

**COMPARATIVE ADVANTAGE, INDUSTRIAL POLICY AND THE
WORLD BANK: BACK TO FIRST PRINCIPLES**

Centre for Business Research, University of Cambridge
Working Paper No. 418

by

Ajit Singh

Emeritus Professor of Economics
University of Cambridge
Life Fellow Queens' College Cambridge
Tun Ismail Ali chair of International Finance for 2010-2011
University of Malaya, Kuala Lumpur
as14@cam.ac.uk

March 2011

This working paper forms part of the CBR research programme on Corporate Governance

Abstract

This paper provides a critical analysis of the World Bank's new thinking on industrial policy. After outlining the changing perspectives on industrial policy put forward by the World Bank over the last three decades, we argue that the bank's economists have taken one step forward (the approval for the enhanced role of the state) but also one if not two steps backward (by strong encouragement to countries to seek their current comparative advantage in pursuing industrial policy). We argue that a critical analysis of the World Bank's policy stance on industrial policy as on other main issues is essential because of the institution's hegemony in policy analysis of economic development as well as its conditionality, which may now well include what this paper regards as its inappropriate industrial policy. The analysis in the paper combines classical contributions on international trade and the world economy, relevant economic history, as well as Krugman's comments on these issues in terms of modern economic analysis. The paper concludes with reflections on the appropriate industrial policy for developing countries that the World Bank should support.

Keywords: World Bank, industrial policy, economic development, trade.

JEL Codes: L50, L52, O14, F12

Acknowledgements

Financial Support from Cambridge Endowment for Research in Finance and the Malaysian Commonwealth Trust is gratefully acknowledged. The author also wishes to thank the Centre for Business Research at Cambridge for the general support of this research.

Further information about the Centre for Business Research can be found at the following address: www.cbr.cam.ac.uk

1. Introduction

As many commentators have noted, in advanced countries structural unemployment, globalisation and the integration of poorer East European countries into the European Union have led to some concepts of industrial policy being revived (Aiginger, 2007). Similarly, in developing countries after two decades of the Washington consensus, which banished industrial policy from polite discourse, there has been recently some renewed interest in the subject by the Bretton Wood institutions. A main protagonist in the debate on industrial policy in developing countries has been the World Bank with its traditional negative attitude towards such policies. However, the recent appointment of Justin Lin as the Chief Economist of the World Bank has led to a major change in the Bank's analysis of the appropriate industrial policy for emerging, developing and transitional countries.

The main aim of this paper is to provide a critical analysis of the World Bank's new thinking on industrial policy following the debacle of the Washington consensus. As we shall see in arriving at their new formulation the World Bank economists go back to first principles. The critique, which will be presented here, will also deliberately go back to the first principles and draw on the work of classical economists, modern economic theory as well as economic history. In order to motivate the discussion the first part of the paper will outline the changing perspectives on industrial policy put forward by the World Bank over the last three decades. We will find that although the bank's economists have indeed now taken one step forward (the approval for the enhanced role of the state) it will be argued here they have taken at least one if not two steps backward (by strong encouragement to countries to seek their current comparative advantage in pursuing industrial policy). The World Bank implicitly encourages developing countries to seek unconditional openness to the world economy. It will be appreciated that a critical analysis of the World Bank's policy stance on industrial policy as on other main issues is essential because of the institution's hegemony in policy analysis of economic development as well as its conditionality, which may now well include what this paper regards as its inappropriate industrial policy.

Compared with its traditional policy stance the World Bank's new thinking makes a major new concession on the role of the state in industrial development. However the Bank's hallowed injunction to developing countries to get their prices right and to seek their comparative advantage remains intact. The presumed purpose of this injunction is to enable developing countries to reap full benefits from free international trade and finance.

In a recent debate with Ha-Joon Chang, Justin Lin outlines the World Bank's new approach to industrial policy very succinctly as follows: 'I shall argue that industrial upgrading and technological advance are best promoted by what I call a *facilitating* state – a state that facilitates the private sector's ability to exploit the country's areas of comparative advantage... the key is to make use of the country's current comparative advantage – not in the factors of production that it may have some day, but in the factors of production that it has now' (Lin in Lin and Chang 2009: 2). This proposition and the associated economic policy framework will be challenged in this contribution on the basis of comprehensive economic and historical analysis. The analysis of the paper supports that of Chang in Lin and Chang (2009) but it highlights rather different aspects of disagreement with Lin.

