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Trade and Industrial Policies in the Developing Countries of East Asia

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# TRADE AND INDUSTRIAL POLICIES IN THE DEVELOPING COUNTRIES OF EAST ASIA

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This report was prepared by Amar Bhattacharya and Johannes F. Linn. Madhusudan Joshi contributed a background paper for Chapter 2. Research assistance was provided by Diane Cohen for Chapter 2, Mark Sundberg for Chapter 3, Hsin Chang for Chapter 4. Cyrus Talati assisted in finalizing the manuscript.

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EXECUTIVE SUMMARY

1. The economic growth of the East Asian countries has outstripped that of most other developing countries during the last decades. The rapid expansion of trade in general, and of exports in particular, and the growth of the industrial sector have played a major role in generating and sustaining this exceptional economic growth performance.

2. This study reviews the impact of the international trade environment and prospects (Chapter 2), and of the domestic policies applied in the areas of trade (Chapter 3), export promotion (Chapter 4) and industrial development (Chapter 5). It aims to glean what lessons may be learned that would help explain the superior performance of many of East Asian countries, and to explore the implications of these lessons for future trade, export promotion and industrial policies in these and other developing countries.

3. The study, particularly in its review of policies, focuses mostly on the five large market economies among the developing countries of East Asia -- Indonesia, Korea, Malaysia, the Philippines, and Thailand. Other economies in the region, especially China, Japan, Hong Kong and Singapore, are referred to only in passing, since they represent rather separate types of settings in regard to economic system, stage of development and size. The report draws heavily on World Bank country studies recently completed. They are referenced as appropriate in the text.

Export Prospects and Issues

4. A brief review of underlying trends suggests that the export environment facing the East Asian countries may be changing quite fundamentally. The era of strong demand from industrial countries, rapid growth of manufactured exports and high commodity prices appears to have come to an end. Instead, East Asian countries now face an export environment characterized by:

   (a) slower growth of markets, particularly in the U.S.;

   (b) increasing competition from other developing countries;

   (c) growing protectionism in the form of non-tariff barriers (NTBs) in both developed and many developing country markets; and

   (d) depressed commodity prices.

5. The structure of exports of East Asian countries could make them quite vulnerable to these trends. In addition to their generally high levels of export dependence, these countries have concentrated on exports, where prospects are limited because of more binding NTBs (textiles, garments, footwear), or where markets are now more saturated (electronics, chemicals). These concerns need to be tempered by the strong export performance of the East Asian countries not only in the past, but also during 1986, and the precedent set by the newly industrialized countries (NICs) of the region. In particular, the lessons that seem to be emerging are:
(a) "Trade diplomacy" and "bilateralism" have become the hallmarks of the new trade environment and countries will have to learn how to maximize their benefits in this new setting.

(b) Nevertheless, a diversified export base and competitiveness can still provide the basis for further export growth. The experience of the NICs is striking, but the other East Asian countries are only a tier below in this regard.

(c) The greatest promise for exports appears to be in the area of machinery, transport equipment ancillaries, and other sophisticated assembly products such as telecommunications equipment and electronics. These have been the fastest growing items underlying the surge in exports of the East Asian NICs. An important attribute of these products is that they are less vulnerable to protection because of their diffuse and "producer-good" nature. The relative industrial sophistication of the East Asian countries and the linkages to Japan and the Asian NICs are important assets on which to base their industrial transition.

6. Despite the more difficult export environment, the still low shares of the East Asian countries in OECD markets and their capacity to compete and respond flexibility to changing market oppportunities--demonstrated convincingly by the resurgence of manufactured export during 1986--all argue that an outward oriented strategy remains the most appropriate for continued rapid industrial development. In fact, given the greater competition that they are likely to face and the tighter macroeconomic resource constraints, improvements in efficiency and productivity become all the more imperative. The most important reason for pursuing an outward-oriented strategy is that it provides the best route to developing such a flexible and competitive economy.

The Role of Trade, Export Promotion and Industrial Policies

7. Good economic management, rather than unusually favorable natural resource endowments or special factors in the external economic environment, largely explains the superior economic performance of the East Asian economies during the last three decades. An essential element of economic management which mattered was the relatively strong outward orientation of these countries' trade and industry policies, complemented by reasonably successful management in other areas: macroeconomic management, agriculture, human resource development and population policies.

8. Despite the relative success in policy and economic performance, with the benefit of hindsight it is apparent that economic policies in East Asia also had their shortcomings. Particularly during the second half of the 1970s and into the early 1980s, distortions in the economic incentives and macroeconomic imbalances became more prevalent. When combined with the deterioration of the external environment in the 1980s, the underlying weaknesses in the economies became evident in the early 1980s. What is striking, however, is that most of the East Asian countries (with the exception of the Philippines before 1985) responded promptly and pragmatically as the danger
signals became apparent rather than persevering with policies and management approaches which had demonstrated their ineffectiveness.

9. The policy packages commonly adopted during the mid-1980s included adjustments in the macroeconomic and exchange rate policies, reforms in trade and export promotion policies, tax reform, adjustments in the private investment incentives and regulations, reductions and rationalization in public expenditure programs (which in most countries had expanded rapidly during the late 1970s and early 1980s), and liberalization of the financial sector. However, much remains to be done in most of the countries under review, if the continuing economic difficulties are to be effectively addressed. Among these difficulties, the following require particular attention: (a) increases in the savings and investment rates from the low levels of the early and mid-1980s; (b) increased efficiency of investment; (c) maintaining, or strengthening international competitiveness; and (d) establishing a sustainable resource balance between savings and investment. Trade, export development, and industrial policies have an essential role to play in all countries concerned, if governments are to address these issues successfully. This role is summarized in the following paragraphs.

10. **Macroeconomic Management.** A recurrent theme of this report is that good macroeconomic management, and good trade and industrial policies are mutually reinforcing. Macroeconomic management, and especially exchange rate policy, is a crucial determinant of export and industrial development, and, of course, of overall economic performance; in particular, good macro policies will help avoid the need to manage macroeconomic imbalances through microeconomic or sector interventions and distortions (restrictions on imports, price and interest rate controls, etc.). At the same time, good trade and industry policies facilitate effective macroeconomic management by ensuring the responsiveness of the economy on the supply side to changing signals emanating from the external environment, in particular, the international economy.

11. In designing macroeconomic policy, a delicate balance needs to be struck in two ways. First, there is the need for balance between expenditure reduction and expenditure switching policies. Policy makers in East Asia and elsewhere have tended to rely more on the former, rather than the latter. In particular, the use of the exchange rate to achieve necessary expenditure switching effects has frequently been partial or delayed (episodes of overvaluation were not uncommon in the Philippines, but also in Indonesia, Malaysia, and Thailand). The main lesson to be drawn here is that the exchange rate is a crucial instrument of macroeconomic as well as sectoral management which needs to be effectively used to enhance the responsiveness of the economy to significant changes in the external environment.

12. Second, a proper balance must be found between the use of monetary and fiscal policy levers. The tendency in the region (especially in Thailand, but also in the Philippines and Indonesia at times) has been to rely too heavily on monetary policy to establish the desired resource balance, resulting in high interest rates and the crowding out of private investment, while the public-sector resource balance remained in serious disarray. It is important, therefore, to ensure that fiscal policy plays an adequate role in
establishing internal and external balance, rather than relying mostly on monetary policy.

13. Trade and Industrial Distortions. Trade and industrial distortions in the region, while less than in the early 1980s and lower than for most other developing countries, remain significant and warrant continued policy reforms in all the countries of the region. Such distortions continue to lead to: (a) an anti-export bias in the Southeast Asian countries; (b) deviation in incentives from comparative advantage-based resource allocation; (c) "rent seeking" and related costs of administering a complex trade regime; and (d) inefficient enterprise behavior because of the restrictive effects on competition. All of these, in turn, can potentially undermine the continued rapid development of these economies, at a time of sharpening world competition and tight resource constraints. Where quantitative restrictions are still significant, particularly in Indonesia but also in the Philippines and Korea, a first step is to complete the process of replacing QRs with tariffs. Rationalization of the tariff structure as well as further reductions in average tariff levels would also be appropriate in all these countries over the medium and longer term. The experience of the region and that of other developing countries strongly suggest that an outward-oriented strategy provides the best route to rapid industrial development. In the end, an outward oriented policy necessarily implies an undistorted import regime. This is particularly important in the present environment of countervailing actions, where there are clear limits on the ability to use aggressive export promotion measures as a compensating device. In undertaking trade reforms, several complementary steps will be important: (i) trade and incentive reforms will require firstly a supportive macroeconomic policy framework, particularly with regard to the exchange rate; (ii) complementary measures to improve the domestic tax structure will have to be adopted; (iii) the need for safeguard mechanisms on under invoicing, dumping and temporary protection will have to be addressed, while ensuring that administrative protection does not replace the old trade barriers; and (iv) the institutional underpinnings for trade and industrial policy formulation and coordination will have to be strengthened, including in the area of trade diplomacy and negotiations.

14. Role of Government Support for Industrial Development. While a central objective of trade and industrial policy reforms is to reduce policy induced distortions, there is a case for well considered government interventions in support of industrial development, since adjustments to incentive reforms are not instantaneous and since there are areas where externalities argue for a government role or selective incentives for particular activities or subsectors. Such support by governments should primarily be done through "functional" interventions, which cut across the entire industrial sector, especially export development, technology development and financial sector reform. Only secondarily should government interventions be at the subsector level or for specific firms. The next few paragraphs deal briefly with each of these types of interventions and the issues they raise.

15. Export Development. Three major lessons have been drawn from the East Asia experience with export promotion: First, it is important and possible for governments to support the development and maintenance of "export neutrality" in the private sector. However, this requires a deliberate,
sustained and comprehensive approach to export development, if the traditional biases in favor of import-substitution and production for domestic markets are to be overcome. Second, the most important ingredient of such an approach is to provide direct and indirect exporters with ready access to inputs at world market prices and to working capital for export production. The most effective way of ensuring that indirect exporters are drawn into this export promotion system is the introduction of the domestic letter of credit (DL/C). Third, infrastructure and institutional support in such areas as utilities, transport, ports and customs handling also contribute significantly to lowering the cost of exporting. Government support through training, technical assistance and marketing can also be helpful but is of a lower order of priority.

16. Technology Development. Technology development policy is currently of particular interest to governments in the region, but it is an area where no clear lessons or approaches appear to have as yet emerged from the limited experiences of East Asia or elsewhere. The discussion in Chapter 5 highlights a few preliminary conclusions, including the need (a) to consider not only the supply side, but also the demand side of technology adoption, (b) to emphasize technology diffusion and adaptation as much as, or even more than new technology development; and (c) to encourage private-sector involvement in the design of technology policy and some cost sharing by the beneficiaries, so as to ensure that technology policy remains closely linked to the needs of industry.

17. Financial Sector Development. Financial sector policy is one of the most problematic areas for development management. Conflicting views abound in the policy debate, the risks and costs of failure are high, and there are no clear models of success which countries might strive to emulate. Two main, albeit tentative, conclusions emerge from the discussion in Chapter 5. First, an effectively functioning financial sector is an important ingredient for successful industrialization. If the mobilization and allocation of financial resources is not market-determined, it puts a heavy administrative burden on government to ensure the appropriate mobilization of financial saving and its allocation through direct lending. Only few governments have the necessary institutional capacity to do this effectively. Even a country such as Korea may have suffered from undue distortions in its financial sector, and its government has found it desirable to increase the role of market forces in the financial sector, as the Korean economy has become more complex. The conclusion, therefore, is that while an interventionist financial-sector policy is not necessarily a prescription for failure, it should generally be avoided.

18. Second, the recent experience of high real interest rates which has been common to many of the East Asian economies calls for serious attention. To the extent these are due to high international interest rates, they will largely have to be accepted in the relatively open East Asian economies. However, to the extent that domestic interest rates exceed international rates as a result of a poor monetary/fiscal policy balance, combined with high taxation of financial intermediation and lack of competition in the banking sector, these issues need to be addressed through appropriate macro policy design, adjustments in the tax structure and banking rules, and measures to promote increased competition in the banking sector.
19. **Subsector and Enterprise Restructuring.** The basic principles on which this study has recommended the exploration of restructuring efforts by government at the subsector or enterprise level are as follows: Government intervention should be supportive of market trends and forces, not preventing change; should be targetted to address market failure as directly as possible; should not stifle private initiative and limit competition; and should always be seen as part of an overall strategy of moving the economy ultimately closer to a situation where distortions and sustained government interventions are minimized. All of this means that a thorough understanding of subsector institutions and conditions, needs and opportunities, is an essential prerequisite for developing appropriate approaches for government support, and that subsector and firm specific restructuring interventions by government have to be justified as exceptions, rather than as the rule, and will by their very nature be limited in number and in time.

20. For the case of "positive" restructuring—i.e., support for new industrial activities—the experience shows that highest priority should be given to ensure effective application of functional incentives (especially, export promotion, finance and technology development) at the subsectoral level, where the support is closely related to the identification of market opportunities, especially in the international economy. Moreover, removal of government distortions (taxes, regulations, etc.) can be given a special subsectoral focus in implementation. On the other hand, subsector promotional interventions on infant industry grounds should only be cautiously considered and applied, mostly by way of temporarily excepting selected industrial branches from the efforts to reduce government interventions, rather than by way of introducing new incentive measures. In terms of the hierarchy of interventions, explicit fiscal subsidies are to be preferred to tax exemptions, which in turn are better than tariff protection; QRs and investment regulation are the least desirable forms of infant industry support. Whatever support is given, it should be subsector-wide and be based on an automatic application of specified criteria, rather than firm specific and subject to discretionary application by government officials.

21. **Government involvement in defensive restructuring—i.e. support for declining industrial activities—runs the serious risks of limiting necessary adjustment and redeployment of factors of production and of "moral hazard" in encouraging private sector investments in inefficient pursuits in the hope of future government bail outs. The conclusions drawn therefore are that (a) defensive restructuring should be explicitly designed to support factor movement by appropriate labor retraining and information schemes, by facilitating the write down of capital, and by promoting the ready reallocation of physical capacity for changing uses; and (b) government should not take responsibility for the inevitable windfall losses which arise out of restructuring of an economy in the normal cause of development and change, just as it would not expect to reap all the windfall benefits which also accompany change.
Priorities in Trade and Industry Policy

22. With a few exceptions then, the principles and lessons for trade, export promotion and industry policy emerging from the East Asian experience are reasonably clear. However, this does not permit the drawing up of a simple or uniform blueprint for reform in these countries or elsewhere. As this report emphasizes throughout, much depends on the starting point, i.e., the current state of incentives and institutions in the areas of trade and industry policy, as well as on the stage of development of the industrial and financial sectors of the economy. Priorities will therefore vary from country to country, as will the scope for change and the speed at which it can progress. This section briefly reviews the major priorities for policy reform in these areas, country by country, as they have emerged from recent World Bank studies, and in the light of the discussions in this report.

23. Korea. The major priorities are: implementation of the current trade liberalization program, extending it in future also to further reform of the tariff regime and of agricultural protection; implementation and further development of the Government's current technology development policies and increasing the role of direct foreign investment in industrial development and foreign capital flows; facilitating the restructuring of declining industries, but with gradual reduction of the government's role in this area; continued movement towards a more competitive, market-oriented banking system and a gradual reduction of government controls of interest rates and other aspects of the financial sector.

24. Indonesia. Much progress has recently been made in a number of areas in reforming the trade, export promotion and industrial policy regimes. For the future, primary attention should be given to: further reduction in QRs and other non-tariff barriers; rationalization and reduction of tariffs; industrial deregulation, including of the licensing system; strengthening of export development institutions; reduction of direct government role in industrial and banking ventures; and restructuring of selected subsectors (e.g., steel, engineering). In view of the limited administrative capacities of the Indonesian government bureaucracy, simplicity of institutional solutions and increased reliance on private initiative are important principles to guide reform.

25. Malaysia. Some progress has been made in recent months in adjusting to lower oil prices, and trade and industrial distortions are substantially less in Malaysia than in Indonesia. Current priorities are: continued flexible exchange rate management to facilitate expenditure switching and avoid excessive reliance on expenditure reduction following the domestic losses in terms of trade; liberalization of industrial licensing restrictions and general export promotion measures, going beyond the free-trade-zone approach pursued in the past in Malaysia; tariff reform and modernization of the tax system are also areas of longer-run concern, but of lower immediate priority.

26. Philippines. The priorities in this country are influenced by the immediate needs for stimulating an economic recovery from the severe recession of the last three years, which are superimposed on the continuing requirements
of incentive reforms appropriate for longer-term adjustment. Accordingly the priorities are: increased reliance on expenditure switching policies (including the exchange rate) rather than continued emphasis on expenditure reduction (monetary and fiscal policy); reduction in QRs and strengthening of export promotion measures, followed, over the medium term, by further rationalization of the tariff structure; financial sector reform, including rationalization and scaling back of government financial institutions and reduction of taxation on financial intermediation; implementation of recent tax reform initiatives; and exploration of subsector restructuring initiatives, of the defensive kind (e.g., automobile subsector) and of the positive kind (e.g., engineering subsector).

27. **Thailand.** While this country has been afforded a breathing space by the recent oil price declines and manufactured export growth, these favorable factors provide a "window of opportunity" to continue some important, but delayed initiatives of policy reform. The priorities are: shifting the balance in macro policy from reliance on a restrictive monetary stance to more reliance on fiscal restraint (including reform of the tax system and of state enterprise finances); major reforms in the tariff system and investment incentives administration; implementation of export promotion initiatives; cautious approach to large industrial and ports projects; and further steps to increase financial sector competition and improve the availability of term finance for private investment.
CHAPTER 1. INTRODUCTION

A. Purpose and Outline of the Study

1.1 The last two decades have been a period of rapid transformation in the East Asia region. Most striking and successful has been the industrial and export performance of the so-called East Asian NICs (newly industrialized countries--Hongkong, Korea, Singapore and Taiwan, China). But even China, Malaysia, Indonesia, Thailand--and until 1980, the Philippines--have had an outstanding record in relation to other developing countries, albeit not quite as dramatic as their NIC neighbors. The East Asian growth performance was high and sustained throughout the 1960s and 1970s; for the 1980s, it slowed considerably in comparison with the earlier two decades, but still remained on average notably better than the median middle-income developing country.

1.2 The historically good performance and the relatively successful adjustment to external shocks is generally attributed to the relatively outward-oriented strategy and flexible policies pursued by these countries, although there has been significant variation in policies and performance among the countries of the region. Over the last two years, as part of its economic and sector work, the Bank has completed country reviews of trade and industrial policies and performance for all the major countries of the region. These studies continue the active policy dialogue on trade and industrial policies that the Bank has maintained with the countries of the region, beginning in the late 1970s. There has also been a large volume of policy lending since 1980 to support policy and institutional reforms in this area. This has included structural adjustment lending in Indonesia, Korea, Philippines and Thailand, and an export development project in Indonesia.

1.3 This study reviews the comparative experience and policy issues in the region with regard to trade, export promotion and industry, based largely, though not exclusively, on the recently completed country studies and experience with policy loans. The coverage of the study, particularly the review of policies, is limited to the five large market economies of East Asia--Indonesia, Korea, Malaysia, Philippines and Thailand. Other developing countries in this region, China (which is covered only in terms of export performance), two other centrally planned economies--Laos and

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Vietnam—and a large number of islands in the Pacific including Fiji 2/ and Papua New Guinea are not covered in this report as they represent rather separate types of setting in terms of size, economic system, and stage of development; Korea is also a member of the elite group of East Asian NICs (newly industrializing countries) which include in addition Taiwan Province (China), Hong Kong and Singapore. Japan is of course the economically largest country in the East Asia region and an important developed country. The entire group of countries of East Asia ranging from Japan in the north to Indonesia in the south is sometimes referred to as the East Asia and Pacific rim.

1.4 The purpose of the study is to:

(a) assess the outlook for trade and industrial development of the region in light of the international economic outlook;

(b) review and draw lessons from the policy and reform experiences of the countries of the region;

(c) summarize implications for the region from the current insights in the Bank and elsewhere on the approaches to trade and industrialization issues; and

(d) develop recommendations for continuing policy reforms.

1.5 The major questions to be addressed by the study are:

- Why and how have export-oriented trade and industry policies worked in the region?

- What is the outlook for the world export environment, and what implications do they have for the region?

- Can a case be made for continuing export-oriented development strategies in the East Asian countries?

- What differences have there been among countries in policies and trade/industry development experience?

- What are the primary instruments for policy intervention in this area, and are there any general principles/criteria to guide policy design and implementation?

- What is the appropriate role for government in the trade, export promotion and industrial policy areas?

2/ An economic report focusing on trade and industrial policies was also completed recently, entitled: "Fiji: A Transition to Manufacturing," Report No. 6372-FIJ, November 1986.
What remains to be done by way of policy reforms in these areas in each of the countries?

1.6 What the study does not attempt is to provide detailed analyses and recommendations for individual countries. Nor does it provide a systematic review of the experience of other developing countries, or of Japan and the East Asian NICs (apart from Korea). Finally, while the lessons and policy insights drawn in the study may have relevance to other countries, the principal focus is on implications for the countries of East Asia.

1.7 The report contains five chapters. The remainder of this introductory chapter provides a brief overview of the general economic environment and policy setting for the East Asian countries covered by this study. Chapter 2 is a survey of export performance and prospects. The chapter analyzes the past export performance of the region in a comparative context, the factors underlying this performance, and future prospects for exports including the degree to which exports from the region are vulnerable to protective barriers. Chapter 3 reviews the prevailing structure of the trade regime and recent changes in trade policy, and identifies the key issues that arise in the design and implementation of trade policy reform. Chapter 4 deals specifically with supplementary export development policies. It summarizes the basic principles underlying export development policies, the use and experience with various instruments in different countries, and the major issues that arise in developing and implementing such policies. Chapter 5 provides a broad brush review of industrial policies, other than trade and export development policies. It reviews the various levels of intervention and instruments used, the issues that arise in various spheres of government intervention, and the appropriate role of government in industrial policy.

B. The East Asian Economic Success--The General Setting

1.8 The success of the East Asian NICs with rapid growth and economic development is widely known. Perhaps less well known is that the semi-industrialized countries of the region, Indonesia, Malaysia, Thailand, and even the Philippines until 1980, also have an outstanding record in relation to other developing countries, albeit not quite as dramatic as their NIC neighbors (see Table 1.1). The East Asian growth performance was high and sustained throughout the 1960s and 1970s; for the 1980s, it slowed considerably in comparison with the earlier two decades, but East Asia's economic performance even then remained on average notably better than that of the median middle-income developing country. This indicates that the countries of the region were relatively successful in their adjustment to tightening external constraints, slower OECD economic and import growth, declines in commodity prices, volatility of oil prices, high interest rates and more limited access to foreign capital.

1.9 This historically good performance and relatively successful adjustment to adverse external circumstances cannot be attributed solely, or even mainly, to unusually favorable external conditions or resource endowments for the East Asian countries as compared with other developing nations. The five countries which are the primary object of this study, Indonesia, Korea, Malaysia, the Philippines and Thailand, come from a wide and in many ways
Table 1.1: ECONOMIC PERFORMANCE INDICATORS

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<td>30</td>
<td>31</td>
</tr>
<tr>
<td>Indonesia</td>
<td>530</td>
<td>4.8</td>
<td>17.4</td>
<td>12.0</td>
<td>12.5</td>
<td>30</td>
<td>32</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2,000</td>
<td>4.4</td>
<td>6.2</td>
<td>8.7</td>
<td>10.4</td>
<td>28</td>
<td>33</td>
</tr>
<tr>
<td>Philippines</td>
<td>580</td>
<td>2.3</td>
<td>12.9</td>
<td>3.5</td>
<td>1.7</td>
<td>16</td>
<td>13</td>
</tr>
<tr>
<td>Thailand</td>
<td>800</td>
<td>4.1</td>
<td>8.2</td>
<td>8.1</td>
<td>5.1</td>
<td>23</td>
<td>21</td>
</tr>
<tr>
<td>All middle-income (MI) countries</td>
<td>1,290</td>
<td>3.0</td>
<td>38.0</td>
<td>5.0</td>
<td>2.8</td>
<td>21</td>
<td>23</td>
</tr>
</tbody>
</table>

representative spectrum of middle-income developing countries. They include one natural resource-poor but relatively industrialized NIC (Korea); two natural resource-rich countries (Malaysia and Indonesia), which, however, in terms of per capita income lie at the opposite ends of the range of middle-income developing countries; and two semi-industrialized countries in the lower to middle range as regards per capita income (the Philippines and Thailand) both of which are still relatively heavily dependent on agricultural production and exports and are oil importers.

1.10 What these countries have had in common, is that, compared with the majority of other developing countries, they have on balance been relatively successful in managing their economies through the application of well-designed policies (World Bank, 1983).

1.11 Of course, the economic development experience in the region has not been entirely homogeneous, as is readily apparent from Table 1.1. The differences among countries in terms of their economic performance must also largely be attributed to differences in the quality of economic policies and management. For example, the change in relative standing of the Philippines and Thailand, two countries which at the end of the 1970s had virtually identical per capita incomes and very similar economic structures and resource endowments, was striking during the last ten years. In 1976, Thailand's per capita income was 8% below that of the Philippines; by 1985, the Thai per capita income exceeded that of the Philippines by 38%. Without a doubt, much if not all of this differential performance must be attributed to differences in economic management: while not flawless, Thai economic policies did permit a sustained growth performance throughout the 1970s and 1980s, and avoided an international debt crisis; in contrast, the Philippines ran headlong into its economic crisis largely because of the mismanagement of resources and failure to adjust promptly to the external shocks of the early 1980s. One could similarly compare the longer-term economic performance between 1950 and 1985 of Korea and the Philippines, countries which in 1950 had roughly similar per capita incomes; by 1985 Korea's per capita income exceeded that of the Philippines 3.6 times, again largely because of differences in economic management performance.

1.12 Therefore, the quality of economic management clearly is a major factor in explaining the relatively good performance of the East Asian economies, as well as in explaining differences in performance among the economies of the region. The main elements of economic management which appear to have mattered were the relatively outward orientation of these countries' trade and industry policies, complemented by reasonably successful management in other areas: macroeconomic management, agriculture, human resource development and population policies.

1.13 Despite the relative success in policy and economic performance, with the benefit of hindsight it is apparent that economic policies in the East Asian countries have not been without blemishes, even in the most successful case, Korea. Particularly during the second half of the 1970s and into the early 1980s, the East Asian economies were experiencing increasing distortions in their economic incentives as a result of government intervention. Tariffs and QRs became more prevalent, as did price and financial
sector controls, and the incidence of unsuitable public or publicly supported investments. When combined with the deterioration of the external environment in the early 1980s for oil importers and the mid-1980s for oil exporters (Indonesia and Malaysia), the underlying weaknesses became evident. They were reflected, for example, in declining savings and investment rates, increases in the savings-investment gap, higher inflation, and ICORs, and increased international indebtedness (Table 1.2).

1.14 What is of interest here is, however, not only the parallelism among countries in the region with regard to the increases in distortions and interventions during the late 1970s and early 1980s, but the fact that most of them responded promptly and pragmatically as the danger signals became apparent, rather than persevering with policies and economic management approaches which had demonstrated their ineffectiveness. The oil importers responded, particularly during 1981-83, with the identification and implementation of structural adjustment programs which contributed, in the case of Korea and Thailand, significantly to the avoidance of crises. In the case of the Philippines, the economic management problems were so broad and deep seated that the relatively narrow structural adjustment program, although successfully implemented in a number of significant respects, failed to address the most important problems, i.e., the savings-investment imbalance and the inefficiency of public and publicly supported investment projects. In the case of the two oil-exporting countries, Malaysia and Indonesia, significant adjustments were initiated in domestic policies (and are still in progress), when the oil and non-oil commodity prices deteriorated dramatically in 1985 and 1986.

1.15 In terms of the major policy areas, the response may briefly be summarized as follows: Macroeconomic and exchange rate policies were particularly responsive in Korea, but also, albeit with some lags and imperfections, in the other countries. The main exception was the Philippines, where macro policies did not respond adequately (see Chapter 5). Reforms in trade and export promotion policies contributed to greater outward orientation through rationalization of the tariff systems, reduction in QRs, and export promotion efforts in all five countries, albeit with occasional reversals. For example, QRs were increased, or reinstalled, temporarily in the Philippines and Indonesia, while in Thailand pressing government revenue needs resulted in retrogressive increases in the average level of protection between 1983 and 1985, after reductions achieved in 1981 and 1982 (see Chapter 3). Nevertheless, as a result of cumulative actions, considerable progress was made in reducing trade distortions during the 1980s in the four countries where trade interventions were widespread—Korea, Indonesia, Philippines and Thailand. In the area of tax policy, far-reaching reforms in the tax structure were introduced in Indonesia, and consolidated in Korea. In the Philippines, the government has recently announced significant reforms in the tax structure. Much less, if any, progress, has been made to date in Thailand and Malaysia in this area. In the area of private investment incentives and regulations, some progress was made in four East Asian countries in terms of

3/ Supported by structural adjustment loans from the World Bank.
Table 1.2: CHANGES IN ECONOMIC INDICATORS, 1973-80 TO 1980-85

<table>
<thead>
<tr>
<th></th>
<th>Korea</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP Growth Rate (%)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1973-80</td>
<td>8.6</td>
<td>7.2</td>
<td>7.5</td>
<td>6.2</td>
<td>7.5</td>
</tr>
<tr>
<td>1980-85</td>
<td>7.1</td>
<td>4.5</td>
<td>6.2</td>
<td>-0.4</td>
<td>5.4</td>
</tr>
<tr>
<td><strong>Average Gross Domestic Investment as % of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-80</td>
<td>31.4</td>
<td>24.2</td>
<td>27.7</td>
<td>29.7</td>
<td>26.5</td>
</tr>
<tr>
<td>1980-85</td>
<td>28.2</td>
<td>21.8</td>
<td>33.1</td>
<td>24.2</td>
<td>22.9</td>
</tr>
<tr>
<td><strong>Average Gross Domestic Savings as % of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-80</td>
<td>25.4</td>
<td>31.3</td>
<td>33.0</td>
<td>24.4</td>
<td>23.9</td>
</tr>
<tr>
<td>1980-85</td>
<td>26.6</td>
<td>20.1</td>
<td>29.0</td>
<td>21.2</td>
<td>21.1</td>
</tr>
<tr>
<td><strong>Average Current Account Balance as % of GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-80</td>
<td>-5.2</td>
<td>0.3</td>
<td>0.7</td>
<td>-4.7</td>
<td>-5.1</td>
</tr>
<tr>
<td>1980-85</td>
<td>-3.6</td>
<td>-3.1</td>
<td>-9.6</td>
<td>-5.3</td>
<td>-5.3</td>
</tr>
<tr>
<td><strong>Average ICOR</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-80</td>
<td>3.8</td>
<td>2.3</td>
<td>3.3</td>
<td>3.7</td>
<td>3.4</td>
</tr>
<tr>
<td>1980-85</td>
<td>4.2</td>
<td>5.5</td>
<td>5.1</td>
<td>8.4</td>
<td>4.6</td>
</tr>
<tr>
<td><strong>Average Long-Term Debt Service Ratio</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1973-80</td>
<td>12.9</td>
<td>16.4</td>
<td>6.4</td>
<td>17.4</td>
<td>12.9</td>
</tr>
<tr>
<td>1980-85</td>
<td>16.8</td>
<td>17.5</td>
<td>10.4</td>
<td>20.1</td>
<td>19.4</td>
</tr>
</tbody>
</table>

Source: Bank staff estimates.
streamlining and simplifying procedures (Philippines, Thailand and Indonesia), reducing the degree of intervention and restrictions (Indonesia and Malaysia), and making them less distortive in terms of factor choice and anti-export bias. Major efforts were made in all five countries to scale back and rationalize public investment programs, including the re-evaluation, and phasing-back or elimination of major industrial projects. Finally, significant efforts were made in freeing up the financial sector, by reducing or eliminating controls on interest rates, scaling back directed and subsidized credit programs, and strengthening, in some countries, the capabilities of banking and banking supervision institutions.

1.16 Only in a few cases did these policy reforms amount to a complete overhaul of the set of policy instruments in a particular area, and much remains to be done in most of the countries concerned in terms of further rationalization of the policy framework, but on the whole the East Asian experience has shown the importance and value of responsive, pragmatic and incremental policy-making and economic management. Of course, the most successful country in this regard to date has been Korea; however, one should also note the timely, deliberate, measured and cumulatively far-reaching reforms which have been introduced in Indonesia. The approaches in Malaysia and Thailand, in comparison, have been characterized by more haphazard, piecemeal and partial responses. In the case of the Philippines, while significant progress was being made in a number of areas over the years, they were insufficient to avert the crisis in 1983 and more than overtaken by the unfolding economic collapse. The task now is not so much one of adjustment, but of rebuilding the economy.

1.17 Looking ahead, the international environment for the second half of the 1980s and the early 1990s, while probably not as hostile to the interests of developing countries as was the international economy during the first half of the 1980s, is likely to be less favorable than was the case during much of the 1960s and 1970s. In particular, low commodity prices will continue to represent a major drag on the rural sectors and thus on domestic income and demand, while OECD income and import growth is likely to be muted.4/ Despite these constraints, international markets will still be open for increased exports from the East Asia region, even if for selected products protective barriers will limit export growth (see Chapter 2). The low shares of these countries in relation to total imports and, even more so, production of OECD countries and their demonstrated capacity to compete and flexibility in responding to changing market opportunities—demonstrated convincingly by the resurgence of manufacturing exports in 1986 in most countries of the region—

4/ The availability of foreign capital does not appear to be a major constraint for the region, even in the Philippines, considering that none of the countries should, and apparently intend to, run major current account deficits which would substantially endanger their creditworthiness. However, real interest rates are likely to remain positive and quite high, and thus, compared with the negative interest rates of the 1970s, could be a drag on the incomes, investments, and the balance of payments of the developing countries.
all argue that an export-oriented strategy is still appropriate. Of course, as has been underlined throughout this report, an outward-oriented, open-economy strategy is also appropriate in terms of the efficiency enhancing impact on the industries serving domestic demand.

1.18 As indicated above, many policy reforms were initiated during the first half of the 1980s in the countries under review, but much remains to be done if some of the continuing economic difficulties are to be addressed. Among these difficulties, the following issues need particular attention: (a) increases in the savings and investment rates from the low levels of the early and mid-1980s; (b) increased efficiency of investment; (c) maintaining, if not strengthening international competitiveness; and (d) establishing a sustainable resource balance between savings and investment, and thus of the balance of payments.

1.19 Trade, export development and industrial policies have an important role to play in all the countries concerned, if governments are to address the above issues successfully. The remainder of this study will evaluate past experience with a view to drawing lessons for how such policies are best designed and implemented.
2.1 The export performance of the East Asian countries has been the strongest among developing countries over the last two and one-half decades. They have progressively increased their share in world markets and have weathered the effects of the slowdown in world trade in the 1980s better than most developing countries. Particularly impressive has been their record on manufactured exports. The growth of their manufactured exports has not only surpassed those of other developing countries but has also been the most dynamic component of overall export growth of these countries. Currently, the newly industrializing and semi-industrialized countries of the East Asia and Pacific rim account for almost 70% of the manufactured exports of all developing countries. The four East Asian NICs have the largest export share. Together, their merchandise exports amounted to about $110 billion in 1986, about half of Japanese or US exports. China's exports have also risen rapidly, so that they have reached the same level as that of Korea. Although non-oil export levels of the Southeast Asian countries (Malaysia, Philippines, Thailand and Indonesia) are much lower than these big-five exporters, they have also recorded impressive gains for both manufactured and commodity exports.

2.2 Despite these past successes, the countries of the region are increasingly concerned about future export prospects, due to what is viewed as a slowdown in the world economy, growing protectionism and limited prospects for the principal exports from the region. This chapter reviews past export trends of the region and factors underlying them, and discusses the key elements that are likely to determine export opportunities and performance in the future.

A. Past Performance

Commodity Developments

2.3 Although the East Asian developing countries are thought of as an emerging center of manufactured exports, they are, with the exception of Korea, all major primary commodity exporters as well. As such, they have been adversely affected by the sharp declines in petroleum and commodity prices during the 1980s. Three countries of the region—Indonesia, Malaysia and China—are large net oil exporters, and have suffered from the precipitous decline in oil prices. Malaysia, and to a lesser extent China, were able to offset the effect of the oil-price decline of the early 1980s through increases in the volume of exports, but Indonesia's oil exports fell by 30% between 1981 and 1985 because of the restricted volume of exports. The more recent and more drastic oil price decline of late 1985 has had a severe impact on all three oil exporters, with the balance of payments impact estimated at about $3.8 billion p.a. for Indonesia, followed by $2.2 billion for China and $1.6 billion for Malaysia. In relation to GNP, the impact was largest for Malaysia (5% of GNP) compared to Indonesia (4.5% of GNP) and China (0.5% of GNP).
While the decline in oil prices has been dramatic and its impact quite severe for the three oil exporters, non-oil commodity prices have also declined substantially in the 1980s. By 1986, the World Bank's index of non-oil commodity prices had reached its lowest level in more than ten years, and in constant prices, had never been lower in the 27 years covered by the index (see Table 2.1). Of particular concern to the LDCs in East Asia, prices of rice, rubber, coconut, palm oil and tin continued to fall. Table 2.2 summarizes the magnitude of the decline for key commodities and the countries affected. As primary commodities including oil constitute a significant proportion of exports of these countries with the exception of Korea (ranging from 92% in Indonesia to 48% in China), the decline in energy and commodity prices has had a strong adverse effect on the export earnings of these countries.

Table 2.1: TRENDS IN COMMODITY PRICE INDICES (1979-81 = 100 at constant prices)

<table>
<thead>
<tr>
<th></th>
<th>Agriculture</th>
<th>Petroleum</th>
<th>Nonfuel</th>
<th>Petroleum</th>
<th>Nonfuel</th>
<th>Agriculture</th>
<th>Petroleum</th>
<th>Nonfuel</th>
<th>Agriculture</th>
<th>Petroleum</th>
<th>Nonfuel</th>
<th>Agriculture</th>
<th>Petroleum</th>
<th>Nonfuel</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950s (average)</td>
<td></td>
<td>24</td>
<td>136</td>
<td>134</td>
<td>172</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1960s</td>
<td></td>
<td>16</td>
<td>113</td>
<td>105</td>
<td>123</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1970s</td>
<td></td>
<td>45</td>
<td>110</td>
<td>113</td>
<td>103</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1980s (first half)</td>
<td></td>
<td>108</td>
<td>92</td>
<td>92</td>
<td>93</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>1985</td>
<td></td>
<td>98</td>
<td>81</td>
<td>83</td>
<td>74</td>
<td></td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>1986</td>
<td></td>
<td>44</td>
<td>73</td>
<td>80</td>
<td>58</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: World Bank, Economic and Projections Analysis Department

Table 2.2: SUMMARY OF COMMODITY PRICE TRENDS

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Percent change (1980-86)</th>
<th>Countries affected</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum</td>
<td>-55</td>
<td>Indonesia, Malaysia, China</td>
</tr>
<tr>
<td>Rubber</td>
<td>-43</td>
<td>Malaysia, Thailand, Philippines</td>
</tr>
<tr>
<td>Rice</td>
<td>-52</td>
<td>Thailand</td>
</tr>
<tr>
<td>Sugar</td>
<td>-76</td>
<td>Philippines, Thailand</td>
</tr>
<tr>
<td>Tin</td>
<td>-64</td>
<td>Malaysia, Thailand, Philippines</td>
</tr>
<tr>
<td>Timber</td>
<td>-26</td>
<td>Indonesia, Malaysia, Philippines</td>
</tr>
<tr>
<td>Palm Oil</td>
<td>-53</td>
<td>Indonesia, Indonesia</td>
</tr>
<tr>
<td>Coconut Oil</td>
<td>-58</td>
<td>Philippines, Indonesia</td>
</tr>
</tbody>
</table>

Source: World Bank, Economic Analysis and Projections Analysis Department
2.5 In terms of recent trends, apart from petroleum, major losses to the Southeast Asian economies have resulted from the drastic declines in prices of edible oils--palm oil and coconut--and tin whose prices in 1986 were almost 40% below the levels of 1985 in current dollars. Malaysia has been the most adversely hit by these commodity developments because of its commodity mix.

2.6 The commodity terms-of-trade declines suffered by the region since the mid-1970s are similar in magnitude to those faced by other groups of developing countries (see Figure 1 on Barter Terms of Trade). What is remarkable is the extent to which East Asian countries have been able to improve their income terms of trade during this period (Figure 2) indicating their success in expanding their total earnings from these crops even in the face of falling real prices. This shows that the success of the East Asian countries in expanding agricultural output and exports is equally noteworthy as the more publicized industrial development success.

Manufactured Exports

2.7 The impressive overall export-earnings performance of the region in recent years in the face of adverse commodity-market developments reflects the rapid growth of manufactured exports. Manufactured exports from the region grew at an annual rate of 14% in volume terms between 1980 and 1984 in an environment where world trade in manufactures grew in the range of 4% p.a. Among developing countries, the East Asian NICs have made the greatest strides in expanding exports of manufactures (see Table 2.3). Together they now account for more than half of manufactured exports of developing countries. Korea, of course, has been an important part of this group. However, other East Asian developing countries also fared favorably. As a result of continued rapid growth, the share of East Asian developing countries excluding the NICs in world exports of manufactures now exceeds that of Latin America. With this rapid growth, manufactured exports now comprise almost 50% of merchandise exports of the East Asian market economies. Of course, there is considerable variation among countries with the share ranging from 90% in Korea to 6% in Indonesia. But in all countries, the share of manufactured exports has risen substantially so that they now constitute an important determinant of overall export growth.
Figure 1
BARTER TERMS OF TRADE OF NON-FUEL PRIMARY COMMODITIES /A
BY DEVELOPING REGIONS: 1965-85

Figure 2
INCOME TERMS OF TRADE OF NON-FUEL PRIMARY COMMODITIES /A
BY DEVELOPING REGIONS: 1965-85

SOURCE: COMMODITY STUDIES AND PROJECTION DIVISION
/A DEFLATED BY IMPORT UNIT VALUE OF MANUFACTURES.
Table 2.3: TRENDS IN MANUFACTURED EXPORTS

<table>
<thead>
<tr>
<th></th>
<th>Annual rate of growth</th>
<th>Share of world exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>19.1</td>
<td>-1.3</td>
</tr>
<tr>
<td>All developing countries</td>
<td>25.4</td>
<td>5.6</td>
</tr>
<tr>
<td>Latin America</td>
<td>25.4</td>
<td>7.4</td>
</tr>
<tr>
<td>East Asia NICs</td>
<td>28.3</td>
<td>8.5</td>
</tr>
<tr>
<td>East Asia Developing Countries</td>
<td>33.6</td>
<td>8.9</td>
</tr>
<tr>
<td>China</td>
<td>26.7</td>
<td>9.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>37.7</td>
<td>25.5</td>
</tr>
<tr>
<td>Korea</td>
<td>36.9</td>
<td>7.5</td>
</tr>
<tr>
<td>Malaysia</td>
<td>49.7</td>
<td>12.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>33.6</td>
<td>6.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>40.3</td>
<td>7.7</td>
</tr>
</tbody>
</table>

/a In current dollar terms.

Source: World Bank Trade Data System

2.8 A second related feature of East Asian exports is the growing importance of the U.S. market. In terms of total trade, Japan is clearly the most important trading partner of the region (see Table 2.4). It is the dominant source of imports for the region as well as the most important destination for total merchandise exports. However, Japan is a relatively minor market for manufactured exports. The US is the dominant market for manufactures, and its relative importance has increased for all the major countries of the region since 1980. In aggregate, the U.S. accounted for 71% of the growth of manufactured exports of the East Asia and Pacific region between 1980 and 1984 although there were significant intercountry differences as shown in Table 2.5. Thus, for manufactures, the relationship for the region has increasingly become a triangular one of buying capital goods and intermediates from Japan and selling finished goods to the US. Although the EEC is still a major market for manufactures, the share of East Asian exports absorbed by the EEC has been much lower during the 1980s compared to the previous decade. Exports of manufactures to other developing countries, including intra-East Asian trade, show a similar trend. Developing country markets accounted for a significant portion of manufactured export growth from East Asia during the 1970s, but a much lower proportion during the first half of this decade. Nevertheless, developing country markets have remained important for China, since more than half of its exports are directed to developing countries, and Malaysia, partly because of the importance of Singapore as a trading partner.
Table 2.4: DIRECTION OF EXPORTS (1984)

<table>
<thead>
<tr>
<th></th>
<th>Japan</th>
<th>US</th>
<th>EEC</th>
<th>Other OECD</th>
<th>Developing countries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Merchandise Exports</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>27.1</td>
<td>15.4</td>
<td>11.5</td>
<td>4.1</td>
<td>41.9</td>
</tr>
<tr>
<td>Indonesia</td>
<td>56.5</td>
<td>29.7</td>
<td>11.3</td>
<td>3.5</td>
<td>4.4</td>
</tr>
<tr>
<td>Korea</td>
<td>21.2</td>
<td>50.5</td>
<td>11.7</td>
<td>9.1</td>
<td>7.5</td>
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</table>

Source: World Bank Trade Data System

Table 2.5: SHARE OF EXPORT GROWTH OF MANUFACTURES BY DESTINATION

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<thead>
<tr>
<th></th>
<th>Japan</th>
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<th>EEC</th>
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</table>

Source: World Bank Trade Data System.
While the manufactured export performance of East Asian developing countries has only been a tier below that of the East Asian NICs, there have been important qualitative differences in the export trends of these two groups as Table 2.6 shows. The increase in manufactured export earnings of the East Asian LDCs has been concentrated in relatively few commodities. Textiles and garments have been among the most prominent, contributing 55% of the total increase of manufactured exports for China during 1970-1984 and 21% of the total increase for the four Southeast Asian countries (Indonesia, Malaysia, Philippines and Thailand). Electronic components have been the other major source of growth of manufactured exports for Southeast Asian countries, but so far this has been mainly confined to semiconductor devices. Other significant areas of growth were semimanufactures including wood products (Southeast Asia) and light consumer goods (China). Machinery exports have had a significant role only in Malaysia and to a lesser extent for China.

By contrast, export growth of the East Asian NICs has relied on a much more diversified profile of exports. Although traditional items such as clothing and footwear continue to dominate, the most dynamic components of export growth, particularly in recent years, have been machinery and transport equipment and electronic products. This has increasingly included sophisticated electronic assembly products (not just semiconductor devices) and a growing range of machinery and capital equipment.

The prevailing structure of manufactured exports reflects these growth trends. Korea has the most diversified structure, and machinery accounts for a higher share of its exports. More surprising, machinery and electronic components account for the major share of Malaysia's manufactured exports. Textiles and garments together account for a large share of manufactured exports for all countries of the region except Malaysia. Indonesia has the weakest export base for manufactures, not only in its absolute level, but also in its concentration in relatively few products.

<table>
<thead>
<tr>
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<td>4.6</td>
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</table>

Source: World Bank Trade Data System
2.12 A striking aspect of the recent manufactured export performance of the region was the sudden slowdown in 1985 and the equally dramatic recovery that has occurred in 1986. In contrast to the strong performance during 1980-84, growth of manufactured exports decelerated dramatically in 1985, affecting all countries of the region. For the first time in recent history, manufactured exports from the Region did not record any significant volume increase. Two aspects of this slowdown were noteworthy. First, in contrast to the region's performance, exports of manufactures of industrial countries to the U.S. continued to increase in 1985. Second, the East Asian NICs were particularly severely affected in terms of export growth.

2.13 Export trends in 1986 marked a complete reversal of developments in 1985. Without any significant change in the rate of growth of world trade, exports of manufactures from the region increased at an unprecedented rate. The East Asian NICs have been at the forefront, Korea among them. Korea's export earnings increased by 9.1% in volume terms in 1986 compared with 2.9% in 1985, signalling the degree to which Korea is exploiting its opportunities for competing with Japan.

2.14 What is more surprising is the upturn in the manufactured export earnings for the other East Asian economies (see Table 2.8 p. 23). China's manufactured exports rose by 34% in volume terms during 1986 more than offsetting the decline in oil revenues. Thailand's exports rose by close to 17%, propelled by manufactured exports but also because of volume increases for commodity exports. In Malaysia, where commodity export declines have been very large in addition to the oil revenue short-fall, strong manufactured export performance has moderated the decline of export earnings. In Indonesia, manufactured non-oil exports increased 14% during 1986, but this was dwarfed by the decline in oil revenues. Even in the Philippines, manufactured exports revived after a year of sharp decline. Preliminary figures for 1987 suggest that manufactured exports from the region continued to record strong gains despite modest overall growth of world trade.

Factors Underlying Strong Performance

2.15 The preceding sections highlight the superior export performance of the East Asia and Pacific countries over the past two decades. The key aspects of the region's export performance that are worth reiterating are:

(a) The East Asian NICs (including Korea) have clearly been the most successful, in the region and the developing world, in expanding their manufactured exports. But, the other semi-industrialized countries of the region (China and the Southeast Asian countries) have also recorded an impressive rate of growth of manufactured exports.

(b) Less publicized, but equally important, has been the success of the semi-industrialized countries of the region in expanding their agricultural exports, even in the face of the terms of trade decline suffered since the mid-1970s.

2.16 The export success of the East Asian countries has been analyzed extensively, and has provided the basis for some now widely held conclusions
about development strategy. First, the export performance of these countries is not attributable to any specially favorable circumstances that they faced, but reflects more the policies that were adopted. In particular, their export success has been closely linked to the "outward orientation" of the economies and the "export promoting strategy" pursued. Second, the outward orientation and export success of the East Asian countries, have been strongly correlated with superior overall economic growth, and greater progress in creating employment and reducing poverty.

2.17 The causality between the policies pursued and export performance is necessarily complex. Some key policies may be cited, though, in explaining the generally better export performance of the region, and the variation between countries within the region:

(a) An important ingredient of the export promoting strategy has been maintaining a competitive exchange rate. The East Asian NICs have been the most consistent in this regard, but other countries in the region have also paid greater attention to maintaining a realistic exchange rate than other developing countries (See Chapter 3, paras. 3.6-3.16). This has required flexible exchange rate policies and sound fiscal and monetary policies.

(b) Good macroeconomic management and emphasis on domestic resource mobilization have allowed these countries to sustain high levels of investment and develop their capacity to supply an increasingly diversified bundle of export goods. On average, investment in East Asian countries has been equivalent to a quarter of their income, with the bulk coming from domestic savings.

(c) The countries in the region have buttressed domestic investment by generally favorable policies towards foreign investment and technology transfer. Foreign investment appears to have played an instrumental role in the emergence of Asian NICs as the world's leading exporters of electric and electronic goods.¹ Other Asian developing countries have also attracted significant volumes of foreign investment (mainly from Japan), but with a greater domestic market orientation. The Asian NICs have also been at the forefront in complementing efforts to acquire foreign technology with an active program to promote domestic science and technology and research and development.

(d) The East Asian economies have been characterized by relatively low trade and other distortions; this has supported more efficient investment and production, reduced the degree of "rent-seeking" in

¹ The top 20 exporting firms of Taiwan Province (China)—all of which exported electric and electronic goods—were either foreign affiliates or joint ventures. In Korea, foreign affiliates and joint ventures accounted for only 16% of firms in the electronics industry but for over 65% of electronics exports (MITI White Paper on International Trade, 1986).
the economy, and moderated the antiexport bias that results from a highly protected trade regime. In countries where such distortions have been more pervasive, such as Philippines and Indonesia, export performance has been concomittantly weaker. A fuller description and assessment of trade regimes in the region is provided in Chapter 3.

(e) The most successful exporters, i.e., the East Asian NICs, went even further in creating an incentive structure conducive to exports. Through a range of export promotion measures, they sought to not only offset the antiexport bias of the protective structure, but actually made exports more profitable than the domestic sectors of the economy. The experience with export promotion policies in the region is discussed in Chapter 4.

(f) The very export success of East Asian countries has created a high degree of openness and exposure to world markets, which in turn has allowed for a more flexible response to changing circumstances and produced important "dynamic" benefits, in terms of learning, technology acquisition and productivity growth.

(g) Finally, a noteworthy characteristic of East Asian countries is that their incentive structures have not been biased against agriculture, unlike many other developing countries. Appropriate price policies in agriculture and investments in irrigation, research and extension, and rural development led to sustained productivity gains and more adaptive agricultural sectors, allowing the East Asian countries to achieve high rates of growth of agricultural output and exports.

2.18 While the preceding arguments explain the overall strong export performance of East Asian countries during the past two decades, a puzzling development was the marked slowdown of export growth in 1985 and the subsequently strong recovery in 1986 without a significant shift in the growth of world trade. The slowdown in 1985 reflects to some extent the exceptional growth of the previous year. But the major factor in explaining export shifts over the past two years has probably been the changes in export competitiveness due to the effects of international currency movements. As East Asian currencies have been largely linked to the dollar, export competitiveness weakened in 1985 with the peaking of the dollar, but then improved dramatically in 1985 with the large depreciation of the dollar. Although this was the result of passive exchange rate policies, it underlines the importance of competitiveness in determining export performance.

B. Export Prospects

2.19 While East Asian countries were so successful in exploiting market opportunities in the past—including during the less-buoyant export environment of the early 1980s—there is widespread concern that export prospects in the future will be much bleaker even for these countries, given fundamental shifts in the world trade environment. The more pessimistic outlook on the part of many policymakers in the countries and international analysis is based on three separate "adverse trends."
2.20 First, there is an expectation that industrial country growth will remain sluggish, and a return to the high growth rates of the 1960s and early 1970s is unlikely. Second, not only have commodity prices tumbled to record lows, but revised projections cast a pall over any significant improvement in the foreseeable future. Third, and most important, because of the growing drift towards protectionism in industrial countries, markets for many traditional industrial products are viewed as becoming less accessible to developing countries.

2.21 As Bhagwati notes in a recent paper, export pessimism is not new to the policy debate in developing countries, and was in fact associated with the founding fathers of development economics, Raul Prebisch and Ragnar Nurkse. Bhagwati draws a distinction between "the first export pessimism" of Prebisch and Nurkse, which focussed on the decline in the terms of trade of primary products and the limited absorptive capacity of industrial markets, and the "second export pessimism" based on the new threat of protectionism. What is in fact striking about the current wave of export pessimism is that it is based on both a resurgence of the earlier concerns about terms of trade and declining absorptive capacity of industrial markets, as well as the new element of protectionism. In order to assess the validity of these concerns and implications for strategy, this section discusses in more detail: OECD and world trade outlook, protectionism in industrial markets, commodity prospects, and trade among developing countries including within the region.

OECD Growth and World Trade Outlook

2.22 Expectations of a recovery in industrial country growth—following the fall in oil and other commodity prices, the relatively smooth decline of the dollar, and the easing of interest rates—have so far not materialized. In fact, the average growth of industrial countries, which had fallen from 4.7% in 1984 to 3.0% in 1985, dipped further to 2.4% in 1986 and is estimated at 2.3% in 1987. For the US, a dampening of domestic demand and a dip in GNP growth below its trend rate was an inevitable outcome of the process of fiscal and external adjustment. But other industrial countries, which have had greater latitude for domestic expansion following the depreciation of the dollar, have so far been unwilling to reflate their economies. This has been compounded by the slow growth of absorption in developing countries, as oil and commodity exporters have sought to adjust to lower prices and high external debt levels.

2.23 On the positive side, the likelihood of a "hard landing" of the dollar and of disruptive adjustment has been substantially reduced. Among the sources of stability have been the large but smooth currency realignment, the commitment to reduce the US fiscal deficit in the medium term and efforts to reconcile payments and adjustment problems of the highly indebted countries. Although the probability of a sharp recession has been reduced, the probability of sluggish growth has not, partly as a result of these same factors.

2.24 External and fiscal adjustment in the US, while an essential prerequisite for sustained longer term growth, will put a brake on growth of imports as domestic demand must grow at a rate below that of GNP. Industrial country growth and the demand for imports from developing countries in the medium term will, therefore, depend on adequate growth of demand in the major surplus industrial countries. Such a shift in stimulus will require close policy coordination on the part of industrial countries. Although there has been some progress on policy coordination, the major surplus countries have so far resisted pressures to adopt more expansionary policies, suggesting that industrial country aggregate demand may remain weak. Adding to this trend of sluggish demand is the need for developing countries to increase the volume of net exports to finance past debt plus the effects of terms of trade deterioration. Efforts by developing countries to curb domestic demand will therefore reinforce the slow growth of demand for imports on a global basis.

2.25 On the supply side, while there has been progress in addressing labor market and other rigidities in industrial countries and in reducing cost-price distortions in developing countries, the decline in investment rates in developed and developing countries alike does not augur well for future growth. An important objective must therefore be to undertake speedy macroeconomic adjustments and reduce uncertainties facing investors in terms of the volatility of interest and exchange rates, the threat of protectionist policies and the availability of long-term capital.

2.26 A recent World Bank review of the world economic outlook concludes that: "The single most likely short-term scenario for the industrial countries and for the world as a whole features continued slow growth at below 3%." Projected growth in the 1990s is somewhat higher, in the range of 3.5% p.a. for the industrial countries. Although sluggish, this growth trend is better on average than what was recorded in the first half of the 1980s and comparable to growth in 1973-80 period (see Table 2.7). What is of greater concern is that the deceleration in the growth of world trade and uncertainties about industrial country demand implies not only poor prospects for commodity exports from developing countries, but also an uphill battle in fighting protectionist pressures against manufactured exports.

Table 2.7: GROWTH OF INDUSTRIAL COUNTRIES AND WORLD TRADE TRENDS
(real growth, % p.a.)

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<thead>
<tr>
<th>Years</th>
<th>GNP growth of industrial countries</th>
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<th>Trade in manufactures</th>
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<td>-</td>
<td>-</td>
</tr>
<tr>
<td>1990-95</td>
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</table>

Source: World Bank, Economic Analysis and Projections Department

2.27 The demand for developing country exports is determined not only by the aggregate rate of growth of industrial countries but also the import elasticity of demand for developing country exports. In the past, the elasticity of demand for developing country exports has been higher the greater the share of manufactured exports. For the East Asian countries, the higher income elasticity for imports of manufactures was an important factor in sustaining the rapid growth of exports. Whether this elasticity will remain at past levels is now more uncertain. Two trends are underlying this concern. First, the shift in the nexus of growth away from the US and the paring of the US trade deficit, imply that exports from East Asian countries to Europe and Japan would have to expand more rapidly than in the past to offset the expected decline in the elasticity of import demand from the US. Events in 1986 have somewhat allayed this concern. East Asian countries have vastly improved their export competitiveness over the past year.

4/ There has been considerable debate in the development literature about the link between expansion in industrial countries and the demand for exports from developing countries. Arthur Lewis (1980) had argued on the basis of historical evidence that exports from developing countries were linked to the growth of industrial countries, and that this elasticity was less than unity. Although this finding has been criticized on statistical grounds by Riedel (1984), a more fundamental point is made by Balassa (1986) that while the elasticity of exports of primary products with respect to industrial country growth may be low (estimated at 0.5% for the period 1963-84), elasticity of manufactured exports is much higher (3.8), so that the elasticity of overall developing country exports with respect to industrial country growth is greater than unity (1.5). For the East Asian countries, with a high and rapidly growing share of manufactured exports, the elasticity for this period would be even higher.
as their currencies have depreciated even more than the dollar during the recent currency realignment. This has led to a surge in exports not only to Europe and Japan, but also to the US, where the East Asian NICs in particular are now able to compete with Japan in an increasingly wider range of goods. A second and more serious cause of concern which raises doubts about simple extrapolation of past elasticities is the growing drift towards protectionism in industrial countries.

2.28 Table 2.8 presents historical estimates and projections on export volume trends for the countries of the region based on the most recent World Bank staff estimates. The past trends highlight the generally strong historical performance of the East Asian countries discussed earlier, as well as the weakening of export performance in 1985 followed by a recovery in 1986. For the future, the projections indicate that strong export growth, particularly of manufactures, are expected to continue. Exports of manufactures from the region is thus expected to increase at a faster pace than overall trade in manufactures, although in all cases, the annual rate of growth for 1987-91 is lower than what was achieved during 1980-84.

<table>
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<td>7.0</td>
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<td>-8.2</td>
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<td>23.0</td>
<td>14.5</td>
<td>14.2</td>
</tr>
</tbody>
</table>

Source: World Bank Staff estimates.
Protectionism in Industrial Markets

2.29 As a result of successive rounds of multilateral trade negotiations, trade barriers on manufactured goods in industrial markets were substantially reduced over the past three decades. This trade liberalization was almost exclusively in the form of tariff reductions on the part of major industrial countries. Developing countries were only peripherally involved in the trade negotiations. Although developing countries benefitted from the general reduction in tariffs, they were not required to reduce their own tariffs reciprocally, as a recognition of their special developmental and balance of payments needs. Also, in response to demands for preferential treatment, the Generalized System of Preferences (GSP) was introduced in 1968, whereby industrial countries have exempted nonagricultural imports from duties up to certain set levels. As shown in Table 2.9, following the Tokyo Round, prevailing tariffs on manufactured goods in industrial country markets are quite low. Developing countries have also benefitted from duty exemptions under the GSP scheme, but this has covered less than 10% of their exports to industrial countries.

<table>
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<tr>
<th></th>
<th>US</th>
<th>EEC</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average, all imports</td>
<td>4.9</td>
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<td>Average, imports from developing countries</td>
<td>8.7</td>
<td>6.7</td>
<td>6.8</td>
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</tbody>
</table>


2.30 In contrast to this phase of liberalization, over the past decade or so there has been an increased shift towards protectionism in almost all of the major industrial countries, in the form of a growing recourse to nontariff barriers (NTBs), which has more than offset the earlier reduction in tariff rates. The OECD estimates that consumption in product groups subject to nontariff barriers in 1983 accounted for 30% of total consumption of manufactures in major industrial countries compared with 20% in 1980. This trend has continued over the last two years. The available measures are also likely to understate the increase in protectionism as they do not capture the tightening of existing NTBs. Thus, trade restrictions have both intensified in the traditionally protected sectors such as steel, textiles and clothing and have been extended to new sectors such as electronics, machine tools, paper products and petrochemicals.

2.31 More disturbingly, both the new nontariff and remaining tariff restrictions are skewed against developing countries. Despite the tariff cuts of the Tokyo Round, manufactured exports from developing countries are, in general, subject to higher tariffs than products originating in developed
countries. Also, there is still significant escalation in the tariff structure of industrial countries (i.e., tariffs on finished products are higher than those on semimanufactures, which in turn are higher than those on raw materials). This leads to higher effective rates of protection and discriminates against industrial processing in developing countries (Table 2.10).

Table 2.10: ESCALATION IN TARIFF STRUCTURE OF INDUSTRIAL COUNTRIES

<table>
<thead>
<tr>
<th>Level of processing /a</th>
<th>Average ad valorem tariff (post Tokyo Round)</th>
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<td>Nominal (on total values)</td>
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<td>Stage 2</td>
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<td>Stage 3</td>
<td>9</td>
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<tr>
<td>Stage 4</td>
<td>9</td>
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</tbody>
</table>

/a Based on processing "chains" for 21 agricultural and mineral products. For example, the chain for cotton and products is (1) raw cotton, (2) cotton yarn, (3) cotton fabrics, (4) clothing.


2.32 More damaging to developing countries has been the increased recourse to nontariff protection. Both by type of product and country of origin, such barriers discriminate against developing countries. Industrial countries impose NTBs on about one fifth of the goods they import from developing countries compared to only one tenth from other developed countries (see Table 2.11).

2.33 The product groups where NTBs have been most binding and which are also of vital importance to East Asian developing countries are textiles, clothing, footwear and steel. Except for steel, nontariff measures in these areas are directed primarily at developing countries. The Multi-Fibre Arrangement which was first negotiated in 1973, and covers textiles and clothing, is aimed solely at developing countries. The original agreement permitted annual import growth of 6% in volume; subsequent renewals and interpretations have been more restrictive. Only in the US did the growth of imports exceed these set levels during the first half of the 1980s. However, partly as a result of the surge in imports, future US policy is likely to be much more restrictive. Equally worrisome, Japan, which was so far not a member of MFA, has recently negotiated voluntary export restraint agreements with Korea and China.

2.34 Table 2.12 summarizes the extent to which exports from East Asia and Pacific countries are subject to NTBs in major industrial country markets. The main conclusions that emerge with regard to the pattern of non-tariff protection are:
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<th>Agriculture</th>
<th>Manufacturing</th>
<th>Textiles and clothing</th>
<th>Footwear</th>
<th>Iron and steel</th>
<th>Electrical machinery</th>
<th>Transport equipment</th>
<th>Rest of manufacturing</th>
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<td>All US EEC Japan</td>
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<td>All US EEC Japan</td>
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<td>29.6 21.3 27.1 31.5</td>
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<td></td>
</tr>
</tbody>
</table>

/\(a\) As of June 1984 with 1981 import weights.

Source: UNCTAD and World Bank Trade Data System.
(a) Like other LDCs, East Asian countries are subject to more NTBs than industrial countries;

(b) Agricultural exports from the region tend to face a higher degree of trade restrictions than manufactured exports. Formal restrictions on agricultural imports are the most pronounced in the case of Japan. Some important key products such as cassava for Thailand also face tight restrictions in the EEC.5/

(c) NTBs on manufactured exports tend to be the greatest for the EEC, and surprisingly low for Japan. China and Korea appear to be the most affected by prevailing NTBs. For both, it reflects the relatively high share of textiles and garments exports. Manufactured exports from Thailand and Philippines also face a considerable level of NTBs, whereas Indonesia and Malaysia appear to have so far encountered less NTBs on manufactured products than the average for developing countries.

2.35 Despite the proliferation of NTBs, East Asian countries succeeded in progressively increasing their market shares in world manufactured exports. The largest gains were made in exports to the US, but there has been an increase in market shares in Japan and the EEC as well. The most modest increase has been the export of manufactures to other developing countries.

2.36 The East Asia and Pacific rim countries (including the NICs) now account for almost 20% of the imports of manufactures of the US (Table 2.13). These countries account for an even larger share (23%) of Japan's imports of manufactured goods. In contrast, the share is only 5.3% in the EEC, but this reflects in part the high volume of intra-EEC trade.

5/ Although they do not face any formal restrictions, some key commodities such as rice, maize and sugar are strongly affected by the price support schemes in the US, EEC and Japan.
Table 2.13: SHARES IN IMPORTS OF MANUFACTURES OF KEY MARKETS (1984)

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>Japan</th>
<th>EEC</th>
<th>Developing Countries</th>
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</tr>
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<td>0.4</td>
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</tr>
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<td>0.7</td>
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<td>9.0</td>
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<td>69.9</td>
<td>68.4</td>
<td>88.0</td>
<td>78.4</td>
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</tbody>
</table>

Source: World Bank, Trade Data System.

2.37 A more accurate indicator of market share is obtained from the import penetration ratio, or the share in the apparent domestic consumption of the home market. Table 2.14 presents trends in import penetration ratios in some major industrial countries for total manufactures and a few key subgroups. These figures confirm that both in terms of absolute level of market penetration and the increase recorded between 1975 and 1983, East Asian countries have made the largest inroads in the US market. Import penetration by East Asian countries is lower in the countries of the EEC, although there was also a substantial increase in the level of import penetration between 1975 and 1983. Finally, while import penetration by the countries of the region in Japan for total manufactures is comparable to levels in the EEC, there has been little increase over the last decade. Overall levels of import penetration (i.e., for all countries) are also much lower in Japan than in the case of either the US or the EEC.

2.38 What is also striking is that, despite these recent gains, the share of developing countries in industrial country markets is still relatively small. In the US, where the levels of import penetration are the highest, the developing countries share in the total market for manufactures is less than 2.9%, half of which is accounted for by the developing countries of the East Asia and Pacific rim. Only in selected products, such as garments, footwear and wood products has import penetration by developing countries reached significant levels. Nevertheless, even in garments, imports from developing countries account for less than a fifth of total consumption in the US and the EEC, and only 10% in Japan. Import penetration by East Asian and other developing countries in areas other than light consumer goods is still negligible. In nonelectrical machinery, the share is less than 4%, and in elec-
Table 2.14: MARKET PENETRATION IN MAJOR INDUSTRIAL COUNTRIES FOR MANUFACTURING AND SELECTED SUBSECTORS /a (percent)

<table>
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</tr>
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</tr>
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<tr>
<td>World</td>
<td>21.95</td>
<td>29.32</td>
<td>27.48</td>
<td>39.97</td>
<td>19.51</td>
</tr>
<tr>
<td>Developing countries</td>
<td>2.57</td>
<td>3.12</td>
<td>13.70</td>
<td>17.41</td>
<td>3.82</td>
</tr>
<tr>
<td>EA NICs</td>
<td>0.63</td>
<td>1.13</td>
<td>12.38</td>
<td>13.29</td>
<td>2.08</td>
</tr>
<tr>
<td>Korea</td>
<td>0.08</td>
<td>0.23</td>
<td>1.74</td>
<td>2.91</td>
<td>0.50</td>
</tr>
<tr>
<td>China</td>
<td>0.05</td>
<td>0.09</td>
<td>0.05</td>
<td>0.46</td>
<td>0.02</td>
</tr>
<tr>
<td>S.E. Asia</td>
<td>0.18</td>
<td>0.26</td>
<td>0.07</td>
<td>1.04</td>
<td>0.37</td>
</tr>
</tbody>
</table>

Source: OECD Compatible Trade and Production Data Base, 1986.

/a Import penetration ratio is defined as the share of imports of the item in the "apparent" domestic consumption of the country, or as $\frac{M_{ij}}{P_{ij} + N_{ij} - X_{ij}}$.

where $M_{ij}$ is imports of $j$ from country $i$, $P_{ij}$ is production of $ij$, $N_{ij}$ is total imports of $j$ and $X_{ij}$ is exports of $j$. 
trical machinery, despite large increases in electronic equipment by the East Asian NICs and semiconductors by the Southeast Asian countries, the share in world markets is still very modest.

2.39 The low levels of import penetration by developing countries in industrial markets would suggest that there is considerable potential for further expansion of manufactured exports. In total, developing countries accounted for only 2.9% of the consumption of manufactures of industrial countries in 1983. Assuming that the consumption of manufactures by industrial countries were to grow by 3.5% p.a., and imports of manufactures from developing countries were to increase by as much as 12% p.a., the share of developing countries in the consumption of manufactured goods in developed countries would still be only 7.5% in 1995. While this increase would appear to be potentially easily absorbed by developed countries, the growing recourse to NTBs could make these growth rates difficult to achieve.

2.40 Existing NTBs already pose a significant constraint for several important traditional manufactures, and the outlook for curbing the growth of NTBs is not favorable. Fueled by continued high unemployment in Europe and the US and a persistent US trade deficit, protectionist sentiment has become more intense. Over 200 bills seeking additional protection have been put forward over the past 2 years in the US Congress. They fall into three types: (i) a general bill to restrict imports through a surcharge; (ii) a wide array of bills to limit imports of specific commodities; and (iii) provisions to respond to "unfair" practices in other countries. So far fortunately, the major protectionist bills have been successfully resisted, but threats of future action persist, particularly if the economy enters a recessionary phase because of the difficulties posed by the needed macroeconomic adjustment. The protectionist pressures have also not been without fallout. Although the President vetoed the most serious of the protectionist bills, which would have drastically reduced textile and footwear imports from East Asian and other developing countries, the US subsequently adopted a much harder stance in the renegotiation of the Multi-Fiber Arrangement and in its bilateral trade negotiations with the countries of the region.

2.41 Negotiations for the renewal of the Multi-Fiber Arrangement (MFA-4) were concluded this past summer. The new arrangement essentially maintains continuity of the framework already in place, although fiber coverage has been extended to all vegetable fibers and silk blends $6/$ and some provisions modified to allow importing countries more discretion in restricting imports. The MFA provides only the broad framework within which specific country agreements are reached. As such, bilateral agreements reflect more accurately the impact on the level and composition of imports. So far, new US bilateral agreements incorporate much lower growth rates than were achieved under MFA-3, around 1% p.a. on average. Canada has also adopted a similarly restrictive approach. The EEC has been somewhat more liberal in its recent bilateral negotiations. Except for the East Asian NICs, where eight "sensitive" product

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$6/$ This was primarily targeted at ramie (a natural fiber) based goods from China, but potentially also affects silk blends from Thailand.
categories have been restricted to 1% p.a. and remaining items to existing growth rates, the EEC has relaxed controls and allowed greater flexibility to other exporters. In particular, agreements with ASEAN incorporate a general, if modest, loosening of quotas with growth ceilings in the 4-6% range depending on product and country. While the MFA has imparted until now a certain degree of protection to Southeast Asian countries from export competition and made entry to developed country markets perhaps somewhat easier, the textiles agreements are likely to be more binding than in the past even for these countries. Increasing export earnings from textiles and garments will, therefore, require greater quota flexibility and better organization to maximize unit values as in the case of Hong Kong.  

2.42 Although textiles and garments represent the most explicit and significant case of export restraint imposed by the industrial countries, a wide range of miscellaneous exports from East Asian countries are affected by NTBs in industrial markets including footwear and leather products, iron and steel, machine tools (US), wood products (Japan, EEC), some electronic products (EEC), ceramics (US, EEC), ships, and a host of agricultural products.  

2.43 Apart from NTBs, a prevalent concern among the countries of the region is what is perceived as the growing incidence of countervailing measures on the part of industrial countries, particularly the U.S. In fact, there has been no marked increase in the number of countervailing actions initiated in recent years. Altogether, 425 countervailing duty (CVD) cases were reported between 1980 (when the new code was ratified) and 1985. More than half were registered in the U.S., but a majority of these were cases filed against other industrial countries and Latin American exporters. The number of cases filed against East Asian countries has been relatively small. The largest number of cases within the region were initiated against Korea (18), and only a small number of cases has been brought against other countries (Thailand (3), China (2) and Philippines and Indonesia one each). However, although only a few countervailing actions have been actually initiated, the threat of countervailing measures has become a powerful force. Exports and export policies are now subject to more careful scrutiny, and under U.S. pressure, Indonesia and Philippines have recently acceded to the Subsidies and Countervailing Duty codes of GATT. The purpose of countervailing measures is not to restrict imports but to discourage unfair trade practices in exporting countries. In practice, though, the threat of countervailing measures is intricately tied to the more complex issues of trade diplomacy. It is instructive that 70% of the cases initiated against developing countries have covered "sensitive" items such as steel, textiles, garments and footwear, where domestic protection lobbies are notably strong. What is particularly worrisome is that negotiations on trade issues, including  

\[7\] The evidence on quota utilization in the US suggest that East Asian countries have been relatively efficient in the utilization of textile and garment quotas. Korea, Thailand, Malaysia, China and Indonesia all had a fill rate in excess of 80% for more than four fifths of the items with quotas in 1984. Only the Philippines had a large proportion of items with unutilized quotas.
concessions, NTBs, export restraints, as well as retaliatory measures, are increasingly falling in the bilateral sphere, thus encouraging a shift from an open trading environment to one of managed trade.

2.44 Much of the discussion in the past on NTBs and market access had focussed on the U.S. and the EEC, but there is increasing awareness of the opportunities and need for expanding exports from the region to Japan. Contrary to the general impression, Japan's tariff and formal non-tariff restrictions to imports from developing countries are quite low, and compare favorably even with the US and EEC. The exceptions are agricultural goods, and until recently leather products. Both tariff and non-tariff protection are quite high on agricultural products, the former sometimes even seasonally adjusted. Together, they constitute a major impediment to exports of fruits, vegetables and animal products from the region to a large and growing market. Steps such as the recent relaxation of controls on frozen pineapples have met with an immediate supply response from exporting countries (Thailand, Philippines).

2.45 Although tariffs and NTBs on imports of manufactures from developing countries are lower in Japan than both the U.S. and the EEC, the level of imports of manufactures from developing countries is very small. This is in spite of the fact that the share of developing countries in Japanese manufactured imports is actually higher than for the U.S. and the EEC. The main issue, therefore, is that the overall level of import penetration for manufactured goods is very low in Japan. In 1983, all imports accounted for only 5.3% of total consumption of manufactures in Japan, compared to 10.3% in the U.S. and 35.1% in Germany. Developing countries share in Japanese consumption of manufactures was 1.9% compared with 3.4% in the U.S. and 4.0% in Germany. East Asia and Pacific countries (including the NICs), have fared better in Japanese markets with a share of 1.3% compared to 1.8% in the U.S. and 1.7% in Germany. Nevertheless, given the close linkages of the economies in the... region with Japan, there is considerable scope for expanding manufactured exports to Japan. For instance, only 5% of Thai textiles exports go to Japan.

2.46 Observers in Japan often point to the "quality consciousness" of the Japanese consumer and the special attributes of the Japanese distribution system. But there are also other factors at play, including informal or so-called covert barriers. Among the barriers cited are administrative guidance, certification requirements, and government steering and support of depressed industries. For instance, in the case of the Thai textile exports, constraints probably arise from implicit government subsidies to the Japanese textile industry as well as the marketing arrangements imposed by Japanese investments in Thailand. Analysis of the nature and impact of such barriers is extremely weak, and so far scrutiny has focussed primarily on products of concern to the U.S. and EEC. Among the positive actions taken to increase imports from the region are market surveys undertaken by JETRO to determine the market prospects for selected products and the nature of improvements required to compete in the Japanese market. While such efforts are clearly important and should be expanded, they will need to be complemented by a thorough assessment of the factors that lead to often very high mark-ups on imported products and of other constraints to expanding imports from developing countries.
Commodity Outlook

2.47 Although this chapter focuses primarily on manufactured exports, a brief review of commodity market prospects is useful as commodity exports still constitute a significant share of East Asian exports. The sharp decline in commodity prices in recent years has led to a reexamination of the prospects of commodity markets. The long-term forces, of supply expansion, substitution and inherently low elasticity of demand, which had been briefly forgotten in the 1970s, have reappeared to keep commodity prices secularly depressed. The shortage scare of the 1970s is replaced by fears of overproduction. Technical possibilities of expanding agricultural production appear to have been better than earlier expectations. For example, many countries in Asia have become self-sufficient in rice.

