The question of the wisdom of adopting an export-promoting trade strategy has recurred in the history of the developing countries. Development economics was born in an atmosphere of export pessimism at the end of the World War II. By the late 1960s, however, the remarkable success of the few economies that pursued “export-promoting” (EP) rather than “import-substituting” (IS) policies swung the weight of academic opinion behind the EP strategy. Aiding this process were numerous academic findings from research projects around the world, which investigated both these EP successes and the failures of the IS countries.¹

The debt crisis of the 1980s, the sluggish world economy, and the continuing depression of primary product prices have revived export pessimism afresh. It is time again, therefore, to examine the old and new arguments that question the wisdom of the EP strategy.

The early postwar arguments in support of export pessimism are briefly reviewed below, before the precise content of an EP strategy is stated. The article then considers a few salient lessons that have emerged in the studies on the advantages of the EP strategy and examines several new sources of skepticism concerning export-promoting trade policies. The contrasts between the old (postwar) pessimism and the new pessimism prevalent today are then exploited briefly to draw a central policy lesson for the developing countries, especially in regard to the multilateral trade negotiations (MTN).²

It is well known that export pessimism characterized the thinking of most influential development economists and policymakers in the developing countries after World War II. The most articulate pro-

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ponents of the pessimist school of thought were the two great pioneers of development economics: Raul Prebisch (see Prebisch 1952 and 1984) and Ragnar Nurkse (see Nurkse 1959). Their diagnoses, however, had significant differences.

Prebisch considered the terms of trade of primary products, then the chief exports of developing countries, to be declining regardless of the policies of the developing countries. Left to themselves, producers in the developing countries would have responded to this secular price shift by industrializing, which would make (trade tariff) protection or (domestic subsidy) promotion unnecessary and unjustified. By contrast, Nurkse’s export pessimism arose from the notion that foreign markets simply could not accommodate imports on a sufficient scale as developing countries accelerated their development. Therefore, export pessimism explicitly meant “elasticity” pessimism, and the case for government intervention then follows. Nurkse, therefore, advocated what he called a policy of “balanced growth.”

Paradoxically, however, Nurkse was mindful of the costs of indiscriminate protectionism, as he had also written about the collapse of the world trading system during the 1930s (Nurkse 1953). “Balanced growth” could only mean government incentives to assist industrialization, a prescription that appears to have combined uneasily with the caveats that Nurkse expressed about protection. By contrast, Prebisch’s brand of pessimism did not justify protectionism but was nevertheless widely used by his followers to do so in Latin America.

The export pessimism of these influential economists was cast in the mold of natural forces and phenomena that the developing countries faced. Nurkse, for instance, wrote about increasing economy in the use of raw materials and a shift further from natural to synthetic materials, both dampening the demand for developing countries’ exports over time. Developing countries could do nothing to change these conditions at the source, just as one cannot do anything about bad weather. But their policies had to adjust to these conditions, just as one can buy an umbrella against the rain. (By contrast, as I note below, the second export pessimism of the 1980s is rooted in protectionist threats, which can be addressed at the source and hence have critically different implications for developing country policies.)

The export pessimism following World War II was to prove unjustified by the unfolding reality. World trade did not merely grow rapidly during the 1950s and 1960s, it grew even faster than world income. The growth rates in both output and trade were unprecedented for such sustained periods (see table 1). Furthermore, the economies that shifted quickly to an EP strategy experienced substantial improvements in their export performance. This was particularly the case for four Far Eastern economies—Hong Kong, Singapore, the Republic of Korea, and Taiwan—but it was by no means confined to them. The
Table 1. Postwar Growth Rates of World Output and Trade
(average annual percentage change)

<table>
<thead>
<tr>
<th>Period</th>
<th>World output</th>
<th>World trade</th>
</tr>
</thead>
<tbody>
<tr>
<td>1953–63</td>
<td>4.3</td>
<td>6.1</td>
</tr>
<tr>
<td>1963–73</td>
<td>5.1</td>
<td>8.9</td>
</tr>
<tr>
<td>1973–83</td>
<td>2.5</td>
<td>2.8</td>
</tr>
</tbody>
</table>


A dramatic rise in these economies’ share of trade in GDP over this period placed them well above the regression lines for trade-GDP ratios and per capita incomes. These regressions would suggest that trade-GDP ratios fall as per capita income rises, whereas these successful exporters showed a spectacular rise in their trade shares as their per capita incomes grew rapidly. Clearly, history has sided with economists such as Cairncross (1962) and Krueger (1961) who had been among the foremost critics of export pessimism.