The present paper is organised as follows. It first reports (section 2) on the traditional World Bank approach to industrial policy, as well as on the related question of economic openness. This account is based on two of the World Bank's well known seminal contributions (1991 and 1993) to the theory and practice of economic development including industrial policy. It also discusses the evolution of the World Bank's industrial policy as a consequence of the Asian crisis of the late 1990s. Section 3 gives an account of the World Bank's new analysis of what is the best industrial policy for developing countries based on Lin (2009) in Lin and Chang (2009). Section 4 is the heart of the paper where a critique of the World Bank's prospective policy and its theoretical underpinnings are presented in the light of reflections from the history of economic thought as well as economic theory and history. This analysis combines classical contributions from Ricardo, Marshall, Keynes and Passinetti on international trade and the world economy, relevant economic history, as well as Krugman's comments on these issues in terms of modern economic analysis. The paper concludes with reflections on the appropriate industrial policy for developing countries that the World Bank should support.¹ The concluding section will also include a brief discussion on the important issue of industrial policy after the current financial crisis.

2. Evolution of the World Bank's Industrial Policy Perspectives

To appreciate the full significance of the World Bank's current thinking on industrial policy, it is best to start with the Bank's two seminal documents, (World Bank 1991, 1993). The two provide a comprehensive account of the Bank economists' thinking on development problems and their conclusions on public policy. The 1991 *Development Challenge* is important because, in the

words of the then President of the World Bank, Mr Barber Conable, it 'synthesises and interprets the lessons of forty years of development experience' by Bank economists. The significance of the 1993 *East Asian Miracle* lay in the fact that the Bank economists invariably justified their policy advice to developing countries around the world by reference to the experience of the sustained fast growth of the East Asian economies. However, the two studies complement each other and need to be considered together. The first provides the Bank's general analytical framework and its broad market-oriented approach to development issues. The second argues that, notwithstanding heavy government intervention in East Asia, the experience of these countries was still compatible with the 1991 Report's recommendation of a 'market-friendly' approach, and therefore did not necessitate any significant departures in the Bank's policy advice.

The starting point for the Development Challenge was the question: why during the last four decades were some developing countries successful in the sense of substantially raising their per capita incomes whilst others were not? The central analytical argument was that economic growth is determined essentially by the growth of total factor productivity of capital and labour. *The Development Challenge's* analyses came to the conclusion that the more open an economy, the greater the degree of competition and the higher its investment in education, the greater would be its growth of total factor productivity and hence its overall economic growth. Although the significance of the international economic factors was recognised, a major argument of the study was that domestic policy matters far more for raising per capita incomes than world economic conditions.

The Development Challenge stated: 'Economic theory and practical experience suggest that (government) interventions are likely to help provided they are market-friendly' (p. 5). In order for 'market-friendly' not to be a mere tautology, the study, to its credit, defined the concept fairly precisely in the following terms:

- a) *Intervene reluctantly.* Let markets work unless it is demonstrably better to step in... [It] is usually a mistake for the state to carry out physical production, or to protect the domestic production of a good that can be imported more cheaply and whose local production offers few spill over benefits.
- b) *Apply checks and balances.* Put interventions continually to the discipline of international and domestic markets.

- c) *Intervene openly*. Make interventions simple, transparent and subject to rules rather than official discretion.

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

Both the neoclassical and the 'market friendly' analyses encountered serious intellectual difficulties since neither could satisfactorily explain the outstanding success of East Asian economies. Heterodox authors, such as Amsden (1989), Wade (1990) and Singh (1995) pointed out at the time that, contrary to the World Bank, in countries like Japan, South Korea and Taiwan, the government played a leading and a heavily interventionist role in the course of their economic development.

The Development Challenge stated, 'The central question of this Report is why countries like Japan have succeeded so spectacularly while others have failed.' Singh (1995), therefore, suggested that the relevant issue was to what extent, if any, the Japanese followed the Report's prescriptions and a 'market-friendly' approach to development. Did the Japanese government intervene in the markets 'reluctantly': did it for example leave the prices and production priorities to be determined by the market forces and simply provide the necessary infrastructure for private enterprise to flourish? How 'transparent' was the government intervention in Japanese industry? To achieve this colossal economic success, how closely did the Japanese economy integrate with the world economy?

The Development Challenge did acknowledge the inescapable fact that there was considerable government intervention in the course of post-War Japanese development. The important issue, however, is whether the Report's characterisation of this intervention and lessons to be drawn from it were valid. Singh called attention to the overwhelming evidence which showed that the governments in Japan, South Korea and Taiwan did not intervene (a) either reluctantly or (b) transparently in any of these economies. Specifically, in their periods of fast economic growth, the governments in Japan (1950-73) and South Korea used a wide array of interventionist instruments including: import

controls; control over foreign exchange allocations; provision of subsidised credit, often at negative real interest rates, to favoured firms and industries, among other measures.

Singh concluded that between them, Japan, South Korea and Taiwan did all the things which the 'market-friendly' approach to development was not supposed to do. Above all, all three countries followed an 'industrial strategy' - a set of policies to deliberately change the market prices and production priorities - which was explicitly ruled out by this approach. *The Development Challenge* acknowledged that there was significant state intervention in all these three countries but argued that 'these economies refute the case for thorough going dirigisme as convincingly as they refute the case for "laissez-faire"' (p.5). Heterodox economists agree that the experience of these countries is certainly an argument against laissez-faire; nor does it provide any support for 'command' planning for production of the Soviet-type, which in effect supplants the market altogether. However, for mixed economy developing countries with strong governments, these economists suggested that the post-War East Asian economic history was unequivocally an argument for adopting an industrial strategy, for guiding the market, and not following the hands-off 'market-friendly' approach as enunciated in World Bank (1991).

As a response to these criticisms,² the World Bank's (1993) second volume on the *East Asian Miracle* produced a new analysis of the economic development of the high performing Asian economies (HPAEs) including Japan. This study fully acknowledged the facts of enormous government interventions in these countries. Thus, the Report: 'policy interventions took many forms - targeted and subsidised credit to selected industries. ... Some industries were promoted while others were not' (World Bank, 1993: 6). However, the Report went on to suggest that such interventions, particularly in the sphere of industrial policy, had in general a limited effect. Some of these worked for some of the time in a few countries, but overall they were neither necessary nor sufficient for the extraordinary success of these countries.

To sum up, the Bank's second stage study (World Bank, 1993) fully accepted that the government had a large role in these economies, but insisted that the industrial policies were largely ineffective. At the policy level, the Bank made no concessions at all, emphasizing that the essential lesson of the East Asian experience was to get the prices right and to follow the country's comparative advantage. However, at the theoretical level, the *East Asian Miracle* study represented a major advance in the thinking of its economists. For example, the close business-government relationship of the East Asian economies was

rationalized in terms of the so-called deliberation councils, which, it was suggested, in the real world of incomplete and missing markets improve welfare by co-ordinating investment decisions. Similarly, the performance standards imposed by these governments on business were interpreted in terms of export contests and contingent contracts, which were conducive to economic efficiency.

At the next stage, in the wake of the Asian economic crisis of the late 1990s, the Bretton Woods institutions totally changed their perspective and suggested that this crisis was a disaster waiting to happen in view of the dirigiste model of capitalism which East Asian countries had all along been following. IMF (1997) in particular argued that whatever the immediate triggers for the crisis (for example, the short term macroeconomic imbalances or property market bubbles), its 'deeper' causes were 'structural'. These derived effectively from the Asian model of capitalism which led to cronyism, over-investment, lack of competition and disregard for profits. Therefore, in its adjustment programmes for the crisis affected Asian countries, the IMF's conditionality required fundamental structural changes in the existing systems of corporate governance, labour laws, the relationship between banks and business, and capital market regulation both internal and external. In short, the Fund preferred Asian countries not only to radically alter their traditionally close government/business relationships, but to have a much diminished role for the government in economic activity altogether.

3. The World Bank's New Industrial Policy

It is against this background of anti-state, anti-traditional industrial policy thinking which pervaded the Bretton Woods institutions during much of the 1990s and 2000s that one has to assess the changes in attitudes towards industrial policy, which have been provided by Justin Lin in the Chang-Lin debate³.

In the new World Bank thinking the state has a totally different and highly positive role in economic development. Lin in Lin and Chang (2009a: 6) suggests that:

neither of us questions the importance of a major state role in promoting economic development. Perhaps this is because in the countries we know most intimately – China and South Korea – a crucial ingredient in growth was a capable and largely developmentally oriented state. The issue is

identifying the key role played by the state in those countries and other rapid developers.

This recognition of the positive role of the state in economic development is a major step forward. However, as we shall soon see, it is qualified in a serious way. The purpose of the state is to help firms and enterprises identify a country's existing comparative advantage and to guide productive activity in that direction. Mr. Lin's 'facilitating state' therefore is mainly concerned with helping the private sector explore its comparative advantage.

Justin Lin notes in Lin and Chang (2009: 3):

In summary, these severe market failures can provide a rationale for government intervention to kick start growth. But what kind of intervention? The key to answering this question is recognising that the optimal industrial structure is *endogenous* to the country's endowment structure – in terms of its relative abundance of labour and skills, capital, and natural resources. Upgrading the industrial structure requires first upgrading the endowment structure, or else the resulting industrial structure will become a drag on development. Therefore the government's role is to make sure that the economy is well launched on this endogenous process of upgrading.

Although Lin accepts a much greater role for the state in economic policies including industrial policy, in other ways his message is deeply conservative. Essentially what he is arguing is that countries should integrate with the world economy and produce according to their comparative advantage.

