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The Role of Trade in Growth and Development: Theory and Lessons from Experience

ANNE O. KRUEGER

At the end of the Second World War, the governments of a large number of poor economies declared rapid economic growth and rising standards of living to be a major, if not the predominant, policy objective. Some of those economies, such as Korea and India, were newly independent after years of colonial rule. Some had long been sovereign states, but low living standards distinguished them from the industrialised economies although their political objectives were similar.[1]

Most political leaders and economists rapidly came to differentiate between developed and developing economies. Economics as a discipline had a number of precepts which were fairly widely accepted. Among the most widely accepted was that of comparative advantage: if each country's resources were allocated to the goods which that country could produce relatively cheaply, living standards in each country would be higher than if each country took measures to produce all goods domestically. And, although the Great Depression and the advent of Keynesian economics had introduced the idea that a legitimate function of government was to maintain full employment and macroeconomic stability, economic theory nonetheless suggested that microeconomic interventions in the absence of market failure would not improve welfare.

The reaction of most development economists and policymakers, when confronted with the political mandate to achieve rapid growth in output and living standards and by these precepts of economics, was to conclude that developing economies' economics were 'different', and that, therefore, the economics of development was different from the economics of industrialised economies.

Several ideas were central to this conclusion. On the one hand, there was a widespread belief that there were 'structural'

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rigidities in developing economies. That, in turn, was taken to mean that responses to price signals were very slow and weak, if indeed they occurred at all. That conclusion was buttressed by experience in the Great Depression and a deep-seated suspicion of markets and their functioning, especially in ex-colonial economies where it was widely believed that colonialism had served to 'exploit' the resources of the country to enrich those in the imperial country.

For those believing that markets did not function effectively in developing economies, a natural conclusion was that government intervention would be necessary to achieve desired growth goals.[2] Policymakers therefore supported the establishment of state-owned enterprises, including manufacturing ventures and financial services provision, historically undertaken by private groups in industrialised economies. There was frequent use of direct controls over private economic activity, and little reliance on incentives and markets to achieve desired economic objectives.

Nowhere was this set of views more evident than with respect to trade and exchange rate policy in developing economies. Almost all developing economies at that time had very similar economic structures, with a very high percentage of their GDP originating from, and their labour force engaged in, agriculture. They were heavily reliant on exports of primary commodities and imported most of their manufactures, as few were produced domestically.

As Bates (1983) explains so well, it was almost universally concluded that rapid industrialisation was synonymous with rapid growth. Equally, it was thought that the only way to achieve rapid industrialisation was to protect fledgling domestic industries against foreign competition. It seemed evident to those in developing economies that their newly established industries would be unable to compete on world markets.[3] In addition, it was anticipated that establishment of new industries would require imports of machinery and equipment, while there was general pessimism about the prospects for growth of export earnings from primary commodities. It was concluded that import substitution would be necessary in order to free foreign exchange from some traditional uses, such as imports of consumer goods, to enable purchases of capital equipment, intermediate goods and raw materials to support industrialisation.

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To the arguments of economists who pointed out the principles of comparative advantage, development economists advocating import substitution had several rebuttals. They noted, *inter alia*, that the notion of comparative advantage was static, concerned with maximising real incomes at each point in time, and did not focus on the dynamic aspects of the ways in which comparative advantage might change with growth. It also seems to have been implicitly assumed that developing economies would remain specialised in primary commodity production in the absence of intervention to promote import substitution. This assumption was also flawed: it is inevitable that rising productivity in agriculture and additional investment will generate resources for development of non-primary industry. The question is the allocation of new resources among new industries. They also reiterated the view that primary commodity prices would decline secularly, and that, therefore, comparative advantage had to shift. This argument is theoretically flawed. If all market participants anticipate the future path of the terms of trade, private investors will appropriately invest without additional incentives.

Regardless of the intellectual merits of the case for comparative advantage or the case for import substitution, the views which prevailed were of those advocating automatic protection for new industries, government establishment of state-owned enterprises to manufacture industrial goods previously imported, and other means of inducing industrialisation outside normal market mechanisms. In fact, the automatic protection and other government measures for import-substitution production constituted a highly powerful incentive for private producers. For later reference, the real difficulty was that these incentives were certainly not uniform and across-the-board, i.e. awarding approximately the same returns for activities which utilised equal resources in earning or saving foreign exchange. Instead, the system quickly evolved into one with very high variation in the domestic resources employed per unit of foreign exchange in different activities.

During the 1950s, virtually all developing economies whose governments formulated development policies began utilising exchange controls in order to regulate their payments regimes. The stated motive was to maintain the exchange rate at a level that made capital goods imports 'cheap'. It was not recognised that cheapness implied excess demand and therefore rationing.

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With rationing of scarce foreign exchange, some investment projects were highly subsidised and both investment and foreign exchange were then misallocated. Simultaneously, these economies adopted measures to encourage investment in new, import-substitution industries. Quickly, however, inflationary pressures began to erode the real exchange rate, resulting in unanticipated shortfalls in foreign exchange earnings, as producers of traditional exports responded to appreciated real exchange rates.[4] The shortfall in foreign exchange earnings, combined with pressures to increase investment (and therefore imports of machinery and equipment) rapidly created considerable excess demand for foreign exchange. Import licensing measures therefore became more stringent and were, themselves, a major factor in inducing domestic investment in import-competing activities. What had started as a drive towards industrialisation through selective import substitution rapidly evolved into indiscriminate high-cost protection for any and all new products produced domestically.

From the mid-1950s, however, some economies in East Asia began following a different development strategy. Among the components of that strategy, as is now well known, was a reliance upon the international market for industrialisation through exporting. The subsequent experience of those economies, and others adopting the outward oriented strategy, contrasts sharply with the experience of economies which have maintained import-substitution policies.

Interestingly, the lessons are both pragmatic and theoretical. They provide a deeper understanding of the role of trade than does the traditional comparative advantage dictum, although they simultaneously reinforce the policy prescriptions emanating from that dictum.

In the remainder of this discussion, the focus is on those lessons. The experience of the East Asian economies after they abandoned import substitution and adopted outward-oriented trade strategies is reviewed briefly. The current theoretical understanding of the direct role of trade in growth, as learned through the contrasting experience of economies adopting import substitution and those adopting outward orientation, is then considered. The discussion concludes with a sketch of current understanding of the relationship between alternative trade policies and forms of government intervention.

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East Asian growth[5]

By now, the salient characteristics of East Asian growth have received so much attention that a very brief review will suffice. In broad terms, Korea, Singapore, Taiwan and Hong Kong have all experienced sustained rates of economic growth well in excess of those earlier thought attainable. In the 1960s, Chenery and others developed the 'two-gap' model of developing economies' growth, in which either the rate of savings or the availability of foreign exchange was thought to be the binding constraint on overall growth. As they developed that model, Chenery and Strout (1966) assumed there was a third constraint, which they described as the maximum attainable rate of growth, and suggested that the number was between 6 and 8 per cent. All East Asian economies exceeded that rate for extended periods of time, with Taiwan and Korea each achieving periods of a decade or longer with rates in excess of 10 per cent.

Each East Asian economy started from a relatively low per capita income; each adopted policies which resulted in rapid growth of exports; each had fairly conservative monetary and fiscal policies; each government provided infrastructure consistent with rapid growth; the educational attainments of the labour force rose rapidly; there was a rapid shift of the labour force from agricultural to industrial employment; and once rapid growth began, savings and investment rates rose. All were, and are, regarded as resource-poor economies, although Taiwan and Korea were net exporters of primary commodities in the 1950s.

For present purposes, it suffices to start with an overview of the economic growth experience and structure of these economies, and then to discuss some of the aspects of their recent economic history that have provided lessons for the analysis of the role of trade in growth.

Comparative growth and structures

Data on comparative growth rates and per capita gross domestic product (GDP) over the 1965–90 period are provided in Table 1.1. All four East Asian economies have grown exceptionally rapidly by world standards. Middle-income economies

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Table 1.1: Economic growth of East Asian newly industrialised economies

	GDP per capita (1990 US dollars)		Average annual rate of growth of per capita income
	1965	1991	1965–90
Hong Kong	2,544	13,430	6.2
Korea	970	6,330	7.1
Singapore	2,312	14,210	6.5
Taiwan	995	8,800	8.1
All middle-income	1,353	2,220	2.2

Note: 1976 (data were converted to 1990 prices by using the IMF Index of Dollar Export Unit Values) from the International Monetary Fund, *International Financial Statistics*.

