# Industrial Policy in Developing Countries

## Reconsidering the Real Sources of Export-Led Growth

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# *Table of Contents*

EXECUTIVE SUMMARY . . . . . 1

INTRODUCTION . . . . . 5

COMPETING VIEWS OF EXPORTS AND DEVELOPMENT. . . . . 8

EXPORT PROMOTION IN THE EAST ASIAN NICs AND BRAZIL . . . . . 14

SOUTH KOREA . . . . . 15
TAIWAN . . . . . 21
HONG KONG AND SINGAPORE . . . . . 26
THAILAND . . . . . 27
EAST ASIAN EXPORTS AND INDUSTRIAL POLICIES: A SUMMARY . . . . . 30
COUNTERPOINT: BRAZIL . . . . . 31

PROBLEMS OF COMMODITY EXPORT-ORIENTED GROWTH . . . . . 35

IMPLICATIONS FOR DEVELOPMENT POLICY. . . . . 39

ENDNOTES . . . . . 45

BIBLIOGRAPHY . . . . . 49

# Executive Summary

This report examines the trade and industrial policies currently advocated by the major development agencies. It calls for a shift away from the current emphasis on extreme trade liberalization to one that recognizes the role of targeted government policies in promoting balanced economic growth.

For the last decade, the less developed countries (LDCs) have been encouraged by the major development agencies simply to open up their markets to imports and to export whatever products they can produce relatively cheaply in the short-term. Many forms of development assistance, ranging from World Bank structural adjustment loans to International Monetary Fund (IMF) assistance to debt relief under the Brady Plan, have been made conditional on this type of "trade liberalization." The operating assumption behind these policies is that successful export-led development can be achieved simply by eliminating LDC government intervention in markets and allowing world market prices to dictate domestic economic incentives.

***Successful export-led growth has generally been based on activist trade and industrial policies.***

This report challenges the historical and factual basis for the view that trade liberalization per se is the key to successful export-led growth in developing countries, Based on detailed case studies of the most successful newly industrializing countries (NICs)-South Korea, Taiwan, Singapore, Hong Kong, and Thailand-the report finds that in every case (except Hong Kong) governments have actively intervened in various ways to promote specific types of manufactured exports of ever-increasing technological sophistication. Far from supporting the extreme trade liberalization view, the actual record of these countries demonstrates that successful export-led growth has generally been based on activist trade and industrial policies.

This report does not question the importance of promoting exports for successful development in today's highly integrated world economy But this does not imply that countries should concentrate only on exports of whatever product lines in which they happen to have a current comparative advantage. -Nor does this imply that countries should never restrict imports of goods they could potentially produce efficiently at home-and perhaps eventually export, Indeed, the evidence in this report suggests that development success has often been correlated with deliberate efforts to transform countries' competitive advantages by promoting those manufactured exports which allow domestic producers to move up the technology and skill "ladders."

Current development policies have been strongly influenced by a "New Orthodoxy" in development economics, which essentially equates "export-oriented' development with *laissez-faire* domestic policies. By the same token, "inward looking" or import substitution-based development is equated with government intervention and regulation. But these are false

equations. In the 1970s and 1980s, virtually all developing countries sought to promote exports of one kind or another, using policies with varying degrees of government intervention, and with varying degrees of success. There is no compelling evidence that the more successful export-oriented strategies have been associated with greater liberalization or less government intervention. On the contrary, a growing body of scholarship-by economists in the United States, in other countries, and in the World Bank itself-has documented the active government intervention which most of the East Asian NICs used in achieving their export successes. Far from simply "letting markets work," governments in these [the East Asian NICs] nations consciously altered price incentives so as to promote manufactures that required increasingly advanced skills and technology Furthermore, these countries often liberalized trade (or abandoned subsidies) only *after* previous interventionist policies had succeeded in fostering efficient and competitive domestic industries.

***Governments in [the East Asian NICs] consciously altered price incentives so as to promote manufactures that required increasingly advanced skills and technology:***

An important conclusion of this report is that *it matters what kinds of products a country exports, and under what conditions.* In general, countries which have concentrated on exports of manufactures have done better than countries which have relied on exports of primary commodities (i.e., agricultural and mineral products). And among exporters of manufactures, those countries which have determinedly implemented a systematic, long-term strategy of raising their technological capabilities and skill levels by moving into more and more advanced product lines have done better than those which have not implemented policies to advance from low-skilled, labor-intensive assembly operations.

Economic development requires above all that countries improve their internal productive capabilities through technology transfer, skill acquisition, "learning effects," and the exploitation of scale economies. Manufacturing activities tend to offer more scope for these kinds of developmental benefits than most agricultural or mining activities. In economic terms, manufacturing offers more "externalities" or "spillovers"-economy-wide benefits which do not accrue to the private producers who generate them. While excessive government intervention can be harmful, even imperfect industrial promotion policies can still improve on the "free market" outcome when that would leave a country industrially underdeveloped.

The experiences of successful exporters are particularly impressive when contrasted with the difficulties of countries which have stressed commodity exports. In fact, the World Bank, the U.S. Agency for International Development (USAID), and other development agencies may have inadvertently aggravated the problems of primary commodity exporters by encouraging commodity exports in an uncoordinated manner. Each regional or country department of each agency operates under the assumption that its recommended export activities will have no effect on prices. There is no adding up the total effect of all these export-promotion activities on global supplies, let alone any projection of the effect on world prices. By pushing

exports of similar commodities on numerous countries at the same time, these agencies contributed to gluts of many commodities on world markets, and thus to the general decline of commodity prices in the 1980s. In this way, the advice to LDCs to promote commodity exports has often clearly backfired.

These findings lead to a number of specific recommendations for development policy reform in the 1990s:

***The advice to LDCs to promote commodity exports has often clearly backfired.***

- First and foremost, the United States and the development agencies (including the World Bank) should cease to encourage extreme trade liberalization measures in LDCs, and should stop making aid or debt relief conditional on such measures. Rather, LDCs should be encouraged to liberalize more gradually and selectively, based on the true lessons of the experiences of the successful NICs as well as on local conditions.

- LDCs and aspiring NICs should be permitted-indeed, encouraged-to plan long-term sequencing of industrial development with the aim of raising their internal technological capabilities. In this regard, some temporary restrictions on imports may be needed, and some activities may have to be subsidized. In all cases, the interventions should be highly selective, specifically targeted, and conditioned on the eventual attainment of economic efficiency and international competitiveness.

- In order to ensure that long-term development objectives are pursued, development agencies should redirect their research to study how other countries can build up the kind of organizational and administrative abilities required to emulate the most successful NICs.

- The World Bank and other agencies need to coordinate their commodity production and export projects. Countries should not be induced to contribute to global gluts or be subject to wild price swings in the name of respecting their short-run comparative advantages. It is recommended that the World Bank put in place a system of internal reporting of export-promoting activities within the various regional departments of the Bank. Moreover, it is recommended that the World Bank collect similar data from other multilateral and national agencies which promote exports, and use the information in its projections of trends in world supplies and prices. The results of such analyses could then be taken into account by project managers in order to avoid the adverse consequences resulting when too many countries export too much of the same commodities at the same time.

- Similarly, the total effect of simultaneous industrial export efforts by different countries has to be taken into account in formulating development and trade policies. In the case of industrial products, however, the problem is market access in the developed countries (including the United States) rather than falling prices. Given the already spectacular growth of manufactured exports from the Asian NICs, and the rapid catch-up of Brazil, Mexico,

India, China, and other developing nations in manufacturing for export, there may be little room for less developed countries to follow suit-especially to the extent that the Japanese market continues to be relatively closed, and that Europe turns inward after 1992. At the same time, the U.S. market is likely to be saturated or else more protected. In response to these problems, a goal of development agencies should be to persuade other industrialized countries (Europe and Japan) to accommodate more imports, and to help developing countries engage in more reciprocal trade among themselves (perhaps through revived regional common markets) in order to provide growing markets for their expanding manufactured output.

***The World Bank and other agencies need to coordinate their commodity production and export projects.***

## Introduction

The great success stories of economic development in the last decade have been the newly industrializing countries (NICs) of East Asia, especially the so-called "Four Tigers" (South Korea, Taiwan, Hong Kong, Singapore), and now increasingly Thailand. In these countries, rapid growth of manufactured exports has produced dramatic increases in income. Their successes have changed the prevailing sentiment in development policy from "export pessimism" to "export optimism." Throughout the 1980s, international development agencies such as the World Bank and the U.S. Agency for International Development (USAID) have urged all less developed countries (LDCs) to follow the East Asian NIC model by adopting a development strategy based on export promotion.

***There is nothing that inherently links export promotion with a completely free market environment.***

These dramatic success stories are indeed important for development theory and policy, but to a large extent the wrong inferences have been drawn about the sources of their success. A conservative movement in development economics which dominated development policy discussions and practice in the 1980s—referred to here as the "New Orthodoxy"-argues that the free operation of the market accounts for these East Asian successes. According to the New Orthodoxy, the key to successful export-led development is simply for governments to abandon the trade protection and industrial policies which have been used in the past to promote domestic production of manufactured goods in many LDCs. This old strategy, known as "import substitution," is thus identified with government intervention, while the "new" strategy of export promotion is identified with *laissez-faire* policies (trade liberalization and domestic deregulation). By opening up domestic markets to international competition, it is claimed, producers are given the right "price signals" (incentives) to produce efficiently (see Krueger, 1980 and 199Oa). As production becomes more efficient, exports naturally expand, propelling the domestic economy to "take off' on a path of self-sustaining growth (although how greater static efficiency is supposed to ensure more dynamic growth is not clearly specified).

A growing body of scholarship, however, has begun to challenge the New Orthodoxy as both empirically and theoretically flawed, as well as damaging to the LDCs that have strictly based their export policies upon it. The New Orthodoxy in effect makes the logical error of assuming that, because the old import substitution policies were highly interventionist, the export promotion policies must be largely noninterventionist. However, there is nothing that inherently links export promotion with a completely free market environment. Governments can and do promote their exports by making targeted interventions in the economy Such interventions include, for example, subsidizing the acquisition of certain technologies and providing tax breaks to industries judged most likely to foster further economic progress. In fact, as this report will show, this is precisely the course that most of the East Asian NICs followed. The governments of South Korea, Taiwan, and most other NICs have undertaken a host of interventionist measures

which have created powerful incentives for export-oriented manufacturing firms, often in particular targeted industries at particular *stages* of development.

There is no question that economic incentives are crucial to development success. However, this does not necessarily mean that the "right" prices are always the current international market prices. Development in the East Asian NICs has, as we shall see, often been guided by price signals (incentives) that deviated from world market prices as a result of conscious government intervention. At the same time, in a policy reemphasized in the 1980s, many LDCs followed the incentives of current world market prices by specializing in primary commodities (agricultural and mineral exports), only to discover that the prices of those commodities subsequently fell as global supplies outstripped demand. While ultimately a country's products must become competitive at world market prices in order to be exported, it does not follow that strict reliance on the incentives given by those prices has been positively associated with development success. The "right" prices for guiding resource allocation in developing countries are not necessarily identical at all times and for all sectors with prevailing world market prices.

***It seems to make a big difference whether a developing country ptvmotes exports of primary commodities or manufactured goods.***

The contrasting experiences of the East Asian NICs and the commodity-exporting LDCs suggest two vital distinctions. First, it seems to make a big difference whether a developing country promotes exports of primary commodities or manufactured goods. It makes a difference not oniy because of the recurring problem of gluts resulting in falling prices in commodity markets, but also because of the greater potential for raising technological capabilities and increasing total factor productivity in manufacturing industries. Second, it is critical to distinguish a country's *static* comparative advantage (what it can produce relatively more efficiently and export successfully in the short run) from its *dynamic* comparative advantage (what it can develop the potential to produce relatively efficiently and export in the long run). All the evidence about the East Asian NICs supports the view that most of them deliberately altered the market incentives through trade and industrial policies which favored manufacturing activities of increasing technological content, and which placed long-run development goals over short-run comparative advantage.

This is not to say, of course, that any kind of government intervention, however inefficient, can be justified by appeal to long-run development objectives. As the history of import substitution policies demonstrates, there is ample room for government intervention to overpromote certain industries to the detriment of long-run efficiency, competitiveness, and growth. This makes it all the more important to understand exactly what kinds of trade and industrial policies have worked and what kinds have not. To paraphrase Albert Fishlow (1987, p. 28), the key is "getting the inferences right" about the real sources of success or failure in export-led development efforts. The evidence in this report will clearly show that South Korea, Taiwan, Singapore, and Thailand fall squarely into the active government

intervention and industrial policy camp, while even Hong Kong appears to be moving in the same direction. This report will also briefly review the experience of Brazil, where the interventionist promotion of manufactured exports has resembled the policies of the East Asian NICs, but where the debt crisis has set back industrial development efforts and compelled a drive to maximize short-run export earnings at any cost.

In criticizing the New Orthodoxy school, this report also calls into question the recent policies of the World Bank, USAID, and other development agencies. Despite mounting evidence to the contrary, the equation of successful export policies with government nonintervention continues. It is a hopeful sign that some World Bank publications are beginning to acknowledge that export promotion may entail active government interventions to stimulate exports at least in the short-term. However, such interventions are portrayed as justified only to compensate for past import substitution incentives and to help absorb the shock of opening up the economy These agencies also continue to promote commodity exports of minerals and agricultural products from developing countries without adequate attention to the cumulative effects of increased output from the various regions on world supplies and prices. Nor are these agencies looking ahead to the possible impact of the promotion of LDC-manufactured exports on developed and developing economies alike, as supply inevitably expands in this sector

***South Korea, Taiwan, Singapore, and Thailand fall squarely into the active government intervention and industrial policy camp.***

Part of the problem appears to stem from errors of analysis, as examined in this report. In addition, the decentralized organizational structure of the World Bank (and other agencies) has also caused difficulties. Each department of the World Bank tends to focus on the individual country or region assigned to it, and assumes that world prices of a given commodity will remain as forecast. This limited view on the world economy does not take into account the effect of other countries simultaneously increasing their exports of the same commodity A major conclusion of this study is that the World Bank must begin to add up information on the commodities **and** manufactures being promoted by the various Bank departments and other agencies as well as account for the possible cumulative impacts on world prices in its published price projections.

## Competing Views of Exports and Development

*Trade and development economists of the New Orthodoxy school have tended to use the terms "export promotion," "outward looking development," and "free trade". .. more or less synonymously.*

Conservative trade and development economists of the New Orthodoxy school have tended to use the terms "export promotion," "outward looking development," and "free trade" (or at least "liberalizing trade regime") more or less synonymously For example, Balassa (1988) explained the export and growth success of the East Asian NICs as a result of the "neutrality and stability of the incentive system." Little (1979, 1982) attributed the stellar success of Taiwan to a free labor market, high real interest rates, a virtual free trade regime for exports, and conservative government budgeting. Other economists seem to have concluded that any active export promotion interventions in Korea, Taiwan, or Singapore merely had the effect of reversing the impact of other import substitution policies, so that, in the end, the same price signals that would have prevailed under free trade emerged out of a set of mutually self-canceling polices.' This interpretation has played an influential part in the development literature and in the perceptions of many American policymakers.[2]

The leading promoter of trade liberalization in the 1980s was the World Bank. It published a study of trade policy and industrial development which received widespread attention in the American and international press: the 1987 *World Development Report* (World Bank, 1987a). That study did much to reinforce the perception that liberalization and export promotion are logically and factually associated with each other. The report begins by distinguishing between what it calls "outward-oriented" and "inward-oriented' trade strategies. For the outward-oriented-strategy it was claimed that "trade and industrial policies do not discriminate between production for the domestic market and exports, nor between purchases of domestic goods and foreign goods..." (p. 78). For the inward-oriented (import substitution) strategy "trade and industrial incentives are biased in favor of production for the domestic over the export market." The report classified forty-one countries as either strongly outward-oriented, moderately outward-oriented, moderately inward-oriented, or strongly inward-oriented in two periods, 1963-1973 and 1973–1985. This classification scheme has influenced some scholarly work and has subsequently appeared as an explanatory variable in empirical studies (e.g., Berg and Sachs, 1988).

The World Bank study (1987a) classifies South Korea, Singapore, and Hong Kong as strongly outward-oriented. In this category, according to the report, "trade controls are either nonexistent or very low. . There is little or no use of direct controls and licensing arrangements and the exchange rate is maintained so that the EERs [effective exchange rates] for importables and exportables are roughly equal" (p. 82). The study called its results inconclusive for the moderately outward- and moderately inward-oriented countries. Therefore, the report actually bases its conclusions on a comparison of growth rates for just three cases of strongly outward-oriented countries (South Korea, Singapore, and Hong Kong) with those of the strongly inward-oriented countries-as categorized by the report, a group com-

posed mainly of low-income LDCs with a host of other problems. The study then concludes that outward-oriented countries have fared better than inward-oriented countries, and attributes the success of the former to policies which "do not discriminate."

There are at least four major problems with this conventional view of export promotion and development success. First, it is notoriously difficult to identify the causes of differences in growth performance in comparisons among countries which differ in many ways besides their external trade policies. Careful attention must be paid to domestic structures, institutions, and incentives. Second, the evidence simply does not support the association of "outward orientation" or "export promotion" with "free trade" policies that "do not discriminate," or even with activist policies that merely "correct" for previous protectionist excesses. Third, the fact that import substitution policies preceded export promotion efforts in most of today's successful NICs—and in some cases still accompany the latter-suggests that it is misleading simply to counterpose the two as alternative strategies. It may be more accurate to conceptualize import substitution as a necessary stage in the development process, potentially laying the foundations for subsequent export success, and sometimes effectively subsidizing contemporaneous export drives. Finally, the whole effort to classify countries as either inward- or outward-oriented ignores the fact that virtually all developing countries have had to promote exports of some kind to fuel their growth. A much more useful distinction concerns whether the countries have relied on exports of manufactured goods or primary commodities, with countries specializing in the former generally outperforming those specializing in the latter in the long run.

***The evidence simply does not support the association of "outward orientation" or "export promotion" with "free trade" policies that "do not discriminate."***

On the first point, developing countries vary greatly in their political and economic institutions, demographic and ethnic composition, and other historical and cultural factors. Unless all of these factors are controlled for, it is impossible to conclude with certainty that their international trade policies were the main determinant of the success or failure of their development efforts. Even in the strictly economic realm, macroeconomic (fiscal and monetary) policies, land tenure systems in agriculture (the concentration of landownership), and the honesty and efficiency of the government bureaucracy seem to matter at least as much as trade policies for development outcomes-in regard to both aggregate growth and distributional equity

Moreover, history matters to contemporary possibilities. The legacy of Spanish colonialism with its feudal concentration of land ownership and corrupt system of government still prevents widespread sharing in the benefits of growth in many Latin American countries and the Philippines. Britain administered many of its African and Asian colonies with free trade policies of low import tariffs and an open door to foreign (at least British) investment, and pushed similar policies on many independent Latin American countries (e.g., Argentina) in the 19th and early 20th centuries. The result was generally regarded as the underdevelopment of these areas relative to the European nations, the settler-colonies, and Japan (most of

which developed industrially (including the United States) behind protectionist barriers). On the other hand, it is not coincidental that South Korea's success followed thoroughgoing land reform after World War II and the Korean War.[3] Later, in the 1970s, the "New Communities" program built on this base with a voluntary program of cooperative development.

A more specific problem with the World Bank analysis is the fact that virtually all of the low-income countries in the sample fell into the strongly inward-oriented category Using data supplied in the appendix of the same 1987 report, one finds that the middle-income countries grew at more than twice the rate of the low-income countries (excluding China and India) during 1965-1980. The growth rate for industry in the middle-income group was nearly double the rate for the low-income group.* Yet it is doubtful that this differential performance between low- and middle-income countries can be explained by a difference in their trade policies. The middle-income group for this period was dominated by the Latin America countries, which by and large exhibited excellent growth performance during that time while typically pursuing strong import substitution policies (see Fishlow, 1987).

***Many of the NICs seem to be exporting manufactured goods which were deliberately subsidized or otherwise encouraged by government policies.***

The identification of export orientation with neutral, nonintenrentionist trade policies almost seems to be based on an error of logic: because import substitution policies are highly interventionist, it is often assumed that export promotion policies must be noninterventionist or at least *less* interventionist. This identification may also have taken its cue from abstract economic theory: the model of international trade in a world of "perfectly competitive" markets. Following that theory across-the-board protection of importable goods through tariffs or quotas shifts domestic price incentives in favor of production for the domestic market and away from production for export. Since widespread protectionism thus has an "anti-export bias," trade liberalization is considered to be inherently export promoting. Liberalization promotes exports because it increases the relative prices exporters receive for their products in comparison with import-competing and nontradeable goods. This theory predicts that the market mechanism will then automatically shift resources away from protected import substitution activities, and direct them toward export activities.[5] There are several problems with applying this abstract theory to actual developing countries. First, it is not necessarily correct to assume that countries end up exporting only those goods which pure "free market" forces would have led them to specialize in. Many of the NICs seem to be exporting manufactured goods which were deliberately (if not openly) subsidized or otherwise encouraged by government policies. Thus it is logically as well as empirically wrong to identify trade liberalization with export promotion. The next section will show that two of the three countries identified as "strongly outward-oriented" in the 1987 report (South Korea and Singapore), along with another major East Asian NIC not included in the study (Taiwan), followed active industrial policies which did indeed "discriminate" through the selective promotion of favored exports.

The view that import substitution and export promotion are mutually exclusive policy options is also misleading. The monumental study of

Chenery, Robinson, and Syrquin (1986, p. 178) concludes that "periods of significant export expansion are almost always preceded by periods of strong import substitution." In many cases, the leading industrial sectors did not change after the switch to export promotion (pp. X30-87). This fact strongly implies that the import substitution phase had something to do with the export success that followed. How and when to make a transition from import substitution to export promotion is an important issue in itself But it should not be thought that Korea or Brazil's import substitution phases were merely mistakes and did not contribute to their subsequent export success. Moreover, many of the major manufactures-exporting NICs simultaneously protect some infant industries while intervening actively to promote the exports of others. Sometimes an export industry also receives protection, as in the case of South Korean automobiles which have had a prohibitive tariff Such a tariff either on an export product or on an exporting firm's other products, can constitute a hidden subsidy to exports. For this reason, it is misleading to classify a country such as South Korea as simply export-oriented, and especially to characterize it as "not discriminating" between different types of products.

***It should not be thought that Korea or Brazil's import substitution phases were merely mistakes and did not contribute to their subsequent export success.***

Rather than classifying countries as more outward- or inward-oriented, and rather than trying to determine which type of orientation is more or less interventionist, it makes more sense to start by recognizing that some export promotion is all but universal among developing countries. Although some countries have emphasized exports more than others,' one can scarcely point to a single LDC which has not had some kind of active export promotion program in the past few decades. Developing countries have, in fact, been forced to emphasize exports for a variety of reasons. For example, many LDCs had to expand exports in the 1970s because the rise in oil prices necessitated obtaining more foreign exchange. Also, the exhaustion of easy opportunities for import substitution and the saturation of domestic markets for manufactures led to searches for outlets for manufactured exports from the 1960s onward (although some countries lagged behind others). And the debt crisis of the 1980s compelled debtor nations to push exports of all kinds very strongly, although not with entirely satisfactory results as we shall see below More fundamentally, economic development requires substantial imports from developed countries, including capital goods, intermediate inputs, some consumer goods, some more advanced services, and higher education.[8] All these imports, plus the servicing of any debts incurred to finance them, must be paid for with hard currencies (i.e., convertible foreign exchange). As these requirements expand with growth, LDCs must supplement traditional export activities, development assistance, and loans (which create a debt burden) with expanded exports in order to increase foreign exchange earnings.

The necessity to expand exports in the development process has long been recognized, even by economists who advocated a stage of import substitution. Indeed, the pioneering "structuralist" development economists of the 1940s argued as strenuously for export promotion as any of the recent New Orthodoxy economists.[9] This is true even of the structuralists criticized most for stressing "inward looking growth," based on a strategy of

import substitution. For example, Rosenstein-Rodan (1943, p. 252) spoke of the need for "pushing exports" and to "create . export industries." Nobel Prize winner Gunnar Myrdal **(1958,** p. 105), often criticized for advocating inward-looking policies, actually concluded that "the underdeveloped country will have to do its utmost to increase its exports." And Hirschman (1958, p. 124) argued that export promotion "may often be the only practical way of achieving" import substitution.

***It is sectoral promotion and not across-the-board trade liberalization that is crucial for dynamic growth and development.***

In practice, virtually all developing countries have been promoting exports. Thus, one cannot distinguish among LDCs on the degree of export orientation alone. Of course, some LDCs have been more successful at exporting than others. It is also true that export promotion was not *consistently* pushed in some countries with strong import substitution policies, or with inconsistent macroeconomic, financial, and exchange-rate policies. In spite of these exceptions, the evidence suggests that *it is sectoral promotion and not across-the-board trade liberalization that is crucial for dynamic growth and development.*

One of the most important determinants of long-term development success from export promotion seems to be a focus on manufacturing as opposed to (or in addition to) primary products. There have long been important arguments in the development literature in favor of limiting dependence on exports of primary commodities, including:

* *Commodity* **price** *instability* Prices of primary commodities are subject to much larger swings than prices of manufactures and services, and so risk-averse, credit-constrained LDCs will suffer from overspecializing in the former (Todaro, 1989).

* *Strong agricultural trade barriers.* Agricultural trade barriers in the developed countries tend to be stronger than manufacturing barriers. Although various voices have called for removing these, including the U.S. in the current Uruguay Round GATT negotiations, as yet few concrete actions or guarantees of removal have emerged."

* *Manufactures produce widespread benefits.* The production and export of manufactures has been widely argued to foster economies of scale, intersectoral linkages, and positive externalities (benefits spilling over to other producers), resulting in accelerated technological progress and productivity growth in LDCs (see Pack and Westphal, 1986). More broadly, industrialization generally brings about qualitative changes throughout the society, including improved education, increased labor skills, greater technical expertise, enhanced capacity for innovation, and more flexible management, which traditional agricultural and mining activities do not tend to generate.