He argues that this is the only sure way of pursuing sustainable economic development. The comparative advantage-defying policies will inevitably fail because they will be too expensive, either for the private entrepreneurs or for the government. From this observation he draws the conclusion that countries should integrate with the world economy to benefit from world trade and finance and that by implication the optimal development strategy is free trade and capital movements.

Lin recognizes the fact that there are many examples to the contrary where the countries have defied comparative advantage and been extra-ordinarily successful. Japan and Korea are leading examples of comparative advantage defying policies. Japan first and then Korea started producing steel when their per capita income was only two and a half percent of the US per capita income.

Lin's recommendations for developing countries' integration with the world economy gives in extreme form the doctrine of getting the prices right. Lin does not go as far as suggesting that getting the prices right is enough for a country to be lifted out of poverty into high rates of economic growth. He has the state play an important role in resolving externalities, remedying incomplete information with respect to products and processes and co-ordination of plans of economic agents. However, the underlying paradigm of free trade and free capital movements as being the optimal strategy for the world economy is implicit in his analysis.⁴

It will be argued in the following sections that this is an ahistorical view, which is extremely misleading and could harm developing countries rather than help them. The operational question for developing countries is what is the optimum degree of openness for an economy. The motivation for this question comes from the fact that economic openness is a multi-dimensional concept. A country can be open, or not so open to all or some of the following: trade, exports, imports, finance, science, culture and education, migration, foreign investment, investment by its citizens and companies abroad, among other things. There is no economic theory that suggests that a country has to be open in all dimensions simultaneously. Given its economic and geopolitical situation, a country may choose to be open in some areas and not in others. The relationship between 'free trade' and optimal degree of openness will be discussed in the following two sections.

4. Optimal Degree of Openness: A Historical and Analytical Approach

In principle, one can approach the problem of defining the optimal degree of openness in two mutually non-exclusive ways. To start with, an obvious method is to use the theory regarding national planning. This involves drawing up a suitable model for the economy that would include the specification of an appropriate social preference function (or more generally, a functional), along with the relevant constraints.⁵ These constraints will typically consist of the quantification of opportunities to transform primary factors into desired commodities through either production or trade. Boundary conditions could be inserted to lend the results a greater degree of realism. The 'optimal degree of openness' will follow as a consequence from the exercise of constrained maximization. The analysis can be cast in static or dynamic terms. The solution variables involve production and /or investment levels by sectors as well as exports and imports. They can be stated as time paths if the relevant model is a time-phased one.

Typically such exercises are carried out in real terms and leave the set of complementary monetary magnitudes undetermined. These are usually worked out with the help of a macroeconomic model. There is a considerable literature on this subject and with increasing ability to handle complex optimization models on more powerful computers, it led to some improvements compared with the initial exercises carried out by Chenery, Bruno and several others in the late fifties.⁶

However, there may be many reasons to believe that the approach is not entirely satisfactory. While a planning approach does avoid easy and facile identification of the optimal degree of openness with a regime of 'free trade' it suffers from a number of limitations. First of all, the postulate of a scalar maxim may be quite inappropriate unless the degree of homogeneity is extended to future generations as well, not a very realistic assumption, to put it mildly. Secondly, the analysis cannot take into account issues connected with irreversibility over time excepting by resort to very ad hoc procedures.

Thirdly, the only bit of connection of this approach with history is through initial specification of vectors of primary factors, which are easily quantifiable. There are no simple and convenient ways of quantifying the states of knowledge to the community or its degree of absorptive capacity if inflows of factors from the outside world are considered to be relevant.

Fourthly, national planning models are rich in details for a single country. However to be operationally meaningful they have to assume that the rest of the world is either going to stay constant or change only in a predetermined way. Strategic choices are excluded.

Structural changes arising from conjunctural shifts in the world economy may also not come out from the model results as sharply as one would like.

If one were to take these criticisms seriously, then the alternative to planning exercises would be a somewhat looser but a more historically grounded approach which not merely emphasizes the advantages that are likely to accrue to a national entity from exploring opportunities to trade with the rest of the world but also emphasizes certain factors which may make it more vulnerable to outside influences. These may produce long term irreversible effects on the country's pattern of production and its ability to generate productive employment.

Such an alternative approach is quite consistent with the paradigm of classical economics, including in this respect not only Ricardo, but also Marshall in his capacity as a classical economist. Contrary to textbook analysis it is important to emphasize here that Ricardo was much more concerned with the effects of foreign trade on the rate and pattern of accumulation, than with the mere demonstration of the theorem of ‘comparative advantage’, as an exercise in static optimization. When Ricardo pleaded for a greater degree of openness of the British economy, he was not being guided merely by his artificial example of trade in cloth and wine between England and Portugal, but because of the need to capitalize on the emerging features of the British economy in the light of revolution in textiles production. Marshall understood this very well when in his ‘Memorandum on the fiscal policy of international trade’, he wrote ‘The principles on which our present fiscal system was based sixty years ago seem to me to be not ultimately derivative. They were obtained by applying certain truths, which are as universal as the truth of geometry or mechanics, to certain conditions which were transitional’ (Marshall, 1926: 386). He displayed a clear understanding of the historical specificity of maxims of policy of free trade which have been treated by many as ahistorical truths.

