For a review, see Mcombie (1987). The TFP growth table in the 1991 Report shows that in general, the larger the fall in the growth of output (in 1973-87 compared with the earlier period), the greater the reduction in TFP growth, much as would be predicted by Verdoorn's Law. Moreover, the South Asian region is the only one to record an increase in TFP growth in the second period; it is also the only one with a substantial trend increase in GDP growth in that period.

v. The period 1950-73, when the OECD economy grew at an unprecedented rate of almost 5% per annum—twice its historic trend rate of growth—has rightly been termed the Golden Age of capitalism. Glyn, Hughes, Lipietz and Singh, (1990) provide a detailed analysis of why the Golden Age rose in the first place and why it fell following the 1973 oil shock. See also Maddison [1982]; Bruno and Sachs [1985]; Kindleberger [1992]. To avoid

misunderstanding, it must be emphasised that we are not considering here the question of short term demand management, but rather that of the forces which affect the long term rate of growth of demand.

vi. See for example Lucas (1973).

vii. See further Johnson, Tyson and Zysman (1989). There have been important changes in the 1970s and the 1980s in the nature and conduct of MITI's industrial policies, compared with the 1950s and the 1960s. In general, MITI does not now have the same kind of coercive policy instruments as it did in the high growth period. It therefore has to use more indirect instruments as well as moral persuasion to a far larger degree than it did before.

viii. Thus the Miracle Study: "We define industrial policies, as distinct from trade policies, as government efforts to alter industrial structure to promote productivity-based growth." (p.304).

ix. The question of the time horizon over which the costs and benefits of industrial policy interventions are assessed is of crucial importance. Amsden and Singh(1994) point out that for thirty years there were few foreign cars to be seen on Korean roads and few Korean cars to be seen on foreign roads. In other words, the Korean government provided protection to the car industry for long periods of time because of the difficulties involved in the learning and the assimilation of foreign technology in developing countries.

x. See for example Krugman (1987) and Roderick (1992).

xi. On this point, see the interesting review by Lucas (1990) of Helpman & Krugman (1989).

xii. See further Freeman(1989)

xiii. see also Box 3.3 on Samsung industries on page 130 which confirms these points.