* *Declining terms of trade for commodities.* Singer (1950), Prebisch (1950), and others argued that the terms of trade for commodity producers are likely to have a long-run falling tendency due to the substitution of synthetic materials for natural products, the low income elasticity of demand

for agricultural products, and the structural characteristics of LDC and developed country labor and product markets." While the debate over the long-term trend of the commodity terms of trade may never be resolved (see Spraos, 1983), it is clear that commodity prices turned sharply downward (relative to industrial prices) in the 1980s—just after large investments in numerous primary commodities were undertaken in Africa, Latin America, and Southeast Asia.[12]

To conclude this discussion of exports and development, it is worth recalling the limitations of the theory on which the trade liberalization argument is based. The theory of free trade predicts only a once-and-for-all increase in efficiency from trade liberalization; it does not guarantee sustained long-term growth. Sustained growth requires, above all, sustained technological progress and continuous increases in labor productivity. Free trade theorists abstract from these requirements in their doctrine of "comparative advantage," which says that a country should specialize in those products which it can produce relatively cheaply using currently available technology and with existing labor productivities.[13] In fact, this problem is recognized by some advocates of the New Orthodoxy, who acknowledge that the dynamic benefits of export promotion may be as important as the static efficiency gains (Krueger, 1990a and 1990b). But what the New Orthodoxy still fails to recognize is that the dynamic benefits do not result from an export orientation alone. In order to ensure long-term growth, a country must consider the potential of different productive activities (e.g., manufacturing versus agriculture) to generate technical progress and productivity growth. Thus, *what* a country exports may be just as important as *whether* it exports, and *laissez-faire* trade policies will not necessarily encourage those exports which are most advantageous in the long run.

***What a country exports may be just as important as whether it exports, and laissez-faire trade policies will not necessarily encourage those exports which are most advantageous in the long run.***

## Export Promotion in the East Asian NICs and Brazil

The East Asian "Four Tigers" (South Korea, Taiwan, Hong Kong, Singapore) and their heir apparent, Thailand, offer essential clues to the ingredients of successful development policies. Misinterpretations of the experiences of these countries have caused much confusion in policy discussions, particularly in the U.S. It is essential that debate about these countries turn on the facts of the countries' actual policies rather than hypothetical models. The New Orthodoxy school is correct in that the growth performance of the Four Tigers has been generally outstanding. What is in dispute is the *source* of this success and the implications which are drawn for development policy in other countries.

***[The Four Tigers] have had among the most active industrial policy programs in the world, following and expanding on the example of Japan.***

The successes of South Korea, Taiwan, and, to a large extent, the secondary East Asian NICs as well, cannot be attributed to reliance on free market policies. In fact, these countries have had among the most active industrial policy programs in the world, following and expanding on the example of Japan.'* Admittedly, the existence of such programs does not prove that these policies caused the successes which followed. Assigning causality unambiguously in such cases is impossible, and some have even suggested that these NICs would have had even higher growth without them (see Lal, 1985). One should note, however, that no countries have ever grown faster in recorded economic history

In addition to increasing their GNPs at historically unprecedented rates, South Korea and Taiwan in particular seem to have fared quite well on other important development criteria, such as keeping inequality from increasing and even reducing it, virtually eliminating absolute poverty, maintaining rapid growth of industrial employment, keeping underemployment in the "informal" sector (e.g., minimally paid street traders, hawkers, and petty service providers) from getting too high, among other things. In Korea, the education and skill levels of the labor force have steadily risen; however, labor rights have been severely restricted.[15]

Development economists disagree as to whether South Korea and Taiwan score as highly as they should on noneconomic development measures. For example, Sen (1983) points out that, although South Korea now has a per capita income five times that of China and Sri Lanka, it has yet to overtake those countries in life expectancy. (Both China and Sri Lanka are often cited as countries which have emphasized basic needs first, and only then built on this base with growth strategies.) Further, "Korea was not nearly as industrially backward in the late 1950s as the 'basket case' designation would make it seem" (Pack and Westphal, 1986, p. 91). Thus the initial conditions that prevailed in Korea 30 years ago cannot be fairly compared to the situation in today's least developed countries. But taken as a whole, the development track record in Korea and the other East Asian NICs has been relatively stellar This record warrants a close look at actual policies, rather than relying upon theoretical presumptions.

## South Korea

Numerous studies have documented a truly prodigious array of incentives for exporting used by the Korean government since the early 1960s. One of the most complete accounts of Korean export subsidies and promotion efforts is given in the World Bank study by Rhee, Ross-Larson, and Pursell (1984). Additional key references (drawn on below) are Amsden (1989); Hong (1979); Frank, Kim, and Westphal(1975); Pack and Westphal (1986); Luedde-Neurath (1986, 1988); World Bank (1987b); Kuznets (1988); Petri (1988); and Y. C. Park (1990). Only some of these policies have been in effect in any one industry at any given time, and effective subsidies have been considerably scaled back (although not eliminated) in recent years. Nevertheless, the scope and pervasiveness of the nineteen major types of intervention listed here should dispel the myth that Korea succeeded by "allowing the free market to work."

***Studies have documented a truly prodigious array of incentives for exporting used by the Korean government since the early 1960s.***

1. *Periodic devaluations* of the Korean currency have been combined with other policies to keep the effective exchange rate (EER) for exporters *higher* than that for importers. As early as 1964, South Korea's EER for exports was 281 and its EER for imports was 247 (Gillis et al., 1987, p. 457)—reflecting not trade neutrality but a pro-export bias.[16]

2. *Preferential access to imports needed for producing exports* has been provided to manufacturers with unrestricted, guaranteed, and tariff-free access to imported intermediate inputs used in goods later exported, while other imports are severely restricted. "Wastage allowances" were often relaxed further for exporters. Strict controls are in place to prevent abuse. Since 1975, industries can collect rebates from the government only after documenting the completion of the exports."

3. *Tariff exemptions* on inputs of capital goods needed in exporting activities. This is a price incentive, while preferential access (#2) is a quantity restriction.

4. *Tax breaks* for domestic suppliers of inputs to exporting firms, which constitutes a domestic content incentive.

5. *Domestic indirect tax exemptions* for successful exporters.

6. *Lower direct tax* on income earned from exports,

7. *Accelerated depreciation allowances* for exporters.

8. *Import entitlement certificates* (exemptions from import restrictions) linked directly to export levels. Korea has long maintained an extensive list of items generally prohibited for import, including both luxury goods and import substitution targets. Profitable exemptions from this prohibition have often been available for firms exporting specified goods with low profit margins.

9. *Monopoly* **rights** granted to the first firm to achieve exports in a targeted industry

10. *Subsidized interest rates* for exporters.

11. *Preferential credit access* for exporters, including automatic access to bank loans for the working capital needed for all export activities. Medium- and long-term loans for investment are rationed and often available only to firms meeting government export targets and pursuing other requested activities.

**The scope and pervasiveness of the 19 major types of intervention listed here should dispel the myth that Korea succeeded by "allowing the free market to work."**

12. ***Reduced*** *public utility taxes and rail rates* for exporters.

13. *A system of export credit insurance and* **guarantees, as** well as tax incentives for overseas marketing and postshipment export loans by the Korean Export-Import Bank.

14. *Free trade zones,* ***industrial*** *parks, and export-oriented infrastructure* have all been created.

15. *Public enterprises* have been created to lead the way in establishing new industries. Public enterprises produced the first Korean output of ships and refined petroleum products and petrochemicals (Amsden, 1989, p. 275). Pack and Westphal (1986, p. 97) note that "the share of public enterprises in Korea's nonagricultural output is comparatively high, being similar to India's" This is a striking comparison because India's high share is often held to be symptomatic of an interventionist stance leading to lowered growth.

16. *Export sales promotion* is carried on by the Korean Traders Association and the Korea Trade Promotion Corporation (KTPC). They are publicly supported activities that promote Korean exports on behalf of Korean firms worldwide.

17. General *orchestration of sector-tie efforts to upgrade the average technological level,* through use of a new generation of machinery (Westphal, 1990).

18. *Government coordination of foreign technology licensing agreements,* using national bargaining power to secure the best possible terms for the private sector in utilizing proprietary American and other foreign technology

19. *Export targets* have been set by firms themselves since the early 1960s, although they may be adjusted by the government.

The last point is perhaps the most surprising. Quantitative targeting in development planning has become particularly unfashionable in New Orthodoxy development economics, perhaps because of its apparent similarity to "comprehensive development planning," or even the failed "cen-

tral planning" of the Soviet Union and its former satellites. Why might quantitative targeting have been successful in the East Asian context? First, these countries specifically targeted manufacturing exports of growing technological content. Such a planning yardstick automatically emphasizes targets with very strong development benefits. In addition, the world export market is an arena in which performance is clearly, quickly, and rigorously tested. This quick feedback tends to keep the development ministries, whose resources and information capacities are inherently limited, tightly focused on relevant and manageable problems. Consider, for example, the heavy and chemical industries push of the mid-to-late seventies, which is often regarded as a failure (e.g., by Collins, 1990). Even though the target of 50 percent of exports coming from these sectors was not reached by the target year of 1980, by 1983 it had reached 56 percent (World Bank, 1987b, p. 45). The slight dip in overall Korean growth in the late 1970s and early 1980s which resulted from this push may thus be understood as a kind of investment toward future growth and an upgrading of the Korean industrial base, Econometric evidence suggests a clear link between industrial policy targets and later industrial structure in Korea (Mahidhara, 1988).

***The world export markef is an arena in which performance is clearly, quickly, and rigorously fesfed.***

In this regard, export targets hold a distinctive advantage over general output targets as a development planning mechanism because export levels are easier to monitor, making it harder for firms to gain benefits by cheating. This fact has long been understood by fiscal authorities, which have often taxed exports precisely because they are easily observable and therefore not subject to the tax evasion which is rampant in the developing world. This distortion produces a well-known and much criticized anti-export bias. The East Asian NICs appear to have been the first countries to put this observability insight to use as the centerpiece of a development planning system. They have done so in a way that reverses by 180 degrees the negative incentive effects of export taxes. Enforcement of export targets in the case of Korea is mostly moral in nature, relying on recognition of achievement more than penalties and fines. But the evidence seems persuasive that in Korea these have been among the most powerful of incentives.

In popular discussions, cultural explanations are commonly given for Korea's export success. These explanations generally cite the workforce's Confucian values of loyalty, discipline, hard work, respect for authority, and education. This argument is ironic, however, since the same culture was often cited in explaining East Asia's relative backwardness in the 1950s and early 1960s, and is still sometimes invoked today in reference to slow development in China.

In practice, the corporate culture and business behavior of Korea may be much more important than the overall culture. In a study of corporate behavior, Deal and Kennedy (1982, p. 7) concluded that companies with "clearly articulated ... qualitative beliefs or values" were "uniformly high performers," while "we could find no correlations of any value among the other companies." Without question, Korea as a whole has emphasized export expansion as a corporate/cultural value. Export performance is a relatively easy value to operationalize, through the instrument of export tar-

gets. In addition to the wide range of economic incentives to achieve the targets just described, Korea as a whole has an extensive pattern of rituals that reinforce these economic incentives with cultural ones.

A key ritual in Korean economic life is the Monthly National Trade Promotion Meeting, at which awards are presented for excellent export performance.

***Korea as a whole has an extensive pattern of rituals that reinforce these economic incentives with cultural ones.***

> Chaired by the president., the monthly trade promotion meetings are select gatherings of the ministers and top bureaucrats responsible for trade and the economy; the chief executives of export associations, research organizations, and educational institutions; and the heads of a few firms, mainly the general trading companies and other large firms. The prominence of those attending shows that the monthly meetings are far more than perfunctory meetings to improve coordination between the private and public sectors. (Rhee, Ross-Larson, and Pursell, 1984, p. 29)

Such rituals are not limited to the business elite. One of the major national holidays in South Korea is Export Day, held on November 30 since 1964, when exports first topped $100 million. The Rhee et al. study described Export Day ceremonies as follows:

> The focus of the celebration is the award of prizes at a large public gathering, prizes that the heads of firms take seriously There are President's prizes for being the number one exporter in an industry for export merit as a small or medium sized firm, for exceeding a target by more than 50 percent. There are Prime Ministers prizes for inventions, for excellence in design, for having a high reputation in exhibitions overseas, or for developing an export product of high quality And there are prizes for reaching a certain level of exports. There are in addition industry medals and prizes awarded by various ministries.
>
> The award of these prizes is akin to the pinning of medals on officers-with salutes, solemnity and sharp strides. The heads of firms typically display the awards in their offices-along with a picture of the president and calligraphy inscribed to the head of the firm and carrying messages on the importance of exporting. … (1984, p. 31).

To what extent is this cultural aspect of the Korean export experience transferrable to other countries?" There is no obvious connection between Export Day and Confucianism. The love of public recognition through contests and competitions, medals and prizes seems to be a universal human trait. One might reasonably conjecture that if it were better known, the idea could be adopted by other developing countries. In fact, as shown later, Thailand is adopting this approach. On the other hand, one may reasonably doubt the effectiveness of awards and recognition in the absence of reinforcing economic policies.

On the import side, South Korea maintained a very extensive system of import controls well into the 1980s (Luedde-Neurath, 1986). What Luedde-Neurath terms the "Korean Kaleidoscope" includes restrictive trader licensing for importers, widespread quantitative controls on imports, domestic content requirements, systematic foreign exchange allocation under the Foreign Exchange Demand and Supply Plan, intervention in export-import settlements, required advance deposits (sometimes as high as 200 percent of the value of imports), and capricious customs practices.[19] In one particularly telling example, prospective importers must achieve a minimum level of earnings from exports before becoming eligible to import. These obligations began at $10,000 in 1962 and increased over time to $1 million in 1982 (Luedde-Neurath, 1986, p. 91). Pack and Westphal (1986, pp. 94-95) concluded that:

> . . . through import restrictions, selectively promoted infant industries were often initially granted whatever levels of effective protection were required to secure an adequate market for their output as well as a satisfactory rate of return on investment. Initial rates of effective protection were frequently in excess of 100 percent.

The country also utilizes an informal system of indicative planning type protectionist measures (Pack and Westphal, 1986, p. 95). Wade (1988d, p. 100) concluded that:

> . . . it is misleading to use tariff revenue over total imports to indicate low tariff protection, because in Korea and Taiwan duties are collected mainly on imports for use in domestic-market-related sales rather than export sales, so that tariff revenue should be averaged over non-export-related imports only, giving a substantially higher average.

After 1971, the Korean government established a "Prior Import Recommendations" list, which "permitted certain imports [even] for export production only if the price advantage of the imported item exceeded a minimum level," and "prohibited the import of selected plant facilities in certain industries even if used for export production" (World Bank, 1987b, p. 44). It also established minimum domestic content requirements for large plant facilities and for those built with foreign loans or foreign currency loans. Based on overall industry data, Petri (1988, p. 61) concluded that Korea has "an unusually protection-prone export bundle."

In the Korean case, import controls have often been a handmaiden of successful industrial export promotion. As a result of the export promotion reforms of the early 1960s,

> imports destined (either directly or indirectly as inputs) for the domestic market remained subject to tariffs and quantitative controls. However, the system of controls on these imports was rationalized and thereby converted from a mechanism of socially unproductive rent seeking into an instrument of industrial promotion. (Pack and Westphal, 1986, p. 93)

***In the Korean case, import controls have often been a handmaiden of successful industrial export promotion.***

Many successful Korean export industries begin as infant industries requiring protection. For example, the electronics industry was the recipient of numerous special government benefits under the eight-year Electronics Industry Development Plan, and subsequent five-year plans. These benefits included import protection as well as export incentives. As of 1984, 185 electrical and electronic goods imports were still restricted in Korea (World Bank, 1987b). And Amsden (1989, p. 273) pointed out that diversified Korean *Chaebol* firms are able to subsidize their entry into new export markets (such as shipbuilding) out of the monopoly rents created by import barriers on other products they produce, under government monitoring.

***Many successful Korean export industries begin as infant industries requiring protection.***

The developing industrial sector functions as a whole and benefits from externalities and linkages between firms, making a market failure case for more general protection at least at the takeoff stage (Luedde-Neurath, 1986).[20] *Widespread* protection may not be necessary for rapid technological progress, even at an early stage, but the *selective* promotion of infants with high training and technological progress externalities is probably necessary (Westphal, 1982).

Unquestionably, in the late 1980s, South Korea substantially liberalized. The lesson one should draw, however, is that substantial liberalization logically follows only *after* a country has virtually joined the ranks of the industrially developed countries, as South Korea, despite certain problems, is now widely accepted to be doing (Amsden, 1989). As Pack and Westphal (1986, p. 94) summarized the evidence, "something approximating neutrality" applies to "established industries. ... But there has been substantial industry bias in favor of the promoted infant industries."

Given the central role of technological progress in this type of development strategy it may be asked what role multinational corporations (MNCs) played in transferring technology to Korea.[21] A major World Bank study concluded that "Korea's export industrialization has overwhelmingly and in fundamental respects been directed and controlled by nationals. ... Technology has been acquired from abroad largely through means other than direct foreign investment" (Westphal, Rhee, and Pursell, 1981, p. 65). The role of multinationals in the economy has been much smaller than most other middle-income countries. Interestingly, this pattern appears to differ from the current experience in Singapore and Thailand (see below). It may not be necessary to favor indigenous firms to the extent Korean policy has, but it may be necessary to have the right industrial policies in place and at least some threshold level of domestic-based firms in order to realize the potential benefits of MNCs.

It should also be noted that an active industrial policy continues to this day, encouraging Korean entry into high technology fields (Borrus and Simon, 1989). Research and development expenditures are planned to reach a striking 5 percent of GDP by the year 2000 (Amsden, -1989). The World Banks International Finance Corporation (its private sector arm) has played a role in financing these developments.[22] Recently, South Korea's

Ministry of Trade and Industry targeted new areas for production, such as computer-controlled machine tools, bioengineering, microelectronics, fine chemistry, optics, and aircraft. The ministry predicted that Korea could catch up with the U.S. and Japan economically and technologically in these fields. The government would be centrally involved in the whole process (see *International Herald Tribune,* 1989). Government-funded but industry-focused institutes such as the Korean Electronics and Telecommunications Research Institute, the Korean Biogenetics Research Institute, and the Korean Automotive Systems Research Institute, are playing a major role. As South Korea becomes a candidate for developed country status, targeted industrial policies oriented toward technology enhancement are continuing to play a pivotal role.

***Like South Korea, Taiwan has put in place active industrial policy systems.***

## Taiwan

Much less has been written about Taiwan than Korea. Due to Taiwan's disputed status in relation to China, information on Taiwan does not appear in official charts of statistics of the World Bank and many other international organizations.[23] Nevertheless, Taiwan has had one of the world's fastest growing economies, averaging nearly 10 percent annual growth in the 1965–1980 period, and an incredible 8.7 percent average over four decades since 1950 *(The Economist,* 1990). Taiwan is also widely regarded in America as an outstanding example of a successful "free market" economy But like South Korea, Taiwan has put in place active industrial policy systems. The Taiwanese government has licensed exports, controlled direct foreign investment both to and from Taiwan, established export cartels, provided fiscal incentives for investment in priority sectors, and given concessional credit for favored industries. Indeed, Taiwan has used most of the same types of interventionist policies used by Korea (see Wade, 1988a, 1988b, 1988c, 1988d; Borrus and Simon, 1989; Amsden, 1979, 1984; Li and Yeh, 1981; Yu, 1988; Fransman, 1986; Liang and Liang, 1988; Linnemman, van Dijck, and Verbruggen, 1987).

Taiwan's post-World War II economic history began with a very highly *dirigiste*, import-substitution-oriented approach to industrialization. The 1958 reforms switched intervention to export promotion and introduced greater reliance on market forces. But what emerged was far from a free market-only a less thoroughly planned one.[24] For example, in Taiwan, all imports and exports have to be covered by a license, a fact not well known in the U.S. Imports are classified into prohibited, controlled, and permissible. Luxury goods are controlled. So are some goods produced locally with reasonable quality, in sufficient quantities, and the prices of which are not more than a narrow margin (about 5 percent) above comparable import prices (Wade, 1988a, 1988c). A striking fact is that even the "permissible" items have been subject to strong controls. For example, until 1980, garments could only be imported from Europe and America-the least competitive sources. Other goods subject to "competitive origin restrictions" have included yarns, artificial fibers, fabrics, some processed foodstuffs, chemicals, machinery, and electrical apparatus.

Moreover, more items are controlled than appear on the published list, so that not all "permissibles" are automatically approved. As Wade (1988b, p. 50) shows,

> Typically, a would-be importer of an item on the hidden list will be asked to provide evidence that the domestic supplier(s) cannot meet his terms (on price, quality, delivery). He may be asked to furnish a letter from the relevant producers' association.

***Trade liberalization ... has always aimed at shifting production steadily up the technological scale.***

Wade explains that these policies form the "referral mechanism" of import control. These Taiwanese policies function as a dramatically innovative domestic content strategy, oriented toward technological progress. According to Wade (1988b, p. 52), these policies

> ... provide strong domestic demand for the products of the industries which the planners consider important, especially new ones.... Petrochemicals, chemicals, steel, other basic metals ... are covered by the referral mechanism. So are some machinery and components industries, including some machine tools, forklift trucks, and bearings.

Fransman (1986) provided more specific details on the active role of government in fostering the development of a machine tool industry-one of the keys to achieving a domestic capability for technological innovation (Rosenberg, 1976).

Under this system, Taiwanese importers cannot import freely, even when producing directly for export. Trade liberalization has taken place since the 1960s, but has never been neutral. Instead, liberalization has always aimed at shifting production steadily up the technological scale. Overall protection-measured by average tariffs and other aggregate measures-has decreased, but quantitative and qualitative intervention has remained pervasive in specific sectors. Clearly, this is not the pure free market but is related to the type of indicative planning pioneered by the French in the 1950s (see Meade, 1970). Taiwan, however, has used indicative planning more systematically than the French ever dreamed of doing. All of this clearly contradicts the arguments of the New Orthodoxy school and the 1987 *World Development Report* that the *sine qua non* of outward orientation is "no discrimination between foreign and domestic goods or between production for the domestic market and production for exports."

Wade explains that this import substitution program has been successful because it is consistent with an emphasis on incentives:

> Because the government is able to control quantities of goods crossing the national boundary, it can use international prices to discipline the price-setting of protected domestic producers. It is very sensitive to the point that there must be good reasons why domestic prices of protected items are significantly higher than international prices, especially in the case of items to be used for export production. In this way

> domestic prices for goods covered by formal or hidden controls can be kept near international levels, without there being a free flow of goods. The threat of allowing in more goods can be sufficient to hold prices down. (Wade, 1988b, p. 51)

This is analogous to the well-known argument that monopolists will keep prices low to the extent that they fear the entry of a rival firm seeking to take advantage of a prevailing high price in an industry.[25] Moreover, the programs illustrate the Taiwanese government's clear understanding of the development benefits of producing and exporting a particular set of manufactures at a given stage of rapid development, especially in regard to externalities (benefits that spill over from one sector to another).

***Taiwan utilizes programs that are actually activist, but which appear to be similar to those of more genuinely free-trading countries.***

Wade argues that Taiwanese "state interventions have been very selective between firms and industries" and "subject to the criterion of international competitiveness" (1988b, p. 58). He states that these interventions meet both "the need to keep the economy exposed to efficiency-enhancing pressure from the world market," and "the need to modulate that pressure so as to capture more value-added and more of the cumulative benefits of technological change within Taiwan" (p. 58).

The China External Trade Development Council (CETDC) provides a particularly clear illustration of the way in which Taiwan utilizes programs that are actually activist, but which appear to be similar to those of more genuinely free-trading countries to carry out industrial policy Superficially, CETDC is just an overseas trade representative office, but in practice it does much more:

> Market research in CETDC's New York office as of 1980 was based on an active search for items that could be sold in the United States. The search began with an analysis of the size and origin of U.S. imports, followed by a preliminary study of the price and quality of the more competitive imported and US products. From this the officers in New York reached an estimate of the likelihood of Taiwan, China firms competing successfully against offerings already on the market. (They claimed to understand the manufacturing capabilities of Taiwan, China firms well enough to do this.) Once a likely product was identified, the office asked firms in Taiwan, China to send it samples of the product and price lists. Representatives of the office would then visit importers, wholesalers, and other traders with samples and price lists, prospecting for sales. They would try to get reactions to the product. If the buyers were interested they would telex the manufacturers. If not, they would find out why and then suggest appropriate steps to the manufacturer (Keesing, 1988, p. 28)

Why might this type of "intervention," broadly similar to that practiced by South Korea (and Singapore), be capable of improving over the "free market" outcome? Essentially, I would argue, the improvement is due to the public good properties of information, reputation, and sales network-

building activities. Active policies of CETDC, like the KTPC in South Korea, have raised the information standards of industry there generally to more efficient levels. Perhaps equally important, they have helped to transform the image of national quality, an enormously valuable asset as onlooking manufacturers in South American and South Asia understand all too well. Supply and sales networks can often be of benefit to many firms from a given country, and may thus hold something of the character of an externality Moreover, in the presence of capital market imperfections, public activities of this kind can help firms surmount high fixed costs.

***To assist small firms with technological. progress, the Taiwanese government has been setting up cooperative research institutes***

Taiwan's industrial organization differs from that of South Korea in one important respect: rather than having an industrial sector intentionally organized around a small number of large business groups (the *Chaebol*), Taiwan has intentionally fostered small- to medium-sized firms clustered together by industry (Bertoldi, 1990). While organized in this manner with the intention of facilitating exports, the effect has also been to create an "industrial district" form of economic organization, of the type which has won so much praise for productivity and innovation in such regions as Baden-Wuerttemberg in Germany and Emilia-Romagna in Italy (Piore and Sabel, 1984; Porter, 1990). The productive externalities between firms which have been cited for such districts explain the productive effect of a government role in their creation, even if such externalities were not the primary target of the government at the time the policies were implemented. To assist small firms with technological progress, the Taiwanese government has been setting up cooperative research institutes, such as the Industrial Technological Research Institute. It is sometimes suggested that Taiwan's small firm orientation reflects less intervention (The ***Economist,*** 1990), but actually it reflects a policy of relying on different technologies in different sectors.

Linnemman, van Dijck, and Verbruggen (1987, p. 343) cite the importance of Taiwan's "broad package of fiscal incentives, subsidies, and other measures" to promote exports, including "cheap credit for exporters, income tax exemptions, cheap export insurance, and marketing support." The Taiwanese combination of selective import controls with activist export inducements demonstrates that industrial policies and trade intervention need not be inimical to economic efficiency As Wade concludes:

> We see from Taiwan that it is possible for a government both to maintain a substantial protection system and to constrain its use of that system by a determination to be competitive on world markets. Indeed, the government has tried-apparently with some success-to use that system as an aid to competitiveness on world markets. It has done so by reducing risk for new producers, helping them to reach economies of scale on the domestic market (including the market for export inputs), and helping them to protect capacity utilization; all the while putting pressure on them to keep their prices at near international levels, especially via the threat to allow in imports ... and vigorous efforts in export promotion, including export marketing, export cartels, and export

quality control have (presumably) helped to offset disincentives to exports stemming from protection.... (Wade, 1988c, p. 54)

In addition to ensuring efficiency and competitiveness, Taiwan's industrial development strategy helps firms to enter fields with ever-greater technological sophistication, which is essential for eventually achieving developed country status. Wade concludes that:

> The government has sought to accelerate and guide capital accumulation in certain lines of activity, using both direct and indirect methods. By doing so it has sought to change the composition of exports, to shift upwards into the 'second generation' range of high technology engineering products, as well as create a solid base of heavy and chemical industries within Taiwan. On the whole it relies upon firms to respond because they see a chance of good profits, rather than because they are ordered or cajoled. But it is active in making sure that the particular activities it wishes to encourage are-within limits—profitable. The government has made the trade regime consistent with these import substituting or industry-creating intentions. Another country, equally opened to trade and trading in the same kinds of products, would probably not have had the same benefits from trade if it had used different instruments and institutions-notably if it attempted to pursue laissez-faire policies. (Wade, 1988b, p. 57)

***Taiwan is now in a position to liberalize large parts of its trade without endangering its hard-won footholds in advanced-technology and high value-added sectors.***

With its considerable progress in economic development and its huge trade surpluses (over $13 billion surplus with the U.S. alone in 1989),[26] Taiwan is now in a position to liberalize large parts of its trade without endangering its hard-won footholds in advanced-technology and high value-added sectors. The lesson for less advanced LDCs from Taiwanese liberalization is not that they should foreswear combined import substitution-export promotion programs. Rather, the lesson for countries with capable government is that liberalization is a process that should be undertaken cautiously, consciously, and often selectively, only as formerly protected or subsidized sectors become efficient enough to be competitive in export markets, or until it become clear *at the sectoral level* that the wrong industry was targeted.

Now that Taiwan's extensive industrial policies are at last beginning to gain some notice, it is a safe prediction that a cottage industry based on criticizing them as inefficient will be growing up in the next couple of years. But with a 9 percent growth rate maintained decade after decade, these policies have clearly had something going for them, though with different elements than those observed in Korea's *Chaebol*-oriented policies. One of the most productive directions for future research will be in regard to the externalities fostered by encouraging industrial districts of smaller firms in closely related sectors, both cooperating and strongly competing in a detailed division of labor, as in the case of the "Third Italy" economic miracle (see Piore and Sabel, 1984). Industrial policies in Taiwan may well turn out to have actively fostered such districts. Even if the government was not intending to realize the external productive benefits of such organizations

but only seeking to facilitate exports, it would nonetheless remain true that Taiwan's policy played an important role in creating these districts. This would suggest the viability of a new industrial development strategy that might be employed consciously elsewhere.

### Hong Kong **and** Singapore

The small city-states of Hong Kong and Singapore round out the Four Tigers group (along with South Korea and Taiwan) as well as the World Banks three "strongly outward-oriented' countries (along with South Korea). The success of these unique microstates makes them deserving of at least some attention, even though the parallels to most LDCs may not be close because of their small size, completely urban population, special history within the British Empire, and special relationship with the surrounding economies.

***The government of Singapore has declared its intent to make the city-state a leader in high technology:***

Like Korea and Taiwan, Singapore has also practiced an active industrial policy, coordinated by its Economic Development Board (EDB). After independence, export promotion and import substitution policies were introduced simultaneously By the late 1960s, Singapore was stressing export promotion, and the protection of domestic industry was almost entirely removed. Currently, "the EDB guides the process of industrialization by preparing a list of industries which are feasible for Singapore and by processing and evaluating applications for pioneer status, a requirement for eligibility for various tax reliefs" (Linnemman, van Dijck, and Verbruggen, 1987, p. 383). Singapore thus also practices, at least in part, industrial and trade policies oriented toward increased technological and skill content of exports analogous to those already described for Taiwan and Korea (see Kng, et al., 1986; Krause, 1988).

The government of Singapore has declared its intent to make the city-state a leader in high technology In the late 1970s, the EDB identified 11 high-tech industries for industrial policy promotion, including precision instruments and controls, computers and peripheral equipment, microelectronics, and advanced machine tools (Borrus and Simon, 1989). The Product Development Assistance Scheme was created, allowing firms to deduct research and development (R&D) expenses for introducing new products. A Joint Industrial Training Scheme provides subsidies for advanced training. A Capital Assistance Scheme provides subsidized financing for firms bringing new technology or skills into Singapore. Strong links between industry and academic research are actively fostered. A new Singapore Science Park and other inducements attract high-tech multinational corporations. Unlike Korea, Singapore has placed a major emphasis on acquiring technology from direct foreign investment. These high-tech-oriented industrial policies may well have been crucial in helping Singapore continue on the fast growth track, with average annual growth rates of about 10 percent for 1988 and 1989, second highest in the world.

Hong Kong is the only one of the Four Tigers in which government intervention in trade and industry has been minimal by world standards. Hong

Kong has also been very successful, if not quite reaching the growth rate standards of South Korea and Taiwan over the last 25 years. However, the association of Hong Kong's success with free trade is not as simple a link as Milton Friedman (1980, pp. 34, 60-61) has suggested. First, the effective cartel of large banks (which have assets considerably greater than Hong Kong's GNP) is said to perform an industrial policy function through the rationing of credit toward the industries that the cartel picks as the emerging "winners" (Wade, 1988c). Hong Kong is thus certainly no textbook model of perfect competition, at least in financial markets. Moreover, as Keesing (1988) reported, the activities of the Hong Kong Trade Development Council, set up in 1966, in many ways resemble those of Taiwan's China External Trade Development Council (albeit without the *dirigiste* flavor).

***Free trade has hindered Hong Kong's ... long-tetm opportunities for technological ptvgress.***

**With** its economy's relative trading advantages slipping in the last few *years,* the Hong Kong government has begun to introduce aspects of industrial policy. For example, the government has subsidized the Hong Kong Productivity Center and encouraged industry-academia links (Borrus and Simon, 1989). Thus, even the special Hong Kong example fails to support the contention that "genuine free trade" can successfully bring about full development. On the contrary, Fransman (1982) concluded that free trade has hindered Hong Kong's "learning by doing" in the critical capital goods sector, thereby hurting long-term opportunities for technological progress. Free trade was helpful in the short run in lower-tech fields, but not for the more technologically sophisticated industries.

### Thailand

Thailand is showing signs of turning a current boom in exports of manufactures into an industrial takeoff in the same way that Taiwan and Korea did in the 1970s. Thailand's industrialization began in the 1960s, under the highly protectionist import substitution strategy of the First and Second Economic Plans (1961-1971). Under this regime, average annual growth rates of total manufacturing reached 11 percent in the 1960s, while the share of primary process manufacturing in the total declined from 60 percent to 40 percent. Consumer goods, petroleum products, and some producer goods industries were established (World Bank, 1989a). The Third Plan (1972–76) inaugurated an active phase of export promotion interventions As a result, the growth of manufacturing continued at 10 percent per year throughout the 1970s. Clothing and electrical machinery gained in importance as well as producer goods in chemicals, transport equipment, and textiles. In the turbulent first half of the 1980s, Thailand experienced uneven economic performance. But since 1986, an explosive growth in investment and exports has renewed the widespread speculation of the late 1970s that Thailand would become the fifth East Asian Tiger. In 1965, just 4 percent of Thailand's exports were manufactured goods, but by 1987 this figure had reached 52 percent.[28]

In 1988 and 1989, Thailand led the world in GDP growth (about 11 percent in 1988 and about 10 percent in 1989). Since 1986, the annual growth rate of merchandise exports has reached 25 percent. Despite much slower

growth in the early1980s, manufactured exports from Thailand to the U.S. grew at an average annual rate of 26.3 percent from 1980 to 1987 (World Bank, 1989a), while the rate of growth of exports to Japan was 12.6 percent. Substantial diversification of manufactured exports has also taken place, with rapidly increasing exports in manufactures with higher skill and technology content. Such movements up the ladder of comparative advantage, in which technological progress is key, are always complex. Undoubtedly, there were "pull" factors at work, as the first four East Asian Tigers were climbing to still higher rungs and establishing high value-added manufacturing. There was also a "push' from lower rungs by new low-wage manufactures exporters such as China and Indonesia. But these favorable external conditions are not enough to guarantee sustained rapid growth. Just as in the cases of Korea, Taiwan, and Singapore, increasingly selective, interventionist industrial policies played an important role in this transformation.

***Since 1986, an explosive growth in investment and exports has renewed the widespread speculation . . . that Thailand would become the fifth East Asian Tiger.***

Many Thai departments and institutions-including the Board of Investment (BOI), the Ministry of Industry, the Ministry of Finance, the Ministry of Commerce, the Fiscal Policy Office (FPO), the Bank of Thailand, and the Department of Customs (DOC)-are actively engaged in formulating and implementing industrial and trade policies.[29] These policies include:

1. *Domestic content regulations.* Automobiles and motorcycles, among other sectors, are subject to stringent domestic content regulations. Locally manufactured engines were required as of mid-1989 on all domestically assembled autos and motorcycles, in addition to previously established domestic content minimums of 45 percent for autos and 70 percent for motorcycles.

2. *Export promotion.* The Thai BOI offers a series of special arrangements to promote exports, including three- to five-year exemptions from corporate income taxes, reductions or exemptions from business taxes and import duties on imported raw materials and machinery, and additional tax reductions in Investment Promotion Zones. These measures are increasingly targeted toward specific sectors, following the Korean example, with an eye to moving into higher value-added and more technologically sophisticated exports. The BOI, DOC, and FPO also offer various extensive duty drawback and exemption systems for exports, as well as special export credit facilities.

3. *Foreign investment.* Very favorable tax holidays and other inducements are used to attract direct foreign investment. Thailand's export boom has been largely fueled by a massive inflow of direct foreign investment from Japan and the Four Tigers. These investors are believed to be responding to their own movement up the technological ladder of comparative advantage and to fear of protectionist retaliation against products produced at home. In recent years strong links have been forged between Thai and Japanese firms.

4. *Selective protection.* Tariffs on consumer goods and light intermediate goods rose dramatically in the 1970s (Thailand's pre-takeoff period) gener-

ally to about 35-60 percent. These goods continue to be relatively highly protected, despite reductions of nominal tariffs in 1986 and 1987 after industries had become established. The objective of recent reductions appears to be more a desire to reduce the incentive to smuggle in such products than liberalization per se. There were still about 20 published import bans in 1988—although this was down from 43 in 1985—and another 33 products were still subject to import licensing.[30] Televisions are still protected with 40 percent nominal tariffs, and many other consumer electronics including VCRs and stereo equipment still have 30 percent tariffs. Average effective rates of protection of manufacturing appear to remain at over 60 percent, and the World Bank (1987c) found Thailand to be one of the most protectionist countries in East Asia. This pattern of Thailand strongly protecting the same goods it is pushing as exports duplicates the earlier patterns of Taiwan and Korea. Thailand publicly describes its motive as one of raising revenues rather than protectionism. Nevertheless, its recent experience argues against the purported ineffectiveness of import substitution. Instead, Thailand offers more evidence that import substitution is an essential early complement to successful export promotion.

***The World Bank found Thailand to be one of the most protectionist countries in East Asia.***

5. *Currency undervaluation.* The Thai *Baht,* which is fixed to the U.S. dollar was devalued by 14 percent in 1984 and 8.7 percent in 1987. These devaluations increased the competitiveness of Thai products in the U.S. market. The *Baht* is now undervalued in the sense that the dollar prices of Thai manufactured exports are lower across the board than prices of U.S. goods. Thai exports to other industrial countries have also benefitted as the dollar has fallen against other currencies since 1985, and the *Baht* remains pegged to the dollar

6. *Export culture.* Following the example of Korea, Thailand is working hard to establish an export culture in government and industry The Deputy Prime Minister chairs the Export Promotion Committee, an influential advisory body with private and public representatives. The Prime Minister chairs the similar Joint Consultative Committee.

For now, Thailand is not developing a large external surplus, though it has reduced its trade deficit. Recently imports have been keeping pace with exports, unlike in the early 1980s. The surging demand for capital goods resulting from the investment boom of the late 1980s largely accounts for this outcome. The same pattern was seen in Taiwan and Korea in the 1970s. Those countries developed their large surpluses only after they had established a domestic capital goods industry, and Thailand may well follow suit.

If Thailand had followed the advice of the New Orthodoxy, it would probably not have achieved its rising status as an East Asian NIC. The New Orthodoxy would have suggested that Thailand focus on commodity exports which formed its natural comparative advantage 20 years ago. Today the New Orthodoxy would argue that exports and growth would be even higher if Thailand had no industrial policy or trade protection. But Thailand is not likely to liberalize substantially until it has reached a higher

level of development. If Thailand were to attribute its current success to its activist industrial policies, it would be hard to fault that logic. For, so far, its policies have more resembled the successes of Taiwan, Korea, and Singapore than the failures of those countries (especially in South America and Africa) that have actually implemented the New Orthodoxy approach, as will be explained in the following sections.

**East Asian Exports and Industrial Policies: A Summary**

***While vast resources have gone into research on and support for liberalization, essentially no resources have been committed to examining how the interventionist successes of East Asia might be duplicated elsewhere.***

The preceding survey of economic policies in South Korea, Taiwan, Singapore, and Thailand should suffice to demonstrate that their policies have often been precisely those singled out for criticism by the New Orthodoxy school. A recurrent theme of these successful cases is the selective involvement of government in projects in which technological progress (product, process, or organizational) has been a central concern, This theme may be traced from early efforts to achieve technology transfers in relatively basic industries, to the current efforts of the Four Tigers to develop original innovative capacity in high technology sectors. The evidence suggests that the East Asian industrial policy mix has served to overcome the market failures involved in the process of technological progress. It is well-known that such market failures are endemic to *original* technological progress due in particular to the public good and externalities properties of technological knowledge. However, the East Asian cases suggest that the importance and extent of such market failures in the *transfer* of product, process, and organizational innovations to developing countries has been grossly underestimated.

It could be argued that South Korea and the other leading NICs might have industrialized even faster if they had maintained free trade policies from the beginning. But this argument hardly seems credible on purely empirical grounds. GNP per capita has grown more rapidly in South Korea, Singapore, and Taiwan than in any other country in recorded economic history. Their growth has outstripped the far more free trade-oriented Hong Kong in the past **25 years.** In spite of this record, World Bank missions continue to advise LDCs to take a noninterventionist stance, arguing that East Asian policies cannot be duplicated and, in any case, free trade can lead to the same performance. While vast resources have gone into research on and support for liberalization, essentially no resources have been committed to examining how the interventionist successes of East Asia might be duplicated elsewhere.

Some observers have argued that activist policies, although successful in East Asia, may still be subject to the corruptions of rent-seeking activities (see Krueger, **1976). An** alternative interpretation is that such policies are a necessary (or at any rate a strongly facilitating) condition of successful development, but not a sufficient one. It is then a combination of industrial policies addressed to specific market failures, and consistent with underlying world market forces (as well as the political economy of a specific LDC)

that promotes industrial development. Without proper attention to incentives for efficiency, these same industrial policies can prove counterproductive. Of course, LDCs and development specialists should take a cautious attitude toward such policies. Far more extensive research on how other countries might adapt these approaches is clearly warranted. This approach would clearly be better than basing our advice on a theory that fails to account for much of the observable success of the East Asian NICS, or by simply assuming that East Asian institutions and competencies cannot be reproduced in any other developing countries.

**Counterpoint: Brazil**

It is often claimed that other developing countries have not achieved the successes of the East Asian NICs because the former have failed to adopt appropriate export promotion policies (see Sachs, 1985). As we have seen, the export promotion policies actually employed in the East Asian NICs (with the sole exception of Hong Kong) were highly interventionist. But it is not true that all other developing countries have failed to adopt similar policies. A case in point is Brazil, the largest and perhaps the most industrially advanced country in Latin America. This section will briefly contrast the Brazilian experience with the record of the East Asian NICs in order to better understand Brazil's relatively poor development performance in the 1980s.

***Active industrial and export policies played an important role in Brazil's successes prior to 1980 and to its comparative success among Latin American countries after 1980.***

Until the 1980s, Brazil was one of the most rapidly growing developing countries, albeit one with historically high rates of poverty and inequality Until 1980, Brazil's growth record compared favorably with that of Korea: 8.8 percent average annual growth of GDP in Brazil against 9.6 percent in South Korea in 1965–80, both far above the average of 6.1 percent for all middle-income countries (World Bank, 1990). After 1980, however, their performances diverged. Korea's growth accelerated to 9.9 percent per year in 1980-88, while Brazil's growth rate fell to 2.9 percent-exactly the average for all middle-income countries. Still, Brazil's average post-1980 performance was significantly better than that of any other country in Latin America, excepting Colombia.

Active industrial and export policies played an important role in Brazil's successes prior to 1980 and to its comparative success among Latin American countries after 1980. Due to this extensive industrial policy system, the share of manufactures in Brazil's total exports grew dramatically in the 1960s and 1970s. By 1980, manufactures accounted for nearly 57 percent of Brazil's exports, up from just 18 percent in 1965 (World Bank, 1983a). Since 1982, however, Brazil has been forced by its debt crisis to expand exports in the quickest and easiest ways possible (see Frischtak, 1989, p. 171). This has often meant a shift toward exporting primary commodities, often at a high environmental cost, and with diminishing economic gains as primary commodity prices have declined on the world market. As of 1988, the manufacturing share of Brazil's exports had fallen to only 48 percent (World Bank, 1990).

**As a result of the debt crisis, Brazil's development efforts have been severely crippled.**

Since the 1960s, Brazil has maintained an export policy which in many ways parallels the policies of Korea and Taiwan by stressing incentives for manufactured exports. Brazil's pattern of combined import substitution and export promotion policies is strongly reminiscent of East Asia. The World Bank (1983b) found a "pro-export bias" in 11 of 2 1 industrial subsectors in Brazil. For example, in order to encourage exports in the electronics industry, Brazil has combined tax incentives with the requirement that importers of parts and components export certain levels of final goods (Erber, 1985). As in Korea, domestic privileges were linked to meeting quantitative export targets in the 1970s under the BEFIEX program.[31] In exchange for meeting targets, firms could import inputs or capital goods for use in either exports or the domestic market at their discretion (Frischtak, 1989, p. 184). Bauman and Braga (1988, p. 832) concluded from an econometric study that "the subsidies involved in official credit have an important individual role in [explaining] exports, especially as regards industrialized products. …" Since the late 1960s, when they were targeted for industrial policy promotion, Brazilian capital goods exports have grown dramatically. On the basis of in-depth case studies, Teubal (1984) found that Brazilian industries achieved success by first building up their reputation and learning by doing in protected domestic markets. It is only at this point that export subsidies have been effective at encouraging a switch to export activities.

Brazil, however, labors under the developing world's highest debt, valued at nearly $115 billion in 1988 (World Bank, 1990). Debt is one of the most important factors keeping its domestic development success from matching its export success. Jeffrey Sachs (1986, 1989b) identified Brazil's failure to stop taking on debt in 1979 (when real interest rates rose dramatically) as the key to understanding its subsequent performance divergence from South Korea which did stop taking on debt in 1979. As a result of the debt crisis, Brazil's development efforts have been severely crippled. Real investment spending fell at an average annual rate of 5.5 percent in Brazil from 1980-85. Investment recovered somewhat in 1986–88, but the growth of investment averaged 0.0 percent over the whole period 1980-88 (World Bank, 1987a, 1990). In addition, the proportion of Brazil's people in poverty has increased significantly (World Bank, 1990). Meanwhile, the distribution of income, already one of the most inequitable in the world (and in fact the most unequal for which reliable data are available)[32] has become even more skewed.

Brazil's move back to primary production has also been associated with the rapid, wholesale destruction of the fragile ecology of the Amazon region. This unchecked exploitation of natural resources casts doubt on whether Brazil's 1980s primary resource-based development will be sustainable. It also potentially aggravates global warming and other environmental problems which may adversely affect the U.S. and other countries (see *The New York Times*, 1988, and The *Washington Post*, 1988).

From 1980 to 1988, Brazil's merchandise exports grew at an average rate of 6.0 percent per year, while imports *fell* 2.9 percent annually The growth

in exports was certainly impressive. But a large part of the improvement in Brazil's trade balance, especially in the 1983-87 period, came from the decline in imports resulting from the depression of domestic demand. Moreover, the improvement in Brazil's trade balance has occurred notably at the expense of the United States. As Table 1 shows, the U.S. was in rough trade balance with Brazil until the debt crisis struck in late 1982. Since that time, the U.S. has imported from Brazil well over twice what it has exported to that country This situation is similar for other Latin American countries, as the example of Mexico in the table illustrates. The Brazilian debt crisis and its impact clearly differentiates that country from the successful East Asian NICs. The urgent need for short-run foreign exchange hobbled Brazil's capacity to carry out longer-range industrial and trade policies. Rising inequality, unsustainable land and resource use, and political instability likely also played an important role (Berg and Sachs, 1988).

***The urgent need for short-run foreign exchange hobbled Brazil's capacity to carry out longer-range industrial and trade policies.***

Since the onset of the debt crisis, numerous other Latin American countries have been engaged in a desperate search for any exports to bring in foreign exchange to service the debts (or to replace foreign loans which-are no longer available). They have acted under the pressure of the crisis and in the absence of a well-conceived industrial policy program capable of taking a long-term view Moreover, the debtor nations' weak position vis-a-vis the International Monetary Fund (IMF) and creditor banks has made it susceptible to outside pressure, pushing the Brazilians to elevate trade liberalization over domestic growth objectives. As a result, the policies recently followed under the guidance of the IMF and the World Bank have conformed

**TABLE 1**
**Value of U.S. Exports to and Imports from Brazil and Mexico**
(in millions of U.S. dollars)

| | Brazil | | Mexico | |
|---|---|---|---|---|
| *Year* | **U.S.** *Exports* | *U.S. Imports* | *U.S. Export;* | *U.S. Import..* |
| 1972 | 1,243 | 997 | 1,982 | 1,728 |
| 1973 | 1,916 | 1,259 | 2,937 | 2,442 |
| 1974 | 3,089 | 1,825 | 4,855 | 3,610 |
| 1975 | 3,056 | 1,623 | 5,141 | 3,112 |
| 1976 | 2,809 | 1,888 | 4,990 | 3,655 |
| 1977 | 2,490 | 2,385 | 4,821 | 4,769 |
| 1978 | 2,979 | 3,035 | 6,680 | 6,195 |
| 1979 | 3,444 | 3,384 | 9,858 | 8,997 |
| 1980 | 4,352 | 4,000 | 15,146 | 12,835 |
| 1981 | 3,798 | 4,852 | 17,789 | 14,013 |
| 1982 | 3,423 | 4,643 | 11,817 | 15,770 |
| 1983 | 2,557 | 5,381 | 9,082 | 17,019 |
| 1984 | 2,640 | 8,273 | 11,992 | 18,267 |
| 1985 | 3,140 | 8,147 | 13,635 | 19,392 |
| 1986 | 3,885 | 7,340 | 12,392 | 17,558 |
| 1987 | 4,040 | 8,433 | 14,582 | 20,520 |
| 1988 | 4,267 | 9,960 | 20,628 | 23,534 |
| 1989 | 4,799 | 9,001 | 24,969 | 27,590 |

Source: International Monetary Fund, *Direction of Trade Statistics, yearbook*, various years.

more closely to the liberalization theory of New Orthodoxy development scholars than to the actual policies that the East Asian countries have followed. The results have been in marked contrast to the outcomes in East Asia. Albert Fishlow's (1987) study of Latin American policies and performance demonstrated that exchange rates appropriate from the New Orthodoxy standpoint have *not* been *sufficient* for solid export performance. In terms of our comparison with East Asia, policies encouraging systematic advancement of the skill and technology content of output and export are also crucial for sustained success. As Fishlow (1987, p. 3) put it, "simple deregulation and privatization are not first best solutions; reconstructing a developmental state is." (See also Fishlow, 1990.)

## problems of Commodity Export-Oriented Growth

This section briefly examines the experience of developing countries that tried to use commodity exports as an engine of growth in the 1980s. LDCs that have stressed commodity export expansion have done so partly as a result of development advice to follow their traditional (static) comparative advantages. The need for foreign exchange to service large external debts has also contributed to the breakneck speed with which commodities exports have been expanded in Africa, Latin America, Southeast Asia, and elsewhere in the 1980s. Whether out of choice or necessity, this recent revival of primary-commodity export-oriented growth provides a test of the criticisms of this strategy which were reviewed earlier.

As noted previously, the World Bank has encouraged LDCs to follow this course through its project lending. In accordance with policies set at the Banks highest levels, its regional and country departments have advised LDCs to cut trade protections and produce whatever goods will bring in immediate foreign exchange on the world market Estimates of the economic returns on these projects have been based on current conditions of supply and demand. But pushing so many countries to export more of the same types of commodities simultaneously inevitably undermines the very conditions which were assumed in projecting those returns.

At the World Bank, project analysis and funding are quite decentralized. A myriad of small, regional departments are charged with promoting exports for their assigned countries. The staff of each department apparently assumes that, since most of these countries are small in the context of the world economy, their extra output will be too small to have an appreciable impact on world prices. World Bank analysts usually assume that prices will hold up (that is, continue to follow the same path as given by existing predictions), rather than fall as the supply of promoted exports (e.g., coffee, cocoa, tropical oils, sugar cane, rubber, or minerals) increases. This approach may simplify the task of the analyst, but is likely to backfire for the countries receiving World Bank advice.

Even if the assumption of a given price were valid for the individual country (and even this is questionable for many of the countries which are large sellers of certain products), if one were to aggregate all the expanded exports that the Bank was advocating, it would be clear that they would tend to depress the prices of those goods. For example, considering all the sugar exports which the Bank was urging upon a number of countries around 1980, one might safely have predicted the fall in sugar prices which ensued over the following decade.[33] The same could be said for dozens of primary products which the World Bank and other agencies have encouraged countries to export. Rather than recognize this dynamic, the Bank has implied that its policies were correct and would have worked if not for the unfortunate "exogenous" decline in the terms of trade for such products.

***If one were to aggregate all the expanded exports that the Bank was advocating, it would be clear that they would tend to depress the prices of those goods.***

It should be emphasized that the World Bank is not without the *capacity* to undertake a serious analysis of price trends in the context of world supply and demand. The Banks International Commodity Markets Division regularly reports price projections and offers a working paper series on commodities. The problems are rather that: 1) each regional department almost always uses the assumption that its activities will not affect these projections; and 2) there is no internal adding up, let alone reporting, of these separate activities within the Bank, let alone across the other various development agencies.[34]

***The IMF's index of "real" primary commodity prices (excluding fuels) ... shows a clear declining trend. .. since the late 1970s.***

The Commodity Markets Division has done at least one retrospective survey of Bank activities in a particular commodity-sugar (Brown, 1987)—which is worth quoting at length:

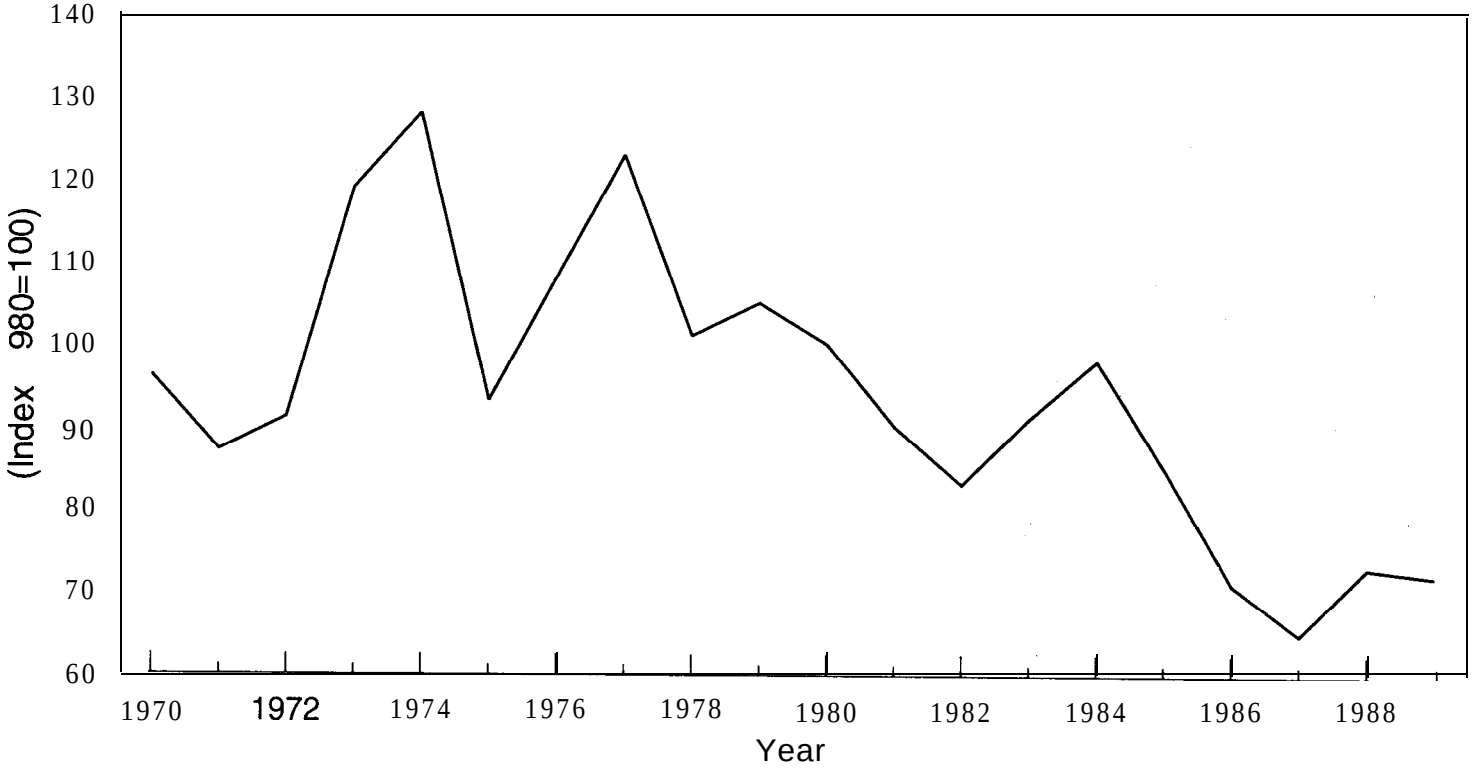
> The Bank has played a significant role in the development of sugar production in many countries. .. In 1974-85, when the average annual price of world market sugar reached an all-time high, 114 projects were approved which included assistance to increase sugar production . in the aggregate, the incremental production estimates in appraisal reports amount to more than four million tons per year at full development ... an important share of traded sugar, which averaged only 20 million tons in the same period. . (Brown, 1987, pp. 5-6)

These efforts included completed projects in 13 countries and projects still in progress in 35 countries in every developing region in the 1974-1985 period.

In 1984, the Division projected that the world price of sugar would be $519 per metric ton in 1990, in current 1990 dollars; that is, about 23½ cents per pound (World Bank, 1984b). The Divisions most recent update reports a spring 1990 price of 15 cents per pound, after a temporary price surge. The Division now projects a decline, in constant 1985 dollars, to 10 cents per pound in 1995, with a rise back to 11.5 cents per pound in 2000 (World Bank, 1989b). These changing forecasts show that the earlier optimism about sugar prices is now recognized to have been mistaken.

Figure 1 shows the IMF's index of "real" primary commodity prices (excluding fuels) for developing countries. This index measures the purchasing power of commodity exports over manufactured goods exported by the industrial countries-what economists call the "commodity terms of trade." The index is constructed to be representative of all LDC nonfuel commodity exports. This index shows a clear declining trend of commodity prices (the terms of trade) since the late 1970s, as the small upturns of 1982-84 and 1987-88 failed to reverse the much larger downturns in other years. As of 1989, this index of real commodity prices for developing countries was still about 28 percent below its 1980 level. An econometric study by IMF economists Morrison and Wattleworth (1988) confirmed that rising supplies of food and larger production capacity of agricultural raw materials and metals were the major factors depressing primary commodity markets in the 1980s and particularly in 1984-86.

# Figure 1
# Real Price Index for Non-Fuel Primary Commodity Exports of Developing Countries, 1970 to 1989




Source: International Monetary Fund, Primary Commodities: Market Development and Outlook, July 1990, p.27.

In the 1970s, the ability of OPEC to raise petroleum prices dramatically appeared to refute the hypothesis of a chronic tendency for the commodity terms of trade to decline. But in the 1980s, even oil proved to be no exception. As a result of oversupply by petroleum exporters (including non-OPEC producers as well as OPEC members exceeding their quotas) and conservation efforts by petroleum importers, oil prices collapsed in the mid-1980s. From 1982 to 1988, the real price of oil (in terms of developed country manufactured exports) fell by about *two thirds*, or 66 percent (IMF, 1989). Of course, the international oil market is very volatile, as evidenced by the surge in oil prices in the period following Iraq's invasion of Kuwait. Nevertheless, it is clear from the experience of the 1980s that countries which rely too heavily on commodity exports, whether fuel or nonfuel, are placing their economic development at risk.

***Countries which rely too heavily on commodity exports, whether fuel or nonfuel, are placing their economic development at risk***

## Implications for Development Policy

This report has shown that, New Orthodoxy doctrine to the contrary notwithstanding, the East Asian Four Tigers have not generally relied on free trade. Except for Hong Kong, they have employed an effective set of trade and industrial policy interventions. Most of the leading East Asian governments have purposefully undertaken protective actions to foster their capacity to produce manufactured exports of increasing technological content. These interventionist policies have played a major role, from early attempts at achieving technology transfers in relatively basic industries to the recent development of original innovative capacity in high technology sectors in South Korea, Taiwan, and Singapore. Such interventions have been crucial to overcoming the market failures endemic to technological progress. As this report has argued, many development experts have underestimated the importance and extent of such market failures in the transfer of product, process, and organizational know-how to developing countries.

*The sysfemafic, well-planned promotion of manufactured exports of sfeadily increasing sophis fica fion seems fo lead to fhe greafesf susfainable long-run growth.*

The industrial and export policy approach followed by Taiwan, South Korea, Singapore, and other successful NICs has been more effective than either extreme trade liberalization or primary commodity exporting. The systematic, well-planned promotion of manufactured exports of steadily increasing sophistication seems to lead to the greatest sustainable long-run growth. A number of factors contribute to making the manufactures-export strategy more effective than a commodities-export strategy: the stimulus given to economy-wide technological progress, the absorption of advanced technology from abroad, the accumulation of "human capital" (labor skills as well as technical and managerial expertise), the construction of infrastructure which reduces future development costs, the ability to take advantage of scale economies, and the relatively stable terms of trade (relative prices) for manufactured exports. These factors have helped the East Asian NICs to realize the greatest possible benefits for growth from their high rates of savings and investments.

In addition, it appears that these gains can best be achieved when export promotion is accompanied by continued (but highly selective) government intervention to restrict imports of targeted products and to skew current private incentives in favor of long-run social benefits, Moreover, the targeting of manufactured exports as a development planning mechanism, as practiced in South Korea and Taiwan, holds a distinct advantage over general output targets: the outcomes are easily observable and face the immediate and rigorous test of world market competition.

All this points to the conclusion that real, sustainable development will, as a rule, require nor just any exports, but manufactured exports. These findings are consistent with the thesis of Nobel Prize winning development economist W. Arthur Lewis, who argued that "international trade became an engine of growth in the nineteenth century, but this is not its proper role. The engine of growth should be technological change, with international trade serving as lubricating oil and not as fuel" (1978, p. 74). The evidence

from East Asian countries indicates that LDCs will better achieve this goal not through market forces alone, but through selective interventionist policies which use international competition as a disciplining device to ensure domestic efficiency Such direction can only come about if government has the resources to make intelligent policy, the ability to implement it, and the will to act in the public interest. Thus, governmental industrial policies concerning production, exports, and imports will be significant determinants of development success.

***Government can improve on the unaided market in achieving development by focusing on specific market failures, especially those associated with technological and skill development.***

It thus behooves the international development agencies to offer pragmatic industrial policy advice and assistance, based on the successful East Asian model, rather than orthodox prescriptions based on *a priori* theoretical models. But first, scholars and policymakers must recognize the actual sources of East Asian industrial success. In falsely equating East Asian success with the unencumbered market, the U.S. government and multilateral agencies have ignored the accumulated evidence of how the leading NICs really used export promotion as an engine of growth. Yet, as we have seen, some of these agencies' own studies have recognized the interventionist nature of development policy in the leading NICs, and the data bases maintained by the World Bank and the IMF accurately document the development failures in the debt-burdened manufactures exporters as well as the primary commodity exporters.

This study has demonstrated that government can improve on the unaided market in achieving development by focusing on specific market failures, especially those associated with technological and skill development. No claim has been made that such policies as have been used effectively in Korea and Taiwan could be transplanted universally to other countries, where government failure and rent seeking might be more endemic, and administrative capacity may be weaker But certainly there are a significant number of countries in the developing world which could benefit.

It is important to emphasize that practiced successfully, this is not a zero-sum policy game (let alone a negative one). The gains made through industrial policies such as those of Korea and Taiwan are not necessarily at the long-run expense of other countries, and in particular other developing countries, which might otherwise be exporting the good that is the policy target. Although static comparative advantage is temporarily distorted, world per capita income may rise if these policies raise total factor productivity in the countries practicing them. As the policies promote skill upgrading and facilitate technology transfer, they promote industrialization, with its external development benefits. Productivity and per capita incomes could rise in all developing countries successfully practicing these policies. This in turn would promote a rise in world demand. Indeed, dynamic gains often swamp static allocational gains in a relatively short period of time; policies oriented toward such dynamic gains are precisely those that should be sought by agencies concerned with international development, all the more so in the current period in which sustained growth is more difficult to achieve.

Ultimately, the developing countries themselves are bound to recognize these facts on their own, given the preoccupation with imitating the success of the East Asian NICs throughout the developing world. Given that the tide of understanding is turning, the development agencies and the U.S. government should at least stop trying to block this recognition by insisting that developing countries adopt extreme trade liberalization in order to qualify for aid, loans, or debt relief In a more positive vein, the World Bank and other development institutions should initiate research into effective government strategies for promoting industrial development that could avoid the pitfalls of either excessive import protection or pure trade liberalization.

Such strategies would emphasize facilitating technological and organizational innovation, both through transfers from developed countries and through the development of indigenous innovative capabilities. These strategies would use world market prices as guides to ensure productive efficiency, but without allowing current price signals to cause LDCs to overspecialize in commodities that will be inferior in the long run. It is indeed sensible for LDCs to start with relatively simple, labor-intensive manufacturing activities, but the long-term goal should be to move progressively "up the technological ladder" to the higher value-added (total factor productivity) activities more likely to generate higher real wages and living standards. There is much we do not know yet both about how to construct effective policies of this type and how to construct the domestic development organizational resources to develop and carry them out. This should be a very high priority on the research agendas of the aid agencies.

***Development institutions should initiate research into effective government strategies for promoting industrial development that could avoid the pitfalls of either excessive import protection or pure trade liberalization.***

Nevertheless, commodity exports will continue to be important for many LDCs. It is therefore recommended that the World Bank and other agencies coordinate their various commodity development and exports projects and undertake analyses of the price implications in the context of world supply and demand. A major problem, as we have seen, has been the assumption of each regional department (and agency) that its activities will not affect future prices. The sort of accounting and forecasting which are required could perhaps be best accomplished through the World Banks International Commodity Markets Division, which already regularly reports commodity price projections. This Division could survey activities and plans for commodity projects on the part of the various World Bank departments (as well as those of other regional and multilateral agencies), and incorporate this information into its projections.

The problem of export oversupply is not limited to primary commodities, however On the contrary, there has been a growing tendency for NICs and LDCs to increase their exports of similar types of manufactured products to the industrialized nations, especially the United States. As shown in Table 2, the U.S. has absorbed a steadily rising share of developing country exports of manufactures over the last 25 years-both from the Asian NICs and from other developing countries. With the European Community pursuing further integration in 1992, and with Japan taking, at best, limited market-opening measures, the likely impact of increased developing coun-

TABLE 2
Absorption of Developing Country Exports by Advanced Countries
*(percentages)*

| | *1964* | *1973* | *1980* | *1985* |
|---|---|---|---|---|
| Shares of NIC Manufacturing Exports to OECO | | | | |
| Germany | 8.1 | 8.1 | 9.7 | 5.1 |
| Japan | 3.2 | 15.0 | 50.7 | 7.3 |
| U.S. | 43.4 | 51.6 | [illegible] | 66.5 |
| Total OECO | 100.0 | 100.0 | 100.0 | 100.0 |
| Shares of Asian NIC Manufacturing Exports to OECO | | | | |
| Germany | 8.4 | 8.2 | 11.1 | 5.4 |
| Japan | 2.8 | 17.0 | 10.8 | 8.3 |
| U.S. | 38.0 | 47.9 | 47.6 | 63.9 |
| Total OECO | 100.0 | 100.0 | 100.0 | 100.0 |
| Shares of Other Developing Country Manufacturing Exports to OECO | | | | |
| Germany | 10.4 | 16.7 | 17.8 | 12.6 |
| Japan | 6.0 | 8.9 | 5.8 | 6.0 |
| U.S. | 31.4 | 26.1 | 28.4 | 41.5 |
| Total OECO | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Organisation for Economic Co-operation and Development, *The Newly Industrialising Countries*, 1988, Tables 2.1, A2.6, A2.8, and A2.11.

***Continued export-led industrialization in the developing countries will eventually produce strong pressure for more conscious management of world trade.***

try exports of manufactures will be to sharply intensify the penetration of the U.S. market by low-wage manufactures.

The problem of markets for increased LDC exports of manufactures was recognized by Cline (1982). Cline argued that if many other developing countries were to expand their manufactured exports to the same extent as the most successful NICs, the result would be to raise import penetration ratios to high levels in many sectors of the U.S. and other developed countries. Cline predicted that such high import penetration ratios could never be realized, since the developed countries would respond by increasing their own protectionist barriers. Since exporting manufactures (of increasing technological content) is generally the most attractive option for LDCs' internal development, for all the reasons examined here, Cline's analysis casts a distinct pall over the growth prospects for the Third World as a whole.

These considerations suggest that continued export-led industrialization in the developing countries will eventually produce strong pressure for more conscious management of world trade. Such trade management would have to take three forms. First, the U.S., Europe, and Japan would have to coordinate the opening of their markets to LDC-manufactured imports in order to share the adjustment burden more equitably among themselves as well as to lessen the adverse impact on affected workers and communities.

Second, the concentration of manufactured exports in a small number of successful NICs would have to be addressed in order to distribute the benefits of industrial development to a wider range of LDCs. In recent years, the

East Asian Four Tigers alone have accounted for roughly 60 percent of total developing country exports of manufactures (Keesing, 1988). The challenge is to gradually make room for new entrants into the manufacturing export arena without creating excessive economic disruptions and employment losses in either the existing NICs or the industrialized countries.

Third, developing countries should be encouraged and assisted to expand their trade in manufactures with each other Today, only 32 percent of manufacturing exports from developing countries are sent to other developing countries.[35] A decade ago, in his Nobel Prize address, Lewis (1980) proposed economic integration among LDCs as a way for developing economies to increase the benefits and lower the costs of trade as an engine of growth.[36] It may be time to dust off this proposal, especially as the apparent formation of trading blocs (U.S.-Canada, European Community, perhaps a Japan-led area) threatens to exclude many developing countries.

***The challenge is to gradually make room for new entrants into the manufacturing export arena without creating excessive economic disruptions.***

There are, however, two potential difficulties with increasing so-called "South-South" trade among developing countries. First, exports to other LDCs might not generate the net receipts of hard currencies required for debt service. Pesos and rupees cannot be used to make dollar-denominated interest and principal payments. Debt relief would help to alleviate this problem, but it is also possible that some of the stronger NIC currencies (e.g., Korean *won* and Taiwan *dollar*) could become internationally convertible. Second, it has been argued (e.g., by Havrylyshyn, 1985) that developing countries have comparative advantages in similar products, and therefore would have little to trade with each other (or would gain little from such trade). However, it has long been recognized that most trade in manufactures among the industrial countries is actually "intra-industry trade"-i.e., the exchange of broadly similar types of products. Such trade is driven by the increasing differentiation of products, the existence of scale economies, and the ability of individual firms to find "market niches." There is no inherent reason why LDCs and NICs cannot begin to engage in more reciprocal intra-industry trade of this type, especially as they move beyond simple labor-intensive assembly operations

Moreover, it is also possible that developing country products may be more "appropriate" for their own markets. There are large, fixed costs associated with entering new country markets, which range from collecting information to developing sales and supply networks to developing a reputation As discussed earlier, some of these requirements have public good attributes (e.g., information about the characteristics of an export market or a reputation for quality or service of a whole national industry). This suggests a role for the development agencies in assisting national governments in developing new markets for their manufactured exports in other LDCs-sharing lessons learned, providing institutional support, etc.

The problem of markets for manufactured exports is not simply a problem of where the goods can be sold, but also of *how much demand* can be created in the world economy as a whole. Particularly in order to make more inter-developing country trade possible, it will be necessary for

developing countries to put more emphasis on generating domestic demand rather than simply relying on external demand from the developed countries. There are several areas in which this could be accomplished. One important area is wages: instead of trying to keep wage growth from following productivity increases in order to compete with low labor costs, LDCs and aspiring NICs should be encouraged to let real wages rise in step with productivity as technology advances (see Mead, 1990). Experiences in South Korea over the past year suggest that the resulting economic and social pressures will eventually explode. South Korea appears to be making the necessary adjustments just in time to preserve long-run prospects for high growth.

***The reorientation of development policy advocated here is by no means contrary to the interests of the United States.***

Second, debt relief for the Latin American debtors would enable them to shift more of their export earnings into domestic investment, rather than spending so much of them on debt service. Higher levels of investment in turn would raise national incomes, increase imports (especially of capital goods), and help to lower their trade surpluses with the United States. They could export more to other developing regions with less pressure to earn hard currency for debt service, and in consequence be able to import more from other developing regions.

It should be emphasized that the reorientation of development policy advocated here is by no means contrary to the interests of the United States. In particular, expanded debt relief and other means of reducing the dependency of the LDCs and NICs on maintaining trade surpluses with the U.S. would help the U.S. solve its own trade deficit problem. U.S. banks are no longer threatened by such writedowns. Greater "South-South" trade among developing countries could give valuable time for U.S. workers and communities to adjust, Ultimately, policies that promote sustainable long-run growth will foster a more prosperous and stable world economy than rigidly adhering to "free markets" and trade liberalization at all times and in all cases. Such a world of more even and balanced growth would be good for U.S. exports, good for the soundness of the U.S. financial system, and ultimately good for the maintenance of a more open global economy

# Endnotes

[1] World Bank (1982, p. 82). See Wade (1988d) for an overview and detailed critique of this "market simulation" interpretation.

[2] See also Krueger (1980, 1983, 1990a, 1990b) and Lal (1985). For a survey of the New Orthodoxy school, see Todaro (1989, pp. 82-85; 530–36).

[3] This was politically feasible because the 20 percent of lands distributed in 1945 had been held by a hated colonizer, while the remaining lands distributed later were held by a landlord class, considered "collaborationist" with the Japanese and without any ties to the new Syngman Rhee regime. See Lee (1979).

[4] World Bank (1987a, Tables 1,2, and 8); see also Singer (1988).

[5] However, these resource shifts rarely occur smoothly, swiftly, or without high costs. This itself necessitates some role for development policy and potentially justifies an interventionist version of shifting to export promotion.

[6] Interestingly, the only exception they find is Japan. This does not mean that Japan was not protectionist, but that it was a large and closed economy (the largest in their sample), and one which therefore had little room to grow further through import substitution.

[7] It is certainly true that many more LDCs have had average effective exchange rates (EERs) biased against exporters than biased in favor of exporters. But there are in principle as many EERs in the economy as there are tradeable goods. As discussed below, targeted export promotion at the individual commodity level may be more important than the economy-wide average EER level.

[8] Most LDCs must also import energy and some raw materials, often from other LDCs, but even so generally with hard currency For example, China and India, among the most self-sufficient of the LDCs, send tens of thousands of university students to the United States.

[9] For a more complete discussion see Luedde-Neurath (1986, pp. S-15). Note that structuralist theories are not to be confused with dependency theories which argue that developing country trade with developed countries is *inherently* anti-developmental, and that therefore argue for nationalist or Third World economic autarky. This radical approach has not had much direct influence on economic policies and lies outside the scope of this paper

[10] See World Bank (1986) for a complete discussion.

[11] In particular, it has been argued that LDCs tend to have labor markets where wages are held to a low level by the existence of large pools of "surplus" underemployed workers living at a bare subsistence level, while developed countries have labor markets which tend to be relatively tight and in which unions can win wage increases keeping up with productivity gains. This implies that workers in LDCs do not share in their industries' productivity growth as do workers in developed countries. Furthermore, it is often assumed that primary products sell in competitive markets where prices are flexible, while manufactured goods sell in oligopolistic markets where prices are set by a mark-up over unit *labor costs*. This implies a recurrent tendency for commodity prices to fall relative to industrial prices in periods of weak demand or excess supply

[12] World Bank, 1987-88. Affected commodities include sugar, coffee, cocoa, natural rubber, palm nuts, kernels, and seeds; tropical oils such as cotton seed oil and coconut (copra) oil; ores of iron, copper, bauxite, lead, zinc, tin, and manganese; beef, certain cereals, certain citrus fruits, fresh vegetables for export in some locations, certain dried fruits, and wood (in various forms).

[13] In Ricardian trade theory, labor productivities are assumed to be exogenously fixed. In the Heckscher-Ohlin model of trade, the marginal productivity of labor varies with the proportion of labor to other inputs, but this relationship is itself determined by the given technology represented by a neoclassical "production function."

[14] For an interesting comparison of the trade management policies of Japan in the postwar period and the more recent policies of South Korea and Taiwan, see Wade (1988d).

[15] For a careful, succinct, and insightful economic analysis of the Korean labor market see S. Park (1988). Restriction of labor rights may be proving to have been a single but very important strategic error in light of the extensive disruptive labor unrest in early 1990.

[16] In other words, exporters receive relatively high amounts of domestic currency for each dollar of exports, while importers must pay a relatively high amount of domestic currency to receive a dollar for importing (but not as high as exporters).

[17] South Korea has had a high dispersion of effective rates of protection even with a relatively low average, again contrary to the advice of the New Orthodoxy school and contrary to the implicit assumption in much New Orthodoxy writing on South Korea.

[18] Deal and Kennedy (1982) provided many examples of analogous award ceremonies or other special cultural rituals at the corporate rather than national level.

[19] The Luedde-Neurath (1986) study refuted decisively the well-known study of Westphal and Kim (1977) which had concluded that the Korean economy liberalized extensively in the 1960s.

[20] This recalls arguments of the early structural development economists, such as Rosenstein-Rodan (1943).

[21] A large literature exists that analyzes the benefits and costs of multinational firm presence in the process of technology transfer For surveys and an introduction to the methodological issues see Biersteker (1978), Todaro (1989, pp. 469–80), and Svejnar and Smith (1984).

[22] For example, the IFC's 1988 annual report cites approvals of World Bank financing for a semiconductor project.

[23] However, the IMF now reports some data on "Taiwan Province of China."

[24] See Amsden (1979). As Wade (1988b, p. 55) put it, the reforms "liberalized an exceptionally 'unliberal' economy and quite a lot of liberalization could take place without its becoming a recognizably liberal one."

[25] I would like to thank Robert Blecker for suggesting this interesting analogy with the models of "contestable markets" current in the industrial organization literature.

[26] U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, June 1990.

[27] While exports *have* been an important means of realizing economies of scale for Taiwan, there is some econometric evidence that economies of scale (made possible by trade) rather than expanded exports *as such* are better able to explain industrial development in that economy (Chen and Tang, 1990).

[28] World Bank (1990, Table 16).

[29] In addition to Linnemman, van Dijck, and Verbruggen (1987), this section draws on numerous World Bank, United Nations, and other development agency reports.

[30] This information is based on Sibunruang (1986) and World Bank (1989a).

[31] BEFIEX is the *Comissão Para Concessao de Benefícios Fiscais a Programas Especials de Exportação*, or the Special Program of Fiscal Incentives for Exporters.

[32] World Bank (1990, Table 38).

[33] In U.S. currency the spot price of Caribbean sugar fell from 28.67 cents per pound in 1980 to 4.05 cents in 1985, before rising to just 12.81 cents in 1989. Similarly, Brazilian sugar fell from 21.79 cents in 1980 to 6.66 cents in 1985, and rose to only 12.19 cents in 1989. Philippine sugar peaked at 20.65 cents in 1981, fell to 12.70 cents in 1984, and then recovered to 19.16 cents by 1989. Prices are from International Monetary Fund, *International Financial Statistics*, June 1990 and 1989 *Yearbook*.

[34] I have discussed the availability of summary information of World Bank export promotion involvement by commodity with Bank library and publications staff as well as with policy and regional staff economists. The consensus is that such information collection has never been attempted.

[35] This figure "includes unallocable data" (World Bank, 1988, Table 14).

[36] Lewis' arguments that trade would not continue to expand and that LDCs as a group could not count on exports to the OECD driving growth in the coming period were widely derided at the time but proved prophetic for much of the 1980s. This is not limited to the halving of commodity exporters' terms of trade. In particular, the total real value of world exports has remained essentially stagnant since the late 1970s. See Todaro (1989, p. 370). World trade growth picked up again at the end of the 1980s; its future course is very difficult to predict.

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# Table of Contents

Introduction
by Jeff Faux ..... 1

List of Participants ..... 7

Overview ..... 8

Consumption Binge ..... 17

Foreign Investment ..... 22

Macroeconomic Policies Versus
Structural Policies ..... 25

Trade Deficit ..... 27

Budget Deficit ..... 31

The Hard Landing Scenario ..... 38

Savings and Foreign Borrowing ..... 40

Public Investment ..... 44

Social Security ..... 48

Monetary Policy ..... 52

Military Spending and the Language
of Macroeconomics ..... 55

Glossary of Terms ..... 58

## Introduction

In December 1988, the Economic Policy Institute brought seven prominent economists together with a panel of informed questioners[1] to discuss whether or not the federal deficit had to be eliminated in order to achieve stable growth and prosperity. One purpose of the seminar was to expose the analyses underlying the different conclusions reached by economists who have had similar training, share similar values, and work with the same statistical data.

Macroeconomics, based on the analysis of statistical aggregates, has dominated economic policy in America for the last 50 years. Macroeconomic concepts (such as Gross National Product [GNP] and its components) are the prisms through which we measure economic performance. Indeed, they are the main elements of the language of modern economic policy. For most of the post-World War II period, it was assumed that the tools of macroeconomics were by themselves sufficient to generate growth and prosperity. The late prominent economist Arthur Okun declared in 1970 that recessions had become "fundamentally preventable, like airplane crashes and unlike hurricanes." All one had to do is get the macroeconomics *right*.

The oil-driven price shocks to the economy of the 1970s and the subsequent tight-money policies which produced the worst recession since the 1930s undercut the confidence that prompted Okun's optimism. The political reaction led to eight years of a government dedicated to so-called supply-side economics. Yet, although rhetorically hostile to macroeconomic stimulation of the economy (supply siders often used "Keynesian"* as a code word for the despised welfare state), the Reagan Administration proceeded to swell peacetime budget deficits on a scale that dwarfed the conventional Keynesian imagination. The legacy includes large, persistent fiscal and trade deficits, escalating private debt, a weakened industrial sector, and a dramatic loss of U.S. economic power in the world. These are the consequences, presumably unintended, of some unexamined but persuasively expressed simple solutions to complex problems.

***Economic policy advice is only as good as its underlying analysis.***

The experience has taught us once more that economic policy advice is only as good as its underlying analysis. Thus,

[1] A complete list of participants will be found on page 7.

[2] John Maynard Keynes is regarded as the founder of modern macroeconomics.

as we attempt to recover our economic balance, to restore competitiveness, and to promote economic opportunities for this and succeeding generations, policymakers and citizens would do well to look at the assumptions-political as well as economic-upon which economists are basing their advice.

***The point of departure for the discussions was the federal budget deficit.***

Among the assumptions underlying the macroeconomic policy debate which the EPI seminar sought to question were:

- How "tight" is the relationship between the so-called "twin" fiscal and trade deficits? More broadly, is a trade deficit always the effect of low national savings (public and private together:), or can the former cause the latter? What are the mechanisms (e.g., interest rates, exchange rates, incomes changes) through which this relationship plays out?

- Is cutting the fiscal deficit necessary in order to eliminate the trade deficit? If so, is it sufficient? That is, might the trade deficit also have "structural" causes (e.g. lagging U.S. productivity and innovation, foreign economic policies) and therefore also require structural solutions (e.g., industrial and trade policies, international coordination)?

- How valid is the thesis that the source of the problem is an "overconsuming" public? Do capacity constraints in the face of the need to expand exports require us to slow the rate of growth of consumer incomes and spending?

- Does lowering consumption raise the savings rate? Does increasing the savings rate raise the rate of investment for productive purposes? Do we know how to raise the savings rate?

- How much risk of recession is there in attempting to slow consumption?

- Is there a credible scenario of *accelerating* growth that would also solve the "twin deficit" problem?

The point of departure for the discussions was the federal budget deficit. Barry Bosworth and Larry Summers hold that the nation's primary economic goal should be to eliminate it. They maintain that U.S. savings is too small to finance the deficit, forcing us to import capital from foreigners, which has led to the trade deficit. Since we do not know how to raise the *private* savings rate, we must compensate by raising

the *public* savings rate (by lowering the government deficit and eventually running a budgetary surplus). According to this view, rising savings will spur domestic investment by reducing the need for high interest rates to attract foreign capital. Moreover, by reducing consumption, increased savings will lower the propensity of U.S. consumers to buy imports.

Wrong, say Robert Eisner, Paul Davidson, and Hyman Minsky. Attempting to increase savings by reducing consumption is self-defeating. Savings are a function of income, which expands with the demand for goods and services. At this stage in the business cycle, if we cut back on consumption by eliminating the fiscal deficit, employment and incomes will drop, leading to less total savings. The fiscal deficit is not our most important problem; economic growth is. Only at full employment can one argue that we need to shift the share of GNP from consumption to savings. At present we ought to raise the rate of income growth, primarily through a more expansionary monetary policy.

Whether or not we are at full employment is one of the critical points at issue here.[3] Bosworth and Summers believe that the 5.3 percent unemployment rate at the time of the Seminar represented full employment, and therefore, further growth would have resulted in more inflation. Eisner, Davidson, and Minsky believe that it did not, and that we had room to grow faster,

James Galbraith worries that faster income growth could ignite inflation. But the answer is not to restrain growth; it is to restrain prices. His strategy calls for government to step in with "direct intervention in wage and price-setting mechanisms" to dampen inflation tendencies and thus give the economy more room to expand.

***Whether or not we are at full employment is one of the critical points at issue here.***

On the other hand, Ed Yardeni sees neither a savings nor a budget nor a growth problem. Whatever macroeconomic theory might say, there is no evidence that investments are not being made because of a shortage of financial capital. His answer to the fiscal deficit is to leave it be. Demographic changes will lower the unemployment rate and boost productivity, while international competition should keep prices down.

The lineup shifts a bit when it comes to the mechanisms through which the trade deficit can be eliminated. Eisner and

[3] In December 1988 the unemployment rate was 5.3 percent.

Yardeni favor letting the dollar fall as low as it has to. Neither is particularly worried about a resultant increase in foreign ownership of U.S. assets or the increase in the foreign "debt." (According to Eisner's calculations, we are not a net debtor.) Summers, Bosworth, and Galbraith are also willing to let the dollar fall-to some degree. Summers and Bosworth believe that the strategy will collapse at the point at which foreigners will lose confidence in the dollar and demand even higher interest rates to buy U.S. securities, eventually causing a recession.

Davidson and Minsky are skeptical that we can or should solve the trade deficit with a falling dollar. They argue that the source of the problem is not undersaving in the U.S., but oversaving by surplus nations-primarily Japan and Germany-and that the solution lies beyond macroeconomics. One direction is toward managed trade policies that threaten to reduce the surplus nations' imports into the U.S. unless they grow faster and import more from us. Another is toward industrial policies that can increase the rate of productive investment and productivity growth in the U.S.

Indeed, throughout the day's discussion of deficits, savings, investment, monetary policy, etc., the boundaries of macroeconomic analysis were regularly reached and indeed, breached. For Summers, the elimination of the trade and budget deficits is, by definition, a macroeconomics problem. Structural policies might have some long term usefulness, but they are irrelevant to our present concerns. For Minsky, macroeconomic and structural policies are inseparable. He points out that the perception of what represents full employment fell substantially during the Reagan years, after having risen during the 1970s. Even further back, he says, "I remember three to four percent unemployment, two percent wage increases and no inflation. It depends upon society's institutions, not just the: 'numbers.' "

***Throughout the day's discussion . . . the boundaries of macroeconomic analysis were regularly reached and indeed, breached.***

Assumptions about monetary policy also differ. Although they admit there is a risk, Bosworth and Summers have faith that the Federal Reserve can be counted on to pursue sufficient monetary expansion to compensate for any slowdown caused by eliminating the fiscal deficit. Galbraith is less sure; he wants an explicit Federal Reserve commitment to be part of any budget deal. Eisner, Davidson, and Minsky think that existing monetary policy is too restrictive, even with current budget deficits.

A question on the meaning of "consumption" reveals another disagreement; this one over the degree to which econ-

omists should be concerned with the *composition, as* opposed to the aggregate levels, of economic activities. It also shows the misunderstandings inherent in the language of economics. Thus, the data from which Barry Bosworth concludes that America has been on a "consumption binge"—and which is widely assumed by policymakers and the press to refer to a rise in personal hedonism-include the massive expansion in military spending over the last decade. Yet, while he believes we should cut back on the share of the economy devoted to consumption, he shies away from making judgments about the appropriate share military spending should take of GNP-on the grounds that he is not a military expert, but an economist. Eisner, however, argued that economists were making judgments about how large the consumption share of national income should be, and could therefore make judgments about the military share as well.

***There was one point of agreement: public spending on investment goods (education, training, infrastructure, civilian R&D) is inadequate.***

There was one point of agreement: public spending on investment goods (education, training, infrastructure, civilian R&D) is inadequate. The dispute was over the question of whether we can increase such investments now or whether we first had to get the budget deficit problem "behind us." Panelist Robert Kuttner suggested a third approach-a two-track policy that would separate the budget and investment issues and raise new revenues "dedicated" to specific increases in public investments.

For those seeking to understand the source of differing views on fiscal and monetary policies, the value of the dialogue is in its disagreements. It reminds us that policy prescriptions are influenced by the values that underlie perceptions of risk. Thus, the dispute over the importance of the budget deficit to continued growth is, to some degree, a dispute between those who would first protect against the risk of unemployment and those who would first protect against the risk of inflation.

It is also a dispute between those who consider that economic policy is confined to a framework in which institutions and their behavior are "given," and those for whom economic policy includes strategies to change those institutions. There is, for example, no economic standard for what inflation rate is "acceptable." So when an economist makes assertions about inflationary dangers, or the lack thereof, he or she is inevitably making a social and political value judgment.

Similarly, assertions about the connection between the fiscal budget and the trade deficit often assume an unchange-

*The evolving debate within the profession is a good sign that reality is leading to some rethinking of propositions that a short time ago had the status of eternal truth.*

able institutional framework-productivity, innovation, trade, industrial policies of foreigners, labor-management relations, and foreign policy goals. But a change in one of these factors could dramatically change the macroeconomic problem. For example, to the extent that institutional policies can make U.S. firms more competitive in domestic markets, the propensity of U.S. consumers to buy imports will drop, raising incomes for domestic producers, increasing savings rates, and lessening the need to reduce consumption or the value of the dollar.

To be sure, the case must be made that such institutional policies can be effective. But just raising the question takes us beyond the limits of the conventional wisdom.

This is not, of course, an argument for abandoning macroeconomics. It is an argument for adding to it trade and competitiveness policies, to change institutional behaviors so that we might solve our trade problems by means other than lowering our wages and incomes. These are intellectually unchartered waters for many American economists and therefore a cause of anxiety But, as noted in the seminar, a switch from loose fiscal/tight money policy to a tighter fiscal/looser money policy also leads us into unchartered waters.

The evolving debate within the profession is a good sign that reality is leading to some rethinking of propositions that a short time ago had the status of eternal truth. We will need all the rethinking we can get to steer a passage through the dangers of debt and competitive weakness left us in the wake of the economic policies of the last decade.

-Jeff Faux
President
Economic Policy Institute

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# Table of Contents

Introduction
by Jeff Faux ..... 1

List of Participants ..... 7

Overview ..... 8

Consumption Binge ..... 17

Foreign Investment ..... 22

Macroeconomic Policies Versus
Structural Policies ..... 25

Trade Deficit ..... 27

Budget Deficit ..... 31

The Hard Landing Scenario ..... 38

Savings and Foreign Borrowing ..... 40

Public Investment ..... 44

Social Security ..... 48

Monetary Policy ..... 52

Military Spending and the Language
of Macroeconomics ..... 55

Glossary of Terms ..... 58

## Introduction

In December 1988, the Economic Policy Institute brought seven prominent economists together with a panel of informed questioners[1] to discuss whether or not the federal deficit had to be eliminated in order to achieve stable growth and prosperity. One purpose of the seminar was to expose the analyses underlying the different conclusions reached by economists who have had similar training, share similar values, and work with the same statistical data.

Macroeconomics, based on the analysis of statistical aggregates, has dominated economic policy in America for the last 50 years. Macroeconomic concepts (such as Gross National Product [GNP] and its components) are the prisms through which we measure economic performance. Indeed, they are the main elements of the language of modern economic policy. For most of the post-World War II period, it was assumed that the tools of macroeconomics were by themselves sufficient to generate growth and prosperity. The late prominent economist Arthur Okun declared in 1970 that recessions had become "fundamentally preventable, like airplane crashes and unlike hurricanes." All one had to do is get the macroeconomics *right*.

The oil-driven price shocks to the economy of the 1970s and the subsequent tight-money policies which produced the worst recession since the 1930s undercut the confidence that prompted Okun's optimism. The political reaction led to eight years of a government dedicated to so-called supply-side economics. Yet, although rhetorically hostile to macroeconomic stimulation of the economy (supply siders often used "Keynesian"[2] as a code word for the despised welfare state), the Reagan Administration proceeded to swell peacetime budget deficits on a scale that dwarfed the conventional Keynesian imagination. The legacy includes large, persistent fiscal and trade deficits, escalating private debt, a weakened industrial sector, and a dramatic loss of U.S. economic power in the world. These are the consequences, presumably unintended, of some unexamined but persuasively expressed simple solutions to complex problems.

***Economic policy advice is only as good as its undertying analysis.***

The experience has taught us once more that economic policy advice is only as good as its underlying analysis. Thus,

[1] A complete list of participants will be found on page 7.

[2] John Maynard Keynes is regarded as the founder of modern macroeconomics.

as we attempt to recover our economic balance, to restore competitiveness, and to promote economic opportunities for this and succeeding generations, policymakers and citizens would do well to look at the assumptions-political as well as economic-upon which economists are basing their advice.

***The point of departure for the discussions was the federal budget deficit.***

Among the assumptions underlying the macroeconomic policy debate which the EPI seminar sought to question were:

- How "tight" is the relationship between the so-called "twin" fiscal and trade deficits? More broadly, is a trade deficit always the effect of low national savings (public and private together), or can the former *cause* the latter? What are the mechanisms (e.g., interest rates, exchange rates, incomes changes) through which this relationship plays out?
- Is cutting the fiscal deficit necessary in order to eliminate the trade deficit? If so, is it sufficient? That is, might the trade deficit also have "structural" causes (e.g. lagging U.S. productivity and innovation, foreign economic policies) and therefore also require structural solutions (e.g., industrial and trade policies, international coordination)?
- How valid is the thesis that the source of the problem is an "overconsuming" public? Do capacity constraints in the face of the need to expand exports require us to slow the rate of growth of consumer incomes and spending?
- Does lowering consumption raise the savings rate? Does increasing the savings rate raise the rate of investment for productive purposes? Do we know how to raise the savings rate?
- How much risk of recession is there in attempting to slow consumption?
- Is there a credible scenario of *accelerating* growth that would also solve the "twin deficit" problem?

The point of departure for the discussions was the federal budget deficit. Barry Bosworth and Larry Summers hold that the nation's primary economic goal should be to eliminate it. They maintain that U.S. savings is too small to finance the deficit, forcing us to import capital from foreigners, which has led to the trade deficit. Since we do not know how to raise the *private* savings rate, we must compensate by raising

the *public* savings rate (by lowering the government deficit and eventually running a budgetary surplus). According to this view, rising savings will spur domestic investment by reducing the need for high interest rates to attract foreign capital. Moreover, by reducing consumption, increased savings will lower the propensity of U.S. consumers to buy imports.

Wrong, say Robert Eisner, Paul Davidson, and Hyman Minsky. Attempting to increase savings by reducing consumption is self-defeating. Savings are a function of income, which expands with the demand for goods and services. At this stage in the business cycle, if we cut back on consumption by eliminating the fiscal deficit, employment and incomes will drop, leading to less total savings. The fiscal deficit is not our most important problem; economic growth is. Only at full employment can one argue that we need to shift the share of GNP from consumption to savings. At present we ought to raise the rate of income growth, primarily through a more expansionary monetary policy

Whether or not we are at full employment is one of the critical points at issue here.[3] Bosworth and Summers believe that the 5.3 percent unemployment rate at the time of the Seminar represented full employment, and therefore, further growth would have resulted in more inflation. Eisner, Davidson, and Minsky believe that it did not, and that we had room to grow faster.

James Galbraith worries that faster income growth could ignite inflation. But the answer is not to restrain growth; it is to restrain prices. His strategy calls for government to step in with "direct intervention in wage and price-setting mechanisms" to dampen inflation tendencies and thus give the economy more room to expand.

On the other hand, Ed Yardeni sees neither a savings nor a budget nor a growth problem. Whatever macroeconomic theory might say, there is no evidence that investments are not being made because of a shortage of financial capital. His answer to the fiscal deficit is to leave it be. Demographic changes will lower the unemployment rate and boost productivity, while international competition should keep prices down

The lineup shifts a bit when it comes to the mechanisms through which the trade deficit can be eliminated. Eisner and

***Whether or not we are at full employment is one of the critical points at issue here.***

[3] In December 1988 the unemployment rate was 5.3 percent.

Yardeni favor letting the dollar fall as low as it has to, Neither is particularly worried about a resultant increase in foreign ownership of U.S. assets or the increase in the foreign "debt." (According to Eisner's calculations, we are not a net debtor.) Summers, Bosworth, and Galbraith are also willing to let the dollar fall-to some degree. Summers and Bosworth believe that the strategy will collapse at the point at which foreigners will lose confidence in the dollar and demand even higher interest rates to buy U.S. securities, eventually causing a recession.

Davidson and Minsky are skeptical that we can or should solve the trade deficit with a falling dollar. They argue that the source of the problem is not undersaving in the U.S., but oversaving by surplus nations-primarily Japan and Germany-and that the solution lies beyond macroeconomics. One direction is toward managed trade policies that threaten to reduce the surplus nations' imports into the U.S. unless they grow faster and import more from us. Another is toward industrial policies that can increase the rate of productive investment and productivity growth in the U.S.

Indeed, throughout the day's discussion of deficits, savings, investment, monetary policy, etc., the boundaries of macroeconomic analysis were regularly reached and indeed, breached. For Summers, the elimination of the trade and budget deficits is, by definition, a macroeconomics problem. Structural policies might have some long term usefulness, but they are irrelevant to our present concerns. For Minsky, macroeconomic and structural policies are inseparable. He points out that the perception of what represents full employment fell substantially during the Reagan years, after having risen during the 1970s. Even further back, he says, "I remember three to four percent unemployment, two percent wage increases and no inflation. It depends upon society's institutions, not just the 'numbers.' "

***Throughout the day's discussion . . . the boundaries of macroeconomic analysis were regularly reached and indeed, breached.***

Assumptions about monetary policy also differ. Although they admit there is a risk, Bosworth and Summers have faith that the Federal Reserve can be counted on to pursue sufficient monetary expansion to compensate for any slowdown caused by eliminating the fiscal deficit. Galbraith is less sure; he wants an explicit Federal Reserve commitment to be part of any budget deal. Eisner, Davidson, and Minsky think that existing monetary policy is too restrictive, even with current budget deficits.

A question on the meaning of "consumption" reveals another disagreement; this one over the degree to which econ-

omists should be concerned with the *composition, as* opposed to the aggregate levels, of economic activities. It also shows the misunderstandings inherent in the language of economics. Thus, the data from which Barry Bosworth concludes that America has been on a "consumption binge"—and which is widely assumed by policymakers and the press to refer to a rise in personal hedonism-include the massive expansion in military spending over the last decade. Yet, while he believes we should cut back on the share of the economy devoted to consumption, he shies away from making judgments about the appropriate share military spending should take of GNP-on the grounds that he is not a military expert, but an economist. Eisner, however, argued that economists were making judgments about how large the consumption share of national income should be, and could therefore make judgments about the military share as well.

***There was one point of agreement: public spending on investment goods (education, training, infrastructure, civilian R&D) is inadequate.***

There was one point of agreement: public spending on investment goods (education, training, infrastructure, civilian R&D) is inadequate. The dispute was over the question of whether we can increase such investments now or whether we first had to get the budget deficit problem "behind us." Panelist Robert Kuttner suggested a third approach-a two-track policy that would separate the budget and investment issues and raise new revenues "dedicated" to specific increases in public investments.

For those seeking to understand the source of differing views on fiscal and monetary policies, the value of the dialogue is in its disagreements. It reminds us that policy prescriptions are influenced by the values that underlie perceptions of risk. Thus, the dispute over the importance of the budget deficit to continued growth is, to some degree, a dispute between those who would first protect against the risk of unemployment and those who would first protect against the risk of inflation.

It is also a dispute between those who consider that economic policy is confined to a framework in which institutions and their behavior are "given," and those for whom economic policy includes strategies to change those institutions. There is, for example, no economic standard for what inflation rate is "acceptable." So when an economist makes assertions about inflationary dangers, or the lack thereof, he or she is inevitably making a social and political value judgment.

Similarly, assertions about the connection between the fiscal budget and the trade deficit often assume an unchange-

able institutional framework-productivity, innovation, trade, industrial policies of foreigners, labor-management relations, and foreign policy goals. But a change in one of these factors could dramatically change the macroeconomic problem. For example, to the extent that institutional policies can make U.S. firms more competitive in domestic markets, the propensity of U.S. consumers to buy imports will drop, raising incomes for domestic producers, increasing savings rates, and lessening the need to reduce consumption or the value of the dollar.

***The evolving debate within the profession is a good sign that reality is leading to some rethinking of propositions that a short time ago had the status of eternal truth.***

To be sure, the case must be made that such institutional policies can be effective. But just raising the question takes us beyond the limits of the conventional wisdom.

This is not, of course, an argument for abandoning macroeconomics. It is an argument for adding to it trade and competitiveness policies, to change institutional behaviors so that we might solve our trade problems by means other than lowering our wages and incomes. These are intellectually unchartered waters for many American economists and therefore a cause of anxiety But, as noted in the seminar, a switch from loose fiscal/tight money policy to a tighter fiscal/looser money policy also leads us into unchartered waters.

The evolving debate within the profession is a good sign that reality is leading to some rethinking of propositions that a short time ago had the status of eternal truth. We will need all the rethinking we can get to steer a passage through the dangers of debt and competitive weakness left us in the wake of the economic policies of the last decade.

-Jeff Faux
President
Economic Policy Institute

# Participants

**Economic Policy Institute**
**Seminar on Macroeconomic Policy**
**December 13, 1988**

**Panel Members:**

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*Brookings Institution*

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*Northwestern University*

Jeff Faux,
*Economic Policy Institute*

James Galbraith
*University of Texas*

Hyman Minsky
*Washington, University*

Lawrence Summers
*Harvard University*

Edward Yardeni
*Prudential Bache*

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*Office of Senator Kennedy*

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*Joint Economic Committee, US. Congress*

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*Industrial Union Department, AFL-CIO*

## Overview

**BOSWORTH:**

I would focus on four issues as an agenda for economic policy over the next four to eight years.

The first is the primary importance of sustaining the economic expansion and continuing to reduce unemployment without an acceleration of inflation.

***The United States trade deficit and the need to borrow from overseas is the result of our country going on a consumption binge.***
*-Barry* ***Bosworth***

The second is the long term problem of economic growth and the disastrous decline in the national saving rate. The United States trade deficit and the need to borrow from overseas is the result of our country going on a consumption binge. If we save two percent of our income and invest six, by definition we have to borrow four. Of course, the identity and the causation could run the other way, but all the studies find the causative ***change*** in the 1980s has been in the domestic saving behavior. The change is not overseas.

The major reason for the decline in the national saving rate was the budget deficit, which was beyond the pale of historical experience. More recently, the private sector saving rate has also substantially declined. We now have a net national saving rate that's two percent of our national income. It used to be in the range of six to seven percent. About half that decline is due to the public sector and about half that decline is due to private saving.

The government, short of coercion, can do almost nothing to influence the private saving rate. Therefore, the private saving rate is something to be taken as a given, and public budgetary policy must adjust to it. The argument is that the U.S. has to aim for a surplus in the total budget over the next decade or so. Obviously our progress towards achieving that goal will have to be modified by the need to sustain the expansion.

The third economic issue is productivity growth. Many of the social problems of the country are due to the disastrous slowing of the improvement in the standard of living in the United States. Although we don't understand the full reasons for the productivity decline, economists can articulate an economic policy to improve productivity growth in the future. The problem which must be faced is that it will cost money.

The final issue is that the U.S. now finds itself in a dramatically changed international economic situation. It therefore has to seriously rethink its economic policies in the international sphere.

**DAVIDSON:**

I'll start with some controversy Deficits are not the problem. They were the solution to getting out of the second Great Depression of the Twentieth Century. Our deficits act as the engine of growth for the economies of the industrial free world. The industrial free world, including Germany, Japan and the NICs [Newly Industrializing Countries], will continue to grow as long as we are willing to solve *their* oversaving problems. The problem is not our undersaving, but their oversaving.

Reagan (for the wrong reasons perhaps) has acted like a good Keynesian. His deficit got the economy out of the recession. But unfortunately, because of the open economy, a lot of the economic growth spilled over to our trading partners who did not reciprocate by expanding their economies. The reason they didn't reciprocate is because under flexible exchange rates, there are three gains to be made from mercantilist export-led growth. One, you can export your own unemployment. Two, you can get an anti-inflation policy because the appreciation in the exchange rate lowers the price of imported goods. And three, you get a real wealth effect because as the exchange rate increases you can buy foreign assets at bargain prices. These advantages wouldn't exist under-fixed exchange rates.

I question whether there is any relationship between budget deficits and trade deficits. I also deny that the fall in personal saving rate is very strong. In 1982, when we were running a goods and service export surplus, 65 percent of the GNP was in consumption. In 1988 we still have 65 percent of the GNP in consumption. We are no more on a consumer binge now than we were in 1982. You might argue that because imports are greater than exports, we are on a consumer binge, but I argue that that's the way we have been keeping the world out of a recession.

As a nation we are not living beyond our means, because the definition of living beyond your means is not how much you spend out of your actual income but how much you spend out of your full employment income. As long as you have unemployed resources, you can continually spend more

***As a nation we are not living beyond our means, because the definition of living beyond your means is ... how much you spend out of your full employment income.***

***-Paul Davidson***

on goods. Keynesians don't say that the unemployed people who are spending are living beyond their means, and that they ought to tighten their belts. What we say is they ought to get more income. You can get more income by transfer payments, or you create jobs for them. You can use the same argument for a family of nations. You would get the same kind of conclusions.

Do real budget deficits lead to less real saving? The argument is that it's not the personal saving ratio that's low, but that the government deficit has absorbed all this saving. Well, compare the Eisenhower Administration with the Kennedy Administration. The deficit under Kennedy was about four times as great as a percentage of GNP as under Eisenhower. But the real national saving in the United States was much greater under Kennedy than under Eisenhower. Large government deficits can lead to large saving. It is a question of the distribution of saving. That gets back to the argument that unfortunately our trading partners have a great incentive to oversave. Under fixed exchange rates, under the Kennedy case, they would not have this incentive to oversave.

EISNER:

There are two major goals of macroeconomics: first, keep ing a high level of employment and prosperity, as Barry indicated, and second, providing for and investing in the future, also as Barry indicated. From there I may part company from the other participants.

**There *are two major goals of macroeconomics: first, keeping a high* /eve/ *of employment and prosperity. .. and second, providing for and investing in the future.***

*-Robert* ***Eisner***

For one thing, we don't measure our investment appropriately Economists have an awful time trying to match the theory in their analysis with the measurement of variables in their analysis. They don't stop to think that the theory and the measurement don't match.

Let's take this issue of lowered saving. Even in terms of standard definitions, the fall in net saving is very suspect. The four percentage point drop is almost entirely accountable to two things.

One is capital consumption allowances i.e., depreciation, which, according to the BEA, have gone up about four percentage points. They would have us believe that somehow there has been a huge decrease in the durability of our capital or a great increase in capital intensity such that a great deal more of our capital is being used up.

A second major element in the purported great decline in saving is that we have a negative trade balance and thus foreign investment. That is due overwhelmingly to what has happened to exchange rates. The remedy is clear; leave the dollar free. Stop encouraging the Japanese or the Germans to keep buying dollars, thereby keeping the dollar expensive. The whole foreign investment problem can be essentially settled by letting the dollar fall, although there will be a lag.

But remember there is a kind of an automatic adjustment to the whole net international position of the U.S., as the dollar falls in value, the value of our foreign investments abroad increases. Thus, we're not the world's greatest debtor nation.

***I would like to see a little confidence in the economy; I believe it can grow.***
***-Robert Eisner***

A basic point of difference I have with my colleagues at Brookings, and perhaps some others around this table, is that they all seem to be mesmerized by the notion that we are at full employment or at the natural rate of unemployment. They believe there is no more excess capacity and therefore, if you increase the money supply, thereby letting interest rates fall (which will bring down the deficit somewhat automatically because of lower government payments for interest on the debt), you will somehow get inflation.

I would like to see a little confidence in the economy; I believe it can grow. Take your chance that you can get below 5.5 percent unemployment. Remember, we had 3.5 percent unemployment 20 years ago. If I happen to be wrong, and we get an uptick of one percent in inflation, that's far better than having an uptick of one, two, or three percentage points in unemployment which you can well get by cutting the budget deficit.

Ultimately, I come back to the whole net investment/saving issue. What is normally called investment or saving is only the tip of the iceberg. The great bulk of investment and provision for the future is in government capital and infrastructure, and overwhelmingly in human capital. Business investment is only about 20 percent of total investment. What the focus on cutting budget deficits says is, "You can't spend more for education and you can't keep up your infrastructure." This deficit focus kills the future in the name of increasing saving for the future. Besides, I would agree with Barry, you can't change private saving much anyway.

GALBRAITH:

We need to sustain growth. I would emphasize export-led

***Interest rates should be lowered immediately and there should be a reallocation in the federal budget to growth of public capital formation in the civilian sector in education, research, infrastructure, and the environment.***
***-James Galbraith***

growth. In the context of doing that, we need to move towards a smaller budget deficit and toward balance in the current account. The emphasis is properly on growth in the first place because there are ways to fix trade, in particular, without growth, but they are catastrophic for the budget and everything else.

I would suggest the following elements: first, higher tax revenue for the U.S. government. Enact a tax increase now, but delay the effective date of the increase for say a year or two, until the other parts of the package have been put into place and have had a chance to take effect. The simplest and most effective way to do this is to enact a future rise in income tax rates.

Second, in return for enacting such a delayed tax increase, interest rates should be lowered immediately and there should be a reallocation in the federal budget to growth of public capital formation in the civilian sector in education, research, infrastructure, and the environment. These are the areas that have been most radically slashed in the last decade. They need to be restored. An appropriate target for the increase in these areas would be one percent of GNP.

Third, we need to move toward debt relief in Latin America to restore the purchasing power of those economies, allowing them to buy advanced investment goods which constitute our major export. A program of debt relief could be funded cooperatively with the Japanese, United States guarantees, and the compliance of commercial banks which could be solicited in a friendly way, or, if necessary, by using the regulatory powers of the U.S. over banking institutions.

Finally, we need, but may not get, an expansion in advanced countries now running large trade surpluses, in particular Japan and Germany. If this does not occur, Bob was right, we would have to tolerate a fall in the dollar to reduce our trade deficit. Certainly our willingness to let the dollar fall ought to foster a willingness on the part of the Japanese and the Germans to cooperate a little bit more in a program of global economic expansion. If we can't get that cooperation, then we will face a short term rise in our import price level. We will need to take steps in the domestic economy to prevent that from spreading into a renewed inflation spiral of wages and prices. So we will have to begin to construct some new institutions for direct intervention in wage and price-setting mechanisms, so as to keep an export-led expansion on track and to make the expansion truly sustainable.

MINSKY:

There is not very much of a problem with the internal deficit, The problem is the external deficit and the solution to the external deficit. The internal deficit is an operational thing. What we have to do is adopt the fiscal and monetary policy to keep us at full employment, and if a government deficit results, so be it.

The external debt has decreased the fiscal independence of the United States and increased the fiscal independence of the countries that have acquired U.S.-based assets. Their increase in fiscal independence, combined with their continued reliance on export surpluses to maintain their own domestic employment, is a classical "beggar thy neighbor" policy. We have the right to protect ourselves against "beggar thy neighbor" policies by creditor surplus economies. Yet we don't recognize the equivalence between a tariff and the depreciation of the dollar. A revenue-generating tariff is not such a bad thing, especially with our fiscal and trade problems. To say any tariff moves you to Smoot-Hawley immediately is saying there are no numbers between zero and one hundred.

We have had a successful fiscal policy that changed domestic behavior by the Reagan Administration. The policy mix has been and continues to be right wing Keynesianism. There is nothing written in the Scriptures that says Keynesianism has to be progressive. The Reagan Administration succeeded in containing wage increases by changing the NLRB [National Labor Relations Board] and other rules affecting the labor market. They did nothing about industrial organization, to contain firm market power. Market power policy has been a weakness of liberal and conservative governments ever since the third New Deal was abandoned after 1939.

Where do we go from here? I believe that a new definition of full employment is called for, a definition that allows for a smaller unemployment rate. What we have to be concerned about is not the aggregate demand relations as such, but whether increases are transformed into wage and price increases or into output increases. That means addressing the structure of product and labor markets.

***We have the right to protect ourselves against "beggar thy neighbor" policies by creditor surplus economies.***
***—Hyman** Minsky*

SUMMERS:

I agree with Barry Bosworth. The four points he made are just about exactly right.

It is a myth that deficit reduction has to be associated with any significant reduction in the level of economic activity. It is true that with a constant money supply, an expansion in the budget deficit does tend to stimulate an economy. This effect is probably less important than it was in an earlier era when, for a variety of reasons, the money supply was more elastic with respect to interest rates.

But this is not the issue before us. The relevant question is: what are the economic consequences of budget deficit reduction, given the monetary policy that is likely to accompany such a change. Reducing the deficit will allow the Federal Reserve Board to adopt a more expansionary monetary policy. The resulting lower interest rates and increased investment will offset any lack of stimulus that comes from reduced consumption. If monetary policy is used to keep the economy growing, the Federal Reserve won't be able to use it to defend the dollar at some particular exchange rate target.

There is, of course, an issue of timing. Given that any deficit reduction program introduced in Congress will only be implemented after six months or a year, the Federal Reserve will have plenty of time to respond appropriately with looser monetary policy. Real interest rates remain substantially higher relative to postwar experience in the United States. The appropriate antidote is an employment-maintaining shift in our fiscal/monetary mix-tighter fiscal and looser monetary.

***It is a myth that deficit reduction has to be associated with any significant reduction in the level of economic activity . . Reducing the deficit will allow the Federal Reserve Board to adopt a more expansionary monetary policy.***
***-Lawrence** Summers*

Second, it is simply wishful thinking to suppose that there are large output dividends available by driving the economy to higher levels of employment. There is nothing in our experience in the last several years, nothing in recent inflation behavior, and nothing that one observes in the labor market to support that idea. Such a dramatic reduction of unemployment from an expansionary policy does not mean a one time increase of one percent in the inflation rate-it means a shift to a permanently higher plane of inflation. Furthermore, it would likely mean a period of ***accelerating*** inflation if the reduction in unemployment continued.

Third, we need to put the deficit problem behind us to increase public investment. As long as huge budget deficits remain, they will be used as a powerful argument against new spending. Putting that problem behind us, preferably with much more emphasis on revenue than on spending, is a prerequisite to discussing serious public investment initiatives.

Fourth, it is an arithmetic identity that net domestic investment equals net domestic saving plus foreign investment and that foreign investment is the mirror image of our current account deficit. This tells us that the United States cannot invest a larger share of its GNP without saving more or running a larger trade deficit. It seems to me that those of you who do not share my passion for increasing national savings must believe that: (a) the current trade deficit and level of investment are acceptable; (b) investment should be allowed to decline as the trade deficit shrinks; or (c) through expansion the United States can reduce its trade deficit and invest more. I don't believe that the latter is a live option. The economy simply can't expand enough to limit the trade deficit and maintain a satisfactory level of investment.

***The United States cannot invest a larger share of its GNP without saving more or running a larger trade deficit.***
*-Lawrence Summers*

**YARDENI:**

Let me start by giving you my optimistic scenario for the next five years, and then I'll tell you what sorts of policies are needed to make it happen:

One, as world trade expands and global competition intensifies, inflation should trend lower. I see it down to two to three percent by **1993.**

Two, real GNP should increase three percent per year on average over the next five years. If global competitiveness forces successfully keep a lid on inflation, then economy-wide recessions are less likely than in the past. In my opinion, a prerequisite for a policy-engineered bust is an inflationary boom-no boom, no bust. Rolling recessions that hit different countries at different times are more likely than economy-wide recessions.

Three, demographic forces related to the aging of the baby boomers should push the unemployment rate down to four percent within the next two years. Yet wage inflation should remain low as managements continue to cut costs in an effort to remain competitive in global markets. Labor shortages should stimulate faster growth in productivity, particularly in the services economy.

Four, capital spending should boom for the next five years, because the economy is doing well, capacity is tight, and labor is in short supply.

Five, consumer spending, which rose four to five percent during the first few years of the current expansion, should

slow down to two to three percent per year. The savings rate should rise to ten percent by 1993 as the baby boomers age.

Six, the government bond yield should fall to five to six percent during the next five years.

***My most optimistic scenario … is achievable, in my opinion, if our policymakers follow a pro-growth agenda.***
***—Eward Yardeni***

Seven, the trade deficit should disappear with the exchange rates around current levels as long as our trading partners continue to grow and to open their markets to imports.

Eight, the federal budget should be in balance in five years without tax increases because of better than expected growth and lower than expected interest rates.

This is obviously my most optimistic scenario. It is achievable, in my opinion, if our policymakers follow a pro-growth agenda. So far in our discussion not much has been said about free trade. I think encouraging free trade should be first on our policy agenda.

Free trade increases global markets and creates enough prosperity for all to share. It also stimulates competition, which helps to keep a lid on inflation. Europe is moving toward freer trade by 1992. The Canadians have joined us in a free trade zone. Japan is developing more ties with Asian newly industrializing countries. Consumption is growing at a faster pace in the Pacific rim nations and trade restrictions are gradually being removed so that American producers can share in the Asian boom.

We should do everything we can to promote these trends. Our trade representatives must persuade our allies to open up their markets at a faster pace. We do have reasons to fear Fortress Europe and mercantilism in Asia. These tendencies toward protectionism must be resisted, but not to the point of sinking into protectionism at home.

Policymakers should continue to permit market forces to regulate more of our economic activities. We should move towards more "market conforming" policies, to use the Japanese phrase. The Japanese assist their industries with market conforming policies, and we should do the same.

## Consumption Binge

**FAUX:**

Barry, you say that we've been on a "consumer binge." Defend that statement.

**BOSWORTH:**

The private saving rate is simply income minus consumption. Net national saving is the sum of private saving plus government savings or dissavings. I agree with Paul's statement about not finding a correlation between private saving and the trade deficit, or a correlation between government saving and the trade deficit. Those are not the correct correlations. You don't see an association between budget deficits and trade deficits. No economist should have expected one. It was a shorthand in the 1980s to express the idea that the national, saving rate has declined.

The government deficit, government dissaving, is well-documented. But private saving has also fallen in the 1980s. The net private saving rate was running in the neighborhood of eight to nine percent in the 1950s, 1960s, and 1970s. It was on a slight upward trend. But in the 1980s it fell sharply in the first half of the decade. That alone was not a cause for concern for the reasons Bob Eisner gave. Capital consumption allowances in a recession are a sharply rising share of the national income and net saving would always fall in a recession. But now we are back to a fairly normal level of output and the private saving rate is still at six percent.

***The government deficit, government dissaving, is well-documented. But private saving has also fallen in the 1980s.***

*-Barry Bosworth*

If you look into the numbers, there are some reasons why that has occurred. A lot of it has to do with the behavior of the private pension system which accounts for about 1.5 percentage points of the decline. When all these funds became over-funded because of the rise in interest rates, corporations dramatically decreased their contributions into their pension funds.

When you do the analysis on a basis of consumption, as Paul did, you want to look at consumption *net* versus the *net* national income. On that basis, the private saving rate is down in the 1980s. If you look at individual years, you find lots of fluctuations but its decade-long average is down.

That the private saving rate is down a notch is not actually fundamental. The fundamental issue is that the national sav-

ing rate is down. The government can't do anything about the private saving rate. So I just take that as given in advocating a tighter budgetary policy. We need more public saving.

I agree with Bob Eisner's statement about investment, except for one qualification. We can do calculations that include human capital, education and a capital budget for the public sector. If you do those calculations, the issue of declining capital formation is worse, not better, because the big cutbacks in the government spending in the 1980s have been precisely in the areas of human capital and physical infrastructure. To emphasize that those are important parts of capital formation and national wealth accumulation is just to tell you that the 1980s were even worse, not better.

EISNER:

I'm not making the argument that the situation is necessarily good on national saving. The important point is to keep up national saving, correctly measured. You keep talking about cutting budget deficits, but what you're talking about is essentially preventive action to raise the national saving rate.

***Why should businessmen invest more when you are cutting their consumer markets and you haven't expanded their export markets?***
*-Paul Davidson*

DAVIDSON:

Why do you want less consumption? There are only two possible reasons. One is external debt, you think you're living beyond your export earnings. The other is to change the mix between investment and consumption.

If you lower the interest rate and keep GNP at the same level, what makes you think our imports are going to fall? If imports are related to income, just changing the composition of our domestic demand from consumption to investment shouldn't automatically change our level of imports.

Suppose you cut consumption and you lower interest rates and you haven't changed your export-import balance at all, why should businessmen invest more when you are cutting their consumer markets and you haven't expanded their export markets. Why do they need more capacity? If anything, they will want to cut back. Under these circumstances, you've got to show that even though interest rates are lower, there are more sales out there somewhere. Where do you get these additional sales? Overseas? In that case, you are talking about an exchange rate change, not a change in the domestic mix through reducing the deficit. You don't have to reduce the deficit.

Now, take these exchange rates. Hyman is right about tariffs. You can look at the specific commodities traded between the U.S. and the rest of the world. You tell me where by cutting exchange rates by another 20 percent, you will find the necessary import-export changes. I defy you to find the $120, $130 billion shift to get the trade surplus down to some reasonable number by any 20 percent fall of the exchange rate. The reason for the trade deficit is that foreigners are saving too much and we somehow must get them to spend more.

The exchange rates won't do it. One of the reasons why exchange rates won't work is, of course, because $55 billion worth of our imports, oil, are in dollar denominations. Part of the gain in our external balance is because the oil prices have dropped since 1985. It has nothing to do with the exchange rate and nothing to do with the J curve. Oil prices are about as low as they are going to get, if anything, they are going to go up and you are going to see worse trade problems. Today's statistics on Japan's balance of payments shows that Japan's exports increased last month including exports to the United States. Bashing is the way to do it, but not bashing just by the exchange rates.

SUMMERS:

The basic difference between Paul and me is that I think that prices and interest rates affect decisions people make. Obviously he does not. My proposition is that to improve America's economic situation, we have to change the fiscal-monetary policy mix so as to keep the GNP at current levels and achieve lower interest rates. Significantly lower interest rates would have two effects. First, businessmen would find more profitable investments because the price of money would be lower. Equivalently, people would find it more worthwhile to buy capital assets. The value of these assets would be greater because the return from those assets is higher when discounted at a lower interest rate.

***To improve America's economic situation, we have to change the fiscal-monetary policy mix so as to keep the GNP at current levels and achieve lower interest rates.***
*-Lawrence Summers*

Second, lower interest rates would make the United States a less attractive place for foreign and American investors to park their capital. This would cause the dollar to fall, which would in turn increase U.S. exports and would encourage substitution of domestic production for foreign imports. In short, lower interest rates would address two of America's major economic problems: inadequate investment and a huge trade deficit. If the U.S. were a small country with a

negligible effect on the world economy, then one would expect all of the effect on the trade balance. Because the U.S. economy is so large, changes in the U.S. interest rates will affect interest rates worldwide. As a result, lowering the U.S. interest rate will affect both investment and the trade deficit.

YARDENI:

Presumably, we want a high enough saving rate so we can have a high enough investment rate. But I don't believe that financial capital is unavailable for companies that need to build plants or to buy equipment.

It doesn't matter where the money is coming from. Money saved by the Japanese is just as good as money saved by Americans. I agree with Paul that one of the sources of imbalance in the global economy is that the Japanese save too much. But that is all right as long as they are willing to channel some of those savings over here.

The main reason we have under-performed in terms of the investment rate is we have had too many recessions; we haven't been able to sustain good solid economic growth for a long enough period to stimulate higher rates of capital spending. We must have policies that promote economic growth.

***I don't believe that financial capital is unavailable for companies that need to build plants or to buy equipment.***
*-Edward* ***Yardeni***

Demographic factors can also explain our sub-par investment, saving, and productivity rates. When the baby boomers flooded into the job markets during the late 1960s and 1970s, they drove up the unemployment rate. Many of them found jobs, particularly in the services economy. Interestingly, virtually all of the slowdown in nonfarm productivity since 1973 can be attributed to the services sector. Service businesses expanded by hiring the abundant and relatively cheap new baby boom workers. They were also inexperienced so productivity suffered.

Real family incomes suffered along with productivity My response to economists who claim that we don't save enough is that we haven't had enough income to save! But now as the baby boomers age they should become more productive workers and they should earn more. So they will have more income to save and odds are that as they age over the next five years they will be more inclined to save.

So I don't believe that policymakers need to meddle with our saving rate or our investment behavior. If my demograph-

ic theory is accurate, then productivity growth should soon rebound. Capital spending should boom as labor shortages persist, especially now that the baby boomers are mostly employed. As family income rebounds along with productivity, the saving rate should move higher.

***Capital spending should boom as labor shortages persist, especially now that the baby boomers are mostly employed.***
***-Edward Yardeni***

## Foreign Investment

**KUTTNER:**

It seems to me that what Paul and Bob are leaving out is the open economy If you don't worry about your domestic saving rate in an open economy, you're going to end up borrowing from the Japanese, or from whomever. They are going to end up owning real assets. So my question for Bob or Paul is, explain why the open economy is not the major fallacy in your logic and why Japan won't end up owning our whole industrial infrastructure.

**DAVIDSON:**

Senator Bentsen proposed legislation that would have solved this problem. If you are cutting your exchange rate and you still can't increase your exports, you have to cut your imports. The question is how to cut your imports against those who are oversaving to encourage them to get rid of their oversaving. Bentsen proposed that any country with an export surplus of 65 percent against the United States and 50 percent against the rest of the world would have a differential tariff placed against them vis-a-vis everybody else. So, they have to reduce their surplus by a certain amount to avoid the tariff. Now, what that involves, for example, is Japanese cars versus Brazilian cars. Brazilians have the sixth largest automobile industry in the world. Plenty of excess capacity there. They would love to sell us cars, but we're buying Japanese. Let's put a tariff on Japanese cars and force the Japanese to act. In other words, there are ways of getting them to save less. If they spend more, that generates aggregate demand and the whole global economy benefits. There are no reasons why we should accept their saving ratio as the ground on which we operate our economy.

***Only if you have global full employment does saving and investment act as a constraint ... But there's plenty of unemployment around the world.***
*-Paul Davidson*

**KUTTNER:**

Doesn't S still equal I?

**DAVIDSON:**

Only if you have global full employment does saving and investment act as a constraint. Then, you can't expand. But there's plenty of unemployment around the world.

**EISNER:**

Let me put a slightly different stamp on this. Import tariffs

are simply halfway depreciation. It's simply making foreign goods more expensive to you without changing the price of our goods abroad. Exchange depreciation will make foreign goods more expensive to us and will also make our goods cheaper to foreigners. The danger of an import tariff is obviously that other countries will levy them on us and we won't get anywhere.

***Import tariffs are simply halfway depreciation… Exchange depreciation will make foreign goods more expensive, to us and will also make our goods cheaper to foreigners.***
***-Robert Eisner***

But suppose we keep running a $150 billion current account deficit for five years. Is that going to be a disaster? It means we run up our foreign "debt" by $750 billion. With a four percent real rate of interest on $750 billion, our interest payments are $30 billion. $30 billion in an economy of $7 trillion (by 1994) is less than one-half of one percent per year. That means that after five years of the current account deficit, we've got ourselves in such a terrible position, in hock to the rest of the world, that we are then paying them less than one-half of one percent of our GNP. And if we keep going on and on with a trade deficit, we are adding less than one-tenth of one percent of GNP to our burden each year. And now against that, my colleagues are going to take their chances on raising unemployment or at least are willing to give up on lowering it any further. But each one percent of unemployment lowers GNP by about two percent, and certainly one percent of GNP.

What you are presumably worried about on a current account deficit is that foreigners are investing in the U.S., that is injuring the international net investment position of the U.S. Remember we are talking about net investment. We have heard over and over again *ad nauseam* that we are the world's greatest debtor nation. We are not. We are probably not a debtor nation at all. What you must do is to look at the *market* value of our investments abroad and the *market* value of foreign investments here. The BEA does not adjust the direct investment component to market value. As a result of that, there is over a $400 billion shift, once that adjustment is made, so that we are not a debtor nation. Now if the dollar falls in value as it probably will if we leave it free, and we still keep running a current account deficit, then what happens? The value of our assets abroad goes up in dollar terms. So we still don't get into a net negative international investment position.

**YARDENI:**

We should stop using the concept of a trade deficit. It is a

very nationalistic notion that may be outmoded in a world of truly global markets with free trade. Economic borders cover more territory than political borders. We have a large trade deficit because many American companies are producing American products overseas. If those companies sold these goods directly from America to foreign markets there would be no trade deficit today.

Rather than fearing Japanese direct investment in the U.S., we should welcome it. That is one of the best ways to restore some balance in world trade. We want them to sell us Japanese goods that are made in America just the way we sell them American goods made in Japan.

***We should stop using the concept of a trade deficit. It is a very nationalistic notion that may be outmoded in a world of truly global markets with free trade.***

*-Edward Yardeni*

## Macroeconomic Policies Versus Structural Policies

KUTTNER:

Larry, why do we have to be satisfied with 5 to 5.5 percent unemployment and two to three percent growth? Europe and Japan in the 1950s and 1960s and the United States in the early 1940s had lower unemployment and higher growth. Given all the poverty, all the idle capacity, all the productivity gains to be made, why can't we do better?

SUMMERS:

I wish the unemployment rate could be lower. We could discuss whether there are structural policies in the United States which would enable us to have faster economic growth and lower unemployment without having higher inflation. We could discuss whether we could be more successful in targeting growth to areas where capacity utilization is low, or whether we can be more successful in intervening in price setting mechanisms to enable us to drive the economy more.

But that is not relevant to today's macroeconomic policy. My remarks were directed at the effect of macroeconomic stimulus in the face of today's institutions and today's labor market-in the absence of new structural policies. Some people believe that if you stimulate the economy, the new natural rate of unemployment will magically ratchet down to three percent. I wouldn't bet money on this. If we expanded the economy by that much, inflation would explode. For that reason, running large deficits to expand the economy is a bad idea.

If one examines America's post-war economic history, it's clear that recoveries don't die of old age or lack of zip. Every recession has started because a recovery was murdered by the Federal Reserve; murdered because of a concern that inflation was starting to spiral out of control. To me, that suggests that if we want to prevent another recession, it's important to avoid the precursor of all previous recessions—inflation. That's why the risks associated with excessive expansion are not just slightly higher inflation.

***If we want to prevent another recession, it's important to avoid the precursor of all previous recessions-inflation.***
***-Lawrence Summers***

MINSKY:

Institutions are important. Over the Reagan years, the rela-

tion between aggregate demand and wage changes has changed. What had been the inflation barrier at 6.5 or 7 percent unemployment has gone to 5.5 percent. I remember 3 to 4 percent unemployment with very little inflation. It depends upon society's institutions, not just the "numbers."

The aggregates work their way into prices and outputs through to the structural. The impact of the consumption boom has been misinterpreted entirely. Reagan misinterpreted it. We gave more disposable income to the rich; they spent it. They don't save necessarily. They're going to make their money, as Keynes used to love to point out, in capital gains. In this environment they don't have to save out of disposable income. This is a structural problem.

*The consumption boom has been misinterpreted entirely. . . We gave more disposable income to the rich; they spent it. They don't save necessarily.*
*—Hyman Minsky*

One of the sources of our economic problems is that Keynesian aggregate demand policies were introduced after structural solutions to the Great Depression. The interpretation of the Great Depression at the time of the Keynesian revolution was that prices had fallen too fast. It was a common belief that price deflation had caused the Great Depression. Structural barriers to price deflation in minimum wages, agricultural price supports, trade unions, etc., were put in place to prevent another Great Depression. But eventually those rigidities became vices that could be exploited. We gave up on antitrust after it was found that firms could be used for war production. In the post-war period we used aggregate demand management in a structural setup where monopoly power led to price increases.

Car firms have power, and they use it. Trade unions were not blameless. There was a shared monopoly by the auto unions and auto companies. Inflationary pressures developed out of that formula. What Reagan did was cut into one of the links-he weakened trade unions. On the other hand, he did nothing about the companies' monopoly power. Some of the things you're seeing in LBOs, etc., is the capitalizing of market power into stock prices.

SUMMERS:

Pendulums swing and it seems to me that it is overdue to return to discussing how to bring down the natural rate of unemployment. But the purposes of discussing what macroeconomic policy in the United States should be over the next two years, the intelligent assumption to make is that over the next two or three year period the structural labor market will be pretty much the structural labor market of today. But that is not why we are here.

## Trade Deficit

**TURNER:**

Is there agreement that you cannot achieve foreign balance through the exchange rate alone, that both foreign expansion and a fall in the dollar are required to reduce the trade deficit without falling into a recession?

**GALBRAITH:**

I'm nearly as unconcerned as Yardeni and Bob Eisner with the strictly financial question of U.S. indebtedness. I'm much more concerned with developing and sustaining a global economic expansion for which the U.S. would be a prime supplier of advanced capital goods because that's where our export industries are concentrated. We can see our domestic investments sustained and validated if we can get that kind of world expansion. Part of the problem with getting an exchange rate that is suitable to U.S. competitiveness lies in the geographic distribution of our trade. In particular we could get, by some estimates, $30 billion in new exports to Latin America. But, if you look at Latin American currencies in relation to the dollar, there's no appreciation there at all, because those currencies are clearly not responsive to movements in global world interest rates. Rather, they are held down by the necessity for those governments to run large current account surpluses to make payments on their debt.

So there are measures that go beyond macroeconomic adjustments that are required to sustain our world growth in a balanced way and in a way which is favorable for a sustained expansion of U.S. exports. One of the reasons for enacting fiscal restrictions now and having them delayed in their effective dates, is that international lags are longer than domestic lags. We would not want restraint of domestic spending to come into play until after other countries' economies have had time to adjust.

However, even if you have a smooth expansion of this kind based in part upon a more rapid recovery of manufacturing, you are going to find that there isn't a happy medium of a moderate but stable growth rate, steady unemployment rates and a stable rate of inflation. There is an implicit assumption in some of the discussion that if we can get all the other macroeconomic variables right, you wouldn't have to worry about inflation, But for the structural changes to occur, the high wage industries would expand in the U.S. economy by

***There are measures that go beyond macroeconomic adjustments that are required to sustain our world growth in a balanced way and in a way which is favorable for a sustained expansion of U.S. exports.***

***-James Galbraith***

drawing labor in through higher wage settlements than in other industries. Therefore, we would probably see inflation increase even if we manage to pursue a steady expansion rate.

**DAVIDSON:**

The key question is whether the exchange rate change will keep that expansion going in Japan, West Germany and the other big oversaver countries. There is a two-part answer. One, if the dollar falls, one cannot forget the impact on Latin America. Most of their exports are dollar-fixed and they would have terrible problems servicing their debt if we allow the dollar to fall. How much more coffee will they sell?

***I think falling exchange rates are more threatening than good. . . We're not going to [increase our export markets] by exchange rates alone.***
***—Paul Davidson***

Two, do we have to get the Japanese to buy U.S. goods? The answer is no. Let them buy from Latin America. In fact, if they don't want to buy and they insist on saving, let them give it away to the Third World in a Japanese Marshall Plan. Some of it will flow back to us, and to the extent we can get the Third World into the flow of Japanese purchases or Japanese gifts, this will be a plus on a world scale. It is not difficult if one starts to use a Keynesian approach.

Are exchange rate falls good? I think falling exchange rates are more threatening than good. Again, look at the particular commodities and tell me where we're going to increase our export markets. We're not going to do it by exchange rates alone. If anything we're going to increase our oil imports in the next few years and the dollar price is going to go up. This is going to create worse problems with the exchange rate and that's going to create worse problems for Brazil, Argentina, and maybe Mexico. You really ask for disaster if you think you are going to do it by relative price changes. Relative income changes are so much easier.

**EISNER:**

I have more faith in the market than Paul does. Business will find where to sell. Brian's questionwas on target about global demand as well as the exchange rate reduction. Letting the dollar fall is going to force foreigners to look to their own domestic markets.

Further, I think Jamie is on to a basic point on the whole Third World issue that needs to be considered as part of our macroeconomic policy. We are holding down global demand in the Third World by insisting that they try to pay debts they can't pay And the sooner we recognize this, and write the

whole debt off or have a very easy settlement, the better for them and the better for us.

PRICE:

But we don't control the exchange rate. We do talk to the Bank of Japan and the others on the extent of their intervention. But I have been very dubious about our intervention affecting the exchange rate over the years.

EISNER:

The confusion is that you can't keep your own currency expensive but you can keep it cheap by buying their currencies.

BOSWORTH:

Sometimes, there is too much emphasis on points of disagreement. For example, I fully agree with Paul Davidson that there are two sides to this story. The U.S. has a very low national saving rate and some industrial countries' saving rates have stuck at amazingly high levels. Both are part of the international adjustment. But we're talking about what U.S. economic policy ought to be. The way to make the Japanese and the Germans do something is to put pressure on them and the pressure comes on them from the falling exchange rate as they start to lose export markets.

***The way to make the Japanese and the Germans do something is to put pressure on them and the pressure comes ... from the falling exchange rate as they start to lose export markets.***
***—Barry Bosworth***

Therefore, I couldn't agree more with Bob Eisner's statement that the whole key to this is to keep your hands off the exchange rate and let it decline as necessary.

I would agree with Brian Turner that if you try to get trade balance solely through an exchange rate effect, it's a very big plunge. One rule of thumb to use is that with price elasticities of unity, which is what studies have shown, to reduce the U.S. trade deficit by one percentage point of national income will require a ten percentage point fall on the real exchange rate on a trade weighted basis. When you are talking about the trade deficits that are in the range of three to four percent the exchange rate adjustment is very large.

This explains why we have had a trade deficit in the 1980s. Up to 1980, we could plan on the fact that the rest of the world GNP would grow at twice the rate of the United States. We also tend to have an income elasticity for our imports that is twice the world income elasticity for our exports. Thus if

the rest of the world grows twice the rate we do, but our propensity to import is twice the world's propensity to import our goods, the trade balance stays roughly the same, at constant real exchange rates. But that it isn't going to happen in the future. If you try to project growth for the rest of the world, you're just not going to get the productivity differentials and population growth differentials that would allow the rest of the world to grow at twice the rate of the United States. That means a declining real exchange rate for the United States. On the other hand, the effects of that on our standards of living are grossly exaggerated and we ought to keep our heads focused on American jobs. If the exchange rate has to fall a half or even a percentage point a year on a secular basis to maintain U.S. trade balance, that is not a big problem.

***If the exchange rate has to fall a half or even a percentage point a year on a secular basis to maintain U.S. trade balance, that is not a big problem.***
*-Barry Bosworth*

So the rest of the world is part of the adjustment. The more we can do in the rest of the world the less we will have to do in changes in the real exchange rates. But the key is we can't control their policies. We can't let our economic situation be dictated by their preferences with respect to budget policy or other policy

FAUX:

Does it matter if our investment is financed by foreign saving?

BOSWORTH:

It does make a difference on how the investment that Mr. Yardeni sees on the horizon is financed. The difference is who benefits from the income flow generated by the new investment. That is why it's not a good idea for a nation to consistently borrow overseas.

## Budget Deficit

MISHEL:

I just want to go back to a simple question: Do we need to be at budget balance and when?

EISNER:

We don't have a budget deficit if you measure it correctly We had a $155 billion unified budget deficit in 1988. Take away net capital investment, working from OMB estimates, that subtracts $70 billion from the $155 billion deficit, and gets you down to $85 billion. State and local government budgets have a surplus of about $55 billion getting the deficit down to $30 billion. Then, there's an inflation tax of four percent-four percent of $2,000 billion of debt held by the public is another $80 billion. By this measure you actually have a surplus.

Let's look at another important measure. For any individual or business you look at debt in relation to income. The meaning of a deficit is that it adds to debt. The question is not whether we have a deficit as we're measuring it, but whether our debt is growing too fast. Is it growing faster or slower than income? The GNP is growing about 7.5 percent per year. The debt held by the public now is some $2,000 billion. Seven and a half percent of $2,100 billion is $157 billion. That is approximately our actual current deficit. Therefore our debt/GNP ratio is stabilized.

Now you can ask, is it stabilized at too high a level? Larry and Barry might say, "Well, it was much less than that eight years ago." But it was much more than that 40 years ago. So now the question is, at what level do you want it stabilized? Answering that question comes down to addressing the impact of budget actions on unemployment and growth, on saving and investment correctly defined.

***We don't have a budget deficit if you measure it correctly.***
***—Robert Eisner***

The fundamental difference is on what we accept as full employment. What some of my colleagues have accepted as full employment seems to me to be much too easy a position.

We never have had, except in war time, an excess demand inflation in this country. To keep talking about inflation is to play into the hands of all of the people who for the 200 years of our history fought for tight money; fought for fighting inflation regardless of the impact on real output or the impact on working people.

I could ask Larry and Barry what they were calling the so-called natural rate of unemployment four or five years ago. Most of my colleagues at that time said ***6.5*** percent, some 7 percent. The whole concept is one of the most outrageous things we have developed in economics. It has no empirically sound basis. It shifts with every supply shock. What was your natural rate four years ago, Larry? Barry? I bet it was above ***5.5*** percent and if it was above ***5.5*** percent, how confident are you that ***5.5*** percent is the natural rate now? How many millions of the unemployed, how many hundreds of billions of output do you sacrifice on this faith that somehow we'll have more inflation?

**SUMMERS**:

Bob, have you ever favored *at any time* a policy that was not more expansionary?

***It's a remarkable leap of some economic theorist's imagination to assume accelerating inflation at current unemployment levels.***

***--Robert Eisner***

**EISNER:**

I have never favored less expansionary fiscal policy, except during the Vietnam War. It's ironic that it took a Vietnam War to get us ***3.5*** percent unemployment in this country. Are we always to be doomed to say that the only way to get unemployment to ***3.5*** percent is to have a war? And that war drove inflation to an astronomic height. What was it-four or five percent? And that level only in the last year. We have no basis for concluding that it was accelerating. It's a remarkable leap of some economic theorist's imagination to assume accelerating inflation at current unemployment levels.

**GALBRAITH**:

We need a tax increase package for two basic reasons. First, to nail down the Federal Reserve and get a commitment on monetary growth and lower interest rates at the earliest possible time. And second, to get the deficit off the table in the United States Congress, so that it will not stand as a barrier to increasing public capital formation. The size of that package should aim to give you a deficit in the range of two percent of GNP. This range, for some of the reasons Bob has given, corresponds to a stable debt/GNP ratio. The final deficit you actually achieve will depend on how successful you are in reaching the sustained global growth your program is designed to achieve.

**FAUX:**

Under your formulation, when we could begin making those public investments?

**GALBRAITH:**

From the moment you have a tax bill signed into law which puts a definitive deficit target into the forecast. You, then, can move to the next item on the agenda. The deficit no longer obstructs thinking clearly about the kinds of investment activities that we need to undertake.

**DAVIDSON:**

Jamie, if you have postponed income tax raises, you will see income switching between years. It will generate tremendous growth in the first year but as soon as the new tax comes in, there would be a sluggish economy.

**GALBRAITH:**

I am not terribly concerned about that problem.

**MINSKY:**

We finally got down to keeping our eye on the right targets, which are employment, growth, price levels, etc., rather than the budget issue *per se.* Maintaining aggregate demand, maintaining the U.S. deficit is a way of maintaining profit rates. Profit rates tend to be good for investment.

The big task is to maintain the linkage among profit-generating aggregate demand thrusts. The problem today is the trade. It is partly structural. We have had a 40 percent swing in the exchange rate. But while we have had a rise in the dollar supply price of Japanese cars, you haven't seen a 40 percent swing in relative prices in the U.S. Obviously, it has something to do with the structure of the automobile industry of the United States.

In terms of the natural rate of unemployment, the Reagan Administration labor policy was one of the reasons we had this shift downward in the noninflationary unemployment rate in the labor market. One cannot talk macro and micro policies in two separate compartments. One of the things to discuss is how to have a full employment policy without it being the type of full employment which generates inflation.

***One cannot talk macro and micro policies in two separate compartments.***
***—Hyman Minsky***

In the 1950s and 1960s we did have appreciably lower unemployment rates and lower inflation rates than we have now. The stronger trade unions did not lead to excessive wage increases.

We cannot ignore the financial implications of the deficit in trade and the ownership of dollar-based assets throughout the world. The Japanese aren't the largest owners of foreign assets in the United States. The British are. There has to be a distinction between the negative trade relation effect and international portfolio diversification. The British ownership is portfolio diversification. They purchase here, they purchase there. Their portfolio diversification is consistent with owning more U.S. and foreign assets. The Japanese direct investment here, on the other hand, has a negative trade relation effect.

**FAUX:**

What is your answer to Larry Mishel's question?

**MINSKY:**

The fiscal deficit is operational. If the only way we can maintain full employment is with a large fiscal deficit, then it stays. If you have enough private investment and your exports are up, then you don't need the fiscal deficit.

If I were a politician I wouldn't go out front for taxes to reduce the deficit. I would go out front for measures that would reduce our import dependence. In turn that would enable us to get along with less fiscal stimulus. Therefore, the fiscal deficit could come down.

***I would welcome the opportunity to run a budget surplus.***
***—Lawrence Summers***

**SUMMERS:**

My target would be a balanced budget by 1993, based on the economic assumptions made in current CBO forecasts. If the economy underperforms that forecast, I would accept slower progress. While it is quite unlikely the economy would perform better than that forecast, I would welcome the opportunity to run a budget surplus. This would move us closer to the goal of removing the Social Security Trust Fund from the consolidated budget.

**EISNER:**

I wonder how many around this table want to see the

private business sector balance its budget and how many want the household sector to balance its budget? And let me remind you that by conventional accounting, you're going to see that almost all private business is in deficit. What's so important about balancing the government's budget? You don't want to balance the business budget the same way.

***I wonder how many around this tab/e want to see the private business sector balance its budget.***
-Robert ***Eisner***

**YARDENI :**

Coming from Wall Street I suppose many of you might expect me to say that the budget deficit is too large and that ***we*** must cut spending or raise taxes. Actually, the moaning and groaning you hear from New York seems a bit strange to me since many people on Wall Street make a good living selling the government's bonds.

So I guess I must confess to a certain conflict of interest when I'm asked to comment on what policymakers should do about the federal deficit. Again, my instincts are to recommend that less policy is better than more policy in this area. I just can't seem to understand why there is so much hysteria about. the so-called "twin deficits." I mentioned earlier why the trade deficit doesn't bother me. I believe that better than expected growth will reduce the federal deficit. Indeed, it should be in balance within five years. But even if it remains $150 for as far as the eye can see, so what? Relative to a growing GNP, the deficit will become a smaller and smaller problem, that is if it really is a problem.

I'm not convinced that'it is a problem at all. Economists say that government expenditures are roughly 20 percent of GNP That sounds like quite a lot. But the number adds apples and oranges. The government's spending actually accounts for eight percent of GNP, and most of that is defense outlays. This ratio has been on a downtrend since the 1950s. The government has been crowded out of GNP! Government outlays on transfer payments account for the remaining 12 percent.

If we really want to eliminate the trade deficit, it is within our power to either raise taxes or to cut spending. But maybe, just maybe, we currently have the best system and we don't even know it. Higher taxes might depress economic growth. Today's low taxes are probably having the same very positive supply-side effects on people's work ethic. Do we want to cut transfers? Here again, workers are probably more productive knowing that there are safety nets in our society to help them or their relatives if adversity strikes. How pro-

ductive would you be if you had to worry about taking care of your relatives if they became ill or lost their income?

DAVIDSON:

There is a difference between the saving rate and absolute saving. We usually think of saving as a portion of income, a saving rate, but the Japanese increased saving by their income expanding as the world income expanded. So the absolute size of saving increased even though as a percentage it may not have. The same thing is true in the United States in reverse.

If we can get a more locally stimulated economy and get the surplus countries spending more, you'd get more absolute saving even if you don't change the saving ratio.' Now, if you look at United States statistics in the last year, the unemployment rate has fallen to about 5.5 percent. Where did this come from out of the GNP? Consumption is still 65 percent of GNP as it was since 1982. The government share has fallen almost one percentage point and the exports, the net export shares comes to almost one percentage point more. So what's happened is that much of our growth in employment and output has occurred because of the changes in the world growth rate.

***The Japanese hooked on to an expanding world GNP to increase their saving. That's what we've got to look for, not for changing the saving ratio within a constant world GNP.***

*-Paul Davidson*

This is not a result of the exchange rate falling. Not that relative prices have no effect, but when you think of the 40 to 50 percent decline in the exchange rate the increase in exports is pretty small. You're not going to close a $120 billion gap by the exchange rate. But the Japanese hooked on to an expanding world GNP to increase their saving. That's what we've got to look for, not for changing the saving ratio within a constant world GNP.

EISNER:

I do find a connection between the budget deficit and the current account deficit. Budget deficits over the whole period from 1955 to 1984 were associated with increased current account deficits. Also, easier monetary policy tended to reduce the current account deficit. Now the lesson of this is that you're going to get a reduction to the current account deficit through reducing the budget deficit precisely by reducing our GNP and our demand. Americans will buy less. They will buy fewer Toyotas, fewer Mercedes, but also buy fewer Chryslers and fewer Buicks. The trade deficit can be cured in a year or so with a big enough recession.

**KUTTNER:**

Reducing the current fiscal deficit in order allow increased capital formation is well worth any risks on the downside. We are not talking about very large share of GNP, only $30-$35 billion a year over the next three to four years in a $5 trillion economy. The recession risks are real but are far exceeded by the need to restore a program of public investment on the order of $50-$100 billion a year.

***You're going to get a reduction to the current account deficit through reducing the budget deficit precisely by reducing our GNP and our demand.***

***-Robert Eisner***

**EISNER:**

First, if a policy is wrong, it's not going to get anywhere. Secondly, the deficit is already down as a percentage of GNP. The thing to focus on is do we want new taxes to finance public investment or do we start switching resources from the military to public investment.

**DAVIDSON:**

According to the Federal Reserve in St. Louis, another reason not to cut the federal deficit is that state governments are going to be cutting their expenditures.

**McGARRAH:**

The state and local fiscal situations are very serious. States that were doing fine a short while ago are now in crisis. On another issue, Jamie and Ed spoke of nailing down the Federal Reserve, how can we do this?

**EISNER:**

There is more hope in nailing them down than you think. That's where we should be putting our pressure. We need to insist on an easier monetary policy. Get the Fed to act. Boskin and Bush may be easier to move in this direction than some of the Democratic congressmen. The Administration is not going to have a tax increase and they can see the importance of looser monetary policy.

## The Hard Landing Scenario

**KUTTNER:**

I want to get back to Hyman and ask if he is a basher or a crasher in relation to Japan.

**MINSKY:**

When people ask about bashing Japan, I ask, what actually do you want to do? You can threaten them with quotas, fewer imports. You talk or negotiate and you find that after awhile you may get something. In truth you may get very little.

I think there is room for tariffs. I don't find tariffs to be a problem for countries that have large holdings of international assets. They are not constrained in their fiscal policy the way countries are that have no such holdings of international assets. Deficit countries without international assets can't act unless they are willing to see their currency plummet. Even if you are willing to see your currency plummet you still have a problem. Is the rest of the world willing to buy assets denominated in your currency? If not, you have to denominate your liabilities in their currency. Then when your currency plummets, you have the Mexican situation, where it has become impossible for Mexican private business to borrow. The currency collapse makes things worse rather than better.

*Countries have a right to protect themselves against creditor surpluses . . . There's nothing wrong with protecting your citizens and your 0 wn domestic prosperity.*
*—Hyman Minsky*

One of the problems of being in our position is whether the Japanese are going to say, "If we are lending it to you, it has to be in yen." We could face the Mexican dilemma if the Japanese insist on lending in yen.

Basically when a country has fiscal independence like Japan and Europe have now, they've got to take greater responsibility for sustaining their own aggregate demand by domestic demands. Countries have a right to protect themselves against creditor surpluses because they are interested in their own employment, their own gross national product, their own structure of industry. There's nothing wrong with protecting your citizens and your own domestic prosperity.

**EISNER:**

The Keynesian lesson is that you did not have to protect yourself that way You just kept up your demand.

**MINSKY:**

You kept up your demand but you didn't like to see your demand go abroad.

**BLACKWELL:**

Before the National Economic Commission recently, some economists testified that we are in for a very hard landing in the U.S. economy unless there is a major change to reduce the budget deficit. Are they right?

***The collapse scenario is hard to make sense of.***
***-James Galbraith***

**GALBRAITH:**

The collapse scenario is hard to make sense of. I don't quite see the consistency between a collapse in the dollar and a rise in interest rates in the U.S. at the same time. It seems to me the latter would prevent the former.

What they are getting at is a scenario in which there is a collapse of confidence of international capital in the United States. The subsequent attempt to defend the dollar in face of that event would then plunge the U.S. and the world economy into a recession.

## Savings and Foreign Borrowing

KUTTNER:

I want to put this question to Hyman Minsky because I am most persuaded by what he says.

*let's talk about what it takes to generate productive investments in this country.*
*—Hyman Minsky*

Two historical examples. The U.S., in World War II, had a very high personal saving rate which was consumed by a very high government borrowing rate, much of which was invested productively. So you had both the demand side stimulus and the supply side stimulus. You had gains in productivity You had gains in real wages. You had high private saving, and high government borrowing.

MINSKY:

And the Office of Price Administration.

KUTTNER:

Right. And price controls and all kinds of institutional arrangements.

MINSKY:

Which forced saving.

KUTTNER:

After the war the countries who did the best had very high saving rates, high productivity growth, high growth and an occasionally fairly high public sector deficit which could be funded internally by the high saving rate. Now come back to the U.S. in the 1980s which has had so-so investment rates, so-so productivity growth, much of which has been funded externally. In an open economy, in order to grow at a reasonable rate, don't we need a higher saving rate internally than we now have? Can you really get a kind of pure, ultra-Keynesian system where somehow the saving rate is merely the residual of high growth and not the engine of high growth?

MINSKY:

The debate has been changed. The debate has changed *to* determinants of saving out of presumed full employment income from the determinants of productive investment in the economy, and how this productive investment will gener-

ate the saving that will offset the investment when you finally draw up the accounts of the period. What's happened is we've switched from the Keynes and Kalecki-Kaldor world in which investment called the tunes and the distribution of income between profits and wages took care of saving, to a world where everybody can borrow to finance consumption so that swings in debt-financed consumption affect saving. We've changed to a world where everybody can create money by using plastic, where getting into debt has become much easier. A country on the front line of that debt revolution may find that generating the investment that provides a rapid rate of growth will lead to historic inflation pressure through aggregate demand.

Let's talk about what it takes to generate productive investments in this country. Then ask, what does it take to have this productive investment financed so that the productive investment will stay productive investment. What is a financing structure which avoids a blowup in aggregate demand that results in open-ended inflation?

**BLACKWELL:**

It is commonly argued that the budget deficit, by claiming a large portion of savings, is causing the trade deficit. Is it not possible, as some economists in the Cambridge school maintain, that the causation runs the other way? Is it not the case that savings and tax revenues that would otherwise have been produced in the U.S. by the Reagan tax cuts accrued instead to our trading partners as a result of the current high propensity to import, leaving us with slow growth and simultaneous budget and trade deficits? Is not faster growth the best way to balance the budget deficit and provide the funds for increased investment?

***[The] view. .. that we could expand the economy very substantially, and that investment will create its own saving or that trade will create its own saving … was an instructive doctrine in 7933, but not now.***

*-Lawrence Summers*

**SUMMERS:**

There are two arguments that could provide legitimate justification for not being concerned about the problem of U.S. saving, and it's important to keep them separate.

One is what I would call "Keynesian happy talk," and that term is consciously disparaging. This view says that we could expand the economy very substantially, and that investment will create its own saving or that trade will create its own saving. That was an instructive doctrine in 1933, but not now. This is my understanding of the argument of Paul Davidson, and British economists like John Eatwell. It is an argument that Bob Eisner moves close to.

The argument is that with all these unemployed resources, if you just invest, people will be richer. People will invest more and we will have more saving.

Even with the most optimistic assumptions, to claim that we can generate a substantial increase in saving through this line of causation is absurd. Even if the United States could reduce unemployment rates to **3.5** percent and increase GNP growth by five percent, and even if the United States saved a third of the increase in GNP, this would still only increase savings by 1.5 percent. That would mean the difference between a net national savings rate of 2 percent and 3.5 percent. That's nothing. If we can do it, great. But that was based on what are clearly extraordinarily optimistic assumptions about how far we could push the economy with the current institutional structure. You can't solve the savings problem with feasible amounts of demand expansion This is not **1933.**

The second and more serious argument, which Bob Eisner raised this morning, is that there's nothing wrong with using foreign capital to finance our investment. I call this the "capital flows are OK" argument. According to this view, we want machines in America to create jobs and make our workers more productive, not so that rich Americans will earn profits from owning those machines. It doesn't really matter whether my apartment is built by Donald Trump or by the Sumitomo Bank, as long as there's housing for Americans. Trade in capital is no better or worse than trade in anything else. There is nothing wrong with the U.S. as a low saving country to borrow heavily from others to maintain a particular rate of investment.

***[The argument that] we can increase savings by stimulating the economy. .. makes no sense because the numbers don't add up.***
**-Lawrence** *Summers*

This line of reasoning is at least plausible. The questions one would then ask are, "How long can this continue?" and, "What are the risks and instabilities that go with that course?" The answers to these questions may change one's mind about the advisability of borrowing heavily from abroad.

It's important that we be clear about these different arguments. One says we can increase savings by stimulating the economy. Even with wildly optimistic assumptions, this argument makes no sense because the numbers don't add up. The other says that we can borrow from abroad to finance our investment. This strategy makes me nervous, but I can at least understand it.

**MINSKY:**

It isn't whether Trump or the Japanese build the apartment

building, but who owns the mortgage. Whether it is a Japanese bank and a Japanese pension fund that holds the mortgage or a U.S. bank and the U.S. pension fund that holds the mortgage. It's no different than when Harvard invested its pension endowment in California mortgages rather than in New England mortgages. The problem is that the California-New England imbalance is eventually solved by New Englanders migrating to California carrying their portfolios with them.

PRICE:

Larry, wasn't one of your arguments tied to the cost of capital from borrowing from abroad?

SUMMERS:

Our level of borrowing affects the cost of capital in three ways. One, we're a large country So when we are not saving, it reduces the supply of capital worldwide and raises the cost of capital worldwide.

Two, while capital is mobile in the global world economy, it is not perfectly mobile. There are large pools of domestic saving that inevitably find their way into domestic investments. That's true both here and in Japan. That's why the price of office buildings in Tokyo is bid up 60 times one year's rent, whereas it's ten times one year's rent in New York. A high saving rate in a country spills over into a low cost of capital in that country.

The third effect, which I tend to discount, is that when we borrow heavily from abroad it strains the willingness of foreigners to hold American assets, and that too raises American capital costs.

***A high saving rate in a country spills over into a low cost of capital in that country.***
*-Lawrence Summers*

## Public Investment

**FAUX:**

Some people have suggested that returns to the economy from investing in the public sector might be greater than returns to investment in the private sector. Is part of the solution to increasing our growth rate increasing investment in the public sector?

EISNER:

I also have results indicating greater productivity not merely from public investment, but from intangible investment in general. It is very important to broaden the scope of public investment discussion. Certainly, bridges, roads, harbors, airports, and preserving natural resources are investment, but to an economist investment is any economic activity that contributes to future productivity.

There is nothing greater to bolster future productivity than basic research and education. Education is overwhelmingly publicly financed. The productivity changes from trying to increase the conventional saving rate are trivial compared to the potential gains from education. That's where the potential productivity growth is.

***There is nothing greater to bolster future productivity than basic research and education... The productivity changes from trying to increase the conventional saving rate are trivial compared to the potential gains from education.***
***--Robert Eisner***

A sensible administration would push for huge public investment. I estimate your whole total tangible private capital stock (largely what we call business capital-business plant and equipment) is something less than 20 percent of the total capital stock on a cost basis when it includes education. We have to get away from the current focus on private investment which reflects a curious ideological bias in our economy. I'm not anti-capitalist, but all people ever think of when speaking of investment is private investment.

My big quarrel with Larry is that I would let people save as much as they want. The Japanese are a young population so they have to save more for their retirement. With growing income, you can save more. So, fine. But there's no reason why we should save any more than we feel like. What we call government saving is very much beside the point. The question is what is government investment. The one form of investment that we can make a social decision on is public investment. We're not making a good decision now.

SUMMERS:

It's obvious that there's a need for more public investment. But it is possible to exaggerate the magnitude of that need. No one seriously questions that the American educational system is terrible. Half the teachers are retiring in the next decade, and people are less attracted to teaching because of the low salaries, so there is room for more money to be constructively spent. But it would be a big mistake to think that the education problem was entirely or primarily a matter of not enough money. I also don't question the need for more investment in infrastructure. But if public investments are needed, one can raise taxes to finance them. It's only a matter of when and by whom those investments are paid for. In a world free of political constraints, there is no reason why decisions about public investment and the deficit have to be linked. We can pick a budget deficit target based on an appropriate stabilization strategy, and prudent levels of private investment and borrowing from abroad. Then we can decide on the right level of public investment, and raise taxes to finance it.

***It would be a big mistake to think that the education problem was entirely or primarily a matter of not enough money.***
***-Lawrence Summers***

In the real world, political considerations are very relevant. There are two possible approaches if one believes that encouraging public investment is an overriding priority One is to minimize the importance of the deficit problem. Advocates of this approach believe that it is better to raise taxes to finance them, but that public investments are so important that they should be made even in the absence of a tax increase. The alternative strategy is to eliminate the budget deficit as the central economic issue. By raising revenue and reducing defense spending, we can return to the situation prior to 1981. Before 1981, a five-year forecast always showed chronic budget surpluses, and Presidents could think about how they were going to spend that money constructively

My reading of the political process is that putting the deficit behind us is likely to lead to more public investment over the next ten years than an approach which tries to minimize the deficit problem.

GALBRAITH:

I agree. Put the deficit behind us. As a political matter, it is the essential first step. That means setting out the appropriate course for deficit reduction.

KUTTNER:

Two points, both political and real-worldly If you follow Jamie's or Larry's strategy and establish a deficit reduction path, you shouldn't have to wait until 1993 or 1992 to start increasing your public investment. There's a charming quirk in the Gramm-Rudman law that lets you increase new outlays at the margin if you finance them in the same piece of legislation. You can be doing that on one track and you can be having deficit reduction on the other track. That I think makes good public policy sense.

MINSKY:

A dedicated tax?

KUTTNER:

It doesn't have to be. For example, in the welfare reform bill last year, Senator Bradley wanted $1 billion a year for day care and training. To avoid a point of order under Gramm-Rudman, they proposed that anybody who makes over $200,000 can't deduct entertainment expenses. And everybody dodged under their desks. But that quirk in Gramm-Rudman, which requires any new proposed program not to bust the budget guidelines, allows for creative loophole closing to finance new programs. It allows you to juxtapose the welfare mother who's going to get trained versus the guy who's going to deduct a $100 lunch. It's very good politics. It allows pay-as-you-go spending on the margin for new programs with or without dedicated revenues.

***Put the deficit behind us. As a political matter, it is the essential first step.***
***-James Galbraith***

DAVIDSON:

***Do*** you want to lower total consumer expenditures?

KUTTNER:

Separate and apart from your debate with Larry about whether a deficit reduction is necessary and at what rate, it's also possible to take a dollar out of the private sector, put it into the public sector and make it deficit-neutral to increase spending.

DAVIDSON:

What about Ronald Reagan's last speech where he said, "If you allow them to tax more, they'll spend more."

**KUTTNER:**

That's the point. Yes, tax and tax, spend and spend, absolutely.

***You shouldn't have to wait until 1993 or 1992 to start increasing your public investment.***
***-Robert Kuttner***

## Social Security

FAUX:

What about the Social Security surplus? Does it have a role to play in increasing investment? Should we segregate Social Security from the budget debate, as Barry suggests?

***Any society that's aging and doesn't want to increase the burden of its own retirement on future generations, increases its saving.***
**-Barry *Bosworth***

SMITH:

The argument that somehow removing the trust fund from the consolidated budget is independently valuable is rooted in the following logic: we don't know what to do about private saving yet we have a saving problem. We need, therefore, a trick, because we can't increase private saving. So let's segregate and separate Social Security. We really can't.

BOSWORTH:

We sure can. If you can segregate out my private pension fund from the federal budget, you can segregate my public pension fund. Just because this pension fund is run by the government doesn't make it any different than any other pension fund.

SMITH:

We are going to continue to finance whatever public deficit we run by issuing treasury bonds and purchasing them with the proceeds that are going into the Social Security trust. The real issue isn't whether that trust fund is separate, the real issue is the total level of the public deficit. Solving that problem is the only way to increase the national saving rate. We will not do it by segregating the trust fund, but only by decreasing the consolidated deficit. One doesn't yield the other. One may help grease the political process, as Gramm-Rudman greased the political process. But I am not looking at the political process.

BOSWORTH:

Either you can try to tell the public that in the old days you had a budget target of balance, but now because the budget includes two percent of national income in the form of the Social Security surplus-a retirement fund, the appropriate budget target is a two percent surplus. Or you could explain it in terms most people will understand. You don't want to spend on consumption income that you are accumulating or

saving for retirement. The argument is easier to explain to people if you do accounting the way state and local governments do. They exclude the private pension funds, and the public sector workers would be outraged at the suggestion that you could raid those funds to pay for public services.

Any society that's aging and doesn't want to increase the burden of its own retirement on future generations, increases its saving. If you have an optimal saving rate, it's a function of the society's demographic characteristics. We know the baby boom is going to retire. Nobody is suggesting a fully funded Social Security fund, we are talking about a partial fund. It just turns out that the amount of this fund is the amount of saving that will generate the increased capital that will generate the increased income to future workers that will pay for the increased costs of Social Security caused by the demographic shifts.

Other countries worry about this all the time. The Japanese justify their high saving rate because they see this coming down the road. Separating Social Security is not just a gimmick. It says what you do in a society where we have been used to steadily getting younger, and is now steadily getting older, is important.

The issue is not investment here but saving here. If you're saving was invested overseas, it wouldn't matter to you. You would receive the same income. The issue has nothing to do with investment. The issue has to do with the accumulation of wealth and the income from that accumulation.

***The issue has nothing to do with investment. The issue has to do with the accumulation of wealth and the income from that accumulation.***
--Barry ***Bosworth***

SUMMERS;

Granting that proposition: is it the level of American saving or the level of American investment which matters? In an open economy, there is still a difference between the two. The argument that Barry was making is that capital is paid its marginal costs. If you invest an extra dollar, capital is paid the extra output it generates, so that everybody else is left indifferent. In that simple case, it doesn't make any difference whether the investments take place here or abroad.

That view should be qualified by two considerations. First, if we're not considering a small increase in investment, but a 25 percent increase in U.S. capital stock, then capital will not capture the whole benefit or output of that 25 percent increase. Labor will get some of that output. To that extent, we care about investments that take place in the United States and not abroad.

Second, in a world in which capital is taxed, investment flows will be determined by after-tax rates of return. Social benefits from investment are determined by pre-tax rates of return. If the US. taxes capital at a higher rate than the rest of the world, we should prefer to have investment here rather than abroad.

BOSWORTH:

You just said that old capital will lose because it is no longer the scarce factor. And workers will gain. There's a redistribution between old capital and workers. But the return to society as a whole of the investment is the same. If capital investment takes place here in the United States, it will depress the rate of return on old capital. Those capitalists don't like that. They will lose. And American workers will gain because capital is relatively more plentiful. But that's just a redistribution between the three groups of society, owners of new capital, owners of old capital and workers. What you want to compute is the social rate of return to all of society To a first approximation the percentage output gain to society of a given percentage increase in capital is invariant to the size of the capital stock or its underlying rate of increase.

***If capital investment takes place here in the United States ... American workers will gain because capital is relatively more plentiful.***
--Barry ***Bosworth***

GALBRAITH:

Following that point, Barry, then you have domestic factors capturing some of the return on foreign investments. So that it does not follow that the Japanese are getting the full benefits of their increased saving.

BOSWORTH:

American workers should want that investment here and American capitalists should not want that investment there. The issue is which will become the scarce factor, labor or capital.

SUMMERS:

It is true if a huge pool of capital comes here, all that capital will be paid the marginal price in the presence of the last bit of capital. The return to America will include all the inframarginal return and that will be captured by Americans. To that extent, we would rather have the investment take place here.

**DAVIDSON:**

With a 25 percent change in the capital stock within a period of time, under the law of diminishing returns you are going to argue marginal productivity theory? Heavens!

***It* does *not follow* that the Japanese *are getting the full benefits of their increased saving.***
***-James Galbraith***

## Monetary Policy

**FAUX:**

How confident are we that we can cut the fiscal deficit and offset the fiscal contraction with monetary stimulus? It is interesting to me that people are quite clear about their fiscal policy goals-for example, how much they want to cut the budget deficit-but less clear on monetary policy goals. For example, what interest rate target are we talking about?

***The federal Reserve should target GNP. The exchange rate is going to have to go down for this to be effective.***
***-Barry Bosworth***

**EISNER:**

We don't really know how much monetary offset you need which is why I keep insisting on getting the monetary reduction first. Don't take your chances, precisely because none of us can guarantee how much easing is needed. We have been arguing for 30 years on how much impact you get from monetary versus fiscal stimulus without a clear resolution of the picture.

**BOSWORTH:**

But I think the way we would normally want to go on monetary policy is not in terms of an interest rate target. Just as years ago, we argued that we didn't want a money supply target. What you want is to try to maintain the growth of GNP along the same full employment path. The Federal Reserve should target GNP. The exchange rate is going to have to go down for this to be effective. Yes, there will be a small reduction in the American standards of living as a result of reduced items of trade, but it will be overwhelmed by the jobs that will be created in the manufacturing sector and the improved opportunities in those sectors.

**FAUX:**

Do the jobs get created from trade through the lowering of the exchange rate or from investment through lower interest rates, or both?

**BOSWORTH:**

Little of it, this time around, will be in the investment area. The big push will be in the trade sector. Timing is very important because of the lag of trade flows behind the exchange rate change. On the existing empirical evidence, the major impact in the real terms won't hit until at least a year

later. So you have to act way ahead of time on monetary policy. That's why most people have said, don't try to do this overnight. I think a maximum tolerable speed on deficit reduction is something in the range of $30-$40 billion a year. And if Bob Eisner turns out to be right and we see the economy faltering, I'd step back.

Ultimately what we are talking about is that we should try to move on a path with a plan. If it's not working because we don't know the precise mechanism, back off. To say it might not work and therefore we're not going to try, would give up all the enormous long term benefits of restructuring the U.S. economy towards a high investment, export-oriented economy.

**EISNER:**

Barry and I almost agree, but I bet we won't. I'm not going to tell you that the $20-$30 billion deficit reduction will cause a recession. Only, it increases the risk of one. Because Barry said he wants the Fed to be committed to a policy of full employment and growth, I want to ask, at what definition of full employment and what definition of growth? You've got 5.5 percent unemployment official measure, 2.5 percent growth. Is that what you're satisfied with?

**BOSWORTH:**

No, but I also recognize that in our profession there's enormous disagreement over this. I remember going through another episode of the 1960s in which people, on the one hand said, don't worry about inflation-keep on going. And those, on the other hand, who said the policies would be inflationary

The biggest danger to sustained expansion is an outbreak of inflation that triggers the Fed with another restrictive policy. I'm willing to keep the unemployment rate temporarily right around five percent a year and see if inflation develops. If not, then we can move ahead with a lower rate of unemployment even without job training programs. But about four to five percent unemployment we will need to get into some upscaling, job retraining programs to equip the labor force to adjust to a lower level of unemployment. Macroeconomic policy can not do it alone.

***I'm willing to keep the unemployment rate temporarily right around five percent a year and see if inflation develops.***
***—Barry Bosworth***

I do see some merit in Jim Tobin's argument that keeping the labor market tight (but not so tight that you get wild

inflation) will stimulate a lot of private sector activity to train workers. But here again, that calls for a pause. You want to get the market tight to encourage training, but not shoot past it to the point where you start to generate future inflation pressures. You want to keep it just tight enough to keep job training programs in the interest of employers.

**GALBRAITH:**

The question of how much mileage you get out of monetary stimulus usually comes up in the depths of a recession. Then you have a lot of excess capacity in construction, and there is a pent-up demand for housing, automobiles, and consumer durables. In those circumstances you get fairly rapid recovery of domestic demand in response to the reduction of interest rates. That's probably not as true in present circumstances. We've had five years of growth and fairly high capacity utilization in those industries. Since 1985, we've seen that a further round of monetary easing does produce a very substantial response on trade. That's encouraging. There is probably room for a third round of monetary easing which will have still more effect on the trade picture.

It probably needs to be supplemented by measures to reach parts of our trading world which are not strongly affected by changes in our exchange rate. First is the question of the Latin debt, Second is the threat relationship which we have with Europe and Japan over their internal macroeconomic policies, for which the exchange rate and our willingness to let it drop is an excellent weapon. And third, we should think in terms of taking advantage, to the extent possible, of the emerging export markets to the Soviet Union and China.

***Monetary easing does produce a very substantial response on trade. ..It ... needs to be sup plemented by measures to reach parts of our trading world which are not strongly affected by changes in our exchange rate.***
***—James Galbraith***

## Military Spending and the Language of Macroeconomics

FAUX:

One of the problems is that the language of macroeconomics tends to confuse politicians and voters and even economists on this question. When most people hear the word "consumption," they think in terms of the private sector, or as private consumption plus government transfers. Then, there is the $300 billion military budget. Some economists consider it consumption, some investment, and for many, it is somehow placed beyond the limits of discussion.

***It's not just a "consumption binge," but a consumption binge by the Pentagon and a binge of tax expenditures for the rich.***
---Lawrence ***Mishel***

BOSWORTH:

I call it consumption.

KUTTNER:

Some of which, by the way, is invested.

EISNER:

Paradoxically, a lot of the military spending is investment. You and I may consider it worthless investment, but Star Wars is an investment. All of the missiles 'are investments. I wonder politically if you want to keep walking down that road of more taxes. If you look at public opinion polls, the public is much more ready than the people here to make the switch from the military to the other kinds of public investment.

MISHEL:

Barry, regarding this question of language, why can't we be more precise? It's not just a "consumption binge," but a consumption binge by the Pentagon and a binge of tax expenditures for the rich. We know that the increase in consumption and government spending per person was primarily due to the increase in defense spending and the tax cuts.

BOSWORTH:

And private consumption.

MISHEL:

There are no good data on whose consumption is going up by income group. My guess is that the people who are consuming more are those to whom income was redistributed. That is, those who benefitted the most from the tax cuts. So is it not true that what we are talking about is a consumption binge by the Pentagon and the rich?

***I'm sorry, I'm not a defense expert. I have a personal view, but I don't have an economic view, about the right level of defense spending.***
***-Barry Bosworth***

BOSWORTH:

I don't know who the people are who spend. All I know is that the overall private saving rate has declined and that consumption spending growth has outpaced the growth of the nation's income. On the other hand, I happen to think that the defense is consumption. It is consumption in the sense that spending on defense does not add to the nation's future productive capacity

Within that category of public consumption, I'm sorry, I'm not a defense expert. I have a personal view, but I don't have an economic view, about the right level of defense spending. As an economist I believe you should pay for defense if you want it. If Reagan wanted it, he should have raised taxes to pay for it. I'm not going to go any further than that.

I say we are spending more than we used to. It is not investment because the investment rate is below the rate of the 1970s. Therefore, if your spending is up and investment is not part of it, it must be consumption.

MISHEL:

OK, the reason I am asking this is that it has a lot of implications for how the public understands the issue.

BOSWORTH:

Yes, they are living beyond their means.

MISHEL:

But they are not, the Pentagon is. The rich are.

BOSWORTH:

The public receives public services they are not paying for.

SMITH:

The Pentagon is not living beyond its means anymore than the Department of Education. You and I would agree about

how we ought to reallocate public consumption. But it's absurd to say that there is a Pentagon budget which is somehow the reason that the federal budget is in deficit.

FAUX:

Wait a minute! Some of you were just blaming the private savings decline on consumers in general because you say they've been spending too much. In terms of the public sector, we know that the spending has been coming in the military sector. Why are you so eager to pin the blame on consumers-even though you don't know for sure who is spending-but so why be shy about pointing a finger at defense spending? Especially when the numbers are so clear.

SUMMERS:

As people who profess to be economists rather than sloganeers, I think it behooves us to say that we don't actually know, as professional experts, the "right" level of defense spending.

EISNER:

But you know about private consumption, You know what and how much they should consume. That you do know. You know their welfare functions better than they do, right?

SUMMERS:

What we spend on defense is the amount that makes sense for our national security. The fact that we have a budget deficit doesn't really have much bearing on the right amount to spend on defense. If you want to argue that we should cut the defense budget, more power to you. I happen to be on your side. But that is a different issue than the issue we as economists are in a position to defend.

*But you know about private consumption. You know what and how much [people] should consume.*
***-Robert Eisner***

KUTTNER:

Forget the defense speech. When economists and investment bankers say we have been consuming too much, the only appropriate retort to that is, what do you mean, "we"? I think that is a part of this debate. When you say America has been consuming too much and statistically eight out of ten people are consuming less, that's a perversion of the King's English, and sensible economics.

## Glossary of Terms

***Capital Consumption Allowances:*** The government's measure of the physical depreciation of the nation's capital stock. Capital consumption allowances are not the same as the depreciation allowances used for tax purposes.

***Current Account:*** In a_ nation's accounting of international transactions, generally referred to as the balance of payments, the current account measures the net flows of goods, services, and transfers. It does not include asset transactions such as loans or direct foreign investment, but it does include the net returns (interest, etc.) on foreign assets as payments for "factor services."

***Discount Rate:*** The rate at which future income streams are reduced to present dollars. Often the interest rate is used as the discount rate.

***Elasticity:*** The ratio of the relative change in one variable (e.g., quantity demanded of a good) in response to a relative change in another variable (e.g., price of a good). The demand for a commodity is said to be price elastic if the absolute value of the ratio is greater than one, inelastic if less than one, and unity if equal to one.

***Exchange Rates (Fixed and Flexible):*** Exchange rates are the prices of foreign currencies in terms of domestic currency (e.g., one pound equals two dollars) or equivalently, the foreign currency prices of the domestic currency (e.g., one dollar equals .5 pounds). After World War II, under the so-called Bretton-Woods system, exchange rates were "fixed" and countries were responsible for maintaining the established rates, devaluing only in response to chronic balance of payments difficulties. After 1971, exchange rates were made "flexible" where, theoretically, market supply and demand for currencies established their rates. However, central banks often intervened to affect the supply and demand relationships. An exchange rate depreciation or appreciation refers to the fall or rise in the value of a currency in terms of other currencies.

***Gross National Product (GNP):*** The total value of the flow of currently produced goods and services in the economy, generally measured on an annual basis.

***J-Curve:*** A description of the trend in the trade balance after a fall in the value of a country's currency. Because prices adjust faster than quantities of exports and imports, the initial effect of a currency devaluation is a rise in the trade deficit because the price of imports rises relative to exports. Later, in most cases, as the quantity of imports falls and the quantity of exports increases (in response to the price changes), the trade balance improves. Map-

ping the level of the trade balance against time on a graph, this overall pattern resembles the letter J; the trade balance gets worse before it gets better.

***Mercantilism:*** *An* approach to economic policy which tries to increase national wealth by restricting imports and promoting exports. This term is often applied to countries which pursue economic strategies based on trade surpluses.

***Net National Product (NNP):*** Gross National Product minus the capital consumption allowances (economic depreciation).

***Regression:*** A statistical technique used to estimate the functional relationship between two or more variables.

***Smoot-Hawley:*** Restrictive U.S. trade legislation passed in 1929, which some economists claim caused or worsened the Great Depression.