While Marshall clearly recognised how the changes in configuration of production forces can alter the degree and character of openness of the economy, Keynes, it would appear, was worried about a somewhat different set of factors when he was devoting his thoughts to working out schemes for post-war national reconstruction. This has to do with maintaining equilibrium in the balance of payments of different countries. As he once put it, ‘To suppose that there exists some smoothly functioning automatic mechanism of adjustment which preserves equilibrium if only we trust to methods of “laissez-faire” is a doctrinaire delusion which denigrates the lessons of historical experience without having behind it the support of sound theory’ (Keynes, 1980; pp.21-22). Now it is clear that in history there have been periods, which as Keynes himself acknowledged, payments arrangements have worked out satisfactorily. This permitted large expansions of trade and trade-induced growth. However these have been episodes that have been characterised by the presence of suitable conjunctures, as the study of the economy for the period after the Second World War, the ‘golden age’, demonstrates (Glyn, Hughes, Lipietz and Singh, 1992).

A country wishing to open up when the conjuncture is adverse in Keynes’ sense (that different economies are characterized by ‘persistent surpluses’ or ‘deficits’ without there being any mechanism to restore global equilibrium) may benefit much less and, in certain cases, may end up being much worse off than if its opening-up process were differently timed.

If timing makes a difference, and timing is indeed important, and if returns to scale are increasing, openness by virtue of assuring higher levels and growth rates of external demand may facilitate major structural changes in the economy and permit labour productivity and the per capita consumption level to increase over time. If on the other hand, the timing is wrong, a country may have to go through painful processes of adjustment precisely because it is more 'open' than otherwise.

This would once again suggest that we ought to deal with the problem of openness in terms of rate and pattern of growth of output with due recognition to carry out structural changes as and when circumstances so warrant. These time-related and conjunctural specific aspects which have considerable bearing on the desirable forms of 'openness' lead us to adopt an approach which is different from that which is usually adopted in formal planning models.

5. Arguments for Free Trade - A Critical Review

In terms of neo-classical analysis the optimal degree of openness is given by the concept of free trade. Arguments in favour of the 'free trade' position can be stated in a compact manner by referring back to the two 'fundamental theorems' of welfare economics. These theorems become relevant to the present discourse if one realizes that 'trade' can be considered as a means of production. To bring out the relevance of these theorems to this analysis, one would further follow Arrow and Hahn (1971) in as much as one would assume that domestic factor supplies can be treated as factors 'private' to a particular group of firms. This is the device that they employ to handle problems related to foreign trade within the ambit of general competitive equilibrium analysis.⁷ Factors as usual, can be treated as products with a negative sign. According to the first 'welfare theorem' a competitive equilibrium, in the absence of externalities and no satiation, constitutes a Pareto optimum. The so-called 'converse theorem' is, however, more important from our point of view and makes much more stringent demands. According to this 'converse theorem', otherwise known as the 'second theorem of welfare economics', a Pareto-optimum can be realized as a competitive equilibrium in the presence of all round 'convexity', provided suitable lump sum transfers can be arranged amongst the participants.

If these assumptions hold, then the second theorem is indeed a useful one from the planning point of view. If the economy is a small open one, and competitive equilibrium exists in the world at large, then the country is better off under 'free trade' than under any restricted form of trade, let alone autarky. Only

when the country is large enough to face downward sloping demand curves in the world market, may it be concluded that there is a first best argument for deviation from free trade. This is the essence of the so-called ‘optimum tariff’ argument. However, the result is applicable to a single country only if the rest of the world behaves as if it were passive and not engaged in retaliation in one form or other. On this argument, earnings of internationally immobile factors are in the nature of rents, that is, they are price-determined. They can fall to zero, as in the case of domestically available unskilled labour, under inappropriate demand conditions. It is assumed, however, that national authorities can take care of this problem by arranging suitable domestic compensatory income transfers, a tall order indeed.

What are the sources of major departures from the assumptions underlying the above theorem? An obvious difficulty is caused by non-convexities and increasing return to scale. Proofs of the existence of competitive equilibrium in situations involving non-convexities lack generality and are often highly restricted in nature.