Sources: For Hong Kong, Korea and Singapore: World Bank, *World Development Report 1992*, Oxford University Press, New York, 1992 and *World Bank News*, 29 April 1993, for 1991 data. For Taiwan, 1965 per capita income data were derived from: International Monetary Fund, *International Financial Statistics*, May 1976, IMF, Washington, D.C. 1991 per capita income for Taiwan is in current dollars from: *Economist*, Survey, 19 October, 1992:5.

as a group are estimated by the World Bank to have experienced per capita income growth of 2.2 per cent over the same period, while other Organisation for Economic Cooperation and Development (OECD) economies grew at 2.4 per cent, compared with more than 6 per cent in each of the newly industrialised economies.

Data on rates of growth of GDP and exports in each country are presented in Table 1.2. In general, the rate of growth of exports exceeded that of GDP for each country and in each time period. The exceptions were Hong Kong in the period right after the oil price increase of 1973 and between 1953 and 1962, and Singapore in the 1963–72 period. Data on the share of exports in each country's GDP for selected years over the 1953–90 period again reflect the growing importance of trade as growth took place (Table 1.3). Exports can exceed 100 per cent of GDP because GDP is a value added concept and exports are measured in value of output. In Singapore's case, there is very large *entrepôt* trade and, in addition, oil refining is a large industry as petroleum is imported and re-exported in various refined forms. In Hong Kong's case, the rapid growth in exports in the 1980s reflects the rapid increase in imports from the

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Table 1.2: Growth of real GDP and exports by country, 1953–91

	1953–62	1963–72	1973–80	1981–91
Hong Kong				
GDP	12.8[a]	11.7	10.1	6.7
Exports	6.9[a]	14.0	9.8	13.6
Korea				
GDP	3.9[a]	9.1	8.3	9.3
Exports	16.1	30.3	17.6	11.6
Singapore				
GDP	. .	10.3	8.1	7.1
Exports	0.3	6.1	29.1	9.5
Taiwan				
GDP	7.3	11.0	8.4	7.8
Exports	17.9	27.7	22.6	9.3

[a] average nominal change without 1952–53.
Sources: For Hong Kong: United Nations, *Yearbook of National Accounts Statistics*, various years, United Nations, New York. For Korea and Singapore, IFS CD-Rom.IMF. For Taiwan, data kindly provided by Dr J. Chou and Dr T.-S. Yu of Chung-Hua Institution for Economic Research.

People's Republic of China for re-export. Singapore did not separate from Malaysia until 1965, biasing Singaporean statistics for the 1963–72 period.

As rapid growth of exports (and the policies under which it took place) is a central feature of the East Asian economies, it is worthwhile to examine this phenomenon more closely. Inspection of the growth of Korean exports will suffice (Table 1.4).

The dramatic increase in exports shows up even more clearly when the very small base from which they began is taken into account. From US$33 million in 1960, Korean exports grew by more than 20-fold to US$882 million in 1970, and then grew almost 20-fold over the following decade, reaching US$17 billion in 1980. Growth tapered off still more over the 1980s, with exports 'only' increasing by a factor of 3.8. It should be noted that imports also rose dramatically, although the size of Korea's trade deficit as a proportion of GDP fell sharply over time. Nonetheless, imports as a percentage of GDP rose from around 10 per cent in the mid-1950s to over 30 per cent by the late 1980s (Table 1.3).

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Table 1.3: Share of exports and imports in GDP, (per cent)

	1953	1963	1973	1980	1990
Hong Kong					
Exports	109.13	67.14	89.26	95.71	135.15
Imports	154.61	99.74	85.53	100.61	129.72
Korea					
Exports	2.11	4.76	29.13	34.03	30.96
Imports	9.92	15.91	32.12	41.47	31.52
Singapore					
Exports	. .	124.55	87.28	165.21	149.52
Imports	. .	153.41	122.62	204.67	172.81
Taiwan					
Exports	8.64	15.22	41.60	47.76	42.70
Imports	12.00	16.60	35.35	47.71	34.86

Sources: For Hong Kong: United Nations, *Yearbook of National Accounts Statistics*, various years; United Nations, New York, and *Economic Survey of Asia and the Far East 1954*, for 1953; and United Nations, *Economic Survey of Asia and the Far East 1964*, United Nations, New York, for 1963. For Korea and Singapore, IFS CD-Rom.IMF. For Taiwan, data were kindly provided by Dr J. Chou and Dr T.-S. Yu of the Chung-Hua Institution for Economic Research.

