

# Chapter 2

## Trade and Industrial Policy for Development

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### ABSTRACT

*This chapter looks at policies for industrialization in developing countries, considering changes that have taken place since the Second World War, including the rise and subsequent demise of the so-called Washington Consensus approach. It discusses import substituting industrialization, export development, trade liberalization and the impact of post-2000 new WTO rules on trade-related policy measures. It shows how the East Asian model of substantial government intervention in the economy has been followed by a number of successful countries, not just Japan, Korea and Taiwan, but also China and Vietnam.*

### INTRODUCTION: TRADE AND INDUSTRIAL POLICY

Development involves processes of massive structural change in the economy (Lewis, 1954; Kuznets, 1966; Chenery & Syrquin, 1975). In the early stages of economic growth labour moves from agriculture, where labour productivity is low, to industry (mostly manufacturing, but also mining and public utilities), where productivity is higher. Broadly speaking, this process peaks at middle income levels and eventually the share of industry in the workforce and in national output is overtaken by the growth of services. Within manufacturing itself, further structural change occurs as output moves from simple labour-intensive activities such as textiles in the

early stages of industrial development, towards medium-tech, higher productivity industries such as metal working, and ultimately to more technologically advanced activities (UNIDO, 2013, ch7). Industrial policy is the means with which governments can hasten and influence the content of these processes beyond what the market would achieve unaided. Industrial policy is often justified to correct the many market failures in developing countries associated with externalities (about which more later). In practice too, the ‘development states’ of East Asia, particularly, such as South Korea or Taiwan have engaged in interventionist industrial policy beyond the correction of market failures (Woo-Cumings, 1999). Industrialization also, and importantly, requires the accumulation of knowledge and capabilities

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at the level of both individuals, firms and other organizations (Cimoli, Dosi & Stiglitz, 2009), which, again, offers a role for government.

Trade policy, though important in its own right – for example, exchange rate policy in relation to the balance of payments – is closely associated with policies for industrialisation. The infant industry policies so widely used in developing countries in the 1950s to the 1970s as part of import-substituting industrialization (ISI) were heavily based on protection of domestic markets by import tariffs and quotas, for example. Often the externalities that policy can work to correct – for instance where the protection of infant industries could encourage learning by doing – do not occur directly in the area of trade. However, trade policies such as tariff protection may be more appealing to governments as being cheaper or easier to administer than more direct measures.

In the years since the Second World War industrial policy has been strongly in fashion, then fallen out of fashion, and now has returned to fashion. The neoliberal ‘Washington consensus’ views in the 1980s and 1990s regarded the market failures that industrial policy could address as much less important than the failures of the state. Policies of trade liberalisation, removal of subsidies, and privatisation of both production and state marketing were widely advocated and followed in developing countries, except in East Asia. Since the 1990s there has been widespread disillusion with the experience of such market fundamentalist policies (Stiglitz, 1998), and interventionist industrial and trade policies have become more acceptable again.

While industrial policy and trade policy for industrialisation have been making a strong comeback in the 2000s and beyond, other developments in the international sphere have reduced the range of policy options (‘policy space’) available for developing countries to promote their industry (Wade, 2003). The World Trade Organisation, established in 1995 to replace GATT (the General Agreement on Tariffs and Trade, set up soon after

the second world war), has introduced various trade-related measures that prohibit policies such as local content provisions imposed on foreign inward investors which were designed to encourage local industry. The dominance of China since the 1980s in the world markets for many labour-intensive products has made it more difficult for more recent ‘late-industrialising’ countries to develop their exports and sometimes even to preserve their domestic industries.

This chapter will examine in turn the changing views on industrial and trade policy since the Second World War; trade policy and export promotion; the evolving global context for industrial and trade policies; and policy in the context of WTO rules and in a world of multilateral trade liberalisation and regional and bilateral trade agreements.

## **CHANGING VIEWS ON TRADE AND INDUSTRIAL POLICY**

The relations between trade and economic growth have been of interest since the era of the classical economists of several centuries ago. Some classical economists, such as Adam Smith and John Stuart Mill, believed that trade could be an engine of growth. Trade could promote development by allowing domestic industries to grow faster than the domestic market, achieve economies of scale, and allow economies to enjoy indirect benefits, including better incentives to work and save as a result of new goods being available to import (Thoburn, 2005).

In the years soon after the Second World War, as countries in Africa and Asia were gaining independence from colonial rule, much less optimistic views became pervasive. Writers such as Hans Singer, Gunnar Myrdal and Raoul Prebisch argued that developing countries were disadvantaged by their participation in the international economy (Singer 1950, 1975; Myrdal 1957; Prebisch 1959; surveyed in Thoburn 1977, ch.3). Overwhelmingly dependent at that time on primary commodities

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