What can be concluded in regard to ‘free trade’ policy in the light of pervasive increasing returns? Paul R. Krugman, who is a leading trade theorist and Nobel Prize winner, has in an earlier survey article addressed himself precisely to this issue (Krugman, 1987). Krugman noted the work of Dixit, Spence, Stiglitz and others who tried to model trade in the context of Chamberlin-type imperfect competition along with the presence of increasing returns. He carefully noted that in the type of ‘second-best’ world, which alone is relevant in the contemporary context, there is no automatic tendency for gains from trade to be realised. While the scope of gains from trade does not necessarily go down, the composition of trade changes significantly from inter-industry to intra-industry trade. Furthermore the need for government intervention can no longer be ignored. Thus, it is clear from his survey that the discussion of trade policy has taken a new turn in contrast to the earlier literature where increasing returns and market imperfections were often relegated in trade textbooks to the status of inessential modifications of the central argument couched in the context of the Heckscher-Ohlin paradigm.

While Krugman himself ends up with a justification for free trade, he noted that ‘this is not the argument that free trade is optimal because markets are efficient. Instead, it is a sadder but wiser argument for free trade as a rule of thumb in a world whose politics are as imperfect as its market’ (Krugman, 1987: 143).

The main reason behind Krugman's cautionary ending is that sophisticated interventionism is likely to be a difficult exercise in political economy. However, in essence, it is difficult to expect, for the reasons that he has elaborated as well as for others, for the world trading system to gravitate to free trading as a generally accepted rule of thumb. Instead the argument is better viewed in terms of the need for 'managed trade'. However, it is necessary to explain this notion in a little detail.

There are several reasons why trade needs to be managed. These have to deal, in a basic sense, with the fact that 'openness' can be a mixed blessing. The point was well understood by John Maynard Keynes when he changed his position from being a champion of free trade to that of an advocate for 'national self-sufficiency' in the midst of depression during the 1930s.

'Openness' can be found to be a great *advantage* for an economy for any of the following reasons:

- a) It may enable a country to concentrate its relatively specialised resources in areas of production where the world demand is highly income and price elastic;
- b) It may lead to diffusion of knowledge of the kind leading to considerable upgrading of the quality of local factors of production;
- c) It may lead to sufficient competitive pressure to eliminate certain forces of what Leibenstein has described as X-inefficiency;
- d) Trade may lead to changes in the distribution of income which can lead to a greater share of production accumulation in national income;
- e) Trade may facilitate what Schumpeter and, following him, Dahmen have stressed so much – namely an accelerated process of creative destruction.

In all these cases, we are assuming that payment arrangements are such that there is no sizeable deflationary bias in the world economy or in any of the leading countries. It was already noted above that Keynes was of the view that the classical theory of equilibrating payments arrangements was gravely deficient. The Bretton Woods system was meant to provide a mechanism that coordinated high levels of effective demand amongst trading countries. The system lasted over the period 1945-71 in the 'mutilated' form that was

acceptable to the major parties involved. Since then the world economy and its institutional arrangements have evolved. Coincidentally the world finds itself in the midst of the biggest economic downturn since the great depression of the 1930s.

Furthermore, it is important to bear in mind that there are situations in which increasing the openness of the economy may harm the quality of locally available factors. This leads to the opposite syndrome to that which we mentioned earlier. An infamous example of the adverse impact of trade liberalisation is that of the 19th century trade in textiles between machine-made materials from Britain and hand-made Indian cotton textiles. This led to huge unemployment of hand weavers which imbalanced the whole Indian agrarian economy. This is because the unemployed weavers were thrown back on the land, reducing further the land-man ratio.

Generally, it has been seen that ‘openness’ works positively if the phenomenon of ‘learning’ from contacts with the rest of the world is suitably institutionalised, and through suitable adaptation on the policy side involving appropriate government interventions which make the domestic economy more responsive to change. The experience of Japan and that of the Asian NICs would seem to suggest that home market expansion can often trigger off growth-promoting investment which then leads sequentially to import and export substitution on highly efficient lines. In its turn, home market expansion may have much to do with increases in food productivity level. Arthur Lewis also strongly underlined the importance of food productivity growth as a method of overcoming the terms of trade loss suffered by many tropical countries that concentrated their exports of beverages, etc. to cater to metropolitan markets.

In the absence of a growing home market accompanied by suitable diversification of the industrial structure, the effect of ‘openness’ can at best be a ‘once-for all gain’ from increased openness. On occasion it may lead to a subsequent accentuation of the economic difficulties of the country that liberalized its trade and investment policies in the expectation of sustained growth but without adequate preparation on the knowledge-absorption side.