2.48 Farm subsidy or protection policies in the OECD countries have contributed to the large surpluses. Tree crops, such as rubber, coconut and palm oil, have also expanded without any significant signs of diminishing returns. On the other hand, the trend in industry seems to be in the direction of economizing in the use of raw materials and towards lower ratios of raw materials per unit of industrial production. Shares of material production have declined compared to services in GNP. Hence, the primary-products economy has become a small part of world economic activity.

2.49 These trends are likely to continue into the future. World Bank projections to the end of the century show very little or no improvement in the real prices of the primary commodities. This is quite a change from the projections of a few years ago when most forecasts showed significant recoveries in the real prices in the long run. Table 2.15 shows the comparison of the projections made in 1985 with the projections made this year, for major commodities produced and exported by the countries in the East Asia and Pacific region. According to this, commodity price forecasts for 1995 have been lowered by 34% for rice, 16% for rubber, 15% for palm oil, and 18% for coconut oil. This is the result of revised (downward) projections of growth in the world economy and of revised assumptions for supply trends. These projections suggest that despite the success of East Asian primary exporters in increasing their incomes in the face of adverse price developments, commodity exports cannot serve as the primary force for continued growth.
Table 2.15: CHANGES IN BANK COMMODITY PROJECTIONS
($) per unit at constant (1983) prices)

<table>
<thead>
<tr>
<th></th>
<th>1985 estimates</th>
<th>March 1987 estimates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Projected</td>
</tr>
<tr>
<td>Rice</td>
<td>257</td>
<td>230</td>
</tr>
<tr>
<td>Maize</td>
<td>139</td>
<td>120</td>
</tr>
<tr>
<td>Sugar</td>
<td>117</td>
<td>74</td>
</tr>
<tr>
<td>Rubber</td>
<td>112</td>
<td>94</td>
</tr>
<tr>
<td>Palm oil</td>
<td>742</td>
<td>614</td>
</tr>
<tr>
<td>Coconut oil</td>
<td>1,176</td>
<td>706</td>
</tr>
</tbody>
</table>

Source: Economic and Projections Analysis Department

Trade with Other Developing Countries

2.50 The expansion of exports to other developing countries, including those within the region, has often been identified as an important goal but which has proved quite difficult to achieve. As shown in the table below, the share of manufactured exports from developing countries absorbed by other developing countries, as well as the share of manufactured exports from the East Asia and Pacific region to developing countries, has shown a downward trend since 1970. In the 1970s, developing country markets did account for a significant proportion of the expansion of manufactured exports from developing countries including those from the region (see Table 2.16). In the 1980s, demand for manufactured imports by developing countries slackened as they entered a phase of adjustment to lower oil and commodity prices exacerbated sometimes by external debt difficulties. In many cases, there was also a tightening of import restrictions, although this was not the case in East Asia, except for the Philippines. The trend of adjustment and reduced demand for imports by developing countries is expected to continue. But a fundamental structural attribute that is a deterrent to trade between developing countries is the similarity in production structure, which is usually protected by a high level of tariffs or other trade restrictions.
### Table 2.16: INTRA-DEVELOPING COUNTRY TRADE

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of developing country manufactured exports to industrial countries</th>
<th>Share of developing country manufactured exports to other developing countries</th>
<th>Share of East Asia and Pacific manufactured exports to developing countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>69.2</td>
<td>30.8</td>
<td>38.9</td>
</tr>
<tr>
<td>1975</td>
<td>74.6</td>
<td>25.4</td>
<td>28.7</td>
</tr>
<tr>
<td>1980</td>
<td>78.3</td>
<td>21.7</td>
<td>29.9</td>
</tr>
<tr>
<td>1983</td>
<td>81.4</td>
<td>18.6</td>
<td>29.3</td>
</tr>
</tbody>
</table>

Source: World Bank Trade Data System

2.51 Table 2.17 provides some summary indicators of tariffs according to some key processing chains. The figures highlight the high level of tariffs, and the escalation in the tariff structure, for some of the main output and export items of developing countries. This clearly discourages trade in these products among developing countries. By contrast, tariffs on raw materials and capital equipment tend to be quite low. This pattern is found in the countries of the region as well. All the countries in the region focussed on developing their light consumer goods industries during the 1960s and 1970s, which has left a legacy of high levels of protection for these activities, such as textiles and garments. In the 1970s and early 1980s, most East Asian countries attempted to simultaneously develop their domestic automobile industries as well as basic intermediate goods industries, but again with concomitant adjustment in their protection regimes.
<table>
<thead>
<tr>
<th>Processing chain</th>
<th>Unweighted tariff averages</th>
<th>NTM frequency ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>WOOD</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rough logs</td>
<td>27.9</td>
<td>46</td>
</tr>
<tr>
<td>Pulp and shaped wood</td>
<td>24.8</td>
<td>43</td>
</tr>
<tr>
<td>Plywood and paper</td>
<td>39.7</td>
<td>52</td>
</tr>
<tr>
<td>Wood and paper manufacturing</td>
<td>47.8</td>
<td>45</td>
</tr>
<tr>
<td>LEATHER</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hides and skins</td>
<td>15.6</td>
<td>45</td>
</tr>
<tr>
<td>Leather</td>
<td>32.6</td>
<td>41</td>
</tr>
<tr>
<td>Leather articles</td>
<td>45.5</td>
<td>61</td>
</tr>
<tr>
<td>COTTON</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Raw cotton</td>
<td>10.4</td>
<td>45</td>
</tr>
<tr>
<td>Cotton yarn</td>
<td>28.9</td>
<td>60</td>
</tr>
<tr>
<td>Cotton fabrics</td>
<td>56.4</td>
<td>63</td>
</tr>
<tr>
<td>IRON AND STEEL</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Iron ore</td>
<td>8.9</td>
<td>30</td>
</tr>
<tr>
<td>Pig iron</td>
<td>10.4</td>
<td>36</td>
</tr>
<tr>
<td>Ingots and shapes</td>
<td>15.1</td>
<td>45</td>
</tr>
<tr>
<td>Bars and Plates</td>
<td>20.2</td>
<td>50</td>
</tr>
</tbody>
</table>

/a Based on a sample of about 27 developing countries


2.52 Within the region, China and Malaysia have the highest proportion of their exports directed to developing countries, but this reflects partly their special trading relationships with Hong Kong and Singapore, respectively. Developing country markets account for a much smaller fraction of the manufactured exports of the East Asian NICs and the other South East Asian countries. Increasing trade between the South East Asian countries has been an important objective of ASEAN, which includes besides Indonesia, Malaysia, the Philippines and Thailand, two additional members: Singapore and Brunei. Although ASEAN was formed in 1967 the commitment to economic cooperation began with the Bali summit in February 1976. A scheme of Preferential Trading Arrangements was introduced including preferential tariffs, preferential financing terms and procurement by Governments and liberalization of nontariff
While tariff cuts have been quite substantial—in the range of 20 to 25%—, a large list of excluded "sensitive items" has limited the impact of the preferential duty reductions. Consequently, intra-ASEAN trade has expanded only at a moderate pace. Recent attempts to expand the scope of preferential trade concessions, including during the Economic Ministers meeting this past August, have not met with success.

What has been more successful are the mechanisms for promoting extra-ASEAN trade. "ASEAN has established a formal dialogue with third countries and adopted a joint approach to international economic problems and issues. A member country is assigned to be responsible for the ASEAN dialogue with a third country and/or party. As of now the arrangement is: Indonesia: Japan and the EEC; Malaysia: Australia and West Asian countries; Philippines: U.S. and Canada; Singapore: New Zealand; Thailand: UNDP and ESCAP." This approach has strengthened ASEAN's position on trade negotiations with major partners.

Apart from ASEAN, attempts to foster intra-regional trade have been made within the framework of the Bangkok Agreement. The agreement was first concluded in 1975 under the auspices of ESCAP, and in addition to the South East Asian countries, Korea and some South Asian countries, including India and Bangladesh, were signatories to it. Increasing regional trade through mutual trade concessions was an important objective of the initial agreement. But because of conflicting interests with ASEAN, the South East Asian countries withdrew as active members, and the Bangkok Agreement has remained largely dormant.

An additional factor likely to play an increasingly important role in export trends of the Region is the impact of China's entry into world markets. In recent years, China's exports have grown at an even faster rate than the rest of the East Asia region. Although its share in world exports is still small (1.5%), the similarity in composition and direction of China's exports to other East Asian countries has implied greater competition in East Asian and third country markets. Although evidence on market share analysis in key product groups is not available, there is a widespread perception of increasing competition from China.

As noted earlier, China is unique among developing countries in that almost half of its exports are directed towards other developing countries. Currently, more than a third of China's exports are directed to the East Asia Region. Except for Korea, the other countries all show a large trade deficit vis-a-vis China. In 1984, China's trade surplus with East Asian developing countries amounted to an estimated $5.0 billion compared with an overall deficit of $1.7 billion. While China's imports from the industrial countries have

8/ The agreement on Preferential Trading Arrangements was signed by the ASEAN countries on 24 February 1977.

grown rapidly, imports from Southeast Asia have increased at only a modest pace, so that these countries account for only 13% of China's imports. Since China is likely to intensify its export efforts in response to the deterioration in its trade balance, the other East Asian economies, and those of Southeast Asia in particular, are likely to face continuing competition from China in both domestic and export markets.

Summary of Export Prospects and Issues

2.57 The brief review of underlying trends suggests that the export environment facing the East Asian countries may be changing quite fundamentally. The era of strong demand from industrial countries, open market access for manufactured exports and high commodity prices appears to have come to an end. Instead, East Asian countries now face an export environment characterized by:

- slower growth of markets, particularly in the U.S.;
- increasing competition from other developing countries;
- growing protectionism in the form of NTBs in both developed and many developing country markets; and
- depressed commodity prices.

2.58 The structure of exports of East Asian developing countries makes them potentially vulnerable to these trends. In addition to their generally high levels of export dependence, these countries have concentrated on exports where prospects are limited because of more binding NTB's (textiles, garments, footwear), or where there are possibilities of additional NTBs (ceramics, furniture, watches and clocks), or where markets are now more saturated (electronics, chemicals). These concerns need to be tempered by the strong export performance of the East Asian countries not only in the past but also during 1986 and 1987 and the precedent set by the NICs of the region. In particular, the lessons that seem to be emerging are:

- "Trade diplomacy" and "bilateralism" have become the hallmarks of the new trade environment and countries will have to learn how to maximize their benefits in this new setting.

- Nevertheless, a diversified export base and competitiveness can still provide the basis for further export growth. The experience of the NICs is striking, but the other EA countries are only a tier below in this regard.

- The greatest promise for exports appears to be in the area of machinery, transport equipment ancillaries, and other sophisticated assembly products such as telecommunications equipment and electronics. These have been the fastest growing items underlying the surge in exports of the East Asian NICs. An important attribute of these products is that they are less vulnerable to protection because of their diffuse and "producer-good" nature. The relative
industrial sophistication of the East Asia and Pacific countries and the linkages to Japan and the Asian NICs are important assets on which to base their industrial transition.

2.59 In conclusion, despite the more difficult export environment, the still low shares of the East Asian countries in OECD markets and their capacity to compete and respond flexibly to changing market opportunities—demonstrated convincingly by the resurgence of manufactured exports since 1986—all argue that an export oriented strategy remains the most appropriate for continued rapid industrial development. In fact, given the greater competition that they are likely to face and the tighter macroeconomic resource constraints, improvements in efficiency and productivity become all the more imperative. The most important reason for pursuing an outward-oriented strategy is that it provides the best route to developing such a flexible and competitive economy.
3.1 Trade policy has been an important means to influence the pattern and pace of industrialization in the market economies of East Asia. However, by general developing country standards and those of other middle income countries, trade policy distortions rank low in these countries. Furthermore, in the last several years, almost all of the East Asian countries have initiated trade policy reforms, in parallel with their macroeconomic adjustment efforts.

3.2 This chapter reviews broadly the role of trade policy in the region, while Chapter 4 focuses more narrowly on the role of export promotion policies. The first part of this chapter provides a brief overview of objectives and instruments of trade policy. The next section assesses the recent policy reforms and the prevailing trade regimes in the countries of the region. The final section examines the imperatives and outlook for further policy measures, and based on the lessons of past reform attempts as well as policy insights, draws conclusions about appropriate policy design and implementation.

A. Objectives and Instruments of Trade Policy

3.3 Trade policy interventions typically serve a number of objectives. A first objective is the raising of fiscal revenues, particularly through tariffs. A second objective often is to suppress balance of payments disequilibria through regulation of imports. A third and dominant objective is to influence the pace and pattern of industrialization through the protection of domestic industry. A fourth objective, which has been important in the East Asian NICs, is the promotion of exports. These objectives are rarely articulated in a coherent manner, so that the policy aims and effects of the prevailing trade regime are often unclear. Compounding the multiplicity of objectives is the wide array of trade policy instruments. Table 3.1 provides a list of different policy interventions affecting imports, which illustrates how large and varied the range of interventions can be. In practice, though, a few policies are likely to dominate. This would vary from country to country, but the major direct instruments of import control tend to be: import tariffs and surcharges, licensing, quotas and prohibited items. In addition, the structure of indirect taxes has an influence on the overall incentive effects. On the export side, the prevalent instruments are export taxes and subsidies, licensing, bans and quotas.

3.4 Trade policy has been an important vehicle used to influence the pace and pattern of industrial development in the region, as with other developing countries. In recent years, there has been considerable debate on what is the most effective trade strategy to achieve efficient industrial development. Evidence from cross country studies of trade strategy and experiences of individual countries suggest that outward orientation is likely
to lead to better overall economic performance than an inward oriented trade regime. An inward oriented trade strategy is one in which trade and industrial incentives are biased towards production for the domestic market. Such a strategy tends to rely on discretionary interventions, so that over time, an inward oriented trade regime is often characterized by controls, high and variable tariff protection and quantitative restrictions and administrative allocation. Outward orientation, on the other hand, emphasizes linkages to the world economy through exports and enhanced import capacity. An important attribute of this strategy is that it does not bias incentives in favor of the domestic market. Export activities are, therefore, treated at least as profitably as import competing activities. While an important principle of outward orientation is a neutrality of incentives between production for home and export markets, it does not imply an absence of government intervention. In fact, Japan and some of the East Asian NICs have relied heavily on government intervention to achieve export market orientation through export promotion policies.

3.5 While the phasing and relative emphasis placed on policies of export promotion and import liberalization can be open to debate, in the end, an outward oriented policy necessarily implies an undistorted import trade regime. This is particularly true in the present environment of countervailing actions, where there are clear limits on the ability to use aggressive export promotion measures as a compensating device. Reform of the import protecting regime, therefore provides a more direct route to achieving the objectives of an outward oriented trade strategy. In particular, reducing and rationalizing import protection leads to: (i) moderation of the anti-export bias resulting from import protection and overvaluation of the exchange rate; (ii) a more efficient allocation of resources through a closer alignment of domestic prices with international opportunity costs; (iii) reducing rent-seeking and unproductive activities associated with controls; and (iv) exposure of domestic firms to the positive effects of world competition.

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<table>
<thead>
<tr>
<th>Table 3.1: LIST OF IMPORT CONTROL MEASURES</th>
</tr>
</thead>
</table>

I. Fiscal Charges

A. Tariff Charges
   1. Customs duties
   2. Fiscal duties

B. Additional Fiscal Charges
   1. Customs surcharge and surtax
   2. Special tax on beverages, tobacco and matches
   3. Special tax on petroleum products
   4. Excise duties on other products
   5. Stamp tax
   6. Countervailing duties
   7. Consular invoice fee
   8. License fee

C. Service Charges with Equivalent Effect
   1. Statistical tax
   2. Tax on transport facilities

D. Sales Tax Levied at Importation
   1. Value added tax
   2. Turnover tax
   3. Production tax
   4. Consumption tax

II. Other Controls

A. Quantitative Restrictions
   1. Restrictive licensing
   2. Quotas
   3. Prohibition

B. Money and Finance Measures
   1. Advanced import deposit
   2. Multiple exchange rates
   3. Restrictive foreign exchange allocation
   4. Tax on foreign exchange transactions

C. Customs Valuation in Form of Fixed Unit Values

D. State Trading Monopoly
   1. Single channel for imports
   2. Compulsory national insurance
   3. Compulsory national transport

E. Preferential Trading Arrangements
   1. Multilateral preferential tariff arrangements
   2. Bilateral preferential tariff arrangements
   3. Preferential arrangements n.e.s.

F. Special Entry Procedures

Source: UNCTAD, Trade Information System
B. Central Role of the Real Exchange Rate

3.6 In addition to specific trade and industrial policy interventions, an important determinant of the overall policy environment is the real exchange rate. The real exchange rate determines the relative profitability of export and import-competing goods vis-a-vis non-traded goods, and hence influences the allocation of domestic resources. An overvalued real exchange rate will penalize traded goods production, and those of export activities in particular. Furthermore, in markets where products are differentiated, the real exchange rate determines the cost, and, therefore, the competitiveness, of exports. In view of its importance, this section reviews the role of the real exchange rate and the recent experience of the East Asian developing countries, as well as the critical issues of real exchange rate management, before turning to the more specific analysis of import protection policies.

3.7 There is a large and growing body of evidence drawing from various country experiences that the exchange rate environment has a powerful influence on export performance and trade flows. For instance, a recent investigation of 24 developing countries for the 1973-78 period, concluded than an appreciation of the exchange rate in real terms led to declines in export market shares in world trade as well as to increases in the share of imports in GDP, unless offset by measures of export promotion or import protection. The responsiveness of exports to the exchange rate changes is corroborated by many other cross-country studies, as well as by time-series estimates for different countries. Empirical estimates indicate that the elasticity of exports with respect to the exchange rate is substantially greater than unity, suggesting that exchange rate policy can be a powerful instrument for promoting export growth.

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3/ The real exchange rate is an index of relative domestic and world prices expressed in terms of a common currency. Since there are a variety of such relative prices, there are in principle several different definitions of the real exchange rate. Two of these are more common. The first is the ratio of traded goods prices domestically compared with traded goods prices in partner or competitor countries. This is therefore a measure of international price competitiveness and is sometimes called the Purchasing Power Parity (PPP) real exchange rate (see Table 3.2). The second, which is important both from the point of view of the domestic incentive structure and macroeconomic balance, is the price of traded vis-a-vis the price of nontraded goods.


5/ For instance in the study by R.M. Bautista, "Exchange Rate Changes and LDC Export Performance under Generalized Currency Floating," Weltwirtschaftliches Archiv, 117:443-468, estimates of export elasticity with respect to the real exchange rate which were significant, range between 1.3 to 3.3 with a median of 2.9.
3.8 An additional conclusion of many such studies is that variability of the exchange rate in real terms will also have an adverse effect on export performance. Among developing countries, the newly-industrializing countries of East Asia have been at the forefront in both maintaining the stability of their exchange rates in real terms and progressively improving their export competitiveness through exchange rate adjustments. It is not coincidental that this group has achieved the most rapid growth of exports, particularly for manufactured goods, among all developing countries.

3.9 A competitive exchange rate strengthens profitability in both export and import competing sectors, while discouraging imports and excess investments in nontradeable segments of the economy such as construction and services. An appropriate exchange rate policy, therefore, provides the basis for efficient export promotion and import substitution. An overvalued exchange rate, on the other hand, results not only in an erosion of incentives for producing exports and import-competing goods, but over time, is likely to result in a bias against exports vis-à-vis import competing goods as well. This is because an overvalued exchange will result in level of imports that is excessive. Without exchange rate adjustment, import curbs are required to maintain external balance. This, however, results in higher costs for import competing goods and penalizes export activities which must now meet the higher costs for their inputs.

3.10 Korea achieved the best record in maintaining a competitive and stable real exchange rate, within the developing countries of the region. While the four Southeast Asian countries generally avoided the gross exchange rate misalignment which frequently troubled the Latin American and African countries, exchange rate overvaluation was not uncommon. In the case of the Philippines and Thailand this was the result of inflexible and unresponsive exchange rate management as the terms of trade deteriorated cumulatively, beginning with the first oil price shock; in the case of Malaysia and Indonesia, the oil price bonanza led during the 1970s and early 1980s to a "Dutch disease" syndrome—i.e., the heavy exports of oil led to an appreciation of the exchange rate for manufactured exports, making production of manufactured goods for exports relatively unprofitable and uncompetitive. With the weakening of oil and non-oil commodity prices, the exchange rate in these two countries has been allowed to respond by depreciating in real terms. In particular, Indonesia undertook two large devaluations, in 1983 and more recently in September 1986, which have achieved substantial real depreciation. Real exchange rate trends of the East Asian countries have also been influenced by recent international currency movements because of the close links of these currencies with the dollar. Thus, there was a tendency towards real appreciation in the early 1980s partly as a result of the strengthening of the dollar. More recently, the sharp decline of the dollar in 1986 has resulted in large real depreciation for all of the countries, which has improved their relative competitiveness, particularly vis-à-vis Japan and Europe (see Table 3.2).

6/ See Mohsin Khan (1985) for a comparative view of exchange rate responses in developing countries.
3.11 There can be little doubt that the management of the exchange rate has been a crucial factor for the successful East Asian exporters. At the same time, the fact that some of the East Asian countries, especially the Philippines, have let their exchange rates repeatedly become seriously overvalued contributed to their economic difficulties, including limited success in fostering export development. However, two questions may be asked: first, is the exchange rate a sufficient tool for effective management of trade; and second, should the exchange rate be undervalued deliberately to support rapid export growth.

3.12 On the first question, whether the exchange rate is a sufficient tool, the answer in general has to be no. In an environment where there are few tax and quantitative distortions to trade and production, maintenance of an appropriate exchange rate will indeed be a powerful instrument on its own ensuring efficient growth of the tradeable goods sector; however, where import tariffs and nontariff barriers are prevalent, the exchange rate will not deal with the prevailing anti-export bias, or with distortions among sectors,

**Table 3.2: REAL EXCHANGE RATE TRENDS /a**

(1980 = 100)

<table>
<thead>
<tr>
<th></th>
<th>Korea</th>
<th>Indonesia</th>
<th>Malaysia</th>
<th>Philippines</th>
<th>Thailand</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>97.2</td>
<td>-</td>
<td>84.0</td>
<td>116.5</td>
<td>97.3</td>
</tr>
<tr>
<td>1971</td>
<td>103.6</td>
<td>139.7</td>
<td>84.5</td>
<td>117.1</td>
<td>101.9</td>
</tr>
<tr>
<td>1972</td>
<td>112.8</td>
<td>126.0</td>
<td>84.5</td>
<td>121.7</td>
<td>105.5</td>
</tr>
<tr>
<td>1973</td>
<td>127.5</td>
<td>102.9</td>
<td>80.8</td>
<td>120.4</td>
<td>103.9</td>
</tr>
<tr>
<td>1974</td>
<td>108.8</td>
<td>102.7</td>
<td>81.3</td>
<td>97.8</td>
<td>94.0</td>
</tr>
<tr>
<td>1975</td>
<td>110.3</td>
<td>100.6</td>
<td>82.2</td>
<td>105.8</td>
<td>97.7</td>
</tr>
<tr>
<td>1976</td>
<td>102.2</td>
<td>92.0</td>
<td>88.7</td>
<td>99.4</td>
<td>97.9</td>
</tr>
<tr>
<td>1977</td>
<td>102.4</td>
<td>89.3</td>
<td>90.7</td>
<td>101.3</td>
<td>100.9</td>
</tr>
<tr>
<td>1978</td>
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<td>109.1</td>
<td>95.5</td>
<td>111.8</td>
<td>108.9</td>
</tr>
<tr>
<td>1979</td>
<td>97.6</td>
<td>111.2</td>
<td>94.4</td>
<td>102.3</td>
<td>106.9</td>
</tr>
<tr>
<td>1980</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1981</td>
<td>97.2</td>
<td>95.0</td>
<td>98.1</td>
<td>94.3</td>
<td>95.6</td>
</tr>
<tr>
<td>1982</td>
<td>97.2</td>
<td>86.9</td>
<td>89.9</td>
<td>88.8</td>
<td>96.9</td>
</tr>
<tr>
<td>1983</td>
<td>103.4</td>
<td>100.6</td>
<td>86.2</td>
<td>97.9</td>
<td>94.4</td>
</tr>
<tr>
<td>1984</td>
<td>106.6</td>
<td>104.5</td>
<td>82.9</td>
<td>87.3</td>
<td>97.5</td>
</tr>
<tr>
<td>1985</td>
<td>113.5</td>
<td>107.0</td>
<td>86.9</td>
<td>83.6</td>
<td>111.4</td>
</tr>
<tr>
<td>1986(p)</td>
<td>130.5</td>
<td>132.5</td>
<td>105.2</td>
<td>104.4</td>
<td>129.4</td>
</tr>
</tbody>
</table>

/a 1980 export weights; nominal exchange rate movements adjusted for relative WPI inflation, except for Malaysia where it is relative CPI inflation.

Source: International Financial Statistics Database, IMF.
resulting from distorted incentives between agriculture and industry; and, of course, exchange rate management will not help eradicate intra-industry distortions. Complementary measures designed to reduce or offset the tax and non-tax distortions are therefore required if exchange rate management is to have the desired effect of supporting efficient export development. Of course, what is relevant here is the real exchange rate; therefore, exchange rate management must be seen broadly as including the whole array of macro-economic policy instruments which have a bearing on the determination of the real exchange rate.

3.13 On the second question, whether undervaluation of the exchange rate is appropriate in support of export development, two cases might be thought to provide the right environment for such a policy: first, the case of "Dutch disease"—here the exchange rate for the non-mineral export sector is overvalued by the existence of a strong, albeit temporary mineral exports sector; second, where it is believed that export industries (and import substitution industries) as a whole are "infant" industries which need support and, in effect, protection during "take-off" to permit their establishment and ability to compete eventually with other countries' export industries.

3.14 For the case of the "Dutch-disease" syndrome, it would be appropriate to maintain the exchange rate at an undervalued level by retaining some of the mineral sector income (or rather wealth) generated for the government and investing the resulting government revenues in income earning assets abroad. This would be particularly appropriate where the domestic supply elasticities are low and absorptive capacity for increased investments financed by mineral wealth is limited. Such an approach during the 1970s and early 1980s might have helped the oil-exporting countries in East Asia, especially Malaysia and Indonesia, provide the right incentives for developing their traded goods sectors, in support of efficient export development and import substitution.

3.15 Opting for an undervalued exchange rate on general grounds of "infant" industry protection is a rather blunt instrument, to the extent that infant industries are not likely to be the full set of tradeable goods production. Pervasive undervaluation would result in overprotection of some industrial activities which are not likely to ever become efficient and viable components of the country's industrial structure. Also, there is the danger of competitive devaluation among developing country competitors, where each seeks to increase its export market share by undervaluation relative to the others. Cumulatively, such undervaluation could result in considerable welfare losses to developing countries as a group.

3.16 Against these cautionary arguments one can, however, marshal a number of reasons why it may be preferable to err on the side of undervaluation: On balance, there are quite probably significant externalities associated with a rapidly growing tradeable goods sector (see Hsia, 1981; Feder, 1972); second, most countries in the region, with the exception of Korea, have experienced lengthy episodes of exchange rate overvaluation in the past, thus underinvesting in knowledge about external markets; third, the science of estimating long run "equilibrium" exchange rates is weak, making it difficult to establish clear guidelines as to what is the "appropriate"
exchange rate at any particular time; finally, an undervalued exchange rate will make it easier to liberalize trade policy, since the pressures on the balance of payments will be reduced and thus one of the common arguments for protection—limiting imports—will not apply with equal force. The argument made here is not for a substantial degree of undervaluation; this is not necessary, as the case of Korea has shown, provided other measures in support of exports are effectively marshalled. Rather, the main point to be made is that erring on the side of undervaluation will be the most effective way of avoiding falling into the all-too-common trap of overvaluation in a rapidly changing international environment.

C. Nature of Protection Regime

Background

3.17 The 1970s were characterized by a shift towards higher levels of protection in almost all of the major market economies of East Asia. During this period, the countries of the region maintained high rates of investment, financed through the rise in oil and commodity earnings, as well as additional external borrowing and direct foreign investment. Much of this investment was aimed at creating new capacity in the industrial sector. Although some of it was directed at export industries, the primary motivation was to further the process of import substitution both in traditional manufactures and in new areas such as intermediate goods and transport equipment. This phase of import substituting investment was supported by an increased recourse to protective barriers, which raised the overall levels of protection. Moreover, since adjustments in tariffs and other barriers were often in response to specific investments, there was a tendency towards growing variance in the structure of protection.

3.18 For instance, available estimates of effective rates of protection (ERPs) for Thailand indicate that the overall average rose more than twofold between 1971-1980, with consumer goods and transport equipment accounting for much of the increase, and there was a substantial increase in the dispersion of rates (World Bank, 1986n). In Korea too, there was a shift towards greater protection following the heavy and chemical industry (HCI) push and the additional protection provided to agriculture and several consumer goods. As a result, effective protection rates rose towards the end of the decade and available ERP estimates for 1978 considerably exceed those of 1968. There was also considerable dispersion in ERPs with the highest levels of protection afforded to transport, consumer durables, machinery and heavy intermediate goods. However, as Korea maintained its system of export incentives, the trade regime was both outward-looking on the export side and restrictive on the import side (World Bank, 1986i; Leipziger and Petri, 1986). In the Philippines, there was a similar trend towards high and more variable levels of protection. The Government introduced a selective duty-drawback system and bonded warehouses in the early 1970s to partially offset the effects of high import protection. However, nontraditional exports remained an enclave activity with few linkages to the rest of the economy (World Bank, 1987b). While Indonesia preserved many of the gains of the dramatic trade liberalization of 1966, trade and domestic policies during the 1970s cumulatively led
to a more protected regime for the large investments financed by the oil boom of the 1970s (World Bank 1987a). Only in Malaysia—which already had a fairly liberal trade regime at independence—did protection remain at moderate levels although there are notable exceptions (World Bank, 1986k). Traditional manufacturing sectors such as food, wood products and textiles continued to receive substantial though fluctuating protection, but the emphasis was shifted to transport equipment, machinery, fabricated metal products and industrial chemicals, reflecting changes in the investment and production structure.

Trade Liberalization in the 1980s

3.19 By the turn of the decade, there was increasing recognition within the countries of the detrimental effects of the distorted protective structure on efficient industrial development. An added momentum was provided by the onset of the second oil-price shock, the world economic recession, the surge in interest rates and the progressive decline in commodity prices. Reforms were accordingly initiated in virtually all of the countries to improve the protective structure. The Bank maintained a close policy dialogue with governments on these reforms, and provided support through SAL lending for trade reform in Korea, the Philippines and Thailand. More recently, in Indonesia, the Bank has supported the new trade policy initiatives through a Trade Policy Adjustment Loan. The generalized attempts at trade reform in the region since 1980 is quite striking, although the timing and nature of reforms have varied depending on the circumstances including the controls that were in place.

3.20 Table 3.3 summarizes the major elements of the trade liberalization programs undertaken in recent years. Trade liberalization in Korea has taken the form of import control relaxation and tariff reduction. The Government began in the late 1970s to remove direct restrictions and to move a large number of items to the so-called automatic approval (AA) list. As of 1980, 31.4% of imported goods were not on this list, i.e., were subject to restriction. This proportion was reduced to 25.3% in 1981, and as part of a structural adjustment program, further reduced to 12.3% by 1985. The ultimate objective is to reduce the number of items not on the automatic-approval list to 4.8% by 1988. Statutory tariffs, which had increased substantially in the late 1960s, were also concurrently reduced from an arithmetic average of 31.7% in 1982 to 21.9% in 1985. In addition to reducing tariffs, the current policy aims to restrict and reduce industry-specific use of tariff exemptions or rebates as a tool of industrial policy. An important attribute of the trade reform package was the complementary measures introduced. In particular, the Government made significant progress in reducing the degree of macroeconomic imbalance and maintaining a flexible exchange rate policy. There was also a selective liberalization of foreign investment controls and some reductions in interventions in the financial sector (World Bank, 1986i).

3.21 The trade reform measures initiated by Thailand in 1982 focussed almost exclusively on tariff reductions as this was the primary instrument of trade policy. Although the tariff reform program of 1982 was substantial in scope and magnitude, it never fully took effect, initially because of a general import surcharge and then because of offsetting tariff adjustments in
Table 3.3: SUMMARY OF RECENT AND ONGOING TRADE POLICY REFORMS

<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
<th>Major reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>1985</td>
<td>• Average nominal tariff level reduced from 28% to 23% and ceiling reduced from 225% to 60%.</td>
</tr>
<tr>
<td></td>
<td>1986-87</td>
<td>• Improved system of duty drawback and free access to imports for exporters.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Import licenses removed or relaxed for 37% of items previously restricted.</td>
</tr>
<tr>
<td>Korea</td>
<td>1978-85</td>
<td>• Average nominal tariff reduced from 41% to 21%.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Imports not automatically approved reduced from 31% (1980) to 12% (1985).</td>
</tr>
<tr>
<td></td>
<td>1986-88</td>
<td>• Average nominal tariff level to be further reduced to 18%.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Imports not on automatic approval list to be further reduced to 5%.</td>
</tr>
<tr>
<td>Philippines</td>
<td>1980-83</td>
<td>• Average nominal tariff level reduced from 41% to 28% and land reduced from 0-100% to 10-50%.</td>
</tr>
<tr>
<td></td>
<td>1985</td>
<td>• 921 consumer items liberalized but most still subject to import approval.</td>
</tr>
<tr>
<td></td>
<td>1986</td>
<td>• Indirect tax reform completed to reduce discriminatory effect on imports.</td>
</tr>
<tr>
<td></td>
<td>1986-85</td>
<td>• 936 items or 62% of items subject to import approval completely liberalized.</td>
</tr>
<tr>
<td>Thailand</td>
<td>1982</td>
<td>• Average nominal tariffs reduced and ceiling set at 60%, but followed shortly by general import surcharge.</td>
</tr>
<tr>
<td></td>
<td>1984-85</td>
<td>• Import surcharge dropped, but nominal tariffs raised within the 60% ceiling.</td>
</tr>
</tbody>
</table>
April 1985. The main constraint was the need for generating fiscal revenues to cover a growing fiscal deficit from tariff collections. As a result, the average nominal level of protection is actually higher now than the pre-1982 period. However, the tariff reforms did achieve an improvement in the structure of protection because of the narrowing of rates. In manufacturing—which was the primary target of the reforms—there has been both a reduction in the level and dispersion of protection rates. Also, in contrast to the marginal changes in the average levels of protection, the revenue raising effects of the tariff structure increased by 30%.

3.22 A five year trade reform program was initiated in the Philippines in 1980, supported by two World Bank Structural Adjustment Loans. The reforms planned included: tariff reform, removal of import restrictions, removal of the protective elements of the tax system, and incentives to strengthen export performance. Several measures were adopted towards this end between 1980 and 1982. In particular, the average nominal tariff level was reduced from 41% to 28%, and the dispersion in rates narrowed from 0-100% in 1980 to 10-50% with a few exceptions. A large number of consumer goods were also removed from the banned import list. But the subsequent steps of trade reform, including the planned liberalization of items subject to import restrictions, was aborted with the onset of severe balance of payments difficulties in 1983. In fact, the number of items subject to prior approval by the Government increased and the system of approval of imports became more restrictive, neutralizing the effects of the earlier reforms. At the peak of the crisis, all imports were governed by an extremely rigid system of foreign exchange rationing. By 1984, the trade reform program was largely abandoned, as the Government grappled with the larger macroeconomic problems. The large external shocks of the early 1980s were an important contributing factor to the balance of payments crisis and the arrest of the liberalization attempts of 1980-1982. But what was also important was that macroeconomic policies including exchange rate management were inconsistent both with the adjustment called for by the external shocks and with the trade liberalization strategy.

3.23 The liberalization process was resumed in 1986, following a major stabilization program which restored external and domestic balance but with a substantial fall in the level of output and income. Of the 1,232 import items that were to be previously liberalized, 936 items were liberalized during 1986. Indirect tax reforms introduced recently have also eliminated most of the discriminatory aspects of the domestic tax structure against imports. Unlike the previous liberalization attempt, the macroeconomic policy stance is now more restrictive keeping domestic and import demand in check. However, the depreciation of the exchange rate, which would have supported the liberalization process, has so far not taken place given the underlying trends in demand conditions and capital flows. Additional difficulties in making the trade reform sustainable are the depressed level of domestic demand, low levels of capacity utilization across the sector and financial difficulties of firms in virtually every branch of industry. While the challenge of

sustaining the trade reforms remain, the current liberalization steps, which build on the process started in 1980-82, will substantially moderate the long-standing antiexport bias and distortions stemming from the trade regime and will open the economy to a far greater degree of international competition.

3.24 In Indonesia, although the growing distortions stemming from the trade regime were recognized for some time, emphasis on creation of domestic capacity in key industries and domestic pressure groups preempted any significant move towards liberalization. The emphasis of policy was instead on macroeconomic adjustment. Following the first large oil price increase in 1981-82, the Government adopted a stabilization program that included more restrictive fiscal and monetary policies and a major devaluation followed by more flexible exchange rate management. At the same time there was a shift towards increased import curbs in the form of importer licensing. By 1984, Indonesia's import regime was characterized by high and disparate tariff rates (average of 33% with a range between 0% and 225%) coupled with non-tariff restrictions that covered a fifth of all import categories. This was accordingly reflected in high and variable rates of effective protection. The first signal towards easing of import curbs came in March 1985, when the Government announced an across-the-board reduction in the range and level of nominal tariffs. The tariff ceiling was reduced from 225% to 60%, with tariffs for most products ranging from 5% to 35%. The full benefits of this tariff liberalization program were not realized because of the existence and continued proliferation of license restrictions. Even so, the fact that 80% of the import categories were not under license and given the nondiscretionary nature of the adjustment, the tariff reform resulted in an unambiguous improvement in the trade regime.

3.25 The second measure to reduce import controls was administrative, through a major overhaul of the customs system and procedures, by placing the job of certifying imports and assessing tariffs in the hands of private surveyors (SGS). Third, on May 6, 1986, the Government announced a package of measures designed to provide internationally-priced inputs to exporters. All of these steps helped to reduce the cost structure of Indonesian industry. However, they did not address the fundamental distortions arising from the high and disparate levels of protection provided by import license restrictions. By the end of 1985, it is estimated that some 1,484 CCCN items (28% of the total) were restricted to holders of an approved-importer license. These items accounted for about 26% of total import value and 32% of domestic value added. In addition, there were 24 products under import ban (including automobiles, motorcycles, TVs and radios). The import policy reforms announced on October 25, 1986 and January 15, 1987 represent a fundamental shift in the direction of Indonesia's import policy, away from import license restrictions toward tariff-only protection. In all, import restrictions were removed or relaxed on 548 items, accounting for 37% of all items and 60% of total import value previously restricted. Moreover, the share of value added protected by restrictive import licensing in the manufacturing sector declined from about 60% before October 25 to about 40% after January 15.

3.26 Of all the countries in the region, only in Malaysia were there no significant changes in the trade regime in the 1980s, although as noted earlier, trade distortions had been more muted.
Summary Assessment of Trade Liberalization Efforts

3.27 Of the recent attempts at trade policy reform, Korea's efforts have clearly been the most successful in moving towards steady and sustainable reform. Several attributes of the trade reform program in Korea are worth noting.

3.28 First, strong export promotion measures preceded and complemented the trade liberalization program, providing an important cushion in the balance of payments. Second, because of the emphasis on export competition, and the pre-announcement as well as the gradual pace of liberalization, domestic firms were in many instances already competitive at the time of liberalization, which may partly explain why imports of liberalized items have increased at a moderate pace. Altogether, the trade liberalization program will have spanned ten years from its inception in 1978. Third, reducing macroeconomic balance and maintaining competitiveness through flexible exchange rate management were important parallel policy objectives, and have also kept balance of pressures in check. In many cases, there can be significant "water" in the tariff, so that domestic prices are lower than would result from world prices and tariff rate, rendering the nominal tariff redundant. Finally, not only did the Government steadfastly adhere to the announced liberalization schedule, even in 1985 when export performance weakened and the balance of payments widened substantially, but offsetting tariff increases have been used only sparsely. While further progress is still possible in increasing the import regime's transparency, Korea has made tangible and sustained progress during the 1980s in opening its markets to foreign competition.

3.29 In contrast, the trade liberalization programs of Thailand and the Philippines in the early 1980s did not include any strong export promotion measures. Nor was there a complementary and consistent macroeconomic policy framework as in the case of Korea. In both countries, the real exchange rate actually appreciated during the liberalization periods. A major impediment to tariff reform in Thailand was the weakness in revenue generation from other fiscal sources. It was revenue more than balance of payments considerations that posed the major macroeconomic constraint to planned tariff reductions. As a result, despite genuine attempts at major trade reform in the early 1980s, only a modest improvement has been achieved in the level and structure of protection in Thailand.

3.30 In the Philippines, the external shocks of the early 1980s made the restoration of macroeconomic balance even more difficult. The inability to respond quickly and flexibly on the macroeconomic side eventually undermined the trade liberalization program because of balance of payments pressures. The initial steps of trade liberalization, including the tariff reductions, were neutralized by the increase and tightening of import restrictions. Nevertheless, the liberalization episode of 1980-82 provided the framework for the eventual resumption of trade liberalization in 1986. As a result of the cumulative actions of 1980-82 and the present liberalization efforts, the Philippine economy is now more open and transparent in its trade regime than it has been in the last three decades. The main issue now is how to sustain the trade reforms. Because of the stabilization program, there is not the
kind of macroeconomic imbalance that characterized the earlier liberalization
episode. The current situation does underline, though, the difficulties of
combining trade liberalization with a stabilization program. The severe
macroeconomic adjustment of the last three years has had a strong impact on
output and employment and could make the adjustment costs of trade liberaliza-
tion more acute. On the other hand, many of the weaker firms were forced to
close prior to the recent liberalization because of the depressed economic
climate. There are two additional complicating factors. First, while an
exchange rate depreciation could have had a general ameliorating effect by
strengthening the profitability of export industries and cushioning the
adverse effect on import competing industries, in the present circumstances,
the exchange rate is subject to only indirect policy influence. Second, in
the absence of effective and timely financial workout systems, financial
difficulties could prevent domestic firms from responding to international
competition.

3.31 In Indonesia, unlike the Philippines, there has been both a timely
macroeconomic response to external shocks and appropriate macroeconomic
adjustments prior to liberalization. Since 1983, the Government has responded
to the changing external situation through cautionary fiscal and monetary
policies and more flexible exchange rate management. It is also noteworthy
that the liberalization of import restrictions announced in October was pre-
ceded by a large exchange rate adjustment. Like the Philippines, though, the
initial tariff reductions were undermined by the intensification of nontariff
import restrictions. However, as the new tariff regime remains in place, the
eventual liberalization of import restrictions will result in an overall lower
and more uniform level of import protection, just as in the case of the
Philippines. Although the stabilization program underway and depressed
domestic demand will make adjustment to trade liberalization more difficult,
the macroeconomic adjustments are not as severe as in the case of the
Philippines, because of prior actions. The pace of trade liberalization is
also more gradual and the exchange rate is being used more actively to support
the trade liberalization process. Finally, the Government has sought to
accelerate export growth by eliminating import controls and improving the
system of duty exemptions beginning last May for a large segment of
exporters. Although the scheme is still modest and the level of nontradi-
tional exports relatively small, strong export growth will be an important
prerequisite for sustained liberalization.

Existing Structure of Protection

3.32 Tariffs. There are many measurement problems that arise when
comparing tariff policies across countries. First, since tariff policy is
usually reflected in summary statistics, there are problems of aggregation and
weighting, both for nominal and effective tariff rates. Comparability is
further complicated by the fact that it is not just the level but the disper-
sion and structure of tariffs that are important in determining the impact on
resource allocation and efficiency. Third, in many cases, there can be
significant "water in the tariff" so that domestic prices are lower than what
would result from world prices and the tariff rate, rendering the nominal
tariff redundant. Finally, tariffs are only one instrument comprising the
overall trade regime. Nevertheless, a great deal can be gleaned from careful
scrutiny of the nominal tariff structure about the protection regime. In examining nominal tariffs, three factors are relevant. First is the level of tariffs. Generally, the higher the average level of nominal tariffs the more restrictive will be the protection regime, and the greater the degree of antiexport bias. Second, the dispersion of the tariff structure will be important in reflecting the degree to which it is likely to create allocative distortions. The third relevant aspect of the tariff structure is the degree of escalation, i.e., to what extent are tariffs on final goods higher than intermediates and similarly intermediate vis-a-vis raw materials. The higher the degree of escalation, the higher will be the effective protection provided to final goods industries.

3.33 As described above, most of the countries of the region have undertaken significant tariff liberalization programs in recent years. As a result of these reforms, the level and dispersion of nominal tariffs were substantially reduced in Korea, Philippines and Indonesia, and partially in the case of Thailand. These recent changes and the prevailing structure of nominal protection are summarized in Tables 3.4 and 3.5. In Korea, average tariff rates have been halved and the variance reduced through a narrowing in the range of rates. The tariff liberalization program set by the Government envisages a further reduction of the average nominal rate to 18% by 1988 and a narrowing of the range to 0-30%. A similar large reduction in the level and range of nominal tariffs was achieved in the Philippines and Indonesia, although initially the reductions were partly offset by prevailing and new

<table>
<thead>
<tr>
<th>Date of reform</th>
<th>Resulting average tariff level</th>
<th>Range</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>April 1985</td>
<td>1980 = 28%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1985 = 23%</td>
</tr>
<tr>
<td>Korea</td>
<td>1978-82 (SAL I &amp; II)</td>
<td>1978 = 41%</td>
</tr>
<tr>
<td></td>
<td>1984-88</td>
<td>1982 = 25%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1985 = 22%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1988 = 18%</td>
</tr>
<tr>
<td>Philippines</td>
<td>1980-83 (SAL I &amp; II)</td>
<td>1980 = 43%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1983 = 28%</td>
</tr>
<tr>
<td>Thailand</td>
<td>1982 (SAL I)</td>
<td>1981 = 31%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1984 = 30%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1985 = 34%</td>
</tr>
</tbody>
</table>

/a Under half of one percent of imports still have tariffs above this range.
/b 33 tariff lines fall below 10%.
/c 4.6% of tariff items remain above 60%.

Source: World Bank Reports.
nontariff restrictions. In Thailand, the reduction in nominal tariffs was reversed but there has been a significant narrowing of rates. Also, unlike the other countries, Thailand had fewer nontariff protective barriers in place at the time of tariff liberalization. In Malaysia, apart from a few adjustments, notably for beverages and tobacco, the level and structure of nominal tariffs have remained largely unchanged. The overall level and dispersion of nominal tariff protection remains the lowest in Malaysia among the East Asia and Pacific countries.

Table 3.5 NOMINAL TARIFF STRUCTURE AND CHANGES FOR EAST ASIAN COUNTRIES
(percent share)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tariff Range</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>0-10</td>
<td>22.5</td>
<td>24.4</td>
<td>32.7</td>
<td>52.8</td>
<td>--</td>
<td>--</td>
<td>23.5</td>
<td>33.4</td>
<td>34.2</td>
<td>17.3</td>
</tr>
<tr>
<td>11-30</td>
<td>57.2</td>
<td>59.1</td>
<td>33.3</td>
<td>37.1</td>
<td>--</td>
<td>--</td>
<td>29.8</td>
<td>40.9</td>
<td>39.4</td>
<td>34.8</td>
</tr>
<tr>
<td>31-60</td>
<td>19.0</td>
<td>15.5</td>
<td>25.9</td>
<td>9.5</td>
<td>--</td>
<td>--</td>
<td>15.8</td>
<td>20.3</td>
<td>13.8</td>
<td>43.4</td>
</tr>
<tr>
<td>&gt;60</td>
<td>1.3</td>
<td>1.0</td>
<td>8.2</td>
<td>0.5</td>
<td>--</td>
<td>--</td>
<td>31.0</td>
<td>5.3</td>
<td>12.5</td>
<td>4.6</td>
</tr>
<tr>
<td>Average Nominal</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tariff (unweighted)</td>
<td>25.0</td>
<td>21.9</td>
<td>28.0</td>
<td>23.0</td>
<td>11.6</td>
<td>13.6</td>
<td>43.0</td>
<td>29.0</td>
<td>31.0</td>
<td>34.0</td>
</tr>
</tbody>
</table>

Source: World Bank Reports and IMG Consultants, Malaysian Industrial Policies Studies Project

3.34 Following these recent adjustments, the general levels and structure of nominal tariff protection in the region compare even more favorably with other developing countries though still higher and more skewed than industrial countries. Average nominal tariff levels in the market economies of the region are in the 15-34% range compared with 137% for India, 37% for Turkey and 25% for Mexico. The dispersion of rates are also generally lower. The available evidence on escalation in the nominal tariff structure indicates that Korea and Malaysia have the most uniform tariff structure by levels of industrial processing within the region, while Indonesia, Philippines and Thailand all have considerable escalation in their tariff structure. The structure of nominal protection in these latter three countries also reflects the sum of many ad hoc adjustments, often in response to individual cases, leading to a complex and often inconsistent overall protective structure.

3.35 The preceding observations on tariff structure were based on legal tariff rates. The actual impact of nominal tariffs on the incentive regime
will be influenced by exemptions allowed from import duties and the degree of smuggling. Although evidence is scanty, smuggling is believed to be pervasive in Thailand, Philippines and Indonesia, particularly for many items where nominal tariffs are high or there are other restrictive barriers. This suggests that high tariffs are unlikely to be effective for many goods in these countries. Actual tariff rates may also differ from legal rates because of exemptions. Two kinds of exemptions are important in this respect. The first is exemptions or rebates to exporters. Such exemptions, which are large for instance in Korea, would tend to offset the aggregate anti-export bias created by the protective structure. Another form of exemptions is duty exemptions on machinery and inputs—often provided as an investment incentive. This is quite prevalent in Malaysia and to a lesser extent in Thailand and Indonesia. Such exemptions raise effective rates of protection.

3.36 Table 3.6 gives the actual level of trade taxes collected as a percent of imports and exports, as well as the relative importance of trade taxes in fiscal revenues. In all countries, actual collections are much lower than the statutory rates. In Korea, the main factor is the duty-drawback system for direct and indirect exporters, whereas in other countries it reflects other kinds of exemptions. Table 3.5 also highlights the importance of trade taxes for fiscal revenues in Thailand, the Philippines and Malaysia compared to the lesser significance of such taxes in Korea and Indonesia. Export duties are the most significant in Malaysia, followed by Thailand and Indonesia. But in all cases such duties are on primary products rather than on the manufacturing sector.

Table 3.6: SHARES OF ACTUAL DUTIES COLLECTED (percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Import Duties</th>
<th>Export Duties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>As share</td>
<td>As share</td>
</tr>
<tr>
<td></td>
<td>of total</td>
<td>of total</td>
</tr>
<tr>
<td></td>
<td>imports</td>
<td>tax revenue</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Korea</td>
<td>7.8</td>
<td>17.3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>7.8</td>
<td>16.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>11.0</td>
<td>29.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>12.5</td>
<td>22.8</td>
</tr>
</tbody>
</table>

Source: Government Finance Statistics Yearbook and IFS.

3.37 Indirect Taxes. In the analysis of the trade regime, attention tends to be focussed on tariffs and import restrictions. However, the indirect tax system can also have an important influence on the incentive structure through: (a) variability of rates; (b) cascading effects through turnover taxes; and (c) discrimination against imports. The use of indirect taxes to discriminate against imports (i.e., akin to tariffs) was practiced in
the Philippines and to a lesser extent in Thailand, but this has been largely eliminated in both countries as a result of recent tax reforms. There has been little analysis undertaken for the countries of the region relating tariffs to the domestic tax structure to determine overall incentive effects. In general, the domestic tax structure appears to be less important than trade interventions in terms of influence on the incentive structure. Although variability and cascading effects are found in the domestic tax structure of all countries of the region, tax rates tend to be only a fraction of tariff levels. In recent years, some of the countries in the region have initiated steps towards a value added tax (VAT) system (Korea, Indonesia and Philippines). This overhaul of the indirect tax system is still mostly in its initial stages, but a shift to VAT will improve the domestic tax structure and make parallel reforms in tariffs easier and more transparent.

3.38 Quantitative Import Restrictions. Parallel to tariff reform, there was an easing of quantitative import restrictions in the three countries where they played an important role—Korea, Philippines and Indonesia. Korea, which had preannounced the liberalization program, has strictly adhered to the set schedule. About 85% of the tariff codes had been liberalized as of 1985 and the ratio is projected to reach 95% in 1988. The full impact of the liberalization steps remains unclear. This is partly because there are still various "special" controls that items may be subject to, even if not on the restricted list.

3.39 The Philippines program has moved less smoothly, reflecting the difficulty of trying to blend liberalization with a severe stabilization problem. In 1985, roughly 40% of all Philippine imports were subject to some restriction; down from 46% in 1980 but much higher than the 20% estimated for 1975. However, with the resumption of import liberalization in 1986, the proportion of imports restricted has been reduced to an estimated 20%. In terms of the number of categories, about 10% of import items are still subject to import restriction compared with more than 30% in 1980.

3.40 In Indonesia, formal import quotas are relatively small amounting to less than 6% of import categories. Import restrictions in the form of importer licensing had, however, proliferated during 1981-85, so that by 1985, about 28% of import categories and 30% of imports were subject to importer license. The October 1986 and January 1987 measures will have eliminated or substantially relaxed import licensing for 548 import items. Thus, 16% of import categories and 15% of imports would still be under a potentially restrictive license system. Within the manufacturing sector, the major activities where import licensing restrictions remain important are basic iron and steel, plastics and textile spinning and weaving. These three activities account for about 10% of value added in the manufacturing sector.

3.41 Table 3.7 summarizes the prevailing NTBs in the region in the form of: banned products, import quotas, import licensing and local content programs. The impact of these import restrictions is difficult to assess, and therefore difficult to compare, because of the varied nature and application of these restrictions as well as the overlapping influence of these and other policy interventions. Nevertheless, some general conclusions can be drawn:
### Table 3.7: PREVAILING NONTARIFF TRADE BARRIERS

<table>
<thead>
<tr>
<th>Country</th>
<th>Banned Products</th>
<th>Import Quotas</th>
<th>Import Licensing</th>
<th>Local Content Programs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>27 products banned - vehicles, TVs, tires, matches, etc.</td>
<td>Yes - linked to licensing system but fewer (300 items)</td>
<td>Yes - covers 17% import items</td>
<td>Yes - vehicles, generators, machine tools, tractors.</td>
</tr>
<tr>
<td>Korea</td>
<td>Few</td>
<td>Yes - quotas aimed unilaterally</td>
<td>12% of import items require import approval</td>
<td>Localization for infant industries</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Few</td>
<td>Yes - 32 products as of 1982</td>
<td>16 items in 1984</td>
<td>Yes. Mainly motor vehicles</td>
</tr>
<tr>
<td>Philippines</td>
<td>On some agricultural products</td>
<td>Few formal quotas</td>
<td>Import approval on protective grounds required for 10% of import items</td>
<td>Mainly vehicles and electronics</td>
</tr>
<tr>
<td>Thailand</td>
<td>23 banned products - vehicles sugar, ceramic products, etc.</td>
<td>No</td>
<td>22 products licensed; gold, tea, silk, used vehicles, etc.</td>
<td>Yes. Vehicles, diesel engines, milks</td>
</tr>
</tbody>
</table>
(a) there are relatively few banned imports in the countries of the region;

(b) import quotas are also relatively small. In Korea, quotas have been used to limit imports from Japan;

(c) import licensing is the principal form of quantitative restriction in the three countries where QRs have been significant—Korea, Philippines and Indonesia. This has also been the area of recent liberalization efforts;

(d) finally, all countries have had local content programs, especially for transport equipment. Although these programs had set ambitious targets for increase of domestic content, they have by and large proved unsuccessful, and despite the rhetoric, most countries have abandoned past targets. Little work has so far been done to systematically evaluate the cost effectiveness of the local content programs and impact on related issues, such as technology transfer, on which grounds they are often justified.

3.42 Two summary statistics that are most commonly used as measures of the degree of protection due to quantitative restrictions are: the percentage of import categories (at the disaggregated CCCN level) subject to import restrictions and the proportion of actual imports covered by QRs. A more meaningful measure would be the proportion of domestic output affected by QRs, but a correspondence between production and import restrictions at the appropriate level of disaggregation is rarely found. In any case, the coverage of either imports or output by QRs is only a crude proxy as the impact of QRs can vary widely, depending on whether they are in the form of a binding quota or loose import licensing. Nevertheless, summary statistics on the proportion of imports or import line items subject to QRs can provide a broad indication on the prevalence of QRs and and of changes over time Table 3.8 summarizes available figures on measures of import restrictions for the region. The figures confirm that, historically, import restrictions have been more important in Korea, Philippines and Indonesia than in Malaysia or Thailand, and that there has been significant progress in reducing restrictions in the former three countries. Overall, the role of QRs in the region has been less important than other developing countries (for instance, the proportion of import items covered by QRs is 21% in Argentina and, until recently, over 60% in Mexico).
Table 3.8: TRENDS IN IMPORT RESTRICTIONS

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Proportion of import items subject to import restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia</td>
<td>1985</td>
<td>28.0%</td>
</tr>
<tr>
<td></td>
<td>1986</td>
<td>21.9% /a</td>
</tr>
<tr>
<td>Malaysia</td>
<td>1984</td>
<td>less than 5%</td>
</tr>
<tr>
<td>Korea /b</td>
<td>1980</td>
<td>31.4%</td>
</tr>
<tr>
<td></td>
<td>1985</td>
<td>12.3%</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>4.6%</td>
</tr>
<tr>
<td>Philippines</td>
<td>1977</td>
<td>35.2%</td>
</tr>
<tr>
<td></td>
<td>1983</td>
<td>29.0%</td>
</tr>
<tr>
<td></td>
<td>1986</td>
<td>10.0%</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>5.0%</td>
</tr>
<tr>
<td>Thailand</td>
<td>1985</td>
<td>less than 5%</td>
</tr>
</tbody>
</table>

/a An additional 4.2% of import licenses were substantially relaxed as part of October 1986 reforms.
/b Items not on "automatic approval" list; about 40% of imports are still subject to exceptions and special laws.

Source: World Bank reports.

Overall Measures of Protection

3.43 It is difficult to arrive at an overall measure of protection for two reasons. First, because of multiple and overlapping trade interventions, it is not clear what the eventual impact is on the incentive regime. In particular, nominal tariffs are an inadequate measure when QRs rather than tariffs are the binding instruments of trade policy. Second, in the presence of intermediate inputs, the relevant measure of trade incentives for producers is the effective (or the protection of value added) rather than the nominal rate of protection.

3.44 A measure of the degree of nominal protection resulting from the trade regime as a whole can be obtained from direct price comparisons. In practice, there are a large number of problems in obtaining such price comparisons ranging from the paucity of data, the definition of comparable product categories, taking account of transport costs and trade margins and dealing with stability of price ratios over time. The only country in the region where such price comparisons have been made on a systematic though partial basis is the Philippines. These price comparisons exhibit a large degree of volatility even over a short period of time, but do provide an indication of the degree
of protection provided particularly by QRs. As expected, for most products where QRs are known to be binding, domestic prices significantly exceed world prices. Such price comparisons can provide therefore a measure of the degree of distortion arising from the trade regime, and can be used in calculating costs including for downstream industries. Trade interventions, however, can also be redundant. For instance, in Thailand, although tariffs on leather products are the highest among all groups (100%), domestic prices are not significantly higher than world prices. Thus, while nominal tariffs can insulate domestic markets from world competition, domestic competition and market size may be sufficient to arrive at competitive world market prices.

3.45 In order to analyze the pattern of incentives between industries, or the resource pull between sectors, it is necessary to take into account the combined effects of protection on inputs and output, or the effective rates of protection (ERPs). The use of ERPs to assess and analyze the prevailing protective structure became increasingly common during the 1970s, in the Bank and in developing countries. Despite the prevalence of the use of ERPs, many conceptual and empirical issues remain, which need to be recognized in the use of ERPs as a diagnostic and policy tool:

(a) Ideally, ERPs should be calculated not just on the basis of nominal tariffs, but taking into account the effects of other trade interventions such as QRs. Thus, ERPs should be based on nominal protection levels derived from direct price comparisons. This is extremely difficult in practice and has been done only in the case of Korea and Indonesia, and even these estimates have tended to be quickly outdated.

(b) While nominal tariffs can understate the degree of nominal protection, they can also overstate protection from the point of view of resource pull when tariffs are redundant.

(c) If a sector has only a single or few firms, as is often the case in developing countries, ERPs would overstate the additional domestic resources employed per unit of value added. Furthermore, if there are factor market imperfections, ERPs would misstate the allocative costs arising from protection. For these reasons, domestic resource costs ratios (DRCs) are conceptually preferred to analyze the costs of protection, but are even more difficult to estimate in practice, requiring first good shadow price estimates.

(d) ERPs provide a measure of the variation in incentives across activities, but this is often not straightforward to interpret. Sometimes the same commodity may be subject to different levels of protection under different circumstances. A common distinction drawn is between profitability of sales to the domestic market vis-a-vis sales abroad. In general, effective protection for domestic sales exceeds that for exports, except for Korea, where ERPs in particular industries for exports exceed those for domestic sales, because of strong export incentives.
There are also a host of problems on the empirical side in the calculation of ERPs. As noted, nominal protection rates should be based on direct price comparisons, but most ERP calculations are based on nominal tariffs alone because of the lack of necessary information. Second, there are the usual aggregation problems when deriving sectoral or economywide ERPs, which can lead to large differences. There are also many different methods for calculating ERPs ranging from simple input coefficients to more complex approaches encompassing effects of nontraded inputs and indirect taxes, which can be another source of variation in estimates. Finally, a common problem that arises is that value added in world prices is often negative, in which case the ERP is undefinable, or very small, in which case the ERP tends to reach very high levels. This makes aggregation even more difficult. In view of the approximate nature of input coefficients and nominal protection levels used in ERP calculations, the high sensitivity of ERP magnitudes to changes in these values poses an empirical problem.

For all these reasons, economywide ERP measures provide only a starting point in trade policy analysis rather than a benchmark for policy reform, and should be used and interpreted carefully from a comparative point of view. Tables 3.9 and 3.10 summarize some recent ERP estimates for the countries of the region and the sectoral pattern of ERPs. Despite being only a broad indication, the figures highlight that average effective rates of protection are still moderately high in the countries of the region, particularly for manufacturing, and that the range is quite variable suggesting a likely misallocation of resources. This is even true of Malaysia where average nominal protection levels are quite low. When ERPs are aggregated into export and import competing sectors, the average ERP for the latter is much higher than the average ERP for the export sectors in Malaysia. Indonesia, Philippines and Thailand, also show a similar antiexport bias as well as significant variability in their respective protection regimes. Although variability in the protection regime is also a problem in Korea, there is no explicit antiexport bias. At the subsector level, ERPs tend to be highest for the transport equipment sector and consumer durables, although with increasing protection afforded to many upstream activities, ERPs have become quite erratic across sectors.
Table 3.9: SUMMARY MEASURES OF EFFECTIVE RATES OF PROTECTION

<table>
<thead>
<tr>
<th></th>
<th>All sectors</th>
<th>Manufacturing</th>
<th>Export sectors</th>
<th>Import-competing sectors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indonesia (1984) /a</td>
<td>-</td>
<td>-</td>
<td>-19 - +23</td>
<td>57 - 4,800</td>
</tr>
<tr>
<td>Korea (1982) /b</td>
<td>49</td>
<td>28</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Malaysia (1982) /c</td>
<td>-</td>
<td>23</td>
<td>5</td>
<td>27</td>
</tr>
<tr>
<td>Philippines (1984) /d</td>
<td>8</td>
<td>20</td>
<td>-10</td>
<td>29</td>
</tr>
<tr>
<td>Thailand (1985) /e</td>
<td>30</td>
<td>52</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

/a Range for selected sectors; ERP's based on direct price comparisons (World Bank, 1986p).
/b Balassa method; estimates from Young and Yoo (1982).
/d PIDS/World Bank study.
/e Corden method; World Bank, 1986n.

- : Not available.

Table 3.10: DISTRIBUTION OF ERPS FOR SELECTED SECTORS (percent)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Textiles</td>
<td>65-500</td>
<td>-</td>
<td>54</td>
<td>106</td>
<td>118</td>
</tr>
<tr>
<td>Intermediates</td>
<td>25-425</td>
<td>40-62</td>
<td>17</td>
<td>15-125</td>
<td>45-60</td>
</tr>
<tr>
<td>Machinery</td>
<td>10-20</td>
<td>31</td>
<td>37</td>
<td>116-201</td>
<td>18-37</td>
</tr>
<tr>
<td>Transport equipment</td>
<td>125-4,800</td>
<td>124</td>
<td>74</td>
<td>118</td>
<td>60-90</td>
</tr>
</tbody>
</table>

Source: As for Table 3.8.

D. Issues in Trade Policy Reform

3.47 Trade distortions in the region, while less than in the early 1980s and lower than in most other developing countries, remain significant and warrant continued policy reforms in all of the countries of the region. Such distortions continue to lead to: (i) an antiexport bias in the Southeast Asian countries; (ii) a deviation in incentives from comparative advantage based resource allocation; (iii) "rent seeking" and related costs of administration and compliance; and (iv) inefficient enterprise behavior.
because of the restrictive effects on competition. All of these factors, in turn, can undermine the continued rapid development of these economies, at a time of sharpening world competition and tight resource constraints.

3.48 Indonesia, Philippines and Korea are all in the midst of further trade liberalization, with the objective of reducing both tariff and nontariff protection. Malaysia is also considering improvements in its protective structure. No initiatives, though, are underway in Thailand despite nominal tariff levels that are now the highest in the region.

3.49 This section reviews the continuing and prospective issues in the design and implementation of trade policy reform for the region, drawing on the lessons of past experience, as well as the more general policy insights from recent analytical and empirical work. The analysis and insights on trade liberalization in developing countries, including those discussed here, are derived almost exclusively from models of perfect competition. Recent trade theory developments, and discussions of developed country trade policy, however, emphasize increasing returns to scale, learning processes and imperfect competition as important elements in determining appropriate strategy. Clearly, such considerations are important in developing countries as well. For instance, the effects and welfare gains from trade liberalization under oligopolistic markets are likely to be quite different than what would result from a competitive market. Equally, strong scale economics in some sectors would also affect overall benefits from trade liberalization. The more these considerations are taken into account, the more successful trade reform packages are likely to be. It is difficult though to enunciate general principles, since deviations from the competitive paradigm will depend on the particular circumstances. Moreover, the available evidence suggests that the levels of protection observed in developing countries far exceed what can be justified by the presence of imperfect competition (Rodrik, 1987).

Sequencing of Liberalization

3.50 One of the main issues that has emerged with regard to trade liberalization is the appropriate sequencing of various policy reforms. There is increasing recognition that the design and implementation of trade policy reform is a complex task, which has to grapple with a large array of overlapping policy instruments and objectives. Since it is not feasible or even desirable to undertake all reforms simultaneously, the coordination and phasing of policy reforms becomes one of the central issues in implementing trade liberalization.

3.51 The thinking on the appropriate sequencing of policy reforms with regard to trade liberalization is in its early stages. It is clear from the theoretical and empirical work undertaken so far in this area that the issues are quite complex and closely interwoven with difficult choices of political

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8/ For a review of some of these issues, see S. Edwards (1985) and M. Wolf (1986).
economy. Nevertheless, some broad principles can be discerned which can provide a framework for designing and assessing trade reform packages. There are several levels at which issues of sequencing arise. A first is sequencing of liberalization of markets. That is, in the removal of distortions, is there a preferred ordering in undertaking economic liberalization, and in particular, should trade liberalization precede or follow the liberalization of other markets. Another is the issue of whether reforms should first address large macroeconomic imbalances in the economy and then cost price distortions, or whether this should be accomplished simultaneously. This is the issue of combining stabilization and liberalization, and of the initial conditions in undertaking trade liberalization. Finally, within trade liberalization, are there any principles in determining the steps in the removal of trade interventions, and what should be the linkages with other policies during trade liberalization.

3.52 The reduction and elimination of distortions through economic liberalization has been a central and common element of the Bank's policy recommendations on structural reform. Trade liberalization has been one component of recommended policy reform in this direction. Liberalization has been recommended in many other areas as well: removal of price controls, deregulation of investment licensing, liberalization of interest rates and domestic financial markets, labor market deregulation, public enterprises reform and removal of capital controls on external transactions. Although there is general agreement on the beneficial effects of liberalization in each of these areas on resource allocation and efficiency, there is less clarity or agreement on whether there is a preferred approach in the sequencing of policy reforms, in moving from a generally controlled economy to a more liberal regime. The dynamics of liberalization is naturally complex, and must take into account not only the expected benefits and the effects of liberalization on other markets, but also the political constraints and opportunities. Thus the appropriate course of action would to a large extent depend on individual country circumstances. However, there also appear to be some important general principles on the appropriate sequencing of liberalization that apply across countries.

3.53 Although there are a host of different government controls and interventions, in discussing the broad issues of sequencing, it is useful to distinguish between four principal forms of controls, and therefore, four main areas of liberalization. These are: domestic controls (such as price controls, investment regulations, wage policies, etc.), controls on domestic financial markets (interest and credit ceilings and regulations), trade policy interventions, and controls on the capital account. Based largely on theoretical reasoning, some tentative principles can be drawn about the ordering of liberalization among these four areas:

(a) A first principle would be that real sectors should be liberalized before financial sectors to ensure that resources flow to the most efficient sectors. On the other hand, a sound financial system can provide an important underpinning for successful adjustment and restructuring, required during a major trade liberalization program.
(b) The easing of domestic controls is likely to improve efficiency and resource allocation with less adverse effects in terms of adjustment costs than trade liberalization, since the competition induced would be among domestic agents. In particular, deregulation of investment licensing, especially in areas where domestic markets are large, can improve resource allocation and stimulate productivity growth much the same way as through import competition. This would make domestic firms more competitive prior to import liberalization.

(c) Domestic financial markets should be liberalized prior to opening the capital account. If capital movements are allowed when domestic interest rates are fixed at a level below market rates, capital flight will result. In turn, domestic interest rates can only be meaningfully liberalized if the fiscal deficit is controlled, otherwise the open capital account will erode the stock of base money leading to even stronger inflationary pressures and further volatility of capital flows.

(d) Finally, barriers to international trade should be removed before lifting capital controls. Otherwise, not only would external capital flow to high cost sectors in the presence of large trade distortions, but the opening of the capital account could lead to destabilizing capital flows and a volatile real exchange rate, making trade liberalization more difficult. In particular, capital inflows during a period of liberalization could lead to real exchange rate appreciation, which is exactly the opposite of what is desired from the point of view of trade liberalization.

3.54 From these arguments, it would appear that the first task is to remove domestic controls, particularly investment licensing. It is not clear whether there is an unambiguous preferred ordering in the liberalization of external trade and the domestic financial sector, but what is clear is that liberalization of both should precede the opening of the capital account.

3.55 This stylized ordering of liberalization was most closely approximated in the region by Korea. Domestic controls have been progressively reduced. Trade liberalization which began in the 1960s gained momentum in the 1980s. Liberalization of the domestic financial sector has proceeded more slowly. Finally, the external capital account has remained largely closed, but steps towards some liberalization have been recently initiated.

3.56 In the other countries, the sequencing of liberalization has been quite different. The capital accounts of the Southeast Asian countries have been open to some extent since the 1960s, and there has been progressive integration with world capital markets, so that by the 1980s these countries were characterized by virtually open capital accounts. The domestic financial market in Malaysia has been traditionally relatively unregulated and closely linked to Singapore for some time. The other three countries—Indonesia, Philippines and Thailand—have all significantly liberalized their domestic financial markets in the 1980s, when their capital accounts were already to a
large extent open. Although there has been significant trade liberalization in the Southeast countries during the 1980s, trade distortions remain significant in all these countries. Finally, investment licensing continues as an important domestic control in Malaysia and Indonesia.

3.57 The open capital account is now an established feature of the Southeast Asian countries, and would be difficult and unwise to reverse. But given that the external and domestic financial markets are now significantly liberalized, it is all the more important to move speedily on trade reforms and the removal of domestic controls to ensure efficient resource allocation. A second implication of the open capital account is that it places an even higher premium on sound macroeconomic management.

Macroeconomic Policies and Trade Liberalization

3.58 A common link between macroeconomic policy adjustment and liberalization is that the momentum for both is usually rooted in an economic crisis, which highlights not only the need for policy actions on the macroeconomic front but also the importance of redressing economic inefficiencies due to policy induced distortions. The crisis itself may be precipitated by an external shock, but typically also reflects the cumulative effects of past inappropriate macroeconomic policies as well as inappropriate structural policies, including trade and other interventions. Certainly, it was the external shocks of the early 1980s that provided the momentum in the region, not only for macroeconomic adjustment, but also for trade and other structural policy reforms.

3.59 Although an economic crisis can highlight the need for undertaking structural reforms, and create a constituency for such reforms in government, there are significant pitfalls in attempting to undertake import liberalization simultaneously with a major stabilization program. It is inevitable that a major stabilization program will result in cuts in absorption and perhaps output, as well as a drop in capacity utilization and employment. In the short run, a cut in expenditures is the most readily available method to achieve the necessary reduction in the fiscal deficit. Since the need for response to an external shock is usually superimposed on a structural fiscal deficit, domestic inflationary pressures and an overvalued real exchange rate, the magnitude of fiscal cuts required in the short run is likely to be quite large. This creates an inherently unfavorable environment for undertaking trade liberalization for economic and political reasons. In the short run, trade liberalization would tend to complicate the stabilization task in two ways: by allowing for increased imports, it could exacerbate balance of payments pressures, and second, by increasing import competition, liberalization will add to the difficulties of domestic firms, which already face demand compression due to the stabilization program. Furthermore, at a time when large economic adjustments are underway, the intended signals of trade liberalization may not be clear, and the supply response to trade reforms may not be forthcoming because of market imperfections. The costs of large changes in the policy environment could be quite high in terms of economic disruptions and unutilized capacity. There are also reasons of political economy for not undertaking trade liberalization simultaneously with a major stabilization program. Adjustment costs associated with stabilization would
reinforce the normal resistance to trade liberalization. Moreover, such adjustment costs would be attributed to trade liberalization rather than stabilization, and could undermine support for sustained trade liberalization.

3.60 An important conclusion, therefore, is that the first response to an economic crisis should be a prompt and well formulated stabilization program, to ensure that macroeconomic imbalances are sufficiently reduced, prior to undertaking trade liberalization. The key elements of the stabilization program would be a reduction in the fiscal deficit (through a reduction of expenditures in the short term), nominal exchange rate depreciation and monetary policy consistent with the reduction in the fiscal deficit and the exchange rate adjustment. While it would be difficult to undertake substantial trade liberalization when a major stabilization program is underway, delays in initiating trade policy reforms will have costs in terms of inefficiencies and resource misallocation. It is important, therefore, to respond speedily and adequately to large macroeconomic imbalances due to external shocks or past policy excesses, so that the environment can be created for structural reforms. Otherwise, not only would the inefficiencies and the resource misallocation persist, but distortions such as import curbs could actually intensify as a means to provide short term palliatives to the economic crisis, but further undermining longer term growth, as was the case in the Philippines. In contrast, in the case of both Korea and Indonesia, macroeconomic stabilization preceded and complemented recent trade reforms.

3.61 Ideally, trade liberalization should begin from a situation of macroeconomic balance. This implies that world economic conditions should be normal or favorable, and that macroeconomic policies should be consistent with the maintainence of balance of payments equilibrium (i.e., the fiscal deficit should be financeable by noninflationary means, and fiscal and monetary policies should be consistent with exchange rate policy). Unfortunately, these initial conditions are rarely met in practice.

3.62 The preceding discussion highlighted the difficulties of undertaking a substantial trade liberalization program at a time when a major stabilization program is underway. On the other hand, complete macroeconomic balance is unlikely, either as starting point, or during the course of trade liberalization. An important finding of the comparative experience on trade liberalization episodes is that it is not the adjustment costs due to trade liberalization, in terms of output and employment and the associated social and political pressures, that commonly leads to the abandonment of trade liberalization, as much as balance of payments pressures reflecting inappropriate macroeconomic policies.9/ Macroeconomic policies must therefore be attuned and responsive to the underlying external and domestic situation and cognizant of the effects of trade liberalization, so that macroeconomic difficulties do not undermine the trade liberalization program. What does this imply?

First, that appropriate policies be pursued to ensure that the fiscal deficit is reduced to noninflationary levels on a sustained basis. In the short-term the adjustment measures to reduce the fiscal deficit will have to be primarily on the expenditure side, but in the medium term, depending on the desired level of fiscal expenditures, revenue mobilization may have to be increased through policy reforms. The trade liberalization itself will have effects on fiscal revenues. If the initial stages of liberalization comprise a shift from QRs to tariffs, then the fiscal effects in terms of additional tariff revenues will be positive. In the second stage of liberalization, though, the reduction of tariffs below revenue maximizing levels would lead to a fall in government revenues. This underlines the need for developing other sources of government revenues in the medium term, or to achieve further reductions in government spending. Trade liberalization could also adversely affect fiscal revenues in the short run through its effects on the profitability of the import competing sector, but this would be more than reversed in the medium and longer terms. Apart from its impact on aggregate demand, fiscal policies are also important in ensuring that the fiscal deficit does not crowd out credit for export and less protected import industries. Finally, wage policies linked to the budget may be important in keeping wage pressures in check and achieving the real wage adjustment that may be required.

A second requirement of macroeconomic policy during trade liberalization will be depreciation of the real exchange rate. If the initial situation is one of excess demand and balance of payments disequilibrium, real exchange rate depreciation will be required to restore macroeconomic equilibrium (i.e., as part of stabilization). Real exchange rate adjustments will also be required in response to any further external or domestic shocks during trade liberalization. Finally, real exchange depreciation will be required as an adjunct to the trade liberalization process itself. This is because, under a protected regime, the real exchange rate would have been overvalued to start with. Without such adjustment, a balance of payments disequilibrium would emerge or be exacerbated, as imports would increase by more than exports, particularly in the short run. Real exchange rate depreciation would thus stave off balance of payments pressures through expenditure switching effects, as well as realign incentives in a way consistent with the trade liberalization, i.e., from nontraded to traded goods and from import competing to export sectors. In terms of sustainability of reform, the real exchange rate depreciation would ameliorate the adverse effects of stabilization and trade liberalization, and make trade liberalization easier in many ways: first, it would increase the demand for output and enhance profitability of export sectors and import substitutes that were previously less protected, and in this way offset the adverse effects on the import competing sectors; second, it would reduce the import premia on goods with QRs making a shift to tariffs easier; third, even for import competing sectors, the exchange rate adjustment would partially offset the effects of reduced import protection; and finally, a real exchange rate adjustment would have a positive though temporary fiscal effect by permitting a larger expansion of domestic credit.

In an environment of generally stable prices—as in the region—the real exchange rate adjustment is best achieved through an adjustment of the nominal exchange rate. Otherwise, it would imply that money prices of nontraded and import substitutes would actually have to fall. If there is
downward rigidity in nominal prices and wages, as would be expected, real exchange rate depreciation of the order of magnitude required without nominal exchange rate adjustment would entail substantial unemployment of resources. A devaluation or depreciation of the nominal exchange rate is therefore the preferred means to achieving the real exchange rate depreciation. In order to sustain the real exchange rate adjustment, fiscal and monetary policies would need to be consistent with the exchange rate adjustment. Consistency and credibility of macroeconomic policies is particularly important for the four Southeast Asian economies, given the relatively open capital accounts.

3.66 All the countries of the region which initiated trade policy reforms during the 1980s have experienced to some extent the problems of combining trade liberalization with stabilization and the need for a suitable macroeconomic policy framework. In Thailand, the short term costs of tariff reductions in terms of foregone revenues was a major concern at a time when the government was attempting to reduce the fiscal deficit, so that the tariff reductions of 1982 were almost immediately followed by an offsetting import surcharge. Eventually, the inability to raise revenues through improvements in domestic tax structure and implementation, led to backtracking on the tariff liberalization program. In Korea, although the trade liberalization program was initiated when a stabilization program was underway, the actual liberalization took place with a lag because of the preannounced nature of the program and was quite gradual. Even then, the balance of payments effects of liberalization have been the dominant concern of the government until recently, and appropriate macroeconomic policies have been extremely important in this respect. In Indonesia, while the government responded quite forcefully in formulating a stabilization program in 1983 in response to the deterioration of the external environment, there was actually an increase in import curbs during the 1983-85 period. It is only since the external shock of 1986 that the Government is attempting simultaneously to undertake further macroeconomic adjustment in response to the fall in oil prices and initiate actions to liberalize the trade regime. The degree of liberalization is still modest, though a signal of the direction of future policy. Concern about balance of payments pressures was a central element underlying the cautionary approach of the Government in adopting the recent liberalization measures. It is in the Philippines that the difficulties of combining liberalization with stabilization have been most acute. Although initiated prior to the large external shocks of the early 1980s, the trade-liberalization program was derailed by the economic and financial crisis of 1983. Delays in formulating an appropriate macroeconomic policy response meant that the stabilization program that had to be adopted eventually was more drastic. Although it remained on the policy agenda, trade policy reforms were by and large not implemented during 1983-85. This was possibly the right course of action. The reform process has been resumed in 1986. In view of the still depressed levels of economic activity and the continuing stabilization programs in the Philippines and Indonesia, the challenge of sustaining trade liberalization requires that the next steps be designed carefully to minimize economic disruptions or create balance of payments pressures, without losing the momentum of reform.
Export Promotion Measures and Removal of Anti-Export Bias

3.67 Since it is not possible to instantaneously eliminate all import restrictions, export promotion policies provide a means of offsetting the anti-export bias embedded in the trade regime. By stimulating export growth, such policies can create more leeway in the balance of payments, and therefore, for undertaking import liberalization. This has certainly been the case for Korea. A natural sequencing order would thus be to pursue export promotion policies, designed to create a free trade status for exporters and possibly even more active support of exports, even prior to trade liberalization.

3.68 However, it is important to ensure that export promotion policies are not viewed as an alternative to trade liberalization. There are clear limits on what can be independently achieved through export promotion policies. First, free trade status for exporters is administratively difficult to achieve (as discussed in Chapter 4), more so because effective rates of protection are still quite high and variable in the countries of the region. Second, an enclave export sector with free trade status will limit the efficiency effects that could be achieved for the economy as a whole. For instance, export orientation in Korea has coexisted with a large number of distortions, and corresponding misallocation of resources. Finally, in the current environment of countervailing actions, support for exports beyond trying to provide inputs at world prices is clearly limited (see Nam 1986). Therefore, while export promotion measures can help in preceding and complementing trade liberalization, the primary focus of policy reform must remain on import liberalization.

Steps in Undertaking Trade Liberalization

3.69 The Bank's recommended strategy on trade liberalization has generally, advocated three sequential steps:

(a) replace quantitative restrictions by tariffs;
(b) reduce the level of nominal tariffs; and
(c) move towards a more uniform tariff structure.

3.70 There are also a number of substeps that have appeared as a part of recommended strategies. Two common ones are: in the removal of QRs, restrictions on imports of inputs should be eliminated or relaxed first; and, a first step in tariff reform should be a shift from specific to ad valorem duties. The issues that arise with regard to these steps are discussed below.

3.71 Replacing QRs by Tariffs. There are well accepted reasons why this should constitute the first step in import liberalization. A shift to tariffs on an equivalent basis will have no effect on protective levels, but makes the trade regime more transparent, reduces "rent seeking" which diverts resources to unproductive activities and bolsters fiscal revenues. Three issues that commonly arise with regard to the liberalization of quantitative restrictions are: (a) if all QRs are not removed simultaneously, what is the preferred
ordering; (b) the determination and setting of appropriate tariffs; and 
(c) valuation problems.

3.72 In the liberalization of QRs in the Philippines and Indonesia, an 
important guiding principle of the ongoing policy reform has been that QRs on 
inputs should be removed or relaxed first. This is based on the argument that 
such liberalization can improve capacity utilization and profitability in the 
downstream industries, making further liberalization easier while keeping 
initial balance of payments pressures in check. On the other side, though, if 
there are import or tariff restrictions on the using industries, effective 
rates of protection would rise further as a result of such phasing of import 
liberalization.

3.73 While in theory every quantitative restriction has a tariff equiva-

tent, in practice, these are often difficult to ascertain because of problems 
of comparability and lack of information. There are also practical problems 
of classification. For instance in the Philippines, the classification of 
import restrictions is different from that of the tariff code. A question 
also arises whether the new tariffs should be set at the full tariff equiva-

tent or not. In Philippines, the tariff ceiling of 50% for the tariff 
schedule has been adhered to where adjustments have been made after liberal-
ization, with the result that the protection level has been substantially 
reduced compared with tariff equivalents prior to liberalization. In 
Indonesia, some tariffs are being allowed to be set above the stipulated 
maximum level of the present code, but for a temporary period. Exchange rate 
adjustment, as noted, could be an important complementary measure to the 
relaxation of QRs by reducing the import premia and lowering the equivalent 
tariff levels.

3.74 A concern that is often raised in implementing the liberalization of 
QRs relates to the problems of underinvoicing and dumping. Such concerns 
prompted the Philippines to set up a complex home consumption value system as 
a benchmark for assessing duties, if the transactions value is found to be not 
acceptable. By engaging SGS, Indonesia has somewhat greater, though by no 
means complete, control of the undervaluation problem. A second concern is 
the vulnerability to dumping. This is an argument for safeguards, which is 
discussed below.

3.75 Reduction and Uniformity of Tariffs. Although the reduction and 
rationalization of protection have long been accepted as the main objectives 
of tariff liberalization, there is a lack of clarity on how this should be 
interpreted and lack of agreement on how it should be achieved.

3.76 In principle, there are a variety of ways by which a gradual reduc-

tion in tariff levels can be brought about: an equiproportional reduction of 
all tariffs, in equal installments; an equiproportional reduction in the 
excess of each tariff over an end target level; higher proportional reductions 
in higher tariffs; as well as other forms. The most favored approach is the 
so-called concertina method which entails the reduction of higher tariffs in 
steps, while leaving the lower levels for the end. A complementary policy 
measure, which has been recommended for instance in the Philippines and 
Thailand, is to raise tariffs that are at zero or very low levels to a minimum 
floor so as to reduce effective rates of protection for finished goods.
3.77 While this recommended strategy is simple and straightforward to implement, many objections are being raised on whether this is the most appropriate approach to tariff reform. First, since the objective is to equalize effective rather than nominal rates of protection, it is not evident that the mechanistic approach will achieve that objective. Strictly speaking, therefore, the recommended strategy should take into account the structure of production. However, it would be virtually impossible to develop a policy package which achieves a gradual reduction in effective rates of protection across all sectors in a systematic way. One approach is to combine a reduction in tariff ceilings with a rationalization of the tariff structure based on subsector information. This would eliminate anomalies in the tariff structure and make more explicit the protection levels and structure that is desired.

3.78 The recommendation of achieving greater uniformity in protection by raising the floor on tariffs is also being questioned in more recent policy work. While this reduces protection in consumer goods industries and raises fiscal revenues, there are some undesirable side effects in that it increases the cost of inputs for exporters, raises protection for the input producing sector and distorts choices between traded and nontraded inputs. An approach that is being advocated that does not have these adverse incentive effects and also mobilizes revenues, is to raise excise taxes on domestically produced goods relative to corresponding import tariffs.

3.79 A more central point that is currently being emphasized is the need for a broader public finance perspective that integrates duties and domestic taxes. Overall policy reform should include not just reductions in tariffs, but a replacement of trade taxes by consumption and income taxes. The design and implementation of such reform must also take into account individual country circumstances, including the tax administration capacity of the government, the targeted level of public expenditure and the protective structure that would be consistent with the country's development level and industrialization strategy.

3.80 So far there has been little analysis or efforts in the region to integrate trade liberalization with domestic tax reform. The only exception is the Philippines, where a review was initiated under SAL II to align the sales and excise taxes with the tariff and trade regime reforms initiated under SAL I. The first phase of these reforms have been completed, though belatedly, and more comprehensive tax reform measures are under consideration.

3.81 Defensive Restructuring. A final, and somewhat controversial, component that is sometimes proposed as an adjunct to trade liberalization is defensive restructuring. This refers to adjustment measures at the firm level in response to changes or anticipated changes in the trade regime. The general issues with regard to restructuring are discussed in Chapter 5, but some summary observations of relevance to trade liberalization can be noted. In principle, the restructuring efforts are designed to accelerate the shift to the new structure of incentives and compensate for the shortcomings of capital and information markets. This could reduce adjustment costs and moderate opposition to the liberalization program. In practice, there are
virtually no examples of such successful defensive restructuring. The problems that tend to arise with restructuring are: the lack of effective tools and capacity in the government to undertake restructuring; and, difficulties in ensuring that restructuring remains consistent and supportive of overall trade liberalization.

Pace, Credibility and Preannouncement of Trade Policy Reform

3.82 There is no benchmark or guideline on what is the appropriate time frame for undertaking a trade-liberalization program. It will depend on the initial conditions, and whether the effects of trade liberalization in terms of adjustment costs will be reinforced by other adjustment measures such as a stabilization program. The experience in the region has varied widely. As noted, the current trade liberalization program in Korea will have spanned ten years in terms of its present time frame. On the other hand, the trade liberalization program introduced in 1966 in Indonesia occurred almost overnight. More recently, the Philippines has not only resumed the trade liberalization program in 1986 after the lapse during 1983-1985, but the progress achieved during the year has been substantial and rapid.

3.83 Very large or sudden changes in the trade regime could be damaging because they would lead to unnecessary economic disruptions and could also undermine the sustainability of reform because of transitional difficulties. Sustainable trade reform requires that transitional difficulties and social-adjustment costs be explicitly addressed in the design of the policy reform, and that reforms be carefully phased and complemented with ameliorating policies to minimize social-adjustment costs and ensure that private costs do not reach levels that would endanger the liberalization process. On the other hand, the history of liberalization episodes demonstrates that without some substantial initial action, the government's liberalization policy will not be credible. Economic agents will not respond in the manner desired, and those affected adversely will put pressure on the government to reverse the policy reform, very often with success.

3.84 The ideal combination is to begin with a substantial and credible adjustment, followed by a preannounced trade liberalization program. The knowledge that further liberalization will be undertaken, and for what items and at which time, will allow factors to shift from the affected sectors with less adjustment costs. Of course, if the preannouncement is not viewed as credible or if domestic lobbying pressures are strong, preannouncement will only offer more time and opportunity to opposing groups to reverse the import liberalization. Many successful liberalization programs have, therefore, often relied on a surprise element, although the general intention to liberalize has been made clear as a policy goal. The appropriate strategy would accordingly depend to a large extent on the individual country situation.

3.85 Korea has carried out one of the most remarkable pre-announced liberalization programs, not just among East Asian countries, but in the history of trade liberalization episodes. The Philippines also attempted to pursue a preannounced program with significant initial action in the early 1980s, but the credibility and sustainability of trade reform was eroded by the growing macroeconomic imbalance. A similar approach underlies the current
and planned liberalization of 1987-88 in the Philippines, but this time with more cautious macroeconomic policies. In contrast, while Indonesia has made clear its intention to gradually liberalize, the precise content and timing of further liberalization has not been announced, to prevent the buildup of domestic political pressures and allow flexibility in undertaking future reforms.

**Transition Costs of Adjustment**

3.86 The objective of trade-policy reform is to induce a shift of resources from less efficient sectors to more efficient ones. As is well known, there are costs and delays in the movement of factors which prevent the productive structure from responding immediately to a policy change. There are also costs and delays in expanding exports for products where world markets are not perfectly elastic.

3.87 The knowledge and assessment of such transition costs during trade-policy reform tends to be deficient in a number of ways. The overall magnitude of adjustment costs will depend on the prevailing production structure and the nature of the expected supply response. Even if there is good information on the former, the latter is likely to be difficult to predict, particularly given the nonmarginal nature of policy change. Second, trade-policy reform does not take place in isolation but in conjunction with other policies. In particular, there is likely to be an overlap with macroeconomic policy adjustment in most cases. Such macro-economic stabilization policies can also have adjustment costs because of price and structural rigidities. In fact, the adjustment costs associated with macroeconomic stabilization can often dominate. This has certainly been the case in the Philippines since 1983. Also, unlike structural adjustment measures, the effect of macro-economic policy induced contraction is adverse on all segments of the economy, and particularly on the more vulnerable segments of the population. It is important, therefore, to take into account the overall policy environment and the ways in which adjustment costs are reinforced. A third aspect in which policymakers express a great deal of interest is the impact on specific industries, and the losers and winners from the policy changes. This is important from the political economy perspective because the costs of trade liberalization will tend to be immediate and concentrated on established interest groups, while the benefits will be delayed and diffuse and often primarily benefitting potential investors. Finally, there is the issue of how different social groups will be affected by the trade liberalization, including the poorer segments of the population.

3.88 The Bank's approach to trade reform has focused primarily on diagnosis, and policy recommendations have been based more on magnitude of distortions than of the assessment of impact. A starting point in developing a better understanding of transition costs is detailed information on production structure and employment. As a result of cumulative work and better capacity for trade-policy analysis in the countries, some progress in this direction has been made. But several additional steps will be required to address the issues of transitional costs more effectively. Based on the described information, the Bank will need to improve its capacity to analyze the impact of trade-policy reforms at a more detailed level and reflect this, in
turn, in policy design and implementation. There are few concrete examples, however, of how this would be done without compromising the end objectives of the trade reform, which is why there has been a preference for more neutral and broad-based trade reform. Two important principles with regard to the pace and sequencing of policy reforms need to be emphasized, to minimize the transition costs. First, as noted earlier, policies such as exchange-rate adjustment and export-promotion measures, which would reduce adjustment costs, should receive greater and early emphasis. Second, steps should be taken to identify and redress the key rigidities so that the supply response can be accelerated. A particularly important step is to ensure that the financial sector can respond to restructuring needs so as to allow for smooth adjustment. Finally, adjustment assistance schemes may have to be developed to offset some of the adjustment costs and protect the more vulnerable and poorer segments of society. The purpose of any adjustment assistance to industry should be to accelerate, and not delay, the movement of factors out of inefficient industries and therefore should focus on retraining and restructuring. The scope for such programs is likely to be limited, given the present level of administrative capacities in most countries of the region. There is no a priori basis to expect trade liberalization to have a more adverse effect on poorer groups. But in a general period of policy adjustment—when social adjustment costs are likely to be large—there is even greater need to maintain effective and targeted support programs for the poor.

**Safeguard Mechanisms**

3.89 Another transitional issue is the assurance that policymakers often seek that the effects of trade liberalization on the balance of payments, fiscal revenues or domestic activity do not become excessive. In particular, policymakers often express strong reservations about undertaking liberalization because of lack of effective administrative measures to prevent (i) underinvoicing; (ii) dumping; and (iii) to provide temporary protection to domestic industry from import competition. In developing policy reform packages, therefore, it is important to address the needs and dangers of instituting such administrative measures. Without careful design and checks, administrative steps could easily become an insidious form of protection to replace the previous trade barriers.

3.90 A good reference price system can be used to assess the magnitude of underinvoicing or whether there is an indication of dumping, but this should not be used as an all-encompassing check. In particular, to control underinvoicing, spot checks with high penalties should be used rather than complex or comprehensive administrative procedures. As an additional threat, governments should establish the right to buy imports at invoiced prices.

3.91 Safeguard mechanisms against dumping should be based on clearly defined rules which provide an impartial assessment of the case and makes clear the trade-off between the import competing and the using industries. A neutral body such as a tariff commission should be established, which would receive and decide on all requests for additional protection (or reduced protection on inputs), either in the case of dumping or special requests for protection from any industry, based on standard factual information. The proceedings should be open to all parties, and active participation of
importers and users of the imported product should be sought. Any protection allowed would be in the form of a temporary surcharge, with a fixed predeter-
termined period of effect, and the costs of this protection should be rou-
tinely calculated and made public. For those countries which are signa-
tories of the GATT Subsidies and Countervailing codes (Indonesia, Philippines and Thailand), these procedures would also provide the basis for complying with the rules on transparency, proof of injury and consultations required for taking action on imports from other signatories.

Institutional Reforms

3.92 The establishment of an appropriate body for deciding and imple-
menting safeguard mechanisms highlights the general need for institutional
strengthening in the area of trade policy formulation and arbitration, as a
vital step in providing the basis for continuing reform. In Korea, the tariff
reform and arbitration process is part of the larger apparatus of trade and
industrial policy, which, though complex, has functioned flexibly and with due
regard to economywide considerations. In other countries of the region,
institutional mechanisms are weaker. Philippines has made the most progress
through the establishment of the Tariff Commission. Nevertheless, overall
trade policy is still fragmented. In Thailand and Indonesia, the basic
institutional apparatus for trade policy formulation and implementation
remains weak and fragmented among different government agencies. Generally,
institutional reforms have received less attention than the view of the
trade policy regime, but improvements in this area are a necessary step in the
Southeast Asian countries for sustained policy reform.

Multilateral and Unilateral Liberalization

3.93 From the point of view of efficiency objectives, the benefits of
unilateral trade liberalization are unequivocal. Yet among many policymakers
in East Asia, there is a growing reluctance to undertake unilateral trade
liberalization on the grounds that liberalization is unwarranted at a time
when the principal industrial countries have been raising protective barriers;
and, import liberalization should be used to secure trade concessions from
partner countries and in multilateral trade negotiations. The first is an
emotive issue, but one that draws a large degree of political support. The
appropriate response is to persist in convincing the government of the gains
to the country from undertaking such reforms. The latter argument carries
weight provided the trade liberalizations proposed and accepted are consistent
with the country's own objectives. This consistency is difficult to achieve
in practice because multilateral negotiations are often too complex and do not
follow the kind of economic logic that would underlie a structured liberaliza-
tion program. However, once an agreement is reached, implementation is made
easier by the force of the contractual agreements with other governments.

3.94 An issue of immediate importance for the countries of the region is
the trade concessions that may have to be made as part of the Uruguay round of
GATT negotiations. Unlike the previous rounds, there will be far greater
pressures for such concessions from developing countries, particularly the
NICs, and also from countries at the level of development as ASEAN. In
return, the developing countries should seek commitment from developed
countries for limits and rollbacks on nontariff trade barriers. In offering trade concessions, it is extremely important for policymakers to have a clear notion of the path of liberalization that would be in the country's own interests. A number of preparatory steps are important in this regard. First, the authorities should have a well-prepared position based on trade liberalization measures taken since the Tokyo, both by way of tariff reform and removal of NTBs. For the tariff reductions to be recognized, the Government would have to make a commitment to bind them at the reduced rates. Second, the authorities should keep in mind ongoing trade liberalization programs as trade concessions already committed as well as have a clear understanding of what trade liberalization is in the country's own interests, and what timetable is appropriate. Third, individual countries as well as developing countries as a group should identify products and markets where industrial country liberalization are most urgently needed. Finally, there is a need for those negotiating the GATT agreement to coordinate closely with policymakers responsible for formulating trade-policy reform, which is often not the case in the Southeast Asian countries.

3.95 Another external influence on countries in setting and implementing a liberalization program is an agreement with international organizations. The process of reaching agreement on a policy reform package and an established timetable can facilitate decisions within a diffuse government. However, policy conditionality in and of itself is unlikely to be a sufficient condition for reform, as liberalization is too difficult a political task to undertake without government commitment. Policy conditionality can also become a weapon in mobilizing opposition to an "externally imposed" trade liberalization program. In such a situation, ex post support for policy initiatives is a better approach. The additional external resources provided in support of the policy reforms could also enhance the sustainability of reform when balance of payments pressures are a concern.
CHAPTER 4. COMPLEMENTARY EXPORT DEVELOPMENT POLICIES

4.1 This chapter deals specifically with export development policies, i.e., policies directly in support of exports. After a brief overview of basic principles and instruments, the chapter reviews export development policies currently in use in East Asia and assesses the major issues arising for each form of intervention. It concludes with a discussion of timing and sequencing aspects of export promotion policies.¹

A. Basic Principles

4.2 The preceding chapter described how import protection biases incentives in favor of import substituting activities and against production for exports. It recommended that the average level of protection and its variance be reduced from those levels commonly observed. The question arises whether, in addition, specific measures in support of exports should be taken. Two types of arguments in favor of export development policies may be made. First, such policies can play a transitional role in offsetting disincentives to exports, while distortions introduced by import protection are gradually being reduced. Second, export development policies might be justified on the grounds that there are externalities in export marketing, information gathering and technology development, which require public intervention.²

4.3 The first of these two arguments is of the usual "second best" variety; it presupposes that the removal of protective barriers cannot be carried out in a single step, but must proceed gradually, both for political reasons and so as to reduce the cost of adjustment. In the meantime, special measures are required to ensure that exporters achieve neutrality vis-à-vis their foreign competitors in international markets, i.e., are not disadvantaged by input and output prices that differ from border prices or by lack of access to capital or undistorted primary factor inputs.

4.4 The second argument is a "first best" argument for export promotion and requires a reasonable basis for judging that externalities are in fact prevalent in exporting. The following might be cited as prima facie evidence of benefits from exporting accruing to others, than merely those engaged in export activity. External trade has been demonstrated to be "the principal

¹ The discussion in this chapter has benefitted substantially from the analysis in Rhee (1985).

² The mercantilist rational for export promotion—i.e., achieving export growth for its own sake, at any cost, and often linked with attempts to limit inputs—is not considered relevant or appropriate for the present discussion, as it is not based on an economic goal of efficient resource allocation either along the static lines of comparative advantage or in terms of enhancing growth and development by dynamically expanding a country's comparative advantage into new areas.
channel through which technical progress is introduced and diffused" (Hsia, 1981, p. 142), for a number of reasons: (a) imports of capital goods, a major source of new technology in most developing countries, must be financed through exports, or foreign borrowing; (b) creditworthiness, in turn, depends on a country's export performance; (c) the savings rate is positively associated with export performance, and thus permits higher sustainable investment rates (Y.C. Park, 1981), which in turn lead to more rapid embodiment of new technology; and (d) export activity in and of itself leads to absorption of new technology, product design, etc., through contact with foreign customers and the assistance of foreign buyers (Rhee, Ross-Larson, and Pursell, 1984; Keesing, 1983). Moreover, the case has long been argued that export growth is beneficial for economic growth, not merely because of its demand stimulus, but also because exports permit better capacity utilization, offer benefits from economies of scale, provide incentives for technological improvements and better management (Balassa, 1978; Heller and Porter, 1978; Krueger, 1980; Michaely, 1977). Feder (1982) demonstrated on the basis of econometric analysis of a sample of semi-industrialized countries that factor productivities are higher in export sectors, compared with non-export sectors, and that those economies which have shifted their resources into the higher productivity export sector have experienced higher economic growth.

4.5 Four concerns are in order, however, regarding export development policies, whether of the first-best or second-best type. First, export promotion should always be seen as complementary to the general trade policy reforms discussed in the preceding chapter. Second, most export promotion measures are likely to be appropriate only on a transitional basis: once the anti-export biases in the trade regime have been substantially removed through general reform of the protective structures, special measures designed to put exporters on an equal footing with their international competitors are no longer needed; similarly, once an economy has become firmly outward oriented and appropriate infrastructure and private production and trading institutions in support of exports have been developed, direct support by government can be reduced and eventually eliminated. Third, the scope for export promotion policies has become increasingly circumscribed by international and bilateral rules and practices which limit the allowable or accepted forms of intervention. This, if anything, has heightened the need for general trade reforms discussed in Chapter 3. Finally, to the extent that there are costs of public intervention—as there usually are—, these have to be outweighed by the benefits of government action, if the government is to have a beneficial role in export promotion.

4.6 It is difficult, if not impossible to establish with certainty that the benefits of direct public support for export development will outweigh the costs in any particular country, although in such cases as Japan and Korea...
most analysts would argue that government intervention in support of exports on balance has been successful. It is much easier to establish what are the major factors which make government involvement in export development successful. Based on the Korean experience, Rhee (1985) has identified four major elements needed for effective government intervention in the area of export promotion: (a) automaticity, i.e., clear rules of the game for all actual and potential exporters, and speedy and non-discretionary assistance; (b) equal treatment of all export value-added, whether produced by direct or indirect exporters; (c) prevention of abuse; and (d) administrative convenience. For these conditions to be satisfied, considerable attention needs to be given to the institutions implementing the export development measures. The next section provides a brief overview of the major instruments available for export development.

B. Instruments of Export Development Policies

4.7 Free Input and Output Trade. An effective system of indirect tax exemptions or rebates/drawbacks for direct and indirect exporters should be designed to ensure that exporters can in effect gain access to inputs, and trade their outputs, at world market prices. In addition, where quantitative controls inhibit imports, direct and indirect exporters in principle should be provided uninhibited access to any imports needed for export production.

4.8 Ready Access to Export Finance. Direct and indirect exporters should have speedy and undisrupted access to preshipment working capital (short term) finance at competitive rates. This may require special support for small and medium-scale exporters, including the introduction of preshipment export finance guarantees. Of lower priority, and in many cases even inappropriate, is the provision of export finance at preferential rates, the special provision of investment finance for exporters, or the provision of postshipment export credit.

4.9 Access to Primary and Nontraded Inputs at Undistorted Prices. This would include efforts to maintain an undistorted labor market and wage structure, and the ready provision of nontraded inputs (especially transport, electricity, telecommunications and other public services).

4.10 Adequate Institutional Infrastructure for Trade. This covers the provision of timely and low-cost customs clearance, shipping, and port handling facilities, support for export market information gathering, training, and research and development (R&D), and assistance with the development of trading companies and exporters' associations. It includes also an active government role in international trade negotiations, in providing exporters with assistance to fully utilize GSP privileges, and in any cases of anti-dumping and countervailing duties brought against the country's exports in importing countries.

4.11 Free Trade Zones. One of the common instruments chosen to implement some of these measures of export promotion listed above is the provision of Free Trade Zones (FTZs), in which the direct exporters are provided with duty-free access to imported inputs, with the necessary physical infrastructure and often with credit and technical assistance, and possibly even exemption from
some of the country's labor laws. FTZs are frequently also designed to attract direct foreign investment to export industries.

C. Export Development Policies Currently Applied in East Asia

4.12 All of the countries reviewed for the purpose of this report have made some effort to promote their exports. Of course, none of them have been as systematic and successful in this regard as Korea, although the other East Asian NICs reaped similar success. Korea has set an example which many of the countries of East Asia and of the rest of the developing world have sought to emulate. In taking stock of export development policies in the region, it is therefore appropriate to begin by reviewing the history of export policies in Korea, and then turn to an overview of the rest of the countries covered in this report.

The Korean Approach

4.13 After an early phase of import substitution policies during the 1950s—which, however, did not involve as significant a degree of discrimination against exports as has commonly been the case in other countries (Westphal, 1979, p. 58)—the country began in the early 1960s to pursue a sustained export-oriented industrialization policy. The instruments selected for this strategy were comprehensive and far-reaching (see Table 4.1). They included the provision of income tax deductions, import duty exemptions and drawbacks, liberal access to pre- and postshipment and investment finance at preferential rates, export finance guarantees and credit insurance, preferential rates for electricity and rail transport, and supportive infrastructure investments, such as the provision of free trade zones. In addition, the exchange rate was generally managed so as to maintain the country in a competitive position, and the entire governmental machinery was oriented towards the achievement of ambitious export targets.

4.14 According to one estimate (Balassa et al., 1986, p. 44), excluding the exchange rate effects, the export incentives as a percentage of export value in terms of domestic currency increased from 12.8% in 1965 to 30.3% in 1971. In addition the real effective exchange rate depreciated by 29% between 1965 and 1973.

4.15 Beginning in the mid-1970s the measures in direct support of exports, and especially those which could be construed as direct subsidies (i.e., income tax deductions, preferential financing terms, and preferential utility rates), were gradually dismantled. What is more, since the early 1970s the Government had initiated a major drive in favor of heavy and chemical industries (HCl) and thus import substitution. As a result, the value of export incentives declined to 16.5% of export value by 1979 (ibid.), and possibly further thereafter.

4.16 The responsiveness of export supply and demand to changes in relative export prices resulting from exchange rate and export development policies has been substantial (a supply elasticity of 2.0–2.5, and a demand elasticity in excess of 1, according to estimates by Balassa et. al., 1986). And, of course, the country's export performance has on the whole been spectacular
ever since the concerted export development policies were introduced. Other factors besides these policies contributed to Korea's successful export-led industrialization experience, including its strong human capital endowment and prior experience with industrialization under Japanese occupation, the rapid growth in world trade during the same period, and special regional developments (e.g., the Vietnam war). Nonetheless, there is strong econometric and circumstantial evidence that the export orientation in its economic policies was a dominant factor explaining the Korean development path since 1960.

Export Development Policies in Other East Asian Countries

4.17 The Korean approach was probably the most single-minded in terms of export orientation among all the East Asian developing countries. However, others, including Japan, Singapore and Hong Kong, preceded or paralleled Korea's success and efforts in this regard, albeit not necessarily with an identical set of policies. For example, Hong Kong and Singapore did not set export targets, nor engaged in as centrally directed an export promotion campaign as did Korea; nonetheless, all of these countries were alike in providing early and strong incentives and institutional support geared to support their export development.

4.18 Other countries in the Region, including Indonesia, the Philippines, Thailand and Malaysia, were much less emphatic in their pursuit of exports. While a quantification of the export incentives in these countries (comparable to the Balassa et al., estimates reported above) is not available, a brief review of the prevalent export development policy instruments as they were applied in these countries will serve to demonstrate that point. The main instruments considered include tax incentives, export and investment finance, infrastructure investment, and other forms of institutional support (or, as the case may be, hindrance). Table 4.1 gives a more detailed overview of the use of these instruments in the four countries concerned, permitting a direct comparison with the Korean case. In all cases, the initiatives at providing special export incentives started only in the early 1970s, and in the case of Indonesia only in 1978. In most respects, the more intensive efforts were initiated only in the early 1980s. Compared to the East Asian NICs, and especially Korea, export incentives were provided late, and even then much less systematically.

4.19 Tax Incentives. All four countries have offered their exporters some relief from import duties and other indirect taxes; some also provide unrestricted access to imports for export production where quantitative import restrictions are in place. In all four countries, however, the experience with administering these systems of tax exemption or duty drawbacks has been unsatisfactory, because of limited access (especially by small and indirect exporters) and slow and cumbersome procedures. In none of the countries have these systems been as comprehensive in coverage, automatic in access, and effective in administration, as has been the case in Korea. In addition to

4/ See Rhee (1985) for an overview of export policies in Hong Kong and Singapore.
Table 4.1: EXPORT PROMOTION POLICY INTERVENTIONS

<table>
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<tr>
<th>Country</th>
<th>Indonesia</th>
<th>Philippines</th>
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- **Philippines**
  - To preferential income tax treatment for exporters.
  - Fixed duty drawback system ("export certificate scheme") introduced, but did not provide adequate or timely rebates. Prior export income exemptions available, but not utilized. Export income exemptions not computed. Entirely new system introduced on July 1, 1986. "Producer-exporters" (exporting at least 10% of production) are allowed to import inputs free of duty and QIE. Other export producers and indirect exporters are also entitled to export duty free (based on new drawback system). IFP domestic suppliers cannot provide products at competitive terms. Private firms (IFPs/Exporters) allowed to export outcome fixtures at ports of origin and factory sites. New system partially free-screening; eventually to be replaced by generalized input-output coefficient schedule.
  - Comprehensive export finance system introduced in 1983, including pre- and postshipment credit at preferential interest rates and related guarantees and insurance schemes. Domestic L/C schemes introduced, but not implemented; therefore, indirect exporters are not covered by export schemes. Foreign exporters have access to preshipment finance. Medium- and long-term loans for export production introduced as a pilot basis in 1986 (with bank support), for firms which export directly or indirectly at least 20% of their incremental production.
  - Since 1983, income tax credit on 10% of net local content of exports (valor-added) based to provided for 10 years (graduated indirect exporters receive tax credit of 5% of net value added). This was extended in 1986.
  - Data drawback system, in operation since 1973, was substantially improved in 1980. System of standard drawback established an end-product-to-end product basis with minimum processing time of 3 days (compared to 60 day average for similar non-woven drawback also still in use). Counterpart of system and reduction of processing time under consideration. For select sets of export products, Free Export permits and signagments have been allowed.

- **Indonesia**
  - GOI reduction in business income taxes on profits derived from exports (abolished 1975). Export Fund for trading companies. Special depreciation allowances for capital equipment used in export production.
  - Full indirect tax exemption for exports, and imports for export production not subject to QIEs. Tariff exemptions expired in 1975 for a fixed drawback system, which was combined with an individual drawback system in 1985. Export margin allowances in operation until 1977. Automatic tariff exemption on capital goods imports used for export production (ceased in early 1970s).
  - GOI bank of Indonesia provide export credit insurance, while GOI Credit Guarantee Fund provides preshipment export finance guarantees.
  - Preferential user charges for electricity and rail transport used for exports. (Abolished 1975).
  - Two trade organizations, the Trade Board Association and Goi Trade Promotion Corp. 50 specialized commodities trade schools.
  - GOI trade quach trade promotion meeting and note export targets in various world markets. Marketing, information assistance provided by the above institutions. Technical assistance and training and quality control inspection provided by public agencies.
  - Various reform of customs clearance procedures in April 1985, with private survey (HSI) clearing imports at point of origin. In addition, port procedures were simplified and unloading and freight forwarders' activities deregulated.

- **South Korea**
  - Small PES in operation. Export estate to be set up under export project, designed to emphasize linkage with domestic market.
  - Export Support Board set up an autonomous body under leadership of private sector. It manages Export Support Board's financial services required by direct and indirect exporters, including all aspects of export promotion and production management, and firm-specific training, all services are to be provided on cost basis. This program is supported by Bank loans. Government also provides export quality upgrading support network and exporter training.

Since 1979, Central Bank rediscounts short-term export (marketing) credit for prepayment (finance at market rates of interest) access has, however, not been quick and automatic (due to time-consuming paper guarantee procedures). AEC is available to export firms. Since 1981, export finance facilities has been cut back due to monetary restric.
- 14 special medium- and long-term credit facilities exist for export producers, but activity is given to export projects under the last Development Plans since the Industrial Incentives and Loan Fund operated by the Central Bank.
- An export credit guarantee scheme is in existence, but it is affected progressively, due to severe financial difficulties of guarantees agency.

Since 1979, PES opened in late 1970s. 5 PES in operation in 1983. Hooded manufacturing warehouses (HMPs) also exist. streamline and upgradable operation of HMPS currently under consideration.
- Government promotional efforts include assistance to exporters in areas of product development, quality improvement, and marketing and trade information.

In March 1985, export clearance requirements were abolished for most export products, except those for which export permits are required, those covered under international agreements or subject to quotas is importing countries. Export clearance for regulated or controlled products has, since 1980, been granted automatically for use in export production, HS Code has been contracted for production valuation of imports so as to facilitate and speed customs clearance.
Table 4.1: (cont’d)

<table>
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<tr>
<th>Thailand</th>
<th>Malaysia</th>
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<tr>
<td><strong>Tax exemption/duty drawbacks and tariff exemption</strong></td>
<td>Investment incentives are to be granted by the Board of Investment (BOI) on a priority basis for exporting firms (along with labor intensive, regionally dispersed activities), including corporate income tax holidays, duty free importation of intermediate inputs and machinery, etc. However, impact of BOI incentives on exports has remained limited, as promoted investments have not been especially export oriented. Trading companies are given promotional assistance by BOI.</td>
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<tr>
<td></td>
<td>Income tax deduction is available for manufacturer-exporter, based on sales for exports (10% of export value added).</td>
</tr>
<tr>
<td></td>
<td>Prior exemption and duty drawback schemes exist, but are cumbersome and time consuming, and are not accessible to indirect exporters. “Domestic availability test” and need to obtain import licenses for commodities under OBUs further limit access to imports for exporters. Limited monitoring provides insufficient deterrent for abuse of schemes.</td>
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<tr>
<td><strong>Credit and export financing (including insurance)</strong></td>
<td>Preshipment (short-term) export financing facility was expanded from rice exports to all exports in 1970. Loan amounts increased rapidly since then, but primary commodity exports retain largest share of credit, which is based on Central Bank rediscounting at preferential rate. Indirect exporters do not have access to these credits. A domestic L/C scheme has been introduced on a pilot basis for trading companies with a view to broaden application.</td>
</tr>
<tr>
<td></td>
<td>Pre- and postshipment export finance is available at preferential rates, but has been limited in use and has not reached indirect exporters. Government is currently reviewing alternative mechanisms to strengthen preshipment finance scheme, including the possible introduction of domestic L/C system (a pilot scheme has been initiated). Preferential rates are to be gradually eliminated. There are no special medium- and long-term investment credit facilities for exporters.</td>
</tr>
<tr>
<td><strong>Other subsidies</strong></td>
<td>None.</td>
</tr>
<tr>
<td><strong>Infrastructure investment</strong></td>
<td>Only one FTZ in existence, and this one is underutilized; 36 firms had BMW status in October 1984.</td>
</tr>
<tr>
<td></td>
<td>Substantial program of FTZs and BMWs (called Licensed Manufactured Warehouses) operated since early 1970s. Exports from FTZs and BMWs accounted for some 60% of total manufactured exports from Malaysia in 1982.</td>
</tr>
<tr>
<td><strong>Other assistance</strong></td>
<td>An Export Development Fund was set up in 1982 to provide marketing support to Thai exporters through export service centers in Thailand and overseas. However, its operations, as well as other governmental institutional support for exporters, have remained limited.</td>
</tr>
<tr>
<td></td>
<td>Malaysia’s Export Trade Center is engaged in export promotion, including marketing and information assistance; there is no assistance for technical training.</td>
</tr>
<tr>
<td><strong>Custom procedure</strong></td>
<td>Port and customs clearing operations are cumbersome and time consuming.</td>
</tr>
</tbody>
</table>
relief from import duties and other direct taxes, only the Philippines and Malaysia have provided some production incentives for exporters through their corporate tax system. In the case of the Philippines, an income tax credit was available based on net local content (value added) of exports (but has now been suspended), while in Malaysia a corporate income tax deduction is based on export value added. In neither of these two cases does the corporate tax relief appear to have equalled that provided to export firms in Korea.

4.20 Export Finance and Insurance. All four countries have introduced some financing support for exporters, most commonly a preshipment short-term (or packing) credit, discounted by the central bank, previously at preferential rates, but now mostly at market rates. In addition, some postshipment finance and some preshipment finance guarantees and postshipment export credit insurance has been provided. Again, however, efforts have been hampered by poor design of systems—including lack of complementarity between finance and guarantee schemes, lack of accessibility by small and indirect exporters, and undue emphasis on postshipment finance, when preshipment finance is mostly required. In no case did there exist an effective system of medium and long term investment finance in support of export activities.

4.21 Infrastructure Investment. Korea had developed an effective infrastructure network nationwide relatively early on, but in addition provided industrial estate and free trade zone (FTZ) facilities, designed especially for export development. Malaysia matched, and probably exceeded Korea's efforts in the area of FTZ development; but its success in this area only temporarily hid the failure to develop a broadly based manufactured export drive (see below for an evaluation of Malaysia's FTZ and bonded warehouse experience). The Philippines were also active in this area, but Thailand and Indonesia offered little by way of special facilities to foreign or domestic investors interested in export-oriented production.

4.22 Institutional Support. Where Korea had a whole array of institutional and bureaucratic support oriented towards export promotion, marketing, technical, and information support involving close collaboration between government and private agencies, the four other countries have engaged in only rather lukewarm efforts to stimulate and sustain entrepreneurial interest and capabilities in export-oriented activities. In essence these countries lacked the well articulated program of export development applied in Korea and based on close coordination between various government agencies and the private sector, all of which added up to a strong "export mentality." Indonesia recently initiated, with World Bank support, what is perhaps the most comprehensive of efforts in this respect among the four countries, by beginning to set up the institutional support for export marketing, production management and training. Perhaps even more significant, however, have been the bold initiatives which Indonesia took in April 1985, when the government instituted sweeping reforms of customs clearance procedures, simplification of port procedures, and deregulation of shipping and freight forwarding activities. (See below for a more extensive assessment of these reforms.)

4.23 The next sections assess in some detail the major issues arising in the design and implementation of export promotion policies.
D. Free Input and Output Trade

4.24 Efforts to provide exporters with access to undistorted inputs and with undistorted export opportunities are particularly important in countries where the domestic price structure is highly distorted by tax and non-tax measures. To the extent that such efforts are, however, in and of themselves not costless they should be limited to cases where the price distortions are significant and cannot be readily removed by direct, or "first-best", reform in the incentive structure.

4.25 On the input side, the common approach is to provide duty exemptions and/or indirect tax rebates, on a case-by-case basis, or based on fixed product-by-product schedules. Rhee (1985) concludes that a combination of individual drawbacks/exemptions and of fixed drawbacks is desirable since it allows the exporter to choose between completely undistorted input prices and administrative cost savings. At the same time, however, the fixed drawback scheme must be based on carefully assembled, disaggregated physical input coefficients, which are regularly updated and published, as is the case in Korea. Aggregate, value-based coefficients drawn from an outdated input-output table, such as were used in the recent past in Thailand, do not provide a good basis for fixed drawbacks. Among other problems, that approach has also invited countervailing duty action by the U.S., on the (largely spurious) grounds that the Thai system overrebates indirect taxes.\footnote{On average, the Thai system has led to underrebating, although in specific cases, because of the undifferentiated nature of the system, overrebating may have occurred (World Bank, 1985c).} Speed and ease of access are also crucial aspects of an effective tax exemption/drawback system. Improved administration, computerization, and training of staff are essential ingredients for reform. This will require persistent commitment and efforts on the part of the concerned policy makers and civil servants.

4.26 In this connection it is essential that inputs at world prices are made available not only to direct exporters, but also to indirect exporters. This is a particularly difficult area, unless systems have been put in place which ensure the adequate identification of indirect export activities. The registration of indirect exporters may provide one limited option, but is likely to leave many actual and potential indirect exporters out of the net of benefits, particularly the smaller ones. Based on the experience in Korea, it appears that the introduction of a system of domestic letters of credit (DL/C) can significantly facilitate the provision of tax free inputs for export production (as well as the ready access to working capital finance by direct and indirect exporters; see below). DL/Cs are financial instruments exactly parallel to regular L/Cs used with frequency in international trading transactions, and are provided by commercial banks to domestic suppliers of ultimate exporters, usually back-to-back with export L/Cs. Box 4.1 explains how the DL/C system works. On the basis of DL/Cs the chain of indirect exporters can be established for any given export L/C, and indirect tax and duty rebates can effectively be provided to all. The need for drawing indirect exporters into the net of benefits is particularly important if one
Box 4.1

Domestic Letter of Credit - How It Works

The single most important innovation in export incentive administration is the domestic letter of credit. The domestic L/C is essential to assuring automatic availability of short-term export loans and free trade status to all firms that generate export value added but do not export directly, i.e., indirect exporters. There are two types of indirect exporters: (a) input-supplying indirect exporters—which supply intermediate inputs to final stage (or next stage) export manufacturers—and (b) output-supplying indirect exporters—which supply finished export products to trading companies that export directly (or sell to other trading companies). Indirect exporters most commonly are manufacturers, but they can also be pure traders. Input-supplying indirect exporters, are critical for achieving backward linkages from exports; output-supplying indirect exporters, are critical for developing trading companies that specialize in overseas marketing.

In many developing countries attempts to encourage final exporters to pass the benefits of export incentives through to indirect exporters have not been successful, because the systems constructed have not dealt adequately with the different needs of indirect and direct exporters in a well-coordinated manner. The successful East Asian countries, on the other hand, have granted equal export incentives to indirect exporters themselves, not through intermediaries. The domestic L/C system has been the most effective administrative tool for this direct granting of export incentives.

The principle of a domestic L/C system is the creation of "back-to-back credit," a vehicle through which the beneficiary of an export L/C (or other export order) can take advantage of the creditworthiness of the importer (and the availability of export incentives tied to an export order). When an exporter has an irrevocable L/C in his favor, the existence of the L/C enables his bank to open a second, similar credit account on behalf of the exporter, with the input-supplying indirect exporter or output-supplying indirect exporter as the beneficiary. Thus, the indirect exporter gains access to all export incentives based on the receipt of the domestic L/C, just as the final exporter gains such access based on the receipt of an export L/C (or other evidence of an export order).

A domestic L/C is a document created by a bank that declares to the indirect exporter that the bank will pay, on behalf of the final exporter, a draft drawn on it when the indirect exporter submits, together with the draft, a receipt that the commodities have been delivered to the final exporter. Therefore, the domestic L/C is the most reliable and automatic instrument for verifying the transaction between the final exporter and the indirect exporter as a basis for providing duty-free access to imports destined for export production. In addition to giving access to duty-free inputs, there will be an encouragement to use the domestic L/C as long as the final exporter
Box 4.1 (continued)

gains access to export loans for purchasing domestic inputs or finished export commodities based on the domestic L/C he issues, and as long as the indirect exporter can use the domestic L/C to gain approval for his production loans. For this mechanism to operate, it is essential that the export financing system be modernized to provide export financing along these lines.

The domestic L/C system is the most effective instrument for meeting the two basic requirements in structuring administrative arrangements that provide critical incentives for indirect exporters. These requirements are: (a) that a means exist for independently and automatically verifying that the supply of intermediate inputs or completed export commodities provided by the indirect exporter were in fact purchased by and delivered to the final exporter and (b) that both the indirect exporter and the final exporter are strongly encouraged to use available instruments in order to gain access to export incentives. Because the domestic L/C is handled by commercial banks, it also offers the advantage of delegating much of the authority for export incentive administration to the commercial banks, which generally offer greater administrative efficiency than government can provide. (This box is based on Rhee, 1985, and World Bank 1985c, Annex IV).

wants to develop a stronger base for growth of trading companies. Where only producer-exporters benefit from tax exemption and rebate schemes, trading companies are naturally disadvantaged in their ability to effectively offer their specialized services.

4.27 Besides access to inputs at world prices, import licensing for direct and indirect exporters has to be automatic, providing, in Rhee's words, absolute free choice between imported and domestic inputs. In this connection the Malaysian and Philippine system of providing import duty exemptions subject to a "domestic availability test" is potentially very harmful, as it may force exporters to use higher-cost domestic inputs, rather than lower-cost imported inputs. In contrast, the recent reforms in Indonesia, which are designed to provide free access to direct exporters to imported inputs at world prices, are particularly noteworthy in the light of Indonesia's experience as a "high-cost" economy, where heavily protected, high-cost import substitution industries have in the past effectively been the only source of many intermediate inputs for export production, thus harming Indonesian export competitiveness.

4.28 Providing automatic and duty-free access to inputs for exporters is not without its trade-offs, however. Indirect taxes, tariffs and non-tariff barriers presumably exist in the first place because they raise revenues and/or provide protection to particular "infant" activities. Newly introduced tax and tariff exemptions or rebates result in tax revenue reductions which must be made up in other ways. In the case of Thailand, for example, it has been estimated that the revenue loss could amount to 2-4% of government revenues, or between 0.3 and 0.6% of GDP (World Bank, 1985c). While not dramatic (especially if gradually phased in), this revenue loss is equal to
the revenue gain of the typical annual tax package introduced by the Thai Government in recent years and thus would amount to a noticeable additional burden in revenue mobilization. Of course, rather than arguing against a streamlined tax rebate system, this observation further buttresses the case for a more far-reaching reform of the present Thai tax system, which relies unduly on trade-related taxation (World Bank 1986n).

4.29 As regards the protective impact of tariffs and quotas, there can be little doubt that the access of exporters to automatic and duty free imports would tend to weaken the protective effects; on the other hand, protection remains for domestic sales, and the larger the domestic market relative to the foreign sales, the more important this effect. What is more, a number of other points argue against taking the loss of protection too seriously: First, much protection that remains in place has probably outlived its usefulness in fostering "infants;" second, the Korean experience demonstrates that effective development of "infants" can and must in fact go hand-in-hand with free access to imports, particularly if the "infants" are to be found in export-oriented activities. Finally, infant industry protection, in any case, should, in principle, not rely on trade measures, but on measures such as value-added subsidies which do not distort trade.

4.30 In sum, provision of automatic access to inputs at world market prices is not always free of conflict with other government objectives, will involve administrative costs and difficulties, requires time for implementation, and will have fiscal implications that need to be explicitly considered and, where necessary, offset. Moreover, it is important that measures designed to provide a "second-best" stop-gap do not detract attention from design and implementation of first-best reform of the overall system of tariff and non-tariff measures. Nonetheless, efforts to facilitate exporters' access to inputs at world market prices deserve serious attention, and may, in fact, be a good intermediate step towards the rationalization of the overall trade policy system. Moreover, to the extent all governments in East Asia already have some systems of tax exemptions and drawbacks in place, the rationalization of existing systems should be feasible without imposing additional administrative costs, and should generally involve reduced compliance costs for private firms.

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6/ In this connection it is worth emphasizing that the introduction of a value-added tax system, which would replace other forms of indirect domestic taxes, would significantly facilitate the provision of tax-free status to exporters, aside from other favorable features inherent in a VAT. For Indonesia, for example, the refund of domestic indirect taxes appears to have been substantially speeded up as a result of the introduction of the VAT.
E. Export Finance

4.31 Financing of export activities involves three different types: preshipment working capital (short-term, or packing credit); postshipment finance (short- or medium-term); and medium to long-term finance for investment. For each of these instruments there may also be insurance or guarantee provisions which pool the risks from default. As seen in Section 4.C above, pre- and postshipment finance and guarantee/insurance systems are the most commonly provided means of support, mostly through rediscounting facilities at the central bank. Each of these financing instruments will briefly be discussed in turn.

Preshipment Finance

4.32 The central elements of an effective preshipment finance system as found by Rhee (1985) in Korea are the following: ready access to credit; risk pooling; and risk reduction. These can be achieved through the following initiatives: automatic and quick refinancing by the central bank; a preshipment export finance guarantee scheme which encourages commercial banks to provide working capital credit to all actual and potential exporters; and application of the system of domestic letters of credit (DL/C) which permits a modernized scheme of preshipment finance to be implemented, providing access to preshipment credit for direct and indirect exporters alike. By making loans available only directly to suppliers through the handling bank, not to purchasers of inputs, it is also possible to economize on the use of credit resources and to create a quasi-physical collateral in the form of the inputs shipped to the purchaser. In addition, preshipment loans should be made available to established large exporters on an expected, rather than actual order basis, subject to subsequent verification of actual orders. Preferential interest rates are not essential to the effective working of preshipment finance systems; ready access is what matters most. In fact, in Korea preferential interest rates have been gradually phased out; preshipment credits are now denominated in foreign currencies and passed on to borrowers at world market interest rates plus a processing margin.

7/ Central bank rediscounting of trade bills has been common in the now developed countries since the beginning of the nineteenth century.

8/ A purist might argue that this practice still involves a subsidy if, in the absence of the export credit scheme, some exporters would either have been denied access to export credits or would have been charged interest rates higher than those charged by the government scheme. However, the provision of export finance is based primarily on the presumption that exporters lack access to working capital finance because there are information imperfections in the capital markets. In particular, it has been argued (Rhee, 1985) that commercial banks in developing countries are insufficiently aware of the longer-term profitability of export activities, especially on the part of small and medium-size exporters. The public provision of export credit is therefore designed to offset a specific market failure, rather than to provide a subsidy.
4.33 Analysis of existing systems of preshipment finance recently carried out by the World Bank in Thailand and Malaysia have resulted in detailed recommendations for introduction of preshipment finance systems along the lines summarized above (World Bank 1985c and 19861). In particular, the introduction of the DL/C system has been proposed, and, in the case of Thailand, DL/Cs have been introduced on a pilot basis for trading companies. Careful monitoring of the Thai experiment will provide important clues for determining how readily and how best a universal system of DL/Cs can be implemented. One of the crucial determinants of success or failure will be the willingness of commercial banks to develop a system of DL/Cs and of domestic traders to use it. Care needs to be taken during the introduction of DL/Cs that banks and traders do not have spurious incentives to stay with their previous financial practices. Linking tax drawbacks and export finance to the use of DL/Cs would presumably provide a strong incentive to indirect exporters to use DL/Cs.

4.34 Some additional observations may be drawn from the recent Bank reviews of preshipment export finance in Thailand and Malaysia showing some of the wider implications of preshipment finance reform: In the case of Thailand the current system of export finance was found to be wasteful in not effectively targeting preferential credit resources for the use of working capital finance used in export production. With the same amount of credit allocated annually to this purpose (which, incidentally, is very high in Thailand in relation to exports, when compared even with Korea) much larger amounts of export activity could be financed, if the streamlined export credit procedures were fully operational. For the case of Malaysia, the World Bank has recommended to do away with local content and domestic value added requirements, since these have faced exporters with an inappropriate choice between access to imported inputs and to export finance, when both should be automatic.

Postshipment and Investment Finance

4.35 Postshipment credit facilities are usually offered alongside preshipment finance, but are less important for export development in developing countries. Financial systems in the importing countries are generally well developed and exporter financing tends to be a lesser factor in buyer decisions than quality and price of product for the types of manufactured exports shipped from developing countries. Only where capital goods exports take on significant shares of exports, as in the case of Korea, will postshipment credit become of significance. In contrast, postshipment credit insurance is likely to be of lesser importance for countries like Indonesia, the Philippines, Thailand and Malaysia. For these reasons, the recent World Bank reviews of export finance facilities in these countries have emphasized reform and expansion of preshipment, rather than postshipment finance.

4.36 Special channels of investment finance for export production are another way of ensuring that resources flow into export-oriented activities, and for Korea this clearly has been a major means of export promotion during the 1960s and 1970s. There it was part of a broader system of government-directed lending, which has been subjected to far-reaching reforms since the beginning of the 1980s. As indicated in the discussion of the current policy
framework in Section 4.C above, investment credit specifically earmarked for export production has not been a major practice in East Asian countries, although the Indonesian government has recently initiated with World Bank assistance a small program to that effect. The benefits from such support for export development have to be weighed against the costs of fragmentation in the financial system of a country which may result from specialized lending activities, and of course the administrative costs of identifying viable export activities and of ensuring that the mechanism results indeed in additional credit for the priority (i.e., the export) sector. For this reason, the Bank's recent efforts, for example in Korea, Thailand and the Philippines, have generally been in the direction of assisting with the reform and streamlining of the entire financial sector, stressing the need to improve the overall system of bank and non-bank finance.

F. Access to Primary and Nontraded Inputs at Undistorted Prices

4.37 Besides access to capital, access to undistorted labor and nontraded inputs, especially transportation and utilities, are an important ingredient of international competitiveness of a country's exports. As regards labor inputs, undistorted wages are one of the major elements of competitive advantage of the East Asian economies, especially when compared to Latin America. Besides any general biases which may arise from an overvalued exchange rate, three factors may contribute to harm, or help, the wage competitiveness of the East Asian countries.

4.38 First, in some countries, labor market segmentation appears to be a significant problem in creating artificial labor shortages and thus increases in wages for particular labor categories. Malaysia, in particular, is affected by this phenomenon along lines of ethnic divisions (Report No. 5908-MA). In Korea, labor market segmentation appears to be affecting the female labor force, which is poorly integrated into the broader labor market. To the extent that these examples of segmentation are caused by ethnic and cultural phenomena, rather than government intervention, there may be relatively little that can be done in overcoming them.

4.39 Second, to the extent that wage cost push is sanctioned by government intervention in the collective bargaining process, or emanates from restrictive labor laws which tend to affect especially "modern", i.e., industrial sector activities, or to the extent that government hiring and wage practices push up wages in the skilled and semi-skilled categories, government labor market practices and policies have an important role to play in ensuring competitive labor inputs for industries, including export-oriented activities. For Korea, in particular, some of these considerations may be gaining in importance as pressures are building in and outside the government to introduce "modern" or "social" labor and employment legislation and practices, including minimum wages, unemployment insurance and provident funds. One of the important tasks facing the Korean government is how to satisfy the demands for socially just development, while avoiding the emergence of labor market rigidities which have troubled the Western European economies during the last two decades.
Finally, education and labor training are important areas where government support in ensuring adequate access to labor is important. However, in this area success will take time and may become effective only long after some of the important steps have been taken. Korea's success certainly has had much to do with longstanding and systematic efforts in human capital development. At the same time, the experience in the Philippines is an important reminder that a good endowment of human capital, when compromised by the poor macroeconomic and sectoral policies, is not sufficient to generate sustained export growth and economic development. Similarly, efforts which have recently been initiated in Indonesia (with World Bank support) to improve the export performance in that country (in part through training of entrepreneurs in the ways of export production and marketing), will bear fruit only if the broader policy framework is supportive of export development.

In the area of infrastructure, there can be little doubt that access to good transport, power, telecommunications, port and other utilities is crucial for the establishment of successful export activities, not only at selected locations, but throughout the country. In this regard, most East Asian economies have made tremendous strides during the last two decades. Physical provision of such services for export industries (and agriculture) is no longer a major bottleneck, although exporters might be given special access in cases where waiting lists are still common (esp. for telephone and telex services). However, the recent developments in the Philippines demonstrate that this achievement is not irreversible. As a result of the economic crisis and the consequent shortage of public investment and maintenance funds, some parts of that country's infrastructure have begun to deteriorate, in particular the road network. Unless remedied soon, this could hinder a revival of export production and thus the economic recovery of the Philippines.

Besides physical accessibility, the cost at which infrastructure is made available to exporters is an important factor. Cost in turn is determined by two main factors: First, costs may be high (low) because of poor (good) investment and operating practices; second, they may be high (low) because of public taxation (subsidization) of the services. The first aspect on balance appears to be a more important concern in East Asia than the second. A few examples may prove useful: The telecommunications sector in Thailand, while historically providing service of reasonable quality, has in recent years been plagued by an unbalanced investment strategy, with heavy investment in switching capacity not matched by an adequate rate of connection of users. As a result, existing users have to bear a high financial burden in financing the excess capacity. Similarly, in the case of the Philippines the decision not to start-up the Bataan nuclear power plant may significantly raise the cost of electricity to industrial (and other) users.

Of course, taxation (or subsidization) of utilities may also be a factor: In the case of the Philippines, for example, industrial power users cross-subsidize residential users by paying a rate that is almost twice as high, while the reverse is the case in most other countries of East Asia (see Report No. 6350-PH). In principle, such taxes on utility rates (i.e., the differential between long run marginal cost and price) should be rebated for exporters. Korea's now-abolished rebates on rail and power tariffs for
exporters are an example of what might be possible. However, the scope for providing exporters with preferential utility rates appears now limited by countervailing duty actions in importing countries, where the concept of financial, rather than economic costing is used to establish whether "subsidies" are given to exporters in competitor countries. It would be useful to carry out a more systematic analysis of the extent to which utilities are levying taxes on industry, including exporters, and what is the scope for alleviating this burden on exporters either by overall reforms in the rate structures, or through targeted rebates.

4.44 One particular example of infrastructure deserves special attention, since it is of paramount importance to exporters: ports, port handling, and shipping. Poor and costly port and shipping facilities can substantially affect a country's trading ability by raising effective import and export costs. Much of this can often be traced back to poor public management and inappropriate intervention. According to one recent study of ASEAN port facilities, savings of some 1.2 billion US dollars per year in shipping costs would be possible, if container berth productivities in ASEAN ports could be raised to levels equal to those currently found in Singapore (Peters, 1986, p. 16). The practice of encouraging domestic flag carriers and then imposing restrictions on exporters' use of foreign carriers can also be a source of high costs in shipping. In Indonesia, the recent reforms of restrictions on competition in port handling and shipping are estimated to have reduced port handling and shipping costs by as much as 30-40% (The Far-Eastern Economic Review, January 30, 1986). Careful design and efficient operation of ports, together with encouraging competition in port handling and shipping, are thus likely to be important elements in providing a country's exporters with competitively priced inputs and the ability to sell their outputs at competitive prices internationally.

G. Institutional Infrastructure

4.45 This area represents a wide field for action. It ranges from rationalization in customs procedures to support for trading companies and exporters' associations, but also includes direct assistance and training in the areas of design, production and marketing for exports, support for broader efforts in R&D and active government involvement in trade negotiations. For each country, different institutional support is likely to be appropriate, as the equally successful experiences of Japan and the East-Asian NICs have shown. In particular, while the Korean practice of export target setting and monthly high-level export meetings of private sector and government representatives were an important and integral component of that country's export strategy (Rhee, Ross-Larson and Pursell, 1984), other successful NICs in East Asia did not employ these particular mechanisms (Balassa, 1979). Nonetheless, in all East Asian NICs there prevailed a pervasive "exports-first" attitude, buttressed by good coordination between government agencies and the private sector. By way of example the institutional reforms recently initiated or proposed in Indonesia and the Philippines provide an indication of the spectrum of opportunities and needs.

4.46 In Indonesia, two initiatives are of particular interest: First, an extensive reform of customs clearance procedures was introduced in April 1985,
as part of the broader reform of port handling and shipping, already referred to above. Specifically, the new measures have reduced the required import and export procedures to a minimum. Exports are no longer subject to regular customs inspection at port of origin, but, for the purposes of duty drawback administration, are inspected (for a fee) at the ports of destination by a Government-appointed Swiss surveyor firm, SGS. Imports are also inspected and valued for tariff purposes by SGS at points of origin. The Indonesian Customs Office's responsibility is restricted to inspection of completed documents and spot checks to prevent cargo switching. Assessment of import and export duties is made by the importers/exporters themselves based on the surveyors' certification, and payment is made directly to designated banks. In general, the new procedures have worked well for imports, particularly by substantially reducing the time required for port clearance and eliminating previously common side-payments required for customs clearance. SGS inspection appears to be functioning reasonably smoothly, except for exports, where lack of buyer collaboration at port of destination has made inspection often difficult (FEER, 30 January 1986). The system is not designed to prevent smuggling; therefore, some reported smuggling cases do not represent an indication of failure. 9/

4.47 The second Indonesian initiative of institutional support has been developed with World Bank loan support. The program of institutional strengthening, which complements other areas of improvement also supported by the loan, includes efforts to strengthen commercial banks' capabilities to identify and appraise export projects, to upgrade the government's programs for export quality upgrading and improvement, to provide direct technical assistance to about 300 export firms, and to develop a program of short-term training courses for exporters. An Export Support Board and Fund, managed by the private sector, are to be set up to provide the above mentioned export support services on the basis of cost sharing, with a goal of becoming eventually self-financing.

4.48 For the Philippines a program of institutional upgrading of export support activities has been under consideration. This program, which as yet has to be finalized, would include, besides efforts to upgrade the duty exemption and drawback schemes and the short term export credit and guarantee schemes, the following elements of institutional support: development of a framework to mobilize technical assistance services in product design, production techniques and marketing; expansion of the government and private sectors' trade promotion activities; and improvement in the government's trade information services.

9/ SGS has also recently been hired by the Philippines government to carry out import inspection and valuation at the port of origin. The extent of reform, however, appears to be less comprehensive than is the case with Indonesia's customs, port and shipping reforms.
Finally, one of the most important, but perhaps underemphasized and least well understood areas for government support is in the area of trade negotiations, including attention to multi- and bilateral trade talks, assistance to exporters in the case of countervailing duty and anti-dumping suits brought by competitors in importing countries, and assistance with reaping fully the benefits of GSP preferences. On the last point, it is noteworthy that the East Asian NICs have traditionally fully utilized their GSP preference quotas allowed by importing countries, while the East Asian developing countries have often failed to do so. Up-to-date information on GSP utilization rates and assistance with compiling the documentary evidence and meeting other requirements of the various GSP systems should be a standard service offered to exporters.

H. Free Trade Zones and Bonded Manufacturing Warehouses

Free Trade Zones (FTZs) are designed to provide a short cut to export opportunities where the financial, physical and institutional infrastructure in support of exports is generally weak and would require many years for effective and broadbased upgrading. FTZs can, in such a setting, offer an effective way to absorb quickly a significant share of a country's labor force in rapidly growing export activities, often drawing on direct foreign investment. Bonded manufacturing warehouses (BMWs) are similar to FTZs in that they provide export producers with duty free access to imports, but on an individual firm basis, rather than for an entire industrial estate.

As for most shortcuts, however, there are problems inherent in the FTZ approach, and over the long haul they do not provide a substitute for building up an appropriate incentive and financial framework, human capital, and physical as well as institutional infrastructure essential for sustained export development. The principal risks inherent in an exclusive reliance on an FTZ strategy are: enclave nature of export development due to lack of forward or backward linkages with the host country for export industries settling in the FTZ; limited impact in terms of technology transfer and human capital development; and overreliance on footloose foreign investors (who provide a volatile source of employment and export earnings, are heavily dependent on favorable tax exemptions, and remain highly sensitive to world market conditions and to changes in the country's competitiveness).

It appears that FTZs are most successful where, as in Korea, they are an element of a broader export development strategy, rather than a substitute for such a strategy, as was, in effect, the case in Malaysia. In Malaysia, where the FTZ program began in 1972 (the BMW program began two years

10/ See Sathirathai and Siamwalla (1986) for an interesting discussion of the Thai negotiations with the EEC on cassava exports. One of the lessons from this case study is that developing country governments need to be taking active steps to develop a full understanding of complex GATT rules, and of the rights and obligations which are specified under these rules, if they are to avoid being railroaded into trade deals that may be less beneficial than what an adherence to GATT rules would permit.
Later), it had a considerable impact in some regards, as FTZ exports accounted for 51% of Malaysia's manufactured exports by 1982, with BMWs making up another 10%. A recent evaluation by an independent consulting firm employed under the UNDP/World Bank Malaysian Industrial Policy Studies Project concluded that the FTZ and BMW programs "generate substantial positive net benefits to Malaysia," "should be considered successful," but that "improvements are possible." (IMG, 1984, p. 5) This assessment, however, is based on optimistic parameter values used in the cost-benefit analysis of the net impact of FTZs on the Malaysian economy which impart an upward bias to the estimates of discounted net benefits (in particular, a very low discount rate, 7.5%, and a low shadow wage factor for unskilled labor, 0.825). Based on indications from sensitivity analyses carried out by the consultants, it would appear that for more realistic parameter values the net present value of Malaysian FTZ investments may well be negligible, if not negative, over the lifetime of the investments. These conclusions, when combined with evidence of very limited effects in terms of linkages with domestic markets, technology diffusion, labor training and fiscal revenues, and when considering the lackluster performance of FTZs in the Philippines, Indonesia and Thailand, demonstrate that FTZs do not provide an easy shortcut to export-led growth and that FTZ investments need to be carefully assessed in terms of their design and implementation. In particular, appropriate pricing of land and infrastructure, avoidance of unduly generous tax treatment for foreign investors, and efforts to ensure increased linkages between FTZ investments and host country are important elements of an appropriate strategy.

I. Other Means of Export Promotion

4.53 In addition to the wide range of measures in support of exports which were identified above there are others which may briefly be mentioned, but these, for various reasons, are likely to play a lesser role.

4.54 First, there is a whole set of possible fiscal incentives which might be used to offset the bias against exports emanating from the system of protection in favor of import substitution activities. In the words of Rhee (1985), in addition to "neutrality", i.e., access to inputs at undistorted prices and the freedom to sell exports at world market prices, incentives might be offered to give exports "extended neutrality" by putting them on an equal footing with import substitution activities. Among the instruments available are various types of tax incentives. These may be profit based (as the corporate income tax reduction in Singapore and, during the 1960s and 1970s in Korea), sales based (as the corporate income tax deduction in Malaysia), value added-based (as the investment tax credits in the Philippines), or investment-based (as Korea's accelerated depreciation allowances, and Thailand's BOI incentives which recently have been used to support especially export oriented activities). In principle, these incentives, especially the value-added based incentive employed in the Philippines (which is neutral with respect to factor choice), are defensible on the second-best argument of providing "extended neutrality." However, they are potential
causes for countervailing duties applied by importing industrial coun-
tries. Moreover, their applicability is likely to be limited during periods of fiscal stringency, and may in practice be difficult to extend to indirect exporters.

4.55 A second area where particular attention might focus is the treat-
ment of direct foreign investment. The experience of the successful NICs in East Asia varies widely with respect to their reliance on, and treatment of DFI. Korea had relatively little DFI, while Hong Kong drew heavily on it. The lesson appears to be that DFI is not a necessary ingredient of successful export-led development. In the other East Asian developing countries reviewed here, the extremes as regards DFI treatment in relation to export production have been Malaysia and Indonesia. Malaysia provided ready access to export-producing DFI in its FTZs, while Indonesia had rules on the book which significantly limited DFI operations in the country and specifically prohibited DFI for export production. These restrictive regulations were substantially relaxed in 1986 (World Bank, 1986c). The main point to be made about DFI is that active discrimination against DFI, especially in regard to export production, is likely to be counterproductive, but that, on the other hand, efforts to pull DFI into the country at the cost of heavy infrastructure investments and generous tax exemptions may not generate much, if any, net benefit to the country.2

4.56 Finally, a word is in order about compulsory countertrade require-
ments imposed by governments in developing countries. These are to be distin-
guished from voluntary arrangements between private trading parties, or countertrade arrangements based on government-to-government transactions, particularly with centrally planned economies, where countertrade is often a precondition of trade. Compulsory countertrade policies have been used especially in Indonesia, particularly in connection with government construction or procurement contracts awarded to foreign companies. Estimates indicate that less than 6% of Indonesia's non-oil exports in recent years have been based on countertrade, and that, instead of providing net benefits to the country, the program has imposed net costs on the country as a result of higher bids and administrative costs (Fitzgerald, 1986). This confirms the general conclusion drawn by previous analysts of compulsory countertrade programs, i.e., that countertrade is not an efficient means of improving a country's export performance. Nonetheless, it should be noted that countertrade appears to retain a certain attraction among government officials concerned with export promotion in some countries of the Region (e.g., Thailand).

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11/ In fact any industry-specific domestic subsidies may be reason for countervailing action according to Nam (1986, p. 43), "while the [GATT] Subsidies Code takes a relevant view of domestic subsidies by suggesting a positive list of objectives under which domestic subsidies may be used, the US has countervailed any domestic subsidy proven to be industry specific, irrespective of its objectives."

12/ For a more extensive discussion of DFI, see Chapter 5 below.
J. Priorities, Timing and Sequencing of Export Development Policies

4.57 A number of reasons argue for careful design of export promotion programs in terms of priority setting, timing and sequencing of the various forms of interventions in support of export promotion: First, governments in developing countries generally have only limited capacity to engage in substantial reforms of major policy areas—priority setting is therefore crucial; second, some of the most important of the export promotion instruments discussed above are complementary in design and should be jointly implemented; third, some measures are more readily accepted by trading partners than others that may run the risk of drawing countervailing actions; finally many of the institutional reforms need adequate preparation and their implementation will by necessity extend over a significant timespan.

4.58 The experience of the East Asian NICs, and especially that of Korea, demonstrates that export development policies should be introduced as early as possible, in a comprehensive manner with clear objectives facilitating national consensus, and with government commitment to a consistent and lasting policy framework. However, the context in which export promotion is set today differs from that of the 1960s, when Korea initiated its export oriented policies and programs. GATT and importing industrial nations are less forgiving of aggressive export policies, especially if they are seen to involve "unfair" trading practices or "subsidies." Moreover, fiscal constraints are paramount in many countries, making the introduction of fiscally costly promotion measures unattractive. Finally, the international trading environment is less buoyant and more constrained by protective devices in the industrialized countries than was the case during the 1960s and the 1970s, raising fears among the semi-industrialized developing countries of finding export promotion measure bumping against demand ceilings. These concerns are justified and make it more difficult to introduce export promotion measures as comprehensively as was the case in Korea.

4.59 Nonetheless, export promotion as an instrument complementary to import liberalization as a means to achieve neutrality is now as important for the lesser developed countries of the region as it was twenty years ago. It may even be argued that export promotion should precede broadbased import liberalization efforts, as was the case in Korea, to provide a cushion in terms of a more favorable balance of payments and since "positive" policies are useful in building up a constituency or lobby which benefits from export-oriented policies, counterbalancing the pressures from the traditional import-substitution lobby, which tends to have the upper hand in debates about import liberalization. In some regards, moreover, export promotion policies are a first step towards liberalization. For example, giving exporters automatic and dutyfree access to imports begins to wean import substituting industries from the crutch of protection. However, where trade distortions are extensive, a coordination of general trade policy reform and export promotion is needed (especially in Indonesia, the Philippines and Thailand).

4.60 In setting priorities among export promotion measures special attention should focus on providing exporters with ready access to inputs and outputs at world market prices and to short-term working capital. An
important instrument and priority for early introduction in this connection is the domestic L/C, which provides the principal means for reaching down to indirect exporters, for the purposes of providing tax drawbacks and access to short term capital. For tax exemptions and duty drawback provisions, the introduction of a disaggregated input coefficient system must rate as a priority matter, especially since it appears to be the only form of fixed drawback system which is acceptable to importing countries. In the area of credit, priority must focus on preshipment finance and the complementary guarantee system, while postshipment and investment finance is of lesser priority. Similarly, fiscal incentives for export activities and investments should be considered of lower order of priority, as they are likely to invite countervailing action and are costly in terms of revenues foregone during times of fiscal austerity. Providing access to competitively priced infrastructure, building up the human capital and the institutional support system for industrial development in general and export-oriented industrial growth in particular are long-term endeavors which need constant attention, even during periods of economic hardship and fiscal stress. Throughout, however, it is crucial that governments make every effort to stress the development of an "export mentality" in the private and public sectors alike.
CHAPTER 5. INDUSTRIAL POLICY

A. Introduction

5.1 Industrial policy as an area of explicit government planning and action has had a rather mixed history in economic policy thinking in recent years in industrialized and developing countries alike. In the US, where industrial policy has played only a very limited role, at least at the federal level of government, a shortlived debate between proponents and opponents of an interventionist industrial policy erupted in the early 1980s, resulting in a resounding defeat of the former. For Europe, where government intervention in support of specific industrial development or restructuring objectives has a much more extensive history, the evidence also points towards increased skepticism about the desirability and effectiveness of government involvement in the industrial policy arena (Roe, 1984; Norton, 1986). Leaving aside the Centrally Planned Economies, Japan may well be the only industrialized country where the historical record of an explicit governmental industrial policy is currently regarded as highly successful (albeit mixed with a few episodes of less-than-fully satisfactory performance) and where the role of industrial planning has not been seriously questioned.

5.2 For the developing countries there are, in broad terms, three schools of thought regarding industrial policy (Dervis and Page, 1984): those who argue for a total absence of industrial policy intervention; those who recommend reliance on market forces, but concede the need for selective intervention in the case of market failures; and finally, those who do not trust the market forces and argue for comprehensive industrial planning, targeting, and accordingly direct intervention by government. On balance, it appears that the former two schools of thought are more prevalent among the academic development community outside the developing countries and among a growing number of economists in the developing countries, while the third approach frequently remains favored by government officials and the business community in the developing countries. Particularly in the East Asia Region, the examples of Korean and Japanese industrial policies are often cited in support of a more interventionist approach.

5.3 This chapter endeavors to explore which of these approaches is most appropriate for the majority of developing countries in East Asia in view of the actual experience with industrial policy interventions and the lessons to be drawn from successful as well as failed efforts. As this area is rather complex, the next section provides an overview of objectives, instruments, levels of intervention, and scope and timing of industrial policy. This is followed by a section reviewing the preferred policy framework towards which industrial policy in developing countries should be aimed as a long-term

1/ See Norton (1986) for a review of this debate and an assessment of its outcome. The opponents' challenge was based on grounds of lack of need and effectiveness of an industrial policy relying on direct government intervention.
goal. However, as industrial policy must necessarily also encompass a strategy of how to get to this long-term goal, the subsequent section discusses the major issues in industrial restructuring and in the appropriate timing and sequencing of reform. The concluding section summarizes the implications of the preceding discussion for the role of the public sector in industrial policy.

5.4 This chapter does not contain a separate overview of industrial policy practices prevailing in the East Asia region. The multitude of policy instruments in use in the industrial field would make this a rather cumbersome exercise. Instead, the discussion will draw frequently on examples of more and less successful cases of industrial policy in the region. This should be sufficient to provide a flavor of current practices in the countries under review.2/

B. Dimensions of Industrial Policy

Objectives of Industrial Policy

5.5 At the most fundamental level, the overarching goal of industrial policy in developing countries is, of course, the triad of economic growth, development, and modernization. However, for practical policy making, a number of distinct, and not always compatible proxies for these broad objectives are often of more immediate concern to policy makers.

5.6 Most importantly, industrialization has frequently been seen as a goal virtually of itself, i.e., to accelerate the transformation from a predominantly agricultural to a predominantly industrial economy, and to "deepen" the existing industrial structure from a predominance of final consumer goods production to increased intermediate and capital goods production. The goal of industrialization, moreover, has often been equated with import substitution. Most of the East Asian countries have gone through a phase of attempting to accelerate the industrialization process through import substitution. As recent World Bank reports have demonstrated, all of them have now traversed the early stages of "easy" import substitution, i.e., they have achieved the capacity to produce a wide range of final consumer goods domestically, albeit in most cases only with considerable protection from foreign producers (see Chapter 3). For all of them, however, industrialization remains a major concern, mostly in the sense of aiming for a deepening of their industrial

2/ Recent overviews of selected aspects of industrial policy and incentives covering important countries in the region include the following: IMG Consultants (1984) and SGV Group (1986) review industrial incentive systems in the ASEAN countries; Age1 (1983) estimates the size of capital subsidies deriving from industrial tax incentives in the ASEAN countries; Lecorch (1986) analyses tax policy and tax reform in four developing countries, including Korea and Thailand; Galenson (1984) provides an overview and evaluation of investment incentives in developing countries, with special reference to the experience in the Philippines and Thailand.
structure, but also, especially in the case of Korea and Singapore, in the sense of acquiring the capability of producing technologically advanced products. Technological development has therefore become a goal of industrial policy in these countries in their hope to capture new and more profitable areas of comparative advantage and to strengthen the foundations for this long-term development. 3/

5.7 As a departure from the predominance of import substitution as a goal for industrial policy, export development has in recent years become a more prominent goal in many of the East Asian countries, particularly as the phenomenal success of Japan and of the East Asian NICs, based as it was on export-oriented industrialization, has become difficult to ignore. The arguments for export-led industrialization were reviewed in Chapter 4, where it was stressed that the most important reasons for actively pursuing the export objective lie in the positive externalities associated with export orientation and the need to reduce the anti-export bias commonly embedded in the domestic policies.

5.8 Another goal of industrial policy is employment creation and/or preservation. The industrial sector is seen as a repository for the growing labor force, but, with its relatively low labor intensity, the sector can be expected to provide a significant share of the needed employment opportunities only if it grows at a rapid pace. In the interest of employment generation, efforts have frequently been made to strengthen the more labor intensive branches of industry, in particular the small and medium scale industries. 4/

3/ Interestingly, the development of the modern services sector, which in the industrialized countries has become more dynamic than the agricultural and industrial sectors, has not yet become a major concern for policy makers in the developing world, including in East Asia. In its most recent economic report on China (World Bank, 1985a) the World Bank has, however, emphasized the need for increased attention to the development of the services sector in that country.

4/ The results from a recent research project financed by the World Bank indicate that small and medium scale industries (SMIs) as a group are not necessarily more labor intensive than larger scale industries. To the extent that any significant pattern emerges, medium scale industries tend to be more labor intensive than small and large scale industries (Little, 1987). The study also concludes that significant distortions in incentives in favor of SMIs are neither desirable on efficiency grounds, nor likely to be effective in practice. A recent review of World Bank lending for small enterprises also cautions about excessive expectations for interventions in support of SMIs (Levitsky, 1985). However, these findings do not invalidate the proposition that any existing biases against SMIs, e.g., in terms of access to credit, tax preferences, licensing, etc. should be removed.
incentive structure, and, second, minimizing any negative employment impacts of industrial restructuring. The recent concern in Korea about the employment impacts of high technology development falls under the latter category. In the East Asian countries there is also the common fear that liberalization will create unemployment in those industries for which protection is removed; unfortunately, the employment creating aspects of liberalization are generally not getting sufficient attention by analysts in and out of government.

5.9 Balanced spatial development is an objective also commonly pursued through industrial policy, with special regulations and tax and credit incentives designed to steer industrial investment to preferred locations, usually away from the larger cities and into the more backward regions. The need for such policies and their effectiveness in achieving their stated objectives has frequently been questioned (see, e.g., Hamer and Linn, forthcoming). Detailed research in Korea has further demonstrated that industrial decentralization measures are likely to be harmful to an efficient industrialization process, and that they have not been effective in achieving their spatial goals (Lee, forthcoming; World Bank, 1986j).

5.10 A number of other goals of industrial policy are not economic objectives in the narrow sense, but nonetheless of considerable importance in various countries. Non-economic goals include the achievement of national independence—in Indonesia, for example, this goal has led to the identification of "strategic" industries which are to be developed irrespective of economic efficiency considerations; the maintenance of political stability and social equity—for example, Malaysia's "New Economic Policy" (NEP) has had as one of its cornerstones the diversification of ownership and employment in the industrial sector in favor of increased Malay participation (relative to other ethnic groups); and integration of the East and South East Asian region—most notable here has been the ASEAN group's joint approach to large scale industrial investment projects, an effort which, however, has not been notably successful (Akrasanee, 1984).

5.11 Finally, besides the broader national objectives summarized above, narrower objectives of particular interest groups and political factions in practice influence, and often determine, industrial policies. Indeed, one of the strongest arguments of the opponents of an interventionist approach to industrial policy is that once governments step actively into this arena, there is a great risk that special interests take over the leading role in the design of industrial incentives, with the attendant costs in terms of misallocation of resources from a national standpoint.

5.12 In assessing what are appropriate goals for industrial policy, one should be guided by two principal considerations: First, the "economic" goals cited above, i.e., industrialization, import substitution, technology development, export orientation, employment generation, SMI development and spatial decentralization, should be seen only as proxies for the broader objectives of efficiency and growth, or as pointers indicating what are the major areas where externalities and biases in existing incentives are most common. Ultimately, the design of policy should aim at allowing for these
externalities and removing, or at least counteracting, the biases, rather than attempting to advance the multiple secondary objectives at all costs.  

Second, to the extent that governments need to pursue noneconomic goals, they should be aware of the economic costs resulting from seeking to attain noneconomic goals and minimize these costs.

The Instruments of Industrial Policy

5.13 Just as there are multiple objectives for industrial policy, there are numerous policy instruments. They fall into ten broad categories (for a detailed review, see Section C below):

(a) Macroeconomic policies (fiscal, monetary, and exchange rate policies);

(b) Trade policy (esp. protection and export promotion policies);

(c) Financial sector policies (including policies affecting the financial sector as a whole, and policies directly affecting the supply and demand for industrial finance);

(d) Labor market policies;

(e) The tax structure;

(f) Industrial investment incentives;

(g) Industrial regulation and licensing;

(h) DFI (direct foreign investment) policies usually involving a combination of b, f, and g above);

(i) Direct government investment and ownership (covering state enterprises activities and public investment in large industrial projects); and

(j) Infrastructure (including physical infrastructure such as utilities, transport, etc., and "software" support such as R&D, marketing, and technology development policy more generally).

5/ It is for this reason that this chapter does not deal extensively with how industrial policy can be designed for maximum impact in terms of proxy development objectives, such as employment creation, SMI development, regional balance, etc.
5.14 Through the late 1970s, the World Bank's industrial sector work, policy dialogue, and industrial lending concentrated on four of these industrial policy instruments: trade policy, industrial investment incentives, large scale industrial projects, and industrial finance. Since then, the Bank's approach has become more comprehensive and integrative, as the interrelations between more specific industrial policy instruments and broader systemic policies have become more apparent. For example, the role of macroeconomic policy, while always acknowledged as relevant to industrial development, has now clearly become a central concern. Similarly, in the financial area, from an almost exclusive focus on the instruments and institutions for industrial sector finance, the attention is now more on how the financial system as a whole can be strengthened so as to permit an efficient development for the entire economy, including the industrial sector. Finally, in the tax policy area, emphasis is now placed less on how to reform the industrial investment incentive system, and more on how to structure the overall tax system, often with major implications for the industrial sector (e.g., when switching from a sales tax to a value added tax).

Level of Intervention

5.15 Industrial development is affected by policy interventions pitched at least at four levels:

(a) Economy wide -- interventions are neutral as between sectors (e.g., macroeconomic policies, or policies addressing "functional" issues, such as financial sector policies, tax policies, support for technology development, sector-neutral investment incentives, etc.);

(b) Sector wide -- interventions which apply to the industrial sector as a whole (e.g., industrial finance policies, industrial investment incentives applying equally across the sector, uniform trade and protection policies, etc.);

(c) Subsector level -- interventions which are targeted to a particular subsector (e.g., subsector restructuring efforts involving financial, technical and incentive reforms designed specifically for the particular subsector); and

(d) Firm level -- interventions aimed at specific enterprises (this covers all measures designed to assist or re-structure the operations of a specific firm not based purely on sector, or subsector-wide criteria).

5.16 Traditionally, only measures operating at levels (b) to (d) above would have been considered as falling under the heading of "industrial policy"; however, because of the pervasive influence which macroeconomic and functional policies may have on the development of the industrial sector, it is essential that economy-wide policies be explicitly considered when developing an industrial policy framework (see also Section C, below).

5.17 Of course, measures pitched at levels (b) to (d) will remain at the core of the debate about industrial policy, and the choice of level of intervention is crucial in the design of an industrial policy framework. In particular, interventions of the (c) and (d) levels would involve the govern-
ment in "industrial targetting" or "picking winners", perhaps the greatest bone of contention among opponents and proponents of an interventionist industrial policy, while sectorwide policies (at level (b)) would not. At the same time, there is a great difference between singling out specific subsectors for preferential support or restructuring, and intervening in a manner designed to affect only a specific firm, to the exclusion of other firms. It is much easier to ensure that efficient entry and exit to subsectors is retained if policies are pitched at the subsector level, than when the government intervenes on behalf of a specific firm. Moreover, the risk of firm-specific lobbying for preferential treatment and the associated transactions costs and misallocation of resources are much reduced where incentives are provided automatically in line with general criteria defined at the subsectoral level.

Scope, Timing and Sequencing of Industrial Policy

5.18 In view of the many possible objectives, instruments and levels of industrial policy, it is important that the frame of reference for industrial policy analysis and design be kept comprehensive. This is necessary to ensure that (a) tradeoffs among objectives not be overlooked, especially the economic costs of pursuing non-economic objectives; (b) all relevant instruments, actually in use or potentially available, are considered, both in terms of their direct effects as well as any possible interactive effects when used in conjunction with each other; (c) consistency between firm-level, subsectoral, sectoral and economy-wide interventions is achieved.

5.19 In addition to developing a comprehensive industrial policy framework, the timing and sequencing of change needs to be explicitly considered, the modalities of restructuring have to be identified, and policy signals have to be conveyed to the private sector and the government bureaucracy in a clear and credible manner. Industrial policy design is thus not just a matter of identifying the first-best framework of incentives ("getting the prices right"), but of designing a strategy for a deliberate process of transition from the existing policy framework, giving due consideration to tradeoffs among objectives, interactions among different instruments and possible administrative and political constraints. The next section considers the first step in this process of policy formulation, i.e., what is an appropriate industrial policy framework towards which a particular country should ultimately aim. Issues of transition or restructuring and of timing and sequencing, and possible constraints are discussed in the subsequent section.

6/ This is especially the case in countries with a large industrial sector, such as China, Korea and Indonesia. In a country with a small industrial sector the distinction between subsector and firm-level intervention may well disappear for subsectors where economies of scale are important and thus only one firm can operate efficiently in the subsector (e.g., in PNG, Fiji, and certain subsectors in Malaysia, Philippines, and Thailand).
C. Towards an Industrial Policy Framework

Macroeconomic Policies

5.20 Successful industrialization is crucially dependent on effective macroeconomic management. Industrial sector growth and transformation is more likely to materialize where domestic demand growth, savings and investment rates are high and sustainable, as this provides the incremental domestic demand for industrial sector products and the investment resources which permit the continuous and swift transformation and modernization of the industrial structure through rapid replacement of the existing capacity and substantial additions to new capacity. Low inflation rates and interest rates that realistically reflect the real opportunity cost of capital are important ingredients for efficient industrial decision making. The maintenance of a stable and realistic exchange rate is essential in providing domestic industry with competitive access to international markets, as well as ensuring an appropriate balance of incentives between tradeable goods (which importantly include industrial products) and nontradeables.7/

5.21 These essential macroeconomic variables are, of course, determined significantly by the macroeconomic policies adopted by the government, in particular by the monetary and fiscal policy stance and by the exchange rate policy. In this connection two aspects are important: one is the avoidance of savings-investment and external imbalances emanating from inappropriate domestic management; the other is the quick adjustment of domestic macropolicy parameters in response to significant changes in the external environment. In both cases the importance of good macroeconomic management lies not only in avoiding domestic and external imbalances, but also in obviating the need for proliferation of inappropriate sectoral interventions and other distortions designed to maintain macrobalance (e.g., increases in tariffs and QRs to reduce imports, wage and price controls to limit inflation, etc.)

5.22 Overall, the macroeconomic management performance in East Asia has been very successful, as is reflected in the relevant major macroeconomic indicators shown in Table 1.1, on p. 4 above. By international comparison, the economic growth rates in East Asia have been high, while the savings investment gaps, current account deficits and resulting external debt and debt service levels remained manageable. This was achieved at low levels of price distortions, including the maintenance of relatively realistic interest and

7/ The argument may be further extended to include the effective management of other sectors of the economy as an important factor in determining the performance of industry. Oshima (1983), for example, has argued that policies supportive of rapid agricultural growth have been the hallmark of successful industrialization in East and South-East Asia, because of the important backward and forward linkages of the agricultural sector with industry. Similarly, it has been argued for the case of China that a more effective development of its neglected service sector could contribute significantly to improved industrial performance (World Bank, 1985).
exchange rates, low inflation rates, and limited interventions through protection of domestic industry and agriculture. Notably, World Development Report 1983 (World Bank, 1983b) placed Thailand, Korea, Malaysia and the Philippines (in that order) among the top six of 31 developing countries in terms of macroeconomic and sectoral incentive management and overall economic performance.

5.23 Of course, macroeconomic management was not uniformly successful across countries as over time. The contrasting macroeconomic policy stances in the Philippines, Korea and Thailand during the early 1980s and their differential impacts on the industrial sectors of each country are instructive in this regard. In the Philippines, the government reacted to the second oil price shock and resulting world recession with an anticyclical expansion of domestic demand led by a rapid expansion of government spending, while letting the real exchange rate appreciate. The resulting worsening in the external balance and foreign indebtedness and the bias in incentives in favor of nontradeables, when compounded by political uncertainty, eventually brought about the economic crisis of 1983. The ensuing combination of high domestic inflation and erratic movements in the real interest rate, financial distress among businesses and banks, lack of export demand, and severe limits on the country's capacity to draw on foreign savings all generated an environment in which the industrial sector collapsed, despite the favorable steps taken during the early 1980s in the areas of industrial and financial sector reform. Of course, the adjustment of the economy was also hampered by a history of poor industrial sector policies which had significantly impaired its flexibility and responsiveness and landed it with a capital stock ill suited to the demands of the early 1980s.

5.24 Korea, in contrast, responded to the detrimental effects of the second oil price shock (which were compounded by a poor agricultural performance due to bad weather) by pursuing a very conservative macroeconomic policy stance, choosing an immediate, but shortlived contraction and real depreciation of the exchange rate over an anticyclical response. As a result of this adjustment pattern, while there was a temporary loss of domestic consumption and growth momentum, the Korean economy adjusted the domestic price signals quickly to the changes in its international terms of trade and soon reestablished a sustainable savings-investment and external balance. Therefore, Korean industry did not lose its international competitiveness, did not suffer from protracted domestic economic uncertainty, and was able to quickly recoup its early losses. Of course, its adjustment was also critically influenced by the inherent responsiveness and flexibility of its industry, as a result of many decades of good industrial policies and management. There is little doubt, however, that Korea could have risked running into the conundrum now confronting the Philippines and many Latin American countries, had its macroeconomic management been less effective.

5.25 Thailand's macroeconomic policy stance fell in between that of the Philippines and Korea. Following the second oil price shock, the country followed a roughly neutral macroeconomic policy stance, neither countercyclically expanding domestic demand as did the Philippines, nor contracting it as did Korea. However, macroeconomic policies were not sufficiently responsive to the deterioration in the country's terms of trade, and, perhaps
as importantly, the mix of macropolicies was not conducive to a healthy adjustment of the industrial sector. Specifically, the combination of an expansionary fiscal stance and a contractionary monetary policy led to high real domestic interest rates and an overvalued real exchange rate, some crowding out of domestic private investment, and thus overall a poor environment for domestic industry. This contributed to the weak performance of Thai industry in the early 1980s, which was reversed only in 1985/86, as the international environment improved with the decline in interest rates and oil prices, and as exchange rate and fiscal management became generally more attuned to the needs of the economy. The economic consequences of this episode for the country were less disastrous than in the case of the Philippines, partly because the macropolicy response was, on balance, less disruptive, but also because Thailand went into the 1980s with a stronger starting position in terms of a lower stock of debt, and more flexible and outward oriented industrial and agricultural sectors than did the Philippines. Of course, the relatively more stable political setting also contributed to the country's avoidance of an economic crisis.

Trade Policy and Export Promotion

5.26 Trade policy and export promotion were extensively discussed in the preceding two chapters. Therefore, only a few points need to be reiterated here. First, it is important to see trade and export promotion policies as an integral part of the industrial policy framework in two respects: (a) one of the primary objectives of interventionist trade and export promotion policies is generally that of fostering industrialization; however, while this is in many circumstances an appropriate goal, trade policy, and in particular an interventionist trade policy, may not be the best instrument; and (b) to the extent that trade policy is designed to serve other objectives—e.g., protective tariffs have often been installed and later retained to generate government revenues—it is essential to recognize the detrimental impact which a carelessly designed and high tariff wall may have on the industrial structure and development of a country.

5.27 Second, import restrictions are not the best instrument to foster selective development of particular industrial activities, even where such support is defended on grounds of infant industry arguments. More efficient ways exist in principle to account for the externalities which justify infant industry support, especially direct fiscal subsidies for the subsectors involved.

8/ It is interesting to note that the American macroeconomic policy stance in 1983-85 was similar to that of Thailand: a combination of expansionary fiscal policy and contractionary monetary policy. The impact on the major macro variables and on industrial performance was much the same in both countries, despite their different stage of development. The importance of macroeconomic policy for industrial development in the US is succinctly analyzed in Norton (1986).
5.28 Third, to the extent that trade restrictions are chosen as a necessary, albeit second best instrument for infant industry support, the target level for the average effective tariff should be low, and it should be as uniform as possible, with the exception of the subsectors which are regarded as requiring infant industry protection. The advantage of this approach is two-fold (see Westphal, 1981): First, with a uniform set of effective tariffs the signals given to the selected few infant industries through higher effective rates of protection (ERPs) will be much more effective than for the case where the dispersion of effective protection rates is very high, providing incentives to lots of industries not actually deserving them on infant industry grounds, while diluting the incentive impact for the infant industries. Second, to the extent that government is not likely to have identified all potential infant industries— as experience in various countries clearly shows, where new industries have sprung up even in the absence of infant industry support—, it is important that the incentive system does not discriminate unnecessarily against such unrecognized "infants".

5.29 Fourth, where an import protection strategy is followed in the interest of building up local industries in selected subsectors, the impact on exports should be minimized to the extent possible through the implementation of appropriate import duty draw back or exemption schemes (see Chapter 4). In fact, efforts should be made, as was the case in Japan and Korea, to ensure the export orientation of domestic industries, even those which sell in a protected domestic market (see Dervis and Page, 1984). Fifth, import protection should preferably take the form of tariff measures, rather than quantitative controls in the interest of improved efficiency and revenue collection and to reduce the scope for discretionary action by government officials on specific shipments. Finally, the infant industry support should be temporary.

9/ The argument that import protection should be offered as a permanent policy has been made on the ground that this would provide a more effective way of impressing on oligopolistic foreign competitors that the government is serious in its efforts to establish the domestic industry as a viable and eventually competitive activity and that therefore it is not worth the competitors' attempt to try and undercut the domestic infant industry during the period of establishment. With the possible exception of Korea, few of the developing countries of the region would currently want to develop infant industries for products whose markets are seriously affected by oligopolistic behavior. Moreover, anti-dumping tariffs could be designed to take care of price cutting efforts of oligopolistic competitors during the early years of the infant's establishment. Therefore, the argument for permanent protection remains weak.
Financial Sector Policies

5.30 Industrial and financial sector policies are intricately intertwined, for two reasons: first, ready accessibility of credit, both for working capital finance and for investment, is a prerequisite for successful industrialization, especially considering the relatively capital intensive nature of industrial activities; second, one of the main instruments conventionally used by governments to support and steer industrial development has been intervention in the financial sector. For this reason a discussion of industrial policies by necessity has to include a consideration of financial sector conditions and policies. A full-fledged review of issues and approaches to financial sector policies is beyond the scope of this report; for a more comprehensive overview the reader is referred to World Bank (1985b) and (1986). Only a few major results will be highlighted here.

5.31 Effective macroeconomic management is as important for financial sector development as it is for industrial sector growth. The main elements here are the avoidance of an overvalued exchange rate, which would encourage capital flight; a responsible monetary policy, which maintains a low inflation rate and thus encourages savers to choose financial instruments over real assets; and a low public sector deficit, which ensures that private investors are not crowded out in their access to investible funds by the public sector's financial requirements. Finally, good macromanagement is a prerequisite for sustaining high and stable economic growth, and higher growth in turn tends to be associated with higher savings rates and thus a larger pool of financial resources available for domestic investment. The Philippines is an example of a country where poor macroeconomic management has clearly added to the stress on the financial sector and through it has contributed to the collapse of industrial activity in the early and mid-1980s. At the same time, of course, it is also true that mismanagement in the financial sector was a factor contributing to the macroeconomic management problems of the country, as well as to poor performance of its industrial sector.

5.32 In settling the broad directions for financial sector policy, the ultimate aim for the countries in East Asia, most of which have already fairly well developed financial sector institutions, should be to foster the growth of an integrated and undistorted financial market. Such a market would have to rely heavily, although not necessarily exclusively, on competitive commercial banking institutions, which effectively mobilize private savings and direct them to highest return investments across activities and sectors. It would also mean that interest rates should not be constrained by government regulation below levels approximating the real cost of financial capital. Artificially low interest rates tend to reduce mobilization of private savings and require rationing of financial resources, many of which find their way into relatively low-productivity uses.

10/ World Bank (1983) contains a good analysis of the importance of macroeconomic management for financial sector development with special reference to the case of Thailand.
Much progress has been made in recent years in East Asia in the area of financial sector liberalization. All countries have taken significant steps to reduce the extent of government intervention (regulated and subsidized interest rates, government ownership of banks, directed credit, etc). As a result of these reforms, real interest rates have increased in these countries and financial market fragmentation and distortions have been reduced.

In fact, it can be argued that real interest rates in many of the East Asian countries have risen to such levels that they are detrimental to efficient development, and especially to industrial growth. The reasons for the high interest rates are multiple: First, international rates are high due to the macroeconomic imbalances in the OECD countries, and especially the US. Given the relative openness of East Asian capital markets, high international interest rates directly spill over into high domestic rates. Second, in some of the countries, e.g., Thailand and the Philippines, high public sector deficits and thus domestic borrowing requirements have pushed up domestic interest rates above international lending rates. Third, high taxation of intermediation (whether direct taxation or indirect taxation through high reserve requirements and subsidized lending requirements) and lack of banking sector competition have raised borrowing spreads and thus further contributed to high real interest rates. In terms of general financial sector policy, reduction in public sector deficits, encouragement of banking sector competition, and reduction in the taxation of intermediation are therefore the principal means for reducing excessive interest rates, and are of considerable importance to permit appropriate levels and patterns of industrial investment and production.

Another critical issue in financial sector policy as it relates specifically to industrial policy, revolves around the question whether and to what extent directed credit should be provided to the industrial sector. The use of directed credit on a selective and temporary basis for industrial restructuring, either in support of infant industries or of declining industries, is addressed in greater detail below in Section 5.D.12/ Here the focus is on the use of directed credit on a pervasive and permanent basis. The main problems with such a practice are readily apparent from the experience worldwide, but also in the East Asian setting: (a) directed credit interventions often do not reach their intended beneficiaries and thus, in effect, channel resources into low productivity uses, either because of poor design and

11/ In the Philippines, for example, recent estimates indicate that interest rates could be reduced by 3.7 percentage points through a reduction of direct and indirect taxation on intermediation, which was estimated to lower the spread between lending and deposit rates from 5.2 to 1.5%.

12/ That Section also briefly discusses the problems encountered in the financial sector during periods of economic crisis and the ensuing restructuring requirements.
limited administrative capacity, or because of outright political favoritism and bureaucratic abuse; (b) by limiting access to credit for "high-priority" uses, potential industrial activities which do not fall into the "priority" category as defined by government, may languish even where they might have had great potential, albeit unrecognized by government; (c) extensive involvement of government in private investment decisions, particularly when backed up by explicit or implicit credit guarantees, results in "moral hazard," i.e., private investors and their financial backers tend to incur greater risks than they would otherwise, in the expectation that government will bail them out in the case of failure, either directly through financial support, or indirectly by limiting competition from imports or entry of new firms; (d) to the extent that directed credit also tends to be subsidized, this favors capital intensive investment with long gestation periods; this in turn will reduce the efficiency of industrial investment (unless offsetting specific externalities), lower the employment absorption in industry, and result in a lower incremental capital output ratio for the sector, and for the economy as a whole; and finally, (e) the administrative and compliance costs of directed credit will be the larger, the broader and more pervasive the system is designed.

5.36 The experience of the Philippines provides a stark reminder that government intervention through pervasive directed credit can lead to major misallocation of resources on account of all the potential problems mentioned in the preceding paragraph (see World Bank, 1986b). On the other hand, it might be argued that the experience in Korea points in the opposite direction, i.e., that pervasive use of directed and often subsidized credit made a major contribution to the successful industrialization of that country. However, the interpretation of the Korean experience which is adopted here does not provide a vindication of the notion that extensive government intervention in the financial sector (or in other sectors, for that matter) is the right recipe for rapid industrialization and economic development in the typical developing country.

5.37 First, in Korea a highly unusual combination of two factors—a single-minded and cohesive political leadership oriented primarily towards well-defined national economic goals, and a highly motivated, trained and tightly managed civil service—ensured that government intervention through the financial system pursued policy goals that were well identified and achieved at low administrative costs and without substantial "leakages." Second, the primary and quite narrow goal of intervention was the promotion of export-oriented activities; this ensured that the activities supported were oriented towards building an internationally competitive industrial structure. Interestingly, when the Korean government temporarily abandoned this export-oriented strategy with its support for import-substituting heavy and chemical industries (HCI) during the second half of the 1970s, its directed lending mechanism was a major contributor to this relatively unsuccessful episode of intervention (World Bank, 1986c). Third, as the HCI episode demonstrates, and as a broader analysis of Korea's industrialization experience confirms (Westphal, Rhee, and Pursell, 1981; and World Bank, 1986c), directed credit is neither a sufficient nor a necessary ingredient explaining the Korean success. Other elements in the Korean industrial strategy were very much at work, including its effective macroeconomic management, its
relatively unbiased incentive structure, and its unfailing support for human
capital development. It should also be noted that the recent Korean steps,
slow as they may be, towards liberalization of the financial sector are the
result of the policy makers' recognition that the country's financial system,
as it had evolved under the pervasive influence of government intervention, is
not well suited for the development challenges which the country now faces.
In fact, it may be argued that the heavy use of directed credit has produced
serious longer-term negative effects on the Korean financial sector and that
those distortions will not disappear easily (World Bank, 1986c, see also Cho,
1986).

5.38 In sum, the conclusion emerges that while an interventionist
financial sector policy is not necessarily a prescription for failure in
industrial development, it should generally be avoided since it requires a
formidable set of favorable conditions—cohesive credit policy, effective
administration, supportive complementary macro and sector policies, all of
which are not usually found in developing countries, whether in East Asia, or
elsewhere—if it is not to be counterproductive.

Labor Market Policies

5.39 The labor markets in the East Asian countries, with the exception of
the centrally planned economies of China, Laos and Vietnam, have generally
been free of the segmentation and distortion which characterize the economies
of many other developed and developing countries. Labor mobility across space
and among sectors and activities in response to employment opportunities has
been high, and direct government interventions designed to limit employment in
particular areas or sectors, or to intervene in the market determination of
wages, have either been very limited or were pursued in such an ineffectual
manner as not to produce major distortions in the labor markets. Notable
among the more effective uses of labor market interventions has been
Malaysia's efforts through regulatory means to increase the share of Malays in
modern sector, high-wage employment. Among the ineffectual attempts made to
influence employment and wages one may cite the existing minimum wage
legislation found in most of the countries, and past sporadic attempts to
limit rural-urban migration in Indonesia (including an unsuccessful ban on
migration to Jakarta). More importantly, most of the countries have been
quite active and successful in upgrading the quality of labor supply through
extensive investment in education and training. Such investments in human
capital, when combined with an undistorted labor market, have undoubtedly been
important factors explaining the successful development and rapid industriali-
zation in many of the East Asian countries.

5.40 For the future, the challenge as regards labor market policies in
these countries will be two-fold: First, pressures will likely continue, if
not increase, to move towards a more active intervention in labor markets,
especially through introduction of minimum wage legislation where it is not
yet in place (e.g., Korea), or more effective implementation where such legis-
lation already exists (e.g., Thailand). To the extent such interventions are
politically unavoidable and socially necessary, they should be tailored so as
to minimize their distortive influence, by limiting their impact to those
segments of the labor force where there is a real need for support or protection. This will be particularly important, if the countries are to continue adapting as flexibly to the rapidly changing international economic environment as they have in the past.

5.41 Second, the need for upgrading the labor force will continue to be pressing, especially in those countries which are currently still at the lower end of the developmental spectrum. The shortage in skills required for modern industrial and service sector development is still a major constraint in most of these countries. Special efforts of training and support may be required in cases where restructuring of industry occurs, whether due to spontaneous changes as a result of changing comparative advantage, or due to changes in the government's industrial and trade incentives. These are further discussed below in Section 5 D.

Tax Policy

5.42 The tax system and its administration can be a powerful determinant of industrialization. While this has long been recognized, it is nonetheless of interest to observe that only few countries have managed to introduce a tax system which is supportive of successful industrialization. The Korean tax system, and the newly reformed Indonesian tax structure—with the notable exception of its trade taxes—are examples of tax policy that is on balance supportive, rather than harmful to economic development in general, and industrialization in particular. Even in the Philippines, extensive tax reforms have recently been carried out or are in process. Commonly, however, tax systems have evolved quite haphazardly over time, providing an uneasy compromise between the primary goal of revenue mobilization on the one hand, and the secondary goals of equity and of providing incentives for special "priority" sectors or activity, on the other hand, but in practice achieving none of these goals very effectively. The following discussion first considers questions of design of the overall tax system, and then deals with the issue of specific incentives.13/

5.43 In the design of a national tax system supportive of industrialization, three sets of taxes deserve particular attention: trade tariffs, corporate income taxes, and taxes on domestic production, sales or value added. The appropriate role and design of trade tariffs was discussed extensively in Chapter 3, and, more briefly, in Section C.2. of this chapter.

5.44 Corporate income taxes are generally structured in such a way as to provide a bias against equity finance in particular, and investment in general. One of the recommendations commonly made for reform of the corporate tax structure (see, e.g., Leechor, 1986) is to place the tax entirely on a cash-flow base, rather than on a profit base. Another problem frequently encountered is that only very few corporations are effectively caught in the

13/ The discussion here is restricted to issues of particular importance in the context of industrial policy. A more general review of tax policy in East Asia is under preparation as a separate regional study.
corporate tax net, requiring on the one hand a high tax rate on those firms which are being taxed in order to achieve a reasonable revenue level, while on the other hand leaving untaxed a large portion of the potential tax base. In Thailand, for example, only 53% of companies reported profits in 1984 and paid any corporate income tax, and less than 1% of all firms paid 77% of the corporate income tax (World Bank, 1986f). Improved tax administration would help reduce the distortions in this regard.

5.45 Taxation of domestic production, sales or value added is the third area where significant distortions can affect the industrial system. The cascading effects of the business tax in Thailand and the sales tax in the Philippines, for example, have been well documented (see World Bank, 1986f, and 1986b). The distortions which result from differential tax rates under such indirect tax regimes have their greatest effect in the industrial sector, where the average tax burden and the variation in tax rates tend to be highest. On the other hand, a value added tax (VAT) has been in place in Korea since 1977 and has been implemented with considerable success (Han, 1986; Leechor, 1986). Indonesia introduced a VAT in 1984, and developing countries in other regions have successfully introduced such a tax (Leechor, 1986). The advantage of the VAT is that it equally taxes (generally with few exemptions) the value added in all economic activities, and thus does not distort the choice of factor inputs, scale of operation or degree of integration in production. In those countries where the VAT has not yet been introduced, administrative difficulties and the absence of sufficiently advanced enterprise accounting practices have usually been cited as reasons for not adopting this tax. However, as experience has accumulated with the successful introduction of the VAT, even long hold-outs such as the Philippines, and possibly Thailand, are now moving actively towards the introduction of a VAT.

5.46 In sum, the basic tenet of taxation, viz., that the tax system should be designed so as to raise the desired amounts of revenue at least cost in terms of distortions affecting economic activities, applies a fortiori to the design of those taxes which have a particular impact on the industrial sector, i.e., trade tariffs, corporate income taxes, and indirect domestic taxes. Considerable progress has been, or is being made, in these areas in Korea, Indonesia, and (if current reform initiatives are successful) the Philippines; much less progress has been made to date in Thailand and Malaysia, with the former facing particularly formidable problems of tax reform (World Bank, 1984).

5.47 Beyond the broad structure of the tax system, special tax incentives have been of importance in the East Asian countries (IMG, 1984 and SGV, 1986). Traditionally, tax incentive schemes in the region have been designed to (a) promote industrial investment, often in particular subsectors; (b) increase export orientation; (c) foster labor intensity; and (d) direct industrial investment away from the principal cities. The methods most commonly used have involved "(i) accelerated depreciation (Malaysia, Philippines, and Indonesia); (ii) investment and/or reinvestment allowances (Malaysia, Philippines and Indonesia); (iii) duty and import tax free importation of capital equipment (Malaysia, Philippines, Indonesia and Thailand); and (iv) exemption from sales tax and/or tax credits for locally purchased capital
equipment (Malaysia, Philippines and Thailand)." (IMG, 1984, p. 38). In addition, protective tariff surcharges have been imposed as a way to give temporary support to selected domestic investors, e.g., in Thailand.

5.48 These tax incentives suffered from a number of significant problems: Most of them resulted in distortions which favored capital intensive investment and import substitution, albeit as unintended side effects, rather than as a matter of deliberate design. Therefore, not surprisingly, the incentives, if anything, tended to channel investment in the wrong directions when compared to the employment and export promotion objectives generally espoused. Even in terms of providing incentives for investment, the overall impact of government intervention has not always been clear. The disincentives built into the overall tax system and those resulting from some of the so called "investment incentives" may actually have offset the favorable incentives provided to new investment (most notably this was the case where incentives were limited to specific firms and linked to measures of market saturation, as was the case for example in the Philippines before 1983).

5.49 When it became apparent during the late 1970s and early 1980s that many of the investment incentive systems in the East Asian countries did not serve their intended goals, efforts to reevaluate them with a view to eventual reform were initiated. Some of these were actively supported by the Bank (see e.g., World Bank, 1980, for Thailand; and World Bank, 1979, for the Philippines). The principles which underlay the reevaluation of investment incentives were as follows: (a) incentives should not distort factor choice in favor of capital intensive investments, nor reinforce anti-export biases; (b) allocation of incentives should follow clearly specified and generally known criteria, and not be tailor-made for specific firms at the discretion of the investment promotion agency; (c) industrial subsector strategies should be formulated to justify the provision of investment incentives based on economic considerations; (d) the incentives should not limit competition and entry by firms; and (e) the administration of incentives should be streamlined, so as to minimize the burden on the investors.

5.50 Following these reevaluations, significant revisions were made in the investment incentive schemes in Indonesia and the Philippines. The most drastic change occurred in Indonesia where all tax incentives were abolished as part of a broader overhaul of the income tax (including accelerated depreciation for all tax payers and a unified income tax with a maximum marginal tax rate of 35%). In the Philippines, the incentives were simplified, oriented towards exports, and given a reduced capital bias by introducing a tax credit based on value added, rather than size of investment; in

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14/ The reforms in the Philippines were part of a structural adjustment program supported by two World Bank SALs. In Thailand, also, some reforms in the investment incentive scheme were introduced in connection with two SALs, but these were less far-reaching than the changes carried out in the Philippines and Indonesia.
addition, the previously used criterion of market saturation was eliminated, thus avoiding a major constraint to entry of new firms. While no comprehensive evaluation is available of the impacts of these reforms, these experiences demonstrate that reforms can be introduced in practice, resulting in significant improvements in the incentive structure when measured against the broad objectives and principles outlined above. Of course, actual reforms have taken rather different approaches in these two countries: In Indonesia, the abolition of fiscal incentives was justified on the grounds that it accompanied a major overhaul in the tax structure which eliminated a number of biases against industrial investment. In the Philippines, such an overall tax reform was not undertaken; instead, as a second-best solution a significantly improved investment incentive system was retained.

**Industrial Licensing and Regulation**

5.51 Industrial licensing and regulation are employed in most of the East Asian countries with the goal of channeling industrial investment and activity into particular directions, although their prevalence and incidence varies among countries. One example is the system of industrial regulations in Malaysia, which was introduced as part of the New Economic Policy during the mid-1970s. The regulations govern the share of equity and employment which must be allocated to Malays (as against other local ethnic groups) and requires licensing for firms above a certain size. Until recently the cut-off limit was set quite low, and the criteria for granting licenses were in some cases quite restrictive regarding the scale of production and entry into new product lines, local sourcing requirements and pricing guidelines (World Bank, 1986d). In response to concerns that these requirements discouraged investors, especially the smaller ones, the government has begun to raise the limits and to ease the licensing requirements.

5.52 In Indonesia,--probably the country in the region which relies most extensively on licensing and regulation--industrial licensing is geared to prevent emergence of excess capacity; to avoid monopolistic or oligopolistic market structures; and to guide investment to peripheral regions (World Bank, 1986e). Particularly the first of these three criteria is problematic, as the government tends to have only limited capability to forecast accurately the likely market demand, and, more importantly, because it limits competition and entry, and reduces the pressure on existing firms to seek new markets, especially export markets. Other countries, especially Thailand, have been much less restrictive in the use of industrial licensing and regulation.

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15 For Indonesia, a complex system of incentives and disincentives remains as a result of the existing measures of trade protection and preferential credit arrangements, which however, apply not only to new investors, but also existing producers. In addition, industrial licensing and regulation are still used to a substantial degree to channel investment into specific directions (see below). As part of a broader reform of the incentive system, it might well be appropriate to substitute investment incentives designed in line with the above principles for the current array of trade interventions and industrial licensing and regulatory practices. This is further discussed below in Section D in the context of the discussion on alternative approaches to industrial restructuring.
While comparative evidence has not apparently been sifted in this regard, a bird's-eye view of private business climate in manufacturing industries would appear to indicate that it is more dynamic and export oriented in Thailand compared to Malaysia and Indonesia.

5.53 Restrictive industrial licensing and regulatory practices are inherently problematic from an economic point of view, although in some cases they may serve well-defined non-economic national goals. At a minimum, a basic registration requirement for all business activity is appropriate for the purposes of statistical record keeping, tax payer identification, and to monitor compliance with health and safety regulations. Beyond this, however, industrial licensing should ideally not be used for restrictive purposes. If it is nonetheless deemed to be necessary, licensing should be designed in a way that minimizes interference with competition and entry, does not bias investment decisions against export oriented activities, and simplifies procedures so as to minimize the uncertainty and compliance burden on investors, especially the smaller ones.

5.54 Industrial regulation in developing countries tends to focus on entry of new firms and on new investment activities; rarely is the same attention given to regulate the conditions under which firms can exit, when they run into difficulties. In particular, the legal framework for bankruptcy tends to be weak or non-existent, making it difficult for firms to fold in an orderly manner and for debt to be written down, so that existing capacity can be rehabilitated by new investors without having to bear the burden of the old debt. This is true even for a relatively advanced country, such as Korea (World Bank, 1986c). In this area, developing countries could well benefit from the experience of some of the industrialized countries such as Germany, where the legal framework has developed in a way that permits relatively quick and simple ways of going through bankruptcy proceedings. These issues will be further discussed in the context of restructuring of declining industries in Section 5.D below.

Direct Foreign Investment Policy

5.55 The treatment of DFI in the East Asian countries has differed significantly across countries: Some countries, such as Thailand and the Philippines, appear to have been relatively open to foreign investment and repatriation of earnings and have treated foreign investors in an approximately neutral manner compared to domestic investor; Malaysia, Indonesia and Korea, in contrast, have limited DFI mainly to export and industrial estates

16/ "At least two countries ........., namely Italy and Germany, have introduced short-cut routes to bankruptcy which should, on the face of it, increase the ability of capital markets to adjust to restructuring requirements. In the case of Germany, the system of 'Vergleich' provides that (with the consent of a majority of creditors and other safeguards) a loss-making company can write off up to 65% of its debt, thereby increasing the likelihood of a new injection of capital." (Roe, 1984, pg. 43).
through restrictive rules on ownership, location, and product lines. Investment incentives for DFI have also varied across countries (SGV, 1986). Table 5.1 summarizes available data on the scale of DFI in selected developing countries.\textsuperscript{17}

5.56 The lessons to be derived from the experience with DFI in East Asia are as follows: First, direct foreign investment (DFI) can make a significant contribution to industrialization, as demonstrated especially by the experience of Singapore and Hong Kong; but substantial DFI flows are neither a sufficient nor a necessary condition for rapid and successful industrialization, if the experience of Korea is a guide (see Chapter 4 above, and Westphal, Rhee, and Pursell, 1981). What is more, DFI is likely to be most supportive of domestic economic development, if it takes place in an outward oriented incentive system (Singapore and Hong Kong), rather than where it merely aims to benefit from high input services (Indonesia).

5.57 Second, in the current environment of high debt exposure and uncertain international economic outlook, foreign equity investment, including DFI, provides a potentially attractive alternative to increased reliance on foreign debt, and offers a way to ensure that foreigners share in the risks of development, not only the benefits. Moreover, DFI provides one way for developing countries to gain access to foreign technology, technical knowhow, and managerial skills, and to foreign markets. At the same time, however, it must be recognized that DFI is not necessarily a cheap source of investment funds for a country, if estimates of repatriated earnings in relation to total DFI are any guide. For Malaysia, for example, the cost of foreign capital provided through DFI has been put at 18\% (World Bank, 1986d).\textsuperscript{18} What is more, in the more advanced countries of East Asia, especially where indigenous entrepreneurial and technical skills are not in overly short supply, access to foreign technology in an "unbundled" manner is a viable alternative to DFI (Westphal, Rhee and Pursell, 1981).

\textsuperscript{17} These data are only suggestive of the role of DFI in manufacturing, since in countries such as Indonesia and Malaysia a significant share of DFI has been directed to the natural resource based activities, rather than manufacturing.

\textsuperscript{18} In Korea, on the other hand, "it appears that in the 1980s Korea has serviced DFI at a lower cost than it serviced external debt. On average, it has paid almost 10\% on its debt but only around 5\% as dividend remittances," (World Bank, 1986i; p. 60).
Table 5.1: SHARES OF DFI IN TOTAL EXTERNAL LIABILITIES

<table>
<thead>
<tr>
<th></th>
<th>Stock of DFI, 1983</th>
<th>Stock of external debt, 1983</th>
<th>Ratio of DFI to total liabilities (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>00.0</td>
<td>00.0</td>
<td>00.0</td>
</tr>
<tr>
<td>Korea</td>
<td>1.8</td>
<td>38.9</td>
<td>4.4</td>
</tr>
<tr>
<td>Argentina</td>
<td>5.8</td>
<td>44.4</td>
<td>11.6</td>
</tr>
<tr>
<td>Brazil</td>
<td>24.6</td>
<td>88.0</td>
<td>21.8</td>
</tr>
<tr>
<td>Mexico</td>
<td>13.6</td>
<td>89.4</td>
<td>13.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>6.8</td>
<td>30.4</td>
<td>18.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>2.7</td>
<td>23.9</td>
<td>10.9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>4.2</td>
<td>5.5</td>
<td>43.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>7.9</td>
<td>0.7</td>
<td>91.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>6.2</td>
<td>15.9</td>
<td>28.1</td>
</tr>
<tr>
<td>Turkey</td>
<td>1.2</td>
<td>17.5</td>
<td>6.4</td>
</tr>
</tbody>
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5.58 Third, providing favorable tax incentives to foreign investors is not likely to be a major factor in determining foreign investors' decisions among countries; more important is the overall political and business climate, the ease of entry and exit (including such matters as complexity of the investment regulations and licensing process), and the freedom of repatriate earnings and capital (SRI, 1984). One of the problems with tax incentives, in particular, is that unless there are special tax treaties between host and source countries, any tax relief granted DFI, while lowering the tax burden in the host country, will merely lead to higher taxes on repatriated earnings, and thus in effect result in a transfer of tax revenues from host to source country, without any net incentive to the investor (Galenson, 1984).

5.59 Fourth, by the same token, there would appear to exist little economic reason for discriminating against DFI in terms of ownership, locational, and product line rules, especially in the area of tradeable commodities, where international competition may be relied upon to limit any possible monopolistic tendencies of multinational corporate investors. In particular, the kind of limits placed on DFI in Malaysia, which have in effect restricted entry of new foreign equity to export processing zones, have probably contributed to the lack of substantial impact which DFI has had there in terms of backward and forward linkages with the rest of the economy.

5.60 In sum, DFI is one potential source of foreign capital and technology which can assist in the industrialization process, but it is neither the panacea, nor the demise, of successful indigenous industrial development. Policies towards DFI should accordingly be geared to be approximately neutral vis-à-vis the treatment offered to domestic investors and in relation to the
support offered foreign investors in neighboring countries; they should also be simple and automatic, thus minimizing compliance costs to investors and providing clear "rules of the game."

**Direct Government Investment**

5.61 The market economies of East Asia have generally witnessed relatively low levels of direct government ownership in the industrial sector compared to developing countries in other regions, although the share of the public sector in total manufacturing value-added varies considerably across countries also in East Asia (Dervis and Page, 1984, Table 2). Direct government investment and ownership in manufacturing have usually been reserved for major industrial projects, where the size of the investment, the potential monopoly power of the producer, and the need to negotiate with foreign partners, suppliers and often bilateral or multilateral lenders were thought to require a direct involvement by government. The sectors concerned have been mostly in areas of import-substituting heavy industries, including fertilizers, petrochemicals, steel, automobile manufacturing, etc. Particularly in the mid and late 1970s a lot of such major projects appeared on national planners' drawing boards in many countries in the region. Some of them even resulted from international investment and market sharing agreements reached by governments under the umbrella of ASEAN (Akrasanee, 1984).

5.62 During the 1980s, however, governments' enthusiasm for these large industrial projects waned as budgets came under pressure, interest rates rose and high public foreign indebtedness became a major concern. At the same time, the profitability of large scale industrial investments was seen to be eroding, government concern shifted from import substitution to export promotion, and the effectiveness of public intervention in these areas came into question in the face of cumulative difficulties with existing government-owned industrial enterprises. As a result, plans for major public investments in industrial ventures have been scrapped, or indefinitely postponed, e.g., in the Philippines and in Thailand, although in Thailand, a petrochemicals project and a fertilizer project with public participation are still under consideration.

5.63 Direct public investment in industry is not necessarily doomed to failure, as the Korean experience with public involvement in the steel sector has shown. Potential difficulties, however, result from three main sources: First, due to political considerations or lobbying by special interest groups, investment decisions may be made without the benefit of careful economic appraisal of the project or against better economic judgment; second, once in operation, lack of market incentives and direct government intervention may result in non-commercial management practices for the publicly owned firm; and

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19/ Another source of public ownership of manufacturing enterprises has been the need for government or government-owned banks to assume ownership of failed firms whose loans had been guaranteed by government. This has been the case especially in the Philippines since the economic crisis erupted in 1983.
third, and perhaps most importantly, once operating with public participation or backing, an enterprise may not easily be allowed to cease operations, even when it no longer is a viable commercial or economic proposition—the temptation of propping up a large industrial firm once it is failing through protective measures or various subsidies is always great, but it is particularly pressing where public ownership is involved. As Roe (1984) has pointed out, governments are not necessarily worse than the private sector in picking winners, but they are decidedly worse in dealing with losers.

5.64 The lessons then for direct government involvement in industrial investment are that (a) such involvement should be minimized and restricted in cases where it can be shown conclusively that private initiative alone would not be sufficient for the establishment of an economically viable industrial undertaking—usually, this justification will apply only to very large capital intensive industrial projects, which cannot be adequately absorbed by domestic capital markets; (b) such investments should be undertaken only after careful economic appraisal which establishes the justification for the project beyond reasonable doubt, and makes allowance for the balance of payments and budgetary implications of the project; this process will usually take considerable time, and will lead to the elimination of many, if not all, of the possible large industrial investment options proposed for public consideration, if the experience in Thailand and the Philippines is any guide; (c) when going ahead with such investments, governments should be very explicit in their commitment that measures will not be taken to support companies through protective measures or subsidies, when their longer term viability is threatened by poor management or unforeseen market developments; and (d) from the outset, management of the firms should be placed on a commercial footing, and plans for gradual privatization should be drawn up and implemented. The restructuring of failing public enterprises and issues in privatization are further discussed in Section 5 D below.

Infrastructure for Industrialization and Technology Development Policy

5.65 Discussions of industrial policy rarely deal with what may be the most important role of the public sector in supporting industrialization. This is the provision of infrastructure, defined, in its broadest sense, to include not only investment in, and maintenance of, the "hardware" of transport, utilities, and communications infrastructure, but also the "software," including support for R&D, marketing, training, technical assistance, etc. Space does not permit an extensive discussion of the issues involved in public infrastructure provision and management, but a few points deserve emphasis.

5.66 First, the management of national transport, communications, and utility networks must be seen as an essential ingredient for a successful national industrialization strategy, and since most industrial activity in fact is located in urban centers, special attention should be focused on the management of urban infrastructure. In particular, the temptation of neglecting large cities on the grounds that improvements in their infrastructure would only further aggravate urbanization trends and concentration should be resisted, since this runs the risk of seriously raising the costs to industrial development and lowering the international competitiveness of the country's industry (Hamer and Linn, forthcoming). It is perhaps no wonder
that Singapore and Hong Kong have been singularly successful in their industrialization efforts, when one considers that their urban management has been without doubt the most effective among cities in the developing countries. (Linn, 1983).

5.67 Second, in all areas of infrastructure provision, whether hardware or software, government should be careful not to displace efficient private initiative, but, where possible, encourage it. This includes, for example, policies towards trucking services, which in some countries (e.g., Thailand) have favored inefficient public enterprises; efforts to broaden the private sector's role in what have traditionally been public utilities (e.g., telecommunications); and interventions in the area of R&D, marketing and information services, where a modern private service industry may well be as efficient, if not more so, than the public sector.

5.68 Third, where public intervention is regarded as essential, care needs to be taken that services are not provided with inappropriate subsidies. In some cases, such as R&D and training, where true externalities are involved because of the non-appropriability of the benefits, some subsidies will be efficient, but even here increasing cost sharing should be aimed for over time so as to avoid the absence of a market test for the government's involvement in these areas.

5.69 Finally, "soft-ware" areas of support for industrialization, especially technology development policy, are now of particular interest to governments throughout the region. In the design of technology policy a number of special factors need to be considered:

20/ As part of its concern to improve the industrial investment climate, the Thai government has in recent years shifted from a policy of deliberate neglect of the urban investment needs of Bangkok to a more supportive policy stance. An effort is now being made to achieve a more efficient functioning of the city through a combination of judicious investment and operation of infrastructure and more effective pricing of public services.

21/ Efforts to privatize selected aspects of public utility provided are under discussion in most East Asian countries. However, progress to date has been slow. This is not surprising, considering that similar efforts in developed countries have also encountered considerable obstacles (for a review of the slow progress with British privatization efforts, see The Wall Street Journal, June 26, 1986).

22/ See World Bank (1986a) for a discussion of issues in the design of industrial technology development (ITD) policies for Latin America. An in-depth review of ITD policies for East and South East Asia is currently in progress as part of the AEN CESW program and should be completed by mid-1987. In the meantime, the major considerations which apply in Latin America, are also of relevance to the East Asia region.
(a) Demand-side factors, in particular the incentives and degree of competition which domestic industry faces, are as important as, if not more important than, supply-side oriented technology policies in determining the rate of acquisition, adaptation and efficient utilization of new technologies;

(b) Controls on technology imports are generally not an effective means of developing an indigenous technological capability;

(c) On balance, more resources should be allocated to the diffusion and adaptation of existing technologies than to the development of new technologies through basic research;

(d) Effective interaction between publicly supported technology development institutions and industry is essential; and

(e) Fiscal and credit measures in support of technology upgrading should be unambiguous and simple, and should involve some cost sharing between public and private sector, as a means not only to make the program less financially dependent on short budgetary resources, but also to ensure that it remains closely linked to the actual needs of industry.

D. Approaches to Industrial Restructuring

5.70 The broad policy framework developed in the preceding section represents the goal towards which policy makers should attempt to move over time, especially as the economy and its industrial sector matures. However, for the developing countries, and particularly those at the lower end of the development spectrum, this broad vision needs to be tempered by the realization that the industrialization process is one which requires a continuous process of restructuring, not only across sectors, i.e., from agriculture to industry and services, but also within the industrial sector among and within subsectors. This restructuring process will require particular attention by governments. Such attention should not be of a highly interventionist type, but one which assists in the efficient restructuring by helping increase factor mobility, reducing transition costs, and taking steps to minimize political opposition, which might, if not neutralized, lead to increased rigidities in the system.

5.71 Two types of industrial restructuring have been identified as deserving special attention (Roe, 1984; Sood and Kohli, 1985): "positive" and "defensive" restructuring, respectively. The case of positive restructuring involves the support of new industrial activities which offer opportunities for rapid growth of production, incomes, employment and exports. Public support may be required to offset or alleviate externalities (information, R&D, training, etc.) or market imperfections (especially, imperfect capital markets). In essence, positive restructuring is based on the argument of "infant industry" support, and involves the government in selecting "winners" or identifying "sunrise" industries. Defensive restructuring deals with the opposite phenomenon: i.e., the case of industrial subsectors that are declining, either in response to changes in the country's comparative advantage or competitiveness, or because government is aiming to rationalize the industrial
incentive system, e.g., as part of a liberalization program which leads to reduced profitability of previously protected industrial branches.

5.72 Generally, of course, positive and defensive restructuring needs will arise simultaneously. For example, Korea now faces the need to restructure the more traditional, labor-intensive industrial activities in the wake of rising domestic wages and thus loss of wage competitiveness vis-a-vis its less advanced neighbors (clothing); to restructure other industries which are on a downturn because of changes in world demand (shipping and the overseas construction sector); to adapt previously protected industries to a liberalized trade regime; and to develop new industrial activities in technologically more advanced subsectors (electronics) World Bank, 1986c; Leipziger, forthcoming). In each case, a change in the industrial structure is occurring, and the government is faced with the question whether and in what ways to facilitate the restructuring process, at the level of the sector as a whole, at the subsector level, or at the level of the firm.

5.73 A number of important principles underly a rational restructuring effort by government: The first is that government intervention should be supportive of market trends and forces, and should be facilitating, not preventing change. Second, it should be targeted in such a way as to address specific market failures or externalities directly. Third, and related to the first two points, government intervention should not stifle efficient private initiative and not limit competition. Fourth, specific restructuring efforts should always be seen as a part of an overall strategy of moving the economy closer towards the ultimately desired policy framework discussed in Section 5 C above. Drawing on these principles, we now turn to a separate discussion of positive and defensive restructuring approaches.

Positive Restructuring

5.74 As a starting point, it is useful to ask what has been the track record of governments in identifying and supporting "winners" or "infant industries" in the East Asia Region. The experience is mixed: Korea and Singapore, like Japan, had some notable successes with their strategy of identifying winners and backing them with a combination of tariff and non-tariff protective measures, tax incentives, preferred access to credit, and infrastructure support. Of course, there were also cases where, with the benefit of hindsight, the wisdom of government support may be questioned (e.g., the case of the heavy and chemical industry--HCI--program in Korea), and cases where new activities grew without government support (World Bank, 1986c; Petri, 1985).

5.75 On the other hand, the experience in many of the other countries of the region points towards a less successful experience with picking winners or providing infant industry support. In the case of the Philippines, government intervention through trade protection, tax incentives, direct investment and directed credit led mostly to inefficient and unviable projects (World Bank 1986b). In Indonesia, protective measures and other industrial incentives have supported, and continue to support, industries which clearly are no longer "infants" or have shown themselves to be losers, rather than winners (World Bank, 1986e). For Thailand, recent World Bank research (Nishimizu and
Page, 1986) has investigated selected protected industries. It concluded that with few exceptions, protection of specific industrial subsectors was associated with declining total factor productivity, and therefore that the protected industries, particularly the heavy industries' subsectors, were not in fact "infant" industries. For Thailand (as in the Philippines, Indonesia and Malaysia) also, the case of the automobile assembly industry represents an example of infant industry support gone seriously awry. The three examples where infant industry protection appears to have worked in Thailand, are the subsectors of footwear, paper products, and electrical machinery. Here total factor productivity rapidly increased during the 1960s and 1970s in the presence of considerable protection (Nishimizu and Page, 1986).

5.76 The cumulative lessons arising from these contrasting East Asian experiences remain tentative. However, lessons can none-the-less by learned for the design of "positive" restructuring efforts by governments. First, the less well developed and the weaker are a government's institutions, its bureaucratic skills and its commitment to well-articulated economic goals, the more limited and simple should be the degree of government intervention in identifying and supporting "winners." Similarly, at the other end of the spectrum, the more complex the economy and thus the more difficult the choices and costly the mistakes, the less should government intervene in the selection of specific industrial ventures. This duality of judgments explains the advice given recently by the World Bank to various countries in the region: In the case of Indonesia, Malaysia, the Philippines and Thailand, the judgment has been that, given current limitations of institutional depth, skills, or commitment to clear economic goals, a reduction in government intervention is warranted. In Korea, although intervention has largely been successful in the last two decades, the judgment has also been that the level of intervention should now be gradually reduced, because the economy has reached a level of complexity which makes it difficult for planners to intervene successfully.

5.77 Second, incentives in support of potential "winners" or "infant industries" should be designed to ensure that (a) competition is not impaired--this would mean, for example, that quantitative restrictions on trade should not be utilized, and measures limiting entry by new firms should be avoided; (b) private agents retain the maximal amount of choice in deciding on technology, factor use, or source of inputs--this would, for example, argue against domestic content legislation which specifies which particular parts have to be locally manufactured (as is currently the case in Indonesia); (c) incentives are limited in time so as to ensure that protected entrepreneurs orient themselves early on towards developing the capacity to compete in an unprotected environment; (d) incentives are factor-neutral, and in particular should not favor use of capital over that of labor as has typically been the case with the incentive systems in use until recently in most East Asian countries.

5.78 Third, positive restructuring should in the first instance be designed to address cross-sectoral objectives and constraints, or, in other words, deal with functional, not subsector or firm-specific problems. As examples, one might cite the export orientation of the Korean interventions during the 1960s and 1970s, or the technology-development policy currently being pursued by the Korean government. These interventions have been
designed specifically to address incentive biases (anti-export bias resulting from protection policies) and externalities (technological information). Even some of the directed credit policies pursued by the Korean government can be seen as efforts to come to grips with specific market failures, i.e., the failure of the capital market to provide the necessary risk capital to new activities at the scale required for full development. However, as indicated above, such intervention needs to be carefully designed to avoid issues of "moral hazard," capital biases in factor choice, open-ended government obligations, and serious distortions and weakening of the financial sector.

5.79 Fourth, a subsectoral approach for "picking winners" is a second-best approach, which would be most attractive in cases where the functional constraints cannot be readily identified or addressed across the entire industrial sector, or where the externalities and market failures are concentrated in one or more specific subsectors. Following a sector-wide overview which identifies selected subsectors for special attention and possible intervention, a more detailed analysis of the subsector would need to be carried out in order to identify whether the sector is likely to provide domestic and export market opportunities; what is the scope for learning benefits and productivity growth in response to public support; what changes in the existing incentive structure are necessary to deepen the subsectors production capacity and to make it internationally competitive over time; and what specific infrastructure, R&D, information, and training needs can be met only by subsector-specific rather than industry-wide programs. Care needs to be taken that the subsectoral strategy fits within the overall policy framework for the sector. Few such subsector analyses have actually been successfully carried out in East Asian countries, providing a sufficient base for the design of subsector specific programs of positive restructuring. One comprehensive and in-depth subsectoral analysis of the type required is the recent study of the Indonesian engineering subsector (IMG Consultants, 1985). Other subsector reviews carried out in Thailand, the Philippines, and Malaysia by consultants for the World Bank or for the governments have been much less successful, either because they were partial in coverage, never adequately completed, too superficial, or insufficiently integrated with an overall industrial development strategy.23/

5.80 Finally, a firm-specific approach to "picking winners," which in the past was the typical manner in which investment incentives were administered in East Asia (and still are today in Thailand and Malaysia), is the least desirable form of intervention. It involves government officials not only in the task of judging what is an appropriate line of industrial activity, but also which among potentially competing firms is the most appropriate firm to carry out this activity. For this, bureaucrats rarely have the expertise; what is more, it means that they lose the distance from special interests.

23/ Another problem to be considered in the design of subsectoral interventions is that industry-specific subsidies may be countervailed in the US, even if they are not explicitly designed to foster export development (Nam, 1986).
which is essential to prevent abuse of the incentive system. Finally, firm-specific incentive administration also tends to limit entry into an activity by newcomers, as the existing firms will lobby hard to protect themselves from competitive pressures on the grounds that domestic limited market size cannot sustain additional firms. Thus, firm-specific intervention in support of positive restructuring should be avoided, or at least minimized. It would be appropriate only in cases where it can clearly be demonstrated that the line of activity for the foreseeable future will be able to sustain only one single firm, even if eventual export market opportunities are fully taken into account. In addition, besides ensuring that the general criteria for incentive design and administration as outlined above are followed, special safeguards would be appropriate to ensure the transparency of the administration of incentives. A public forum, in which producer and consumer representatives can argue the case for and against protection of a particular branch of industry is always a good idea, but is particularly needed where a single firm is benefiting from government support.

Defensive Restructuring

If it is difficult to design an efficient and effective system of positive restructuring, the problems encountered in the design of an appropriate approach to defensive restructuring of declining industrial subsectors appear at least as daunting. Since defensive restructuring by definition involves the reallocation of resources from the declining activities to other sectors, the restructuring efforts, if they are to be successful, have to involve some pain (i.e., reduced employment and earnings, capital losses and transition costs) in the affected industries, and thus political opposition, even if the defensive interventions by government are designed to reduce this pain at least for some of the actors involved (Roe, 1984). Virtually all of the countries in East Asia have faced these problems, as they have had to come to grips with shifts in industrial activity which call for defensive restructuring: In Korea, the shipping and overseas' construction industries are declining industries (World Bank, 1986c); in the Philippines, large segments of industry and banking have been hit by the need to regroup after the recent economic crisis and in the face of prospective changes in the industrial incentives system (World Bank, 1986b). In Indonesia, the Philippines and Thailand, the automobile sectors are in dire need of restructuring due to pervasive inefficiencies. In Malaysia, the extensive involvement of the public sector in industrial enterprises has recently come into question and efforts are underway to privatize selected public enterprises.

The recently completed review of industrial development and policies in Korea (World Bank, 1986c; see also Leipziger, forthcoming; and Leipziger and Petri, forthcoming) probably has the most explicit treatment of defensive restructuring policies to date in the region. The analysis pointed to the need for a careful assessment of the "when" and the "how" of intervention and proposed a set of decision rules which are summarized in Box 5.1 on the next page. The main point of these rules is to (a) ensure that the need for intervention is justified; (b) determine to what extent the decline of the subsector is reversible; (c) design interventions in the most efficient, or least distortive, manner, and (d) monitor the intervention and adjust it when and where necessary.
There are two main risks which government involvement in defensive restructuring has to face up to: The first is that, rather than effecting a restructuring, the public sector gets drawn into propping up indefinitely a subsector or firm(s) which should in fact be phasing out their activities and releasing factors of production to other firms. Alternatively, where the decline is policy induced, efforts to assist the declining industry, e.g., through preferential credit, or trade protection, may only serve to neutralize policy reform. Commonly such assistance to declining industries not only supports the unviable branch of industry at some fiscal cost or cost to consumers, but directly or indirectly also results in disincentives to newly emerging industrial activities. The examples of failed defensive restructuring efforts in Western European countries have been amply documented (Roe, 1984). The second risk is that of "moral hazard", i.e., the risk that investors, in assessing the risks of new investments, are led to assume that government will bail them out in future also, just as government is bailing out industries currently suffering as a result of poor judgment of demand or cost factors.

In dealing with the first risk, government should design interventions in a way that maximizes factor mobility, i.e., facilitates the redeployment of capital, land and labor from the declining sectors to other activities, rather than attempting to encourage their continued use in the declining subsector. For capital, an important issue is that it should be possible to write down the value of physical investments so that it reflects their actual market value and so that the assets can be acquired and utilized by investors who will use them in activities that maximize their usefulness under changed economic circumstances. In effect this means introducing a system of bankruptcy procedures, as discussed above in Section 5.C. For land, industrial land use and zoning regulations and public infrastructure provision should be flexible enough to readily permit changes in land use as the mix in industrial activities changes over time. Korea's tax exemptions for capital and land transfer taxes in the case of distressed firms and subsectors, is one example how factor mobility can be increased for capital and land. For labor, retraining programs and transitional unemployment benefits are ways to lower the economic and social costs of transition, but may be costly and of limited effectiveness.

One particular way in which governments have attempted to assist restructuring has been to encourage mergers of the less viable firms of an ailing subsector with those that are in better shape. This has been the practice, for example, in Korea, usually in combination with some incentives in terms of debt rescheduling or infusion of new credit (World Bank, 1986c). To the extent that this approach leads in fact to some real adjustment in the subsector, places the remaining capacity under the most effective management, and internalizes some of the transition costs of change in factor use this is an appropriate approach. Again, however, the risk has been identified that the government is supporting the new firm with incentives that introduce new distortions, or perpetuate old ones (World Bank, 1986c).
Box 5.1: Possible Decision Rules for Intervention

Policymakers faced with requests for assistance from troubled industries need to follow predetermined steps with respect to public sector involvement. While there will always be room for "enlightened pragmatism:" in the end, the initial public policy response should be structured and predictable. Insofar as Korea's industrial structure is fast-moving and the markets in which it competes somewhat unpredictable, it is reasonable to assume that declines will continue to occur. Private sector decision-making and planning would be improved if Government dealt with these industrial crises on a systematic rather than ad hoc basis. The decision process might involve the following series of steps: (a) an assessment of the direct and indirect costs to society of the distressed industry's performance, that is, a judgment of the extent of externalities (the "intervention test"); (b) an analysis of the source of decline and a judgment on its reversibility (the "reversibility test"); and (c) if a public solution is needed, realistic near-term and medium-term objectives should be established, based on the source of the decline, appropriate policy tools should be selected to bring about public objectives, and limits should be placed on both the duration and cost of intervention ("the efficiency test"). The tools selected should provide incentives to private agents to pursue efficient solutions, i.e., to merge or shut down capacity if circumstances warrant; public restructuring should neither reward past or current uneconomic behavior. The intervention should be monitored vis-a-vis its public objectives ("the monitorability test") and potentially reversed or abandoned if it fails to measure up.

The first step is important because the source of decline will reveal whether internal management or external forces are the major determinant of difficulty, and, therefore, whether changes in the management/ownership of resources are needed or whether the allocation of resources to the industry is to be questioned. In judging the adequacy of management, lenders should take on an increasing role, although this may be complicated by interlocking directorate problems. In cases where genuine externalities seem to exist, i.e., where public policies may need to be amended, a more direct public sector plan may be necessary and this may require a public sector view on the reversibility of the decline. Such judgments should be based as much as possible on narrowly defined economic criteria. Finally, if direct public intervention is warranted, it is important that the "dosage be consistent with the disease" and policy interventions be time-limited and dependent on certain corporate actions, i.e., conditional. The test is that every marginal expenditure of public resources committed to a declining industry must pay for itself in social benefits.

(This box is taken from World Bank, 1986c).
5.86 In any case, these measures do not avoid, or only partially reduce, the windfall losses to the economic agents (capital, land, and labor) who have invested in the declining subsector. In addition, there are possible ripple effects through the financial sector to the extent that banks hold nonperforming assets and are threatened by failure as a result of the restructuring. For economic and political reasons the motivation is therefore large to bail out losers, rather than merely help increase factor mobility. This, however, will increase the risk of future failure as investors come to expect such government response and become less cautious in assessing investment risks. Government therefore should be particularly cautious in engaging in bailouts which do not pass on a substantial part of the adjustment costs to private agents.

5.87 There is one case where it might be argued that government should in fact bear part of the burden of adjustment, viz., where industries are negatively affected by reversals in government policies, in particular reforms in the industrial incentive structure. This might be thought desirable on the grounds of fairness to those who have been following government signals, and on simple political grounds, i.e., as a means to minimize opposition to reform. However, this rationale, too, involves serious risk, in that it encourages lobbying by special interest groups for special incentives, since with a history of government bailouts the downside risks of incentive removal are effectively neutralized. Therefore, it would be more effective to look for defensive restructuring measures which maximize factor mobility, rather than those that minimize windfall losses. One effective way of reducing both windfall losses and reaping maximum benefits from factor mobility, is to phase reforms in a way which helps the private sector to adjust gradually to the changed incentive environment. The issue of phasing and timing of industrial restructuring, as well as some of the obstacles commonly faced in restructuring efforts will be discussed next.

**Issues and Constraints in Restructuring**

5.88 A number of issues arise in the context of designing and implementing strategies for industrial restructuring, which cut across the distinction between positive and defensive restructuring. First, there is the question of timing and sequencing of reform. At very low levels of industrialization, when governments are also generally characterized by relatively weak institutions, across-the-board protection of industry as an "infant" may be appropriate as a way to build up the human capital and basic technological capability necessary to enable the country to compete in international markets. However, as the industrial sector develops greater depth and proficiency, and as the administrative capabilities of government increase, as has been the case in countries such as Thailand, Malaysia and even Indonesia, a more selective approach to protection and incentives becomes necessary, by concentrating support on a small number of specific subsectors, while keeping protection at low and uniform levels for the remainder of the industrial sector. In this context, it would appear to be correct to be concerned about the deepening of the industrial structure; as industrialization tends to start with production of finished consumer goods, it would be appropriate to support a gradual shift backwards towards strengthening the intermediate and capital goods sectors. Finally, in countries such as Korea, where the industrial modernization
process has gone a long way, a shift from subsetor towards functional support, particular for technology development, is desirable.

5.89 Other issues of timing and sequencing arise in the context of reforms designed to change the incentive system from import substitution towards export orientation. Here the question arises whether reduction in effective protection (as discussed in Chapter 3 above) should be carried out simultaneously with export promotion measures (discussed in Chapter 4), or whether export promotion measures should be introduced first to build up an export-oriented constituency, with extensive experience in export markets, which would then support and successfully build on a second stage import liberalization reform. The simultaneous approach has the advantage of providing stronger signals of the intended switch from import substitution towards export promotion, especially in an environment where the incentive system is characterized by high average protection rates with a great variance (as in Indonesia, the Philippines and Thailand). On the other hand, where protection rates are on average relatively low, and do not exhibit a high variance (as in the case of Malaysia), the need for import liberalization is less significant while measures in support of exports would have a greater incremental impact; therefore, moving to provide the needed support for exports deserves more and early emphasis in this case, than does liberalization on the import side.

5.90 Another issue of timing and sequencing in the context of liberalization relates to the relative timing of opening up the current account of the balance of payments (through trade reform) as against opening up the capital account (by reducing or eliminating restrictions on capital flows). This issue was discussed in some depth above in Chapter 3; here, the conclusion will merely be reiterated: When opening up the economy, it is desirable first to open up the current account, and only follow gradually thereafter with an opening up of the capital account.

5.91 Particular difficulties face industrial policy reform and restructuring in a depressed economy, as is currently the case in the Philippines, like in many of the Latin American high debt countries. In such a setting, high excess capacity combined with weak business confidence and high real interest rates results in low private investment, and thus makes a shift in the industrial structure in response to changed incentives that much more slow and painful. High unemployment rates make it politically and economically difficult to argue for import liberalization which would lead to labor shedding in the previously protected sectors. At the same time, the budgetary situation is usually highly constrained and limits the government's ability to take a lead through export promotion measures which might result in further burdens on the budget. In this context, as was argued in the recent World Bank's economic report for the Philippines (World Bank, 1986b), it is essential that the recovery process be initiated quickly, with an appropriate mix of fiscal, monetary and exchange rate policies taking the lead, while trade reform is introduced only gradually, but systematically, so as not to undermine a revival of business and investor confidence at home. At the same time, however, clear signals should be provided that export orientation is the goal of longer term reform and appropriate initial steps should be taken in that direction (especially, removal of quantitative restrictions and explicit
measures to support exports). One area of special concern in these circum-
stances is the role of the financial sector in restructuring. There is
generally an overhang of financial obligations which limits the sector's
ability to mobilize the financial resources and channel them in the directions
required for restructuring and recovery of the economy. In this case, the
government may have to assume an active role, albeit carefully circumscribed
and limited in time, to assist in the financial workout.

5.92 Of course, the need for clarity of policy signals is pervasive under
all circumstances. The direction of changes should be established clearly and
early on as part of an industrial policy reform initiative, even if the actual
measures are introduced gradually. Only if the government's directions are
seen as long-lasting and cumulative, will they achieve the necessary change in
attitudes among investors. Unfortunately, this may be very difficult to
achieve in practice where differences about the basic philosophy of industrial
policy and the influence of special industrial and bureaucratic interests
combine to offer strong resistance to industrial policy reform. This rein-
forces uncertainty about a government's ability to develop and stick to a
clearly articulated long-term strategy of industrial development and
restructuring along the lines developed in this chapter.

E. The Role of Government in Industrial Policy

5.93 In designing an industrial policy for a developing country it is
necessary to have a view, or "vision", of what is the ultimate framework
towards which policy reform is aiming. This chapter has provided the ingre-
dients for such a vision. In conclusion, it is useful to pull together the
main strands of the argument from the particular perspective of what is the
appropriate role of government in supporting industrial activity.

5.94 The central conclusion of this chapter is that the appropriate role
of government is just that, i.e., supporting market-oriented industrial
activity. Such support has to come through responsible macroeconomic
management, through policies designed to mobilize and efficiently allocate
financial resources through an effectively functioning banking sector, and
through judicious investment in human capital and infrastructure. Direct
public interventions in setting the directions of industrial activities would
be minimized, whether through the credit, tax, regulatory instruments or
through direct public investments. Unintended distortions of market signals
would also be minimized through a neutral design of tax and credit policies.

5.95 The fundamental reason for this conclusion is the judgment that the
industrial planning, targeting and intervention approach practiced in Korea
cannot readily be repeated elsewhere, as the experience of industrial inter-
vention episodes in Indonesia, Malaysia, the Philippines and Thailand have
demonstrated. Probably the largest single obstacle is the absence of the
strong civil service tradition and of the close and effective collaboration
between private and public sectors in the interest of clear national economic
goals found in Korea.
The industrial policy framework proposed here is clearly designed with one particular objective in mind, viz., that of an efficient industrialization process. To the extent that other, non-economic objectives are being pursued by governments, including such goals as national independence, regional decentralization, or political stability, modifications of the above framework may be necessary, but in such cases two aspects need to be explicitly borne in mind by the policy makers: first, that these modifications will likely result in economic costs, including the costs of industrial development opportunities foregone; second, that there may be alternative and less costly ways of pursuing the same objectives as, or even more, effectively.

However, a "vision" of an ultimate policy framework is not sufficient; in addition, thought needs to be given to how one is to move from the existing set of industrial policies, whether explicit or implicit, intended or unintended, towards the goal of the policy framework outlined above, and what may be possible constraints or obstacles incurred in such a move. The argument made in this chapter was that there do remain cases where limited, i.e., selective and temporary, support by government for industrialization is warranted, provided this is carefully designed and implemented. The case for selective intervention arises from two types of arguments: a "first-best" argument for cases where there are demonstrable market failures that can be overcome by government intervention—e.g., public goods (infrastructure), externalities (training, information) and market imperfections (capital and labor markets); and a "second-best" argument which starts from the recognition that in most countries there are in fact numerous interventions and distortions emanating from explicit or implicit industrial policies adopted by the government, and that therefore it is necessary to develop a comprehensive view of the existing policy framework, an assessment of the need for change, and an agenda for policy reform. One might add that an explicit consideration of the existing industrial policy framework and its reform is particularly important in the current world environment, which is more hostile and difficult for most developing countries than was the case for much of the 1950s through the 1970s. Under the prevailing circumstances of slower world growth, high debt, and need for restructuring in most developing countries, increased efficiency of the domestic industrial sector is critical (Michel and Petri, 1985).

In terms of the three alternative approaches to industrial policy mentioned at the outset, this chapter therefore has made the case for the intermediate approach, rather than for the laissez-faire or the highly interventionist extremes. The proposed approach is designed to provide the basis for a carefully designed and flexible plan for reform. Such a plan starts from the existing patterns of industrial policy interventions and aims for an ultimate outcome in which market forces play the predominant role, but where some selective interventions may remain appropriate for some time to come, partly because there are first-best reasons for their persistence, and partly because the process of change and restructuring realistically will have to proceed in a gradual manner.
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