Phenomenal growth was, of course, accompanied by a major change in the economic structure of each country. Not only did the importance of trade increase markedly as a share of GDP but the relative importance of urban activities increased greatly in Korea and Taiwan, while that of the rural areas diminished. Over the 1965–90 period, agriculture's share of GDP fell from 38 to 9 per cent in Korea, and 24 to 4 per cent in Taiwan. As Hong Kong and Singapore were city-states, there was little agriculture at the beginning of the period. Some analysts have contended that the absence of a rural sector provided a major advantage for Hong Kong and Singapore. It is true that the growth of agricultural output was slower than that of industrial output in the other two East Asian economies (in Korea, agricultural output grew at an average annual rate of just under 3 per cent over the 1965–90 period, while industrial production grew at an average annual rate in excess of 14 per cent). Over the same period, manufacturing as a percentage of GDP rose from 25 to 45 per cent in Korea, 22 to 24 per cent in Taiwan

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Table 1.4: Evolution of Korean exports and imports, 1960–90 (US$m)

	Exports	Imports
1960	33	306
1965	175	416
1970	882	1,804
1975	5,003	6,674
1980	17,214	21,598
1985	26,442	26,461
1990	63,123	65,127

Note: Both exports and imports are reported f.o.b and are from balance of payments data. Exports and imports cover both goods and non-factor services. Shares of GNP were calculated from the national income accounts.
Source: International Monetary Fund, 1990 and 1991, *International Financial Statistics Yearbook*, IMF, Washington, D.C.

and 24 to 37 per cent in Singapore, but fell from 40 to 26 per cent in Hong Kong.

In all economies, savings and investment rose as a percentage of GDP, at least until the 1980s (Table 1.5). The most dramatic increases were in the poorest economies. Taiwan and Singapore financed rates of investment above those of savings by relying heavily on private foreign investment. Korea relied more on borrowing, first from official sources in the early 1960s, and then increasingly from private commercial banks.

Evolution of economic policies in East Asian economies

As with any description of the overall features and growth experience of East Asian economies, any account of economic policies encounters both similarities and key differences. Economic histories for these economies are significantly different, and provide important clues as to the interpretation of growth experiences.

The Korean experience is the best documented among the East Asian developing economies (Cole and Lyman 1971; Frank, Kim and Westphal 1975; Kim 1991; Krueger 1980a; Mason et al. 1980). The period prior to 1960 had been one of political and economic shocks, accompanied by fairly chaotic policies, including import substitution, multiple exchange rates, and inflation rates that were among the world's highest at that time. As an accompaniment to those policies, economic growth

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Table 1.5: Savings, investment and the current account balance in GDP, 1953–90 (percentage)

	1953	1963	1973	1980	1990
Hong Kong					
Savings	..	..	..	..	..
Investment	..	..	20.61	30.61	28.53
Current account balance	..	..	..	..	..
Korea					
Savings	..	..	16.44	15.08	..
Investment	15.61	18.23	25.50	31.73	36.95
Current account balance	−3.23	−3.72	−2.25	−9.23	−0.90
Singapore					
Savings	..	..	27.11	30.46	..
Investment	..	17.46	39.20	46.34	39.13
Current account balance	..	−11.85	−15.25	−16.63	8.46
Taiwan					
Savings	14.46	19.06	34.36	32.23	29.88
Investment	14.04	18.28	29.09	33.80	22.40
Current account balance	0.40	0.78	5.28	−1.56	7.47

Sources: For Hong Kong: United Nations, *Yearbook of National Accounts Statistics*, various years, United Nations, New York; United Nations, *Economic Survey of Asia and the Far East 1954*, United Nations, New York, for 1953; and United Nations, *Economic Survey of Asia and the Far East 1964*, United Nations, New York, for 1963. For Korea: 1973 savings from United Nations, *Yearbook of National Accounts Statistics*, 1974, Vol. 3, United Nations, New York; 1980 from *1986 Korea Statistical Yearbook*; others from IFS CD-Rom.IMF. For Singapore: savings from United Nations, *Yearbook of National Accounts Statistics*, various years, United Nations, New York; others from IFS CD-Rom.IMF. For Taiwan: data were kindly provided by Dr J. Chou and Dr T.-S. Yu of the Chung-Hua Institution for Economic Research.

rates after 1953 (the year the Korean War ended) averaged only 3 to 4 per cent annually, very low for a country with possibilities for reconstruction.

In 1960, South Korea was among the poorest economies in Asia. With few natural resources and the highest ratio of people to arable land of any country in the world, outside the city-states, there seemed little prospect for economic growth. Indeed, the domestic savings rate was close to zero, and only large inflows of US foreign aid had permitted some investment. The current account deficit, financed by foreign aid, equalled

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