It is important at this stage to pinpoint the phenomenon of learning over time as a more relevant paradigm for development gains through trade as distinct from the neoclassical emphasis on exploitation of arbitrage opportunities. John Stuart Mill was fully aware of this dimension in his classical writings on the subject, as was Alfred Marshall whose ‘Memorandum of Fiscal Policy of International

Trade' was mentioned earlier. More recently, L.L. Pasinetti has always been very emphatic on this point. (Pasinetti, 1981: chapter 11)

To drive home this point, it is worth quoting the following paragraph from Pasinetti:

The primary source of international gains is international learning (not international trade), where firms in one country are challenged by lower-priced products from abroad. They will either learn how to cut down costs or close down. Some of them, at best, may learn and survive. Furthermore, when a new product is invented in one country, the very first thing that all other countries will try to do is to learn how to make the product themselves (by buying licenses and paying royalties, if necessary). Only in the temporary learning period, or in the period which may sometimes be quite long in which internal demand is not yet big enough to allow the minimum scale required by the new methods, will [the product] normally be produced in all countries. The case of agriculture and mining is quite different. (Pasinetti, 1981: 259)

To sum up, while the classical and neoclassical arguments for 'free trade' suffer from serious conceptual and operational difficulties, there are indeed substantive benefits from 'economic openness', which are more robust than the traditional neoclassical arguments. However they can be realised only in a specific world economic conjuncture coupled with an appropriate set of domestic policies, which institutionalise learning. Instead of focussing on current comparative advantage, the World Bank's new industrial policy should attempt to encourage economic openness on a case-by-case basis.

6. Conclusions

There are two kinds of conclusions that follow from the above analysis. The first relate to industrial strategy, economic openness and strategic integration of a country with the world economy as well as the timing of these events. The second relate to the implications of the above analysis for industrial policy, after the crisis. We start with the latter subject, which is important not least because it is one of the main themes of a forthcoming special issue of the journal *Policy Studies*.

Industrial policy in the post crisis period raises rather different questions for emerging countries than for developed countries. The first point of note is that many developing countries have been very little affected by the crisis.

Countries like India, China and Brazil have continued to record strong growth rates and have not suffered sharp downturns of the kind experienced by the US, UK and Eurozone countries. Therefore the post crisis scenario for the rich and the poor countries are going to be rather different.⁸

However there is one important area in which the problems in the two groups of countries are necessarily intertwined. This is the question of global financial imbalances, particularly those relating to US and China, but also including other countries such as India, Japan and oil exporting countries. It is generally agreed that from a global perspective countries like China and India should rely more on internal than on exports or external demand for their future growth, while the opposite is the case for the US, UK and the Eurozone countries. To achieve this rebalancing speedily and in a coordinated way it is best to use industrial policy. Relying on market forces to generate the desired structural changes would be a very slow process whilst what is required are decisive steps towards balancing the world economy. It would be in the interests of both rich and poor countries to co-operate and co-ordinate industrial policies for this purpose (see further Izurieta and Singh (2010) and Cripps, Izurieta and Singh (forthcoming)).

I turn now to the second type of conclusion, which relates to the main theme of this paper, the World Bank's new industrial policy. As we have seen in the previous sections, after two decades of the rejection of industrial policy in favour of a market friendly approach to development the World Bank economists have recently undertaken a comprehensive review of policies under this rubric. They have taken a big step forward by recognising the crucial role governments play in economic development in particular in the making of the East Asian miracle. The chief economist of the World Bank notes that 'a half century later, it remains true that there are few if any examples of governments that have succeeded with a purely laissez-faire approach that does not try to come to grips with market failures, and far more examples of rapid growth in countries whose governments have led effectively. Therefore, it is incumbent upon policy-makers and researchers to identify the most effective ways of promoting the productivity growth and change in industrial structure necessary for development' (Lin, in Lin and Chang (2009: 3)).

However, under the World Bank's new industrial policy the chief task of the government is to help industry or firms to discover their current comparative advantage and act accordingly. This is the old story of close integration with the world economy through trade liberalisation. This paper has argued on the basis of the writings of the classical economists, modern economic theory as well as economic history that this approach may hinder rather than help

developing countries. While under realistic assumptions the case for free trade and current comparative advantage suffers from serious empirical and conceptual shortcomings, there is a much better and far more robust case for economic openness which neoclassical theorists usually ignore. Instead of current comparative advantage the World Bank should assist developing countries in pursuing an optimal degree of economic openness according to their individual circumstances. Rather than close integration with the world economy, developing countries should seek strategic integration that enables them to integrate up to the point where it is in their interests to do so. This was the strategy followed by the East Asian Miracle countries. The World Bank's new industrial policy would be a sure step forward if it assists developing countries to achieve similar strategic integration with the world economy.

Notes

¹ In writing this paper I have used the updated material from Singh 1995 and 2002.