Although the evidence of successful trade expansion decisively refuted the validity of export pessimism, the economic analysis in support of such pessimism was also to prove enlightening and has a bearing on the dissection of the resurgent, second export pessimism prevalent today. Nurkse, for instance, had embraced Robertson’s classic phrase: trade as “an engine of growth,” which established a rather strong and direct link in the export pessimists’ minds between external conditions and internal expansion. In a classic throwback to this form of argumentation, Lewis (1980) argued more recently in a much-quoted passage:

The growth rate of world trade in primary products over the period of 1873 to 1913 was 0.87 times the growth rate of industrial production in the developed countries; and just about the same relationship, about 0.87, also ruled in the two decades to 1973...

We need no elaborate statistical proof that trade depends on prosperity in the industrial countries (p. 556).

But, it is evident from several analyses, the latest being by Riedel (1984), that such stable relationships (which suggest the exclusive dominance of demand in determining trade performance) simply cannot be extracted from the export experience of developing countries in the postwar period. The export performance of these and other countries must be explained by domestic incentives (or supply) more than by external (or demand) conditions. It is worth restating the two main arguments supporting this conclusion.

First, although Lewis addresses the linkage between industrial country incomes and developing country exports of primary products,
Riedel (1984, table 4) shows that even this aggregate developing country relationship is not stable. The stability, in turn, obviously cannot be maintained for individual developing countries.

Second, it is important to note again that the postwar period has seen a dramatic shift in the export composition of developing countries toward manufactures. Developing country exports of manufactures grew threefold in the 1955–78 period and represented one-fourth of overall exports. Manufactures are now close in magnitude to the other nonfuel exports such as food, minerals, and agricultural raw materials. Of course, the successful exporters of the postwar period dominate this shift. But their experience, based on domestic policies, proves that one cannot assess trade potential through mechanical linkages to industrial country income expansion.

The most compelling aggregate statistics show that during the prosperous 1960s, developing countries’ exports of manufactures grew nearly twice as fast as the industrial countries’ incomes. The expansion of developing countries’ trade over the 1950s and 1960s occurred as protection in the industrial countries was diminishing sharply as a consequence of first the elimination of quotas and then the reduction in tariffs. Even during the troubled 1970s, developing countries’ exports of manufactures grew more than four times as rapidly as the industrial countries’ income.8

The only key question that has remained at issue, therefore, is what has been called the “fallacy of composition”: can all, or most, developing countries become successful exporters simultaneously? Or, focusing on the successful Asian exporters, the question may be put: can the Asian export model be successfully exported to all? The suspicion still lingers that the success of a few was built on the failure of the many and that, if all had shifted to the EP strategy, none would have fared well.

There are two distinct sources of this worry. The first presumes that markets would not be able to absorb all of the exports that would materialize if developing countries shifted to an EP strategy. The second argues that while the markets could be found, they would be closed by protectionist measures, provoked by the import penetration and outcries of market disruption. The second source is the major cause of export pessimism today, while the first source was the one that afflicted the earlier wave of export pessimism. I now examine the former argument and defer discussion of the latter.

First, as I shall argue more fully below, the fear that world trade would have to grow by leaps and bounds if most developing countries pursued an EP strategy is unwarranted. This fear follows from trying to put all countries on the curve estimated in Cline (1982) for the Asian exporters with very high ratios of trade to national income. The pursuit of an EP strategy simply amounts to the adoption of a
structure of incentives which does not discriminate against exports in favor of the home market. This does not imply that the resulting increases in trade-income ratios will be necessarily as dramatic as in the Far Eastern case.

Second, the share of developing countries in the markets for manufactures in most industrial countries has been, and continues to be, relatively small. In the aggregate, the share of manufactured exports from developing countries in the consumption of manufactures in the industrial countries runs at a little over 2 percent. "Absorptive capacity" purely in the market sense, therefore, is not prima facie a plausible source of worry.

Third, a chief lesson of the postwar experience is that policymakers who seek to forecast exports typically understate export potential by understating the absorptive capacity of import markets. This comes largely from having to focus on known exports and partly from downward estimation biases when price elasticities for such exports are econometrically measured. Experience underlines the enormous capacity of wholly unforeseen markets to develop when incentives exist to make profits; "miscellaneous exