

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

DEVELOPMENT STRATEGIES IN A GLOBALIZING WORLD



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INTRODUCTION

In almost all successful cases of rapid and sustained growth in developing countries, a dramatic shift in economic structure from the primary sector to manufacturing has triggered a progressive rise in productivity and income levels. This rise has been sustained by a move from less to more technology- and capital-intensive activities both within and across sectors, and the resulting improvement in productivity has helped domestic producers compete in increasingly demanding international markets. The engine of this process of structural change and productivity growth has been rapid and sustained capital accumulation. Where the market and private property have assumed a prominent role, resources have been concentrated in the hands of a minority, whose behaviour has, to a large extent, determined the pattern of investment and growth. This process has rarely been a smooth one, and the need to manage the resulting tensions and conflicts in the domain of income distribution has added a strong political dimension to “late industrialization”.

In the past two decades, globalization has become the counterpoint to late industrialization strategies. The growing influence of international economic forces on growth and welfare prospects does not, in itself, mark a new departure in capitalist development. However, globalization has assumed a strongly one-sided identity in recent times. It has become synonymous with the impulses of private actors operating in unregulated global markets, principally international banking and other financial institutions and transnational corporations (TNCs). According to many commentators, new information and communication technologies have strengthened these impulses by shrinking geographical distances, eroding political frontiers and weakening the countervailing public and social pressures that have, in the past, been part of a more balanced development process. The collapse of the Berlin Wall in 1989 exposed the economic bankruptcy of central planning, leaving globalization as the one-model-to-fit-all economic occasions, or as one corporate leader has recently put it - “the free market system on an international scale”.

Such thinking sits comfortably with the conventional analysis of industrialization and growth in poorer countries which builds its case for a market-driven development strategy around raising private savings and investment through good macroeconomic fundamentals.¹

¹ The *Trade and Development Report 1997* provides a critical review of the conventional globalization literature and the criticisms have been supported in various UNCTAD/G-24 Technical Papers and UNCTAD Discussion Papers; see for example P. Mosely, “Globalization, Economic Policy and Growth Performance”, *International Monetary and Financial Issues for the 1990s*, vol X, 1999; R. Rowthorn and R. Kozul-Wright, “Globalization

From this perspective, greater openness to international market forces and competition is expected to strengthen growth prospects by improving resource allocation, by attracting foreign savings and by deepening technological capacities through greater inflows of foreign direct investment (FDI). Together with political stability, good governance, respect for property rights and public investment in human capital, these elements make up what is regarded as a generally applicable strategy for sustainable growth in a globalizing world.

A shift to such a strategy in developing countries requires many of them to break with past policies and pursue much closer and faster integration into the world economy through rapid liberalization of trade, finance and investment. Since the debt crisis of the early 1980s, such policy advice has become conventional wisdom, with strong backing from leading international development bodies. The growth of world trade and the recovery of financial flows to developing countries in the 1990s were taken as confirmation that a new era of prosperity was unfolding, and a large number of developing countries were expected to close the income gap with industrial countries. The fast growing economies of East Asia have often been held up as examples of what can be achieved as the result of a dedicated application of such policies, although many commentators have questioned whether the policies pursued should be characterised in such simple terms.

As an organization established to examine and redress biases and asymmetries in the international economy, UNCTAD is principally concerned with whether or not this market-driven process of economic integration has in fact opened a new chapter on development prospects. As detailed in recent *Trade and Development Reports (TDR)*, growth during this period has been highly uneven and volatile, with polarization more powerful a trend than convergence. Another telling feature of recent experience is that industrial activity in many developing countries has stagnated during this period, and in some cases there has been “deindustrialization”. The rapid pace of liberalization appears to have been a contributory factor to these trends.

By contrast, despite occasional drawbacks, many of the most successful economies have continued to manage the challenges of rapid accumulation and closer integration with the help of a strong development state and a wide range of policy instruments. Although these experiences should not be taken as a detailed blueprint for policymakers elsewhere, they do confirm the general strategy lessons that emerge from earlier episodes of industrialization in today’s advanced economies. They also provide a very important counterclaim to the argument that there are no alternative policy agendas that are consistent with an increasingly interdependent global economy.

The aim of this paper is to provide a synthesis of the work done in the past 10 years by the DGDS on development strategies. The first section looks at how the basic elements of late industrialization – accumulation, structural change and technological upgrading – link up with more managed integration into the global economy through the strategic use of trade, investment and financial policies. The second section looks at how closer regional ties can complement national development strategies by reinforcing the forces of structural change,

and economic convergence: An assessment”, *UNCTAD Discussion Paper*, no. 131, March, 1998; M. Khor, “Globalization and the South: Some critical issues”, *UNCTAD Discussion Paper*, no. 147, April 2000; see also D. Nayyar, “Globalization and Development Strategies”, High Level Round Table on Trade and Development: Direction for the 21st Century, UNCTAD X, Bangkok, February 2000; G. Helleiner, “Markets, Politics and Globalization: Can the Global Economy be Civilized?” 10th Prebisch Lecture, December 2000.

technological dynamism and industrial upgrading. The final section considers what improvements to the multilateral trading and financial system may be needed to return to a more rapid and balanced process of economic development.

A. DEVELOPMENT STRATEGIES

1. *Investment, profits and growth*

For most poor countries, policies aimed at raising the level of investment must initially be designed for a predominantly rural economy where agricultural activities form the main basis of wealth creation. Economic environments such as this tend to be difficult and risky: large infrastructure projects are often required to raise output, labour scarcity can pose a constraint on expansion, and a high proportion of the output can be sold only in a limited range of markets. A basic aim at this stage of development is to increase productivity in the agricultural sector – particularly among smallholders – and to generate a net agricultural surplus that can be used to nurture non-traditional activities. A comparative examination of various experiences shows that success at this stage is crucially dependent on a number of factors.

First, producers should be given appropriate incentives through a judicious combination of input and output prices. Exchange-rate policies and price stabilization play an important role in providing producers with relatively stable incomes, given that world prices of agricultural commodities are highly volatile. Second, sector-specific supply-side policies should focus on measures to improve the technological capacities of farmers and their access to material inputs and credits. They should also aim to achieve economies of scale and specialization, encourage market development and help minimize risks. Finally, a particularly important factor is public investment and its appropriate funding. Evidence clearly shows that agriculture was taxed everywhere during the early stages of development. However, in successful cases in East Asia, a two-sided approach was adopted, with the state taxing agriculture through pricing policies, whilst counterbalancing this resource outflow by investing in basic infrastructure for agricultural production. The state also helped to introduce a stream of innovations needed to enhance the productivity and profitability of private investment. Reforming local government to ensure taxes were collected fairly and efficiently and used for local development purposes also helped to produce quick returns, although in many cases raising investment involved more sensitive issues of land reform.²

As industrial activity begins to take off and a corporate sector emerges, the net agricultural surplus becomes relatively less important as a source of accumulation. However, the sustainability of industrialization depends both on the timing of the shift from agriculture to industry as a central locus of accumulation and on the momentum of the savings-investment process within the industrial sector. The industrialization process is unlikely to be sustainable if resources generated by agriculture are transferred to industry before considerable progress has been made in raising agricultural productivity and while industry continues to depend on such transfers. Thus, to be sustainable industry needs to generate an

² For a discussion of the policies needed to strengthen agricultural production in Africa, see *TDR 1998*, Part Two. For a comparative perspective see *Cambridge Journal of Economics. Special Issue on African Development in a Comparative Perspective*, vol. 25 no.3, May 2001, particularly the papers by Akyüz and Gore; Boratav; and Karshenas.

adequate surplus for its own expansion. Moreover, since industrial accumulation depends very much on imports of intermediate and capital goods, the industrialization process would not be sustainable unless the sector itself becomes an important source of foreign exchange earnings.

In these respects, the lessons drawn from successful East Asian industrialization experiences tend to be very one-sided.³ Certainly, high rates of investment played a very important role in the exceptionally rapid industrial growth of these economies (as they did earlier in Japan and successful late-industrializing countries in post-1945 Western Europe). This investment was, after an initial period, matched by high rates of domestic savings and, in the interim, foreign savings helped close the financing gap and soften the payments constraint. However, as discussed in considerable detail in *TDR 1994* and *TDR 1996*, their exceptional savings-investment performance was due less to household behaviour and more to corporate profits. The accumulation drive was founded on a strong investment-profit nexus whereby profits simultaneously provided firms with the incentive to invest and the capacity to finance new investment. Investment, in turn, raised profits by enlarging the stock of productive capital and by increasing the pace of productivity growth. However, profits were not automatically translated into productive investments in response to market forces, but required various policies designed to manage this investment-profit nexus to ensure corporate and development interests coincided.⁴

Two broad sets of policies have been used to successfully animate this profit-investment nexus. Firstly, fiscal measures can be used to increase corporate profits and encourage their retention in order to accelerate capital accumulation. This includes specific instruments – such as tax breaks and special depreciation allowances – as well as more general legislation which allows firms to put aside reserve funds against risks and exempts funds from taxation, thus making it possible to defer tax payments on profits. Such policies can also play a catalytic role in stimulating lending for more productive purposes, since banks are often more willing to make loans for investment qualifying for accelerated depreciation allowances. Fiscal measures can also be used to strengthen the investment drive by preventing profits and dividends draining into excessive luxury consumption.

Secondly, trade, financial and competition policies can help raise profits above levels that would normally be attained under free-market conditions. These state-created rents can play an even more vital role in boosting profits and promoting investment than fiscal incentives. Rents can be created through a combination of selective protection, controls over

³ These experiences have been discussed in considerable detail in UNCTAD discussion papers; see for example, A. Amsden, “Structural macroeconomic underpinnings of effective industrial policy: Fast growth in the 1980s in five Asian countries”, no. 57, April 1993; D. Felix, “Industrial development in East Asia: What are the lessons for Latin America”, no.84, May 1994; C. Gore, “Development strategy in East Asian newly industrializing economies: The experience of post-war Japan, 1953-1973”, no.92, November 1994; A. Singh, “How did East Asia grow so fast? Slow progress towards an analytical consensus”, no. 97 February 1995; S. Sen “Growth centres in South East Asia in the era of globalization”, no. 118, September 1996; J. Kwon “The East Asian model: An exploration of rapid growth in the Republic of Korea and Taiwan Province of China”, no. 135, May 1998; R.Rasiah, “The export manufacturing experience of Indonesia, Malaysia and Thailand: Lessons for Africa”, no. 137, June 1998.

⁴ See Y. Akyüz and C. Gore, 1996, “The investment-profits nexus in East Asian Industrialization”, *World Development*, vol 24 no. 3. See also *Journal of Development Studies*, vol. 34, no.6, 1998: special volume on East Asian Development, *New Perspectives*, ed. by Y. Akyüz, particularly the papers by Akyüz; Chang and Kozul-Wright; and Singh.

interest rates and credit allocation and managed competition, including the management of mergers, the coordination of capacity expansion, restrictions on entry into specific industries, screening of technology acquisition, and the promotion of cartels for specific purposes such as product standardization, specialization and exports.

Creating rents in this way carries some obvious dangers. Accordingly, their management implies a good deal of policy vigilance, and their implementation must be closely linked to building a range of institutions that improve the investment climate. Policies must be applied in a deliberate and targeted manner with clear objectives linked to learning, scale economies and productivity performance that offer some measure of policy success and that can also facilitate the withdrawal of measures as they begin to outlive their usefulness. The design, employment and withdrawal of these measures should be seen less as a question of picking winners and more a matter of cooperating with a fledgling business class in coordinating investment decisions to prevent investment races under conditions of scarce endowments of capital, entrepreneurship and skill and inadequate and imperfect information. In this respect, a clearly stated aim of strategic industrial policies should be to prevent firms from stimulating destructive competition that would lead to falling profits and wasted investments. This perspective clearly implies a very different notion of competition policy from more conventional economic analysis which derives its rationale from the notion of consumer sovereignty.⁵

There can be little doubt that both the characteristics of the business community and government policy play a crucial role in the process of capital accumulation. Both theory and evidence suggest that industrial dynamism is consistent with different degrees of reliance on large and small firms, foreign and domestic producers and state and private ownership. The ideal mixture cannot be prescribed independently of an economy's initial resource endowments, its history of business relations and the pace at which industry develops. However, where a fast pace of capital accumulation is a stated policy objective, large firms are likely to assume a prominent role in the growth process. Corporate structures based on large, diversified but tightly knit business groups that have a close relationship with banks can help enterprises overcome the information and coordination problems linked to large investments, allowing them to take a long view of their corporate strategies. However, as indicated by the Asian crisis, the effectiveness and stability of such institutions depends on the existence of checks and balances, notably in two crucial areas: control over external borrowing, and state guidance and coordination of private investment.⁶

Formal and informal links between policymakers and business organizations can help improve the design, implementation and coordination of such policy measures. However, an effective government-business network presupposes a strong economic bureaucracy which is insulated from daily political and economic pressures and which is able to remain independent should the interests of the corporate sector come into conflict with wider social interests.⁷

⁵ See A. Singh "Savings, Investment and the Corporation in the East Asian Miracle", *East Asian Development: Lessons for an New Global Environment*, study no. 9, UNCTAD, 1996.

⁶ See Y. Akyüz, "Causes and Sources of the Asian Financial Crisis", Paper presented in the Host Country Event: Symposium on Economic and Financial Recovery in Asia, UNCTAD X, Bangkok, February 2000.

⁷ For further discussion of the institutional lessons from the East Asian experience, see the papers by Evans and Cheng, Haggard and Kang in the *Journal of Development Studies*, op. cit.

2. *The role of external finance*

The early stages of rapid growth, particularly as industry takes off, are likely to face a significant financing gap as investment surges ahead of domestic savings. It is clear from previous experiences that private capital flows are unlikely to serve as a reliable source of financing in the early phases of industrial development, leaving official financing to play a key role in filling the gap and to act as a catalyst for domestic savings and private capital inflows.

An examination of the East Asian experience certainly shows that, after an initial period of heavy reliance on foreign aid in order to meet rising investment, the gap can gradually be closed as domestic savings rise rapidly as a result of rising income levels. The dependence on aid also falls as rising growth attracts private capital. However, the experience elsewhere has been less encouraging. Sub-Saharan Africa (SSA) experienced a marked increase in its investment rate during the 1960s and the early part of the 1970s, but these investment booms were all too often followed by a widespread investment slump, rather than being translated into a virtuous growth process, due to the failure to establish a virtuous growth circle involving complementary increases in savings and exports. Initially, the dependence of investment on foreign savings was no less in East Asia than in SSA, but while the investment boom in Asia was accompanied by a rapid and indeed a faster increase in domestic savings, in SSA savings lagged considerably behind investment and the boom became increasingly dependent on resource transfers from abroad. In Latin America, the savings rate in some of the middle-income countries failed to show a significant increase from the 1960s to the 1980s despite relatively rapid growth. Between 1968 and 1977 Brazilian growth was close to that of the most dynamic economies in East Asia, but its savings rate failed to rise.⁸ Low savings rates have persisted in Latin America, even as growth recovered in the 1990s, leaving foreign capital to dictate an uneven and volatile development path.

Concerns about excessive reliance on external financing raise issues of whether to let market forces determine what form these flows take and where they should go, or whether policy measures are needed to guide the process. The evidence from recent experience suggests that there are serious shortcomings regarding the size, stability and sustainability of unregulated private capital flows to developing countries.⁹ For those not favoured by international capital markets, paucity of external financing remains one of the key constraints affecting adjustment and growth. For those who do have access to private capital, the sustainability of these flows is a key issue. However, even for them the question of the adequacy of external financing arises to the extent that such flows are subject to boom-bust cycles or are one-off in nature.

With the decline in official financing and the instability of short-term private financial flows, foreign direct investment is often seen as the preferred solution for closing the financing gap in developing countries because it does not add to the debt burden. In fact, as discussed in *TDR 1999*, the nature, use and impact of FDI for financing development is

⁸ For a detailed account see *TDR 1997*, Part Two, chap. V.

⁹ See *TDR 1999*, Part Two, chap. V for a more detailed survey.

considerably more complex.¹⁰ Certainly, the fact that FDI tends to be an expensive source of finance and a lag variable in the growth process (except in mineral-rich countries) excludes it from playing a catalytic role in the poorest countries and, generalising from the cases, such as Malaysia, where it has played a much more significant role, runs the danger of a fallacy of composition.¹¹ Moreover, it should be recognised that the most successful late industrializing economies from East Asia did not rely on FDI, using international capital markets instead, particularly bank lending, albeit carefully monitored and subject to government approval and guarantees. The need for such vigilance persists even at higher levels of development. As described in *TDR 1998*, not only did the rapid financial deregulation in these countries unleash an unhealthy boom-bust cycle that brought to an end their strategic approach to global economic integration, but the crowding of FDI into certain sectors added to the intensity of the cycle. Unlike the Asian economies, Latin American countries have adopted a much less strategic approach to external financing, including FDI, which has been of much more importance for financing the savings gap – notably fiscal deficits – through privatization and other forms of acquisitions, often in the non-tradeable sector.

These experiences leave little doubt that it is essential for developing countries to preserve sufficient policy autonomy to be able to manage capital flows in all their forms and chose the most appropriate capital-account regime. Indeed, a basic objective for countries at all levels of development should be to avoid attributing control over trade, industry and employment to finance capital. To achieve this the policies needed range from efforts to strengthen the domestic financial system and improve the collection and disclosure of information to various forms of controls on capital inflows and outflows to help prevent the cumulative build-up of foreign liabilities and their rapid reversal. The techniques to achieve this are well known, but a useful distinction needs to be made between direct restrictions (e.g. on banks' net external positions, on borrowing abroad by non-banks, or on foreign equity participation in domestic firms) and market-based disincentives that leave discretion to lenders and investors (e.g. non-interest-bearing reserve requirements on foreign liabilities or taxes designed to reduce the international arbitrage margin). Both have been used with varying degrees of success in various industrial and developing countries.¹²

3. Trade, technology and industrialization

The role of trade in growth and development is one of the most contentious issues confronting policymakers. While it is generally agreed that trade plays a major role in industrialization and economic growth, its role can be envisaged in a number of ways. The mainstream analysis focuses on efficiency gains resulting both from better resource allocation in the economy and from the effects of competitive pressure at the level of the firm. Another important linkage is through market size, which provides the essence of the classical assertion that the division of labour is limited by the extent of the market. The domestic market can provide initial growth opportunities to fledgling industrial activities, and allow tentative steps

¹⁰ See also on the role of FDI in financing development, J. Kregel "Capital flows: Globalization of production and financing development", UNCTAD Review 1994; M. Agosin and R. Mayer "Foreign investment in developing countries: Does it crowd in domestic investment?", UNCTAD Discussion Paper no. 146, February 2000.

¹¹ See *TDR 1997*, Part Two, chap. II for a discussion of the investment fallacy of composition.

¹² These measures are discussed at length in *TDR 1990, 1994, 1996 and 1998*; see also Y. Akyüz, Financial Liberalization, The Key Issues, *UNCTAD Discussion Paper*, No. 56, March 1993.

towards building industrial capacity through infant-industry programmes designed to reduce the import content of growth. However, linking investment to exports and encouraging domestic firms to compete in international markets is likely to be essential as poorer economies take off into sustainable growth. Exporting allows domestic firms to overcome some of the traditional organisational constraints facing new producers and introduces dynamic impulses associated with productivity-enhancing spillovers.

While much of the literature on the rationale for exports emphasizes efficiency gains and productivity increases, in practice perhaps the most import factor underlying export drives by developing countries has been the need to overcome the balance-of-payments constraint. In building up industrial capacity and competitive strength all newly industrializing countries (NIEs) need to import a large volume of capital and intermediate goods. Thus, in an economy where investment is growing both in absolute terms and as a proportion of GDP, imports may also need to grow faster than GDP and their financing may pose a formidable constraint on sustainable growth.

Given the deficiencies of international financial markets and the unreliability of aid flows, exports remain pivotal to balancing faster growth, structural change and macroeconomic stability. However, since export expansion in turn depends on the creation of additional production capacity in industry as well as on productivity growth, and hence on new investment, a sustainable growth process requires mutually reinforcing interactions between savings, exports and investment. Building this strong investment-export nexus is key to a successful development strategy.

For many developing countries, a successful investment strategy will begin by exploiting initial advantages in the primary sector. In the case of most natural resources, this will involve the production of a large surplus that will have to find markets abroad. Further investment growth opportunities can be found through diversification and increased processing of natural-resource-based products. However, most of the high-value-added components of these activities are tightly controlled by corporations in advanced economies, making entry into these markets difficult and leaving developing country producers exposed to monopsonistic conditions with limited opportunities to upgrade technologically and vulnerable to unfavourable price movements.¹³

Shifting away from traditional low-productivity activities towards the production and export of manufactured goods is likely to begin in unskilled activities that tend to be technologically less demanding and can quickly absorb large numbers of workers from the traditional sectors. As discussed in various *TDRs*, it is generally not possible to rely on market forces alone to move economies through the various stages of industrialization and export orientation, given a number of potential failures related to externalities, problems of coordination, imperfect and asymmetric information, economies of scale, missing markets and imperfect competition. Even in the initial stages of industrialization when export opportunities are in low-skill manufactures, low wages and existing factor proportions should not be seen as a sufficient basis for sustained growth. Rather, while policymakers concentrate

¹³ The opportunities and the and limits of natural-resource-driven growth are discussed in the *TDR 1996 and 1998*; see also J. Mayer, "Implications of new trade and endogenous growth theories for diversification policies of commodity-dependent countries", *UNCTAD Discussion Paper* No. 122, December 1996, and "Is having a rich natural-resource endowment detrimental to export diversification?", *UNCTAD Discussion Paper* No. 124, March 1997; Jomo K.S and M.Rock, "Economic diversification and primary commodity processing in the second-tier South East Asian newly industrializing countries", *UNCTAD Discussion Paper* No. 136, June 1998.

on measures needed to raise investment and enhance productivity, governments can help promote exports through tariff rebates, tax exemptions, preferential credits, and export credit insurance.

At this early stage, developing countries need to pay careful attention to the management of their exchange rates if they are to benefit from greater integration into the international trading system. Not only must they be concerned about sustaining competitive rates over the longer term but they must also make orderly adjustments when faced with exogenous shocks. As discussed extensively in *TDR 2001*, under a system of free capital mobility no regime is able to guarantee exchange rates that are either stable or competitive. Similarly, such a system will not combine steady growth with financial stability. In this respect, the most promising option for most developing countries is to manage nominal exchange rates in a flexible manner in order to minimize fluctuations in the real exchange rate, combining this with controls on destabilizing capital flows.

Many of the industries offering export opportunities for developing countries produce items that would be considered luxuries for the domestic market, such as motorcars and electronic and other consumer goods. These industries typically employ mass production technologies using dedicated capital equipment where scale economies are critical to cost efficiency. Moreover, because product variety and changing product lines are key ingredients of success, the risks are often considerable. These characteristics can make entry into global markets quite a demanding task, while reliance on the domestic market poses other dangers – fostering luxury consumption or the accumulation dynamic, for example. In recent years, falling organization and communication costs have allowed international firms in these industries to subdivide their production process and situate individual parts in different locations, according to specific resource and cost advantages.¹⁴ In a number of developing countries, export-oriented strategies have concentrated on measures to facilitate entry into the labour-intensive parts of international firms' production networks, either by attracting foreign subsidiaries or by creating subcontractor relationships. The measures used, with varying degrees of success, include fiscal incentives, more accommodating ownership requirements and remittance laws.

Even as policymakers begin to see signs of success in terms of higher investment levels, a deepening structure of economic institutions and rising market shares in labour-intensive manufactured exports, what distinguishes success in the export-investment nexus is not fully exploiting gains from labour-intensive activities, but rather anticipating the future difficulties that these industries might face. These difficulties include rising wages, limits to productivity growth and constraints on the expansion of demand in export markets. Overcoming these constraints requires a gradual and purposeful nurturing of a new generation of industries, particularly in capital goods and intermediate products, with greater potential for innovation, productivity growth and export dynamism.

Measures aimed at actively encouraging the development of more sophisticated industries include import restrictions, rolling back tax exemptions on the import of certain intermediate and capital goods, and granting higher investment tax credits to businesses purchasing domestically produced machinery. In addition, measures will be needed to build and strengthen technological capacity at the national, industry and firm levels: these may

¹⁴ The industries involved are clothing, electronics goods and automobiles. A more detailed examination of the trading opportunities in these industries will be included in *TDR 2002*.

include tax and other incentives for vocational and other forms of training in firms and educational institutions. Measures to facilitate local research and development, including financial subsidies, particularly for large and risky projects, the creation of science parks and special industrial estates, offer potential ways of strengthening technological capacity. Nevertheless, it is important that policymakers do not lose sight of the simple fact that because new skills and technologies are embodied in new capital equipment, successful upgrading programmes generally go hand in hand with a rapid pace of investment.

Although a successful development strategy must be firmly based on the establishment of strong local firms linked to a dynamic accumulation process, there is little doubt that foreign firms are also likely to play an important role at all stages in the development process. In the primary sector, the vent for surplus will involve close contractual relations with the large TNCs that tend to dominate the markets for these products. Major new industries producing manufactures for export cannot be easily established without some form of assistance – technological or otherwise – from companies in more advanced countries. However, there are different ways in which such help can be extended, and more strategic policies will be needed to complement efforts to build domestic capacity. A variety of techniques can be used to maximize the advantages of interacting with foreign firms, including reverse engineering, licensing and the hosting of foreign affiliates. In most cases, a combination of all these is likely to be desirable, tailored to specific circumstances.

FDI has become increasingly important in more conventional accounts of development strategies: access to a bundle of more sophisticated technological and organisational skills and assets makes hosting foreign firms attractive, as does the hope that they will quickly establish linkages with local firms and industries. However, because these firms are attached to a wholly or partially-owned foreign subsidiary, access is not automatic and the policy objectives in such matters as local content, technological upgrading and balance-of-payments stability may clash with the commercial interests of the corporations. Overall, the evidence suggests that any spillovers to domestic firms are industry-specific and depend on how domestic policymakers manage FDI, including its role in the export-investment nexus. Indeed, the role of policy is now even greater, given that the determinants and organization of FDI flows have become more complex.¹⁵ For poorer countries looking to integrate at the low-cost end of the production chain, the very heavy import content of these activities poses a particular set of policy challenges. The potential technological and other spillovers, particularly for middle-income economies and in sectors where specific knowledge and capital equipment are closely knitted together, require that host governments preserve a full range of policy options to enable them to bargain effectively with TNCs. Successful measures include restrictions on FDI where the aim is to build up large domestic producers, domestic content agreements and technology screening. Only as productivity levels and technological capacities cross certain thresholds is a more liberal approach likely to bring significant benefits.

¹⁵ See further the discussion on the links between FDI and development in *TDR 96, 97 and 1999*; also in the context of East Asian industrialization the references in footnote 3 above; and W. Milberg, “Foreign direct investment and development: Balancing costs and benefits”, *International Monetary and Financial Issues for the 1990s*, vol. XI, 1999; G. Hanson, “Should countries promote foreign direct investment”, *G-24 Discussion Paper Series*, No. 9, February 2001.

4. **Managing distribution**

For most poorer countries, successful development depends on a rapid pace of investment and their ongoing participation in the international economy. There is little in the recent record of globalization to suggest that market forces can be relied upon to guide the pace of investment, or that the disappearance of systemic biases and asymmetries in the international economy has removed the case for a strategic approach to integration. The importance of building viable development states has, it would seem, lost none of its urgency in the era of globalization. Indeed, the challenges facing such a state appear all the more daunting in light of the growing inequality within developing countries that has accompanied the process of rapid liberalization.¹⁶

History shows that in most societies at any one time a degree of inequality is tolerated and widely regarded as legitimate. The notion of what constitutes socially acceptable inequality changes over time as the balance of power among different classes shifts, setting a limit on the extent to which income distribution and inequality can be changed without causing serious socio-political dislocations. The fundamental problem for policymakers is that income inequality has an important role to play in the accumulation and growth process in the capitalist system; investment provides social as well as economic justification for the concentration of an important part of national income – in the form of profits – in the hands of a small minority. Disregard for the social and economic relations that determine the interaction between income distribution and capital accumulation has been a particularly damaging feature of conventional development strategies.¹⁷

In this respect, policymakers should recognise that neither the interests of corporations nor of the investing class necessarily coincide with a wider developmental agenda, and policies should be designed accordingly. Taxes designed to discourage the distribution of profits in the form of personal incomes, as well as luxury consumption, serve not only to accelerate investment and job creation, but also to reduce inequalities in personal incomes. More active labour market policies as well as profit-related pay – both of which have been widely used in East Asia – can also help strengthen the social fabric surrounding the profit-investment nexus.¹⁸ In the later stages of the development process, attention to educational and health policies is also likely to take on increasing importance.

B. DEVELOPMENT STRATEGIES IN A REGIONAL CONTEXT

The preceding argument shows that policies designed to build mutually supportive links between capital accumulation, structural change and technological development are the key to strategically integrating into the global economy. But just how deeply and quickly any developing economy can open up to international economic forces depends, to a large extent, on the resulting productivity performance of its industry and the speed with which it upgrades its technological and skills base.

Regardless of the specific policy measures advocated, there seems to be a growing consensus that domestic producers cannot be “shocked” into better productivity performance

¹⁶ See *TDR 1997* and UNCTAD, *Globalization and the Labour Market*, November 2001.

¹⁷ This, of course, was the theme of the first Raul Prebisch lecture given by Prebisch himself, “The crisis of capitalism and the periphery”, UNCTAD, July 1982.

¹⁸ *TDR 1997*, Part Two, chap. VI.

through premature exposure to the full force of international competition. Rather, a more gradual and sequenced approach that is consistent with domestic conditions and the learning capacities of firms, employees and policymakers seems better suited to this end. In this context, the development of regional economic ties can offer a sensible first step towards meeting the challenges associated with a more open economic system.

Conventional economic thinking tends to dismiss regional arrangements as a second-best solution for meeting development goals and a potential stumbling block on the road to a fully open and integrated multilateral system. However, this conclusion builds on unrealistic comparisons with an idealised global economy. Where domestic firms still have weak technological and productive capacities and the global economic context is characterised by systemic biases and asymmetries, regional arrangements may well provide the most supportive environment in which to pursue national development strategies. The fact that so many rapidly growing economies have come from East Asia suggests that the regional dimension played an important role in their industrialization.

Although closer political ties among neighbouring countries have often been the impetus for closer regional economic arrangements, this was not the case in East Asia. Rather, as described in detail in *TDR 1996*, a regional division of labour emerged only in the 1980s, partly as the result of successful strategic trade and industrial policies and a variety of macroeconomic pressures originating in the region's more advanced economies. Closer trade and investment ties between Japan and the first-tier NIEs quickly spread to include a second-tier of NIEs from South East Asia, with Japan and the first-tier importing labour-intensive goods such as clothing and footwear from the second-tier and exporting capital goods and chemicals. However, the second-tier soon began exporting more sophisticated goods in telecommunications, computers and electrical machinery, thus holding out the possibility that a third tier of peripheral regional economies could soon enter an expanded division of labour. There were also strong parallels between the patterns of FDI from Japan and from the first-tier NIEs in the region, the latter eventually following the former as development progressed. Thus, the FDI was initially concentrated in resource-extracting industries, moving into manufacturing as large Korean conglomerates began developing regional production networks. Taiwan Province of China also adopted an active policy of moving labour-intensive industries abroad under its "southbound" policy of investment.

This pattern of integration in East Asia has been described as the "flying geese" model: opportunities for less developed countries to enter simpler manufacturing stages in a regional division of labour have been created as the leading economies successfully shift from resource-based and labour-intensive industries to increasingly sophisticated manufacturing activities. Regional trade and investment flows have played a central role in this process by helping to create markets and transfer skills and technology to neighbouring countries.¹⁹

Although experiences with regional arrangements elsewhere in the developing world have proved less satisfactory, the question remains whether they could nonetheless stimulate the kind of growth pattern that was established in East Asia. In its idealised form, the flying geese model involves the relocation of whole industries across borders in line with shifting cost advantages. To the extent that this is part of a process of sustainable growth, it cannot

¹⁹ See R. Rowthorn "East Asian development: The flying paradigm reconsidered" in *East Asian Development: Lessons for a New Global Environment*, UNCTAD 1996.

rely on corporate responses to market forces alone, but will in important respects need to be managed through targeted trade and industrial policies. Such policies appear to have been particularly important in the first-tier Asian NIEs as they moved out of labour-intensive manufactures into more technologically sophisticated and capital-intensive activities. In particular, a strategic approach to FDI inflows was used by policymakers in order to maximize their advantage as a source of foreign exchange, competitive discipline and technology and to ensure that these complemented efforts to strengthen domestic capacity. This strategic approach was extended to outward FDI as domestic firms began to build their own international production networks.

In part because regional economic arrangements imply close dependence on a small group of economies as well as some loss of domestic policy autonomy, the danger exists that problems in one country may be transmitted to its neighbours. Arguably, that danger has intensified in today's globalizing world. In fact, a number of changes in the regional pattern of integration during the 1990s do appear to have contributed to the instability that hit East Asia towards the end of the decade. A rather rapid shift to more liberal trading and investment regimes across the region has generated convergence in trade structures often associated with integrated production networks organised by TNCs. However, these arrangements tend to restrict upgrading, particularly in labour-intensive activities in the manufacture of higher-technology products, at the same time as they provide opportunities for new competitors to enter these activities. This raises the danger of recourse to lower wages and currency depreciations to meet competitive threats. With volatile capital flows fuelling a boom–bust cycle, a more fragile macroeconomic context has developed which is vulnerable to shifting investor sentiment.²⁰ Thus, return to stable and rapid regional growth must be underpinned not only by policies directed at the upgrading of production and exports but also, in view of the close links between trade and finance, accompanying regional arrangements designed to ensure the stability of financial markets, including lending facilities and agreement on a sustainable pattern of exchange rates.

As discussed in *TDR 2001*, the European experience has been held up as a model for regional financial arrangements in areas such as intra-regional currency bands, intervention mechanisms, regimes for capital movements, external payments support and regional lender-of-last-resort facilities. Such arrangements among developing countries in all probability require the inclusion of a major reserve-currency country.

C. GLOBAL ARRANGEMENTS FOR INDUSTRIALIZATION AND GROWTH

Developing countries have made substantial efforts in recent years to integrate more closely into the global economy. These efforts have been pursued with the expectation that growth would accelerate, poverty rates would drop and income and productivity levels would begin to converge with those of the advanced countries. There is also a general acceptance that closer integration carries costs in terms of heightened vulnerability to external pressures and shocks, as policymakers are obliged to give up some degree of policy autonomy in managing these problems. However, there is a reasonable expectation that this loss of

²⁰ China's rapid emergence as an exporter of labour-intensive manufactures and greater participation in international production sharing introduce new dimensions to stability and competition in the region. These issues will be addressed in *TDR 2002*.

autonomy will be complemented by the establishment of supportive multilateral arrangements that are capable of supporting high and sustained growth rates.

So far, the liberalization of the world economy has not led to a more stable external environment consistent with faster economic growth in poor countries. Indeed, after more than a decade of liberal policies, payment disorders in developing countries remain as acute as ever, and dependence on external financial resources for the achievement of growth targets is greater than in the past. As a result, shocks and economic crises have become a more frequent occurrence. As described in *TDR 1999*, the situation reflects a combination of declining terms of trade, slow growth in industrial countries and a “big bang” approach to the liberalization of trade and the capital account. This situation contrasts with the post-1945 experience of liberalization in late industrializing countries, where the process was a gradual one and was underpinned by exceptionally strong growth in the advanced economies.

The international community needs to face up to problems posed by the pronounced external constraints on development, the need for exports rather than unstable private capital flows to underpin the growth process across the developing world, and the requirement that markets and prices be sufficiently stable to encourage the long-term investment which is a prerequisite for productivity growth. In this respect, a tendency to polarize the development challenge into a series of binary choices – market versus state and inward versus outward-oriented development – provides an unhelpful basis for policy advice and has little justification in historical experience. Although major features of successful experiences are now broadly familiar after two centuries of industrial growth and development, the strategies followed have nonetheless shown considerable diversity in major institutional features and in the methods deployed to ensure that private and public interests coincide.

It is generally recognised that building competitive industries is the key to overcoming external constraints. However, after the Uruguay Round, the scope for promoting exports through government action has been reduced and may even rule out late-industrialization strategies of the kind pursued in East Asia. Closing off successful policy options is a questionable way to help developing countries, particularly when considerable financial resources are being employed by the world’s richest countries to support their own mature producers, in many cases without any prospect that they will become internationally competitive. More importantly, many developing countries are still not using all the policy options open to them. Many of the financial, fiscal and macroeconomic policies that can help create the basic conditions for faster and better-directed capital accumulation and channel investments in a manner consistent with broader development objectives are not governed by multilateral agreements. Nor to a very large extent are the institutions and informal networks required to support such policies. Moreover, the scope for export promotion, though reduced, still allows for various forms of direct and indirect support, particularly in the poorest countries, and various forms of protection and other support, especially temporary, are still allowed for infant industries.²¹

In some areas of trade policy, where review processes are under way or new agreements are being considered, the full impact on the policy options and development of developing countries needs to be considered, in particular with respect to subsidies, intellectual property rights, competition and FDI. Greater flexibility in these areas is not

²¹ See *TDR 1996*, Part Two, chap. III; and A. Amsden, “Industrialization under new WTO law”, High Level Round Table on Trade and Development: Direction for the 21st Century, UNCTAD X, Bangkok, February 2000.

compatible with artificial and arbitrary time frames that are unrelated to need or performance. Instead, special and differential treatment should be linked to specific economic and social criteria as part of the contractual obligations of the rules-based system. Moreover, there remains an urgent need to address some of the systemic biases in the trading system. Here the major focus should be market access. Tariff levels and the frequency of tariff peaks in advanced industrial countries remain high in many areas of export interest to developing countries, and new forms of protectionism are being introduced. This is particularly the case in agriculture – where massive subsidies further restrict entry for developing-country producers – and in many labour-intensive manufacturing sectors, such as clothing and footwear. These are the areas where developing countries have the potential to build dynamic investment-export linkages. Improving market access in these areas is particularly important in view of the pressure on developing countries to follow export-oriented growth strategies. This pressure raises the prospect that volume gains will be eroded by price declines – a trend already visible in some sectors and which in some cases has been accentuated by the entry of large developing-country exporters.²² More effective monitoring of market access at the global level could provide developing countries with a better appreciation of both the opportunities and the limitations of certain sectors as potential export markets.

Although recent events in emerging markets in Asia and Latin America have tended to single out finance as a potentially destructive force in the global economy, its impact is not unrelated to weaknesses in the trading environment. Liberalization of capital flows has often been prompted by the need to finance growing external deficits, albeit in the process actually making matters worse; it has also led to currency appreciation and instability, thereby weakening investment and undermining trade performance. Under these conditions excessive haste in integrating into the global financial system can damage growth prospects. Again there is a clear responsibility on the part of multilateral bodies to promote, to the fullest extent possible, sensible options for modalities of integration into the global system and to adopt a pragmatic rather than an ideological approach to the use of those options. It is essential that the autonomy of developing countries in managing capital flows and choosing their capital account regime is not constrained by international agreements on capital-account convertibility, trade in financial services or multilateral investment agreements. Equally, options should not be narrowed so as to appropriate exchange-rate regimes. As already noted, managing nominal exchange rates in a flexible manner in order to minimize fluctuations in the real exchange rate, in combination with controls on destabilizing capital flows, needs to be accepted as a plausible option for many developing countries.

But the larger question here is whether there exists a viable and appropriate exchange rate regime for those developing countries that are closely integrated into global financial markets when major reserve currencies are subject to frequent gyrations and misalignments, when capital flows are greatly influenced by policies in the major reserve currency countries, and when international currency and financial markets are dominated by speculative and herd behaviour. Given the extent of global interdependence, a reasonably stable system of exchange rates globally is difficult or impossible to attain in the absence of a minimum degree of coherence among the macroeconomic policies of major industrial countries. The existing modalities of multilateral surveillance do not include ways of attaining such coherence or dealing with unidirectional impulses resulting from changes in the monetary and

²² The fallacy of composition and its implications have been extensively discussed in *TDR 1996, 1999 and 2002*.

exchange rate policies of the United States and other major industrial countries. This weakness should be a major item on the agenda of international financial reform.²³

For many developing countries official financing and debt relief remain an indispensable prerequisite of successful development strategies. There is ample evidence that the external debt position of many developing countries is currently having a severe adverse impact on investment and on indispensable categories of government expenditure, as well as on FDI. A comprehensive assessment of the sustainability of debt throughout the developing world is urgently required. Such an undertaking should not be limited to heavily indebted poor countries (HIPCs) but should incorporate a broader spectrum of countries, including the so-called middle-income debtors, who are in need of special measures to overcome their debt overhang. This would best be carried out by an independent panel that would not be unduly influenced by creditor interest and whose recommendations on debt relief would be given priority at the multilateral level. Diminishing aid flows have also hit many poorer countries. In light of the limits of private capital flows to meet external financing needs, particularly in the poorest countries, the case for increased and better-coordinated aid is stronger than ever.²⁴

In a world of significant private capital flows and endemic financial instability, major reforms are required in the liability management of recipient countries and in the arrangements for preventing and managing crises. Concerning liability management, policymakers should disregard the doctrine that rising current-account deficits and external indebtedness generated by the private (as opposed to the public) sector are not sources of external financial vulnerability. Regarding an improved approach to managing financial crises, it is now widely accepted that large bailout operations have not worked and that while measures to strengthen domestic financial institutions are desirable, these will evolve only slowly. Attention is now shifting to greater involvement of the private sector in crisis resolution, thus ensuring that the burden is shared equitably. One approach would entail mandatory temporary standstills on debt payments, lending into arrears, and strict limits on access to Fund resources. This would require moving towards international application of bankruptcy principles along the lines of chapters 9 and 11 of the United States Bankruptcy Code, a proposal first made in *TDR 1986*, which has recently received more widespread acceptance in major industrial countries.²⁵

A renewed multilateralism needs to be much more even-handed in its dealings with rich and poor countries and with creditors and debtors. If reforms to the existing system are to be credible, they must provide for greater collective influence for developing countries and embody a genuine spirit of cooperation among all countries. This will require a careful examination of the representation and decision-making practices of existing multilateral institutions that deal with both trade and finance. It will also require the eventual mitigation and elimination of biases and asymmetries that adversely affect significant segments of their memberships.

²³See *TDR 2001*, Part Two, chap. 5; also see A. Velasco "Exchange-rate Policies for Developing Countries: What Have We Learned? What Do We Still Not Know?", *UNCTAD G-24 Discussion Paper Series*, no. 5, June 2000; I. Goldfajn and G. Olivares "Can Flexible Exchange Rates Still "Work" in Financially Open Economies?", *UNCTAD G-24 Discussion Paper Series*, no. 8, January 2001; and H. Flassbeck "The Exchange Rate: Economic Policy Tool or Market Price?", *UNCTAD Discussion Papers*, no. 157, November 2001.

²⁴On increased aid in the African context, see UNCTAD, "Capital Flows and Growth in Africa" 2000.

²⁵See also *TDR 1998 and 2001* for more detailed discussions of this proposal.