² Apart from these academic attacks on the World Bank's theses on the East Asian economies, there was, importantly, criticism from the Japanese government. See Shiratori (1993) and Lall (1994).

³ This paper assumes that perspective put forward by Lin in the Chang-Lin debate is intended to be operational in due course. Justin Lin is not only the chief economist but also the Senior Vice-President of the World Bank and therefore writes with the full authority of his office.

⁴ In Lin and Chang (2009) the capital movements are not explicitly discussed but there is no ambiguity about the paradigm which he favours.

⁵ This part of the paper is based on and updates unpublished notes written by the late Prof. Sukhamoy Chakravarty (an eminent economic planner) and myself. Interested readers may obtain a copy of these notes by application to the author and to the World Institute of Development Economic Research (WIDER), Helsinki.

⁶ See for example Arrow and Hurwicz (1977), Calsamiglia (1977), and Heal, (1973).

⁷ See Arrow and Hahn (1971). They write: 'We will find it convenient to consider some commodities as being private to a firm or group of firms (e.g. managerial ability or in the case of foreign trade, domestic factor supplies)'.

⁸ On these issues see further Singh and Zammit forthcoming. See also the Special Issue of the *Cambridge Journal of Economics* on the crisis (June 2009).

References

- Aiginger, K. (2007) 'Industrial Policy: Past, Diversity, Future; Introduction to the Special Issue on the Future of Industrial Policy' *Journal of Industry Competition and Trade*, 7, 143-146.
- Arrow, K.J. and Hahn, F.H. (1971) *General Competitive analysis* (San Francisco: Holden-Day).
- Arrow, K.J. and Hurwicz, L (eds). 1977. *Studies in Resource Allocation Processes* (Cambridge: Cambridge University Press).
- Amsden, A.H. (1989) *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press).
- Calsamiglia, X. 1977. Decentralized resource allocation and increasing returns. *Journal of Economic Theory*, 14, 263-83
- Chang, H.-J., and Lin, J. (2009) 'Should Industrial Policy in Developing Countries conform to Comparative Advantage or Defy it? A Debate Between Justin Lin and Ha-Joon Chang' *Development Policy Review*, 27(5).
- Cripps, F, Izurieta, A. and Singh, A. 'Global Imbalances, Under-Consumption and Over-Borrowing: the State of the World Economy and Future Policies', forthcoming in *Development and Change*
- Glyn, A. Hughes, A. Lipietz, A. and Singh, A. (1992) 'The Rise and fall of the Golden Age' in Marglin, S.A. and Schor, J. (eds.), *The Golden Age of Capitalism* (Oxford: Oxford University Press).
- Heal, G. M. 1973. *The Theory of Economic Planning* (Amsterdam: North-Holland).

- Izurieta, A. and Singh, A. (2010) 'Does Fast Growth in India and China Help or Harm US Workers?', *Journal of Human Development and Capabilities* 11(1): 115-42.
- Keynes, J.M. (1980) 'Collected Writings', Donald Moggridge (ed), Vol.XXV (Cambridge: Cambridge University Press).
- Keynes, John Maynard (1936), *The General Theory of Employment Interest and Money* (New York: Harcourt, Brace and Company).
- Krugman, P.R. (1987) 'Is free trade passé?' in *Journal of economic Perspectives*, 1: 131-143.
- Lin, Justin Yifu (2009) *Economic Development and Transition: Thought, Strategy and Viability*. Marshall Lectures, 2007/8. (Cambridge: Cambridge University Press).
- Marshall, A. (1926) *Official Papers* (London: Macmillan & Co).
- Pasinetti, L.L. (1981) *Structural Change and Economic Growth* (Cambridge: Cambridge University Press).
- Singh, A., (1995), 'The Causes of Fast Economic Growth in East Asia', *UNCTAD Review*, pp. 91-127. Geneva.
- Singh, A., (1997), 'Financial Liberalisation, Stockmarkets and Economic Development', *Economic Journal*, 107: 771-782.
- Singh, A., (2002), 'Asian Capitalism and the Financial Crisis'. In Eatwell, J., and L. Taylor (eds.) *International Capital Markets: Systems in Transition* (Oxford: Oxford University Press), 339-367.

Singh, A. and Zammit, A. (forthcoming 2011) 'The Global Economic and Financial Crisis. Which Way Forward?', in P. Arestis, R. Sobeira and J.L. Oreiro (eds.) *An Assessment of the Global Impact of the Financial Crisis*. (Basingstoke: Palgrave Macmillan).

Wade, R. (1990) *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press).

World Bank (1991) *The Challenge of Development: World Development Report* (Washington, DC: International Bank for Reconstruction and Development).

World Bank (1993) *The East Asian Miracle* (New York: Oxford University Press, for the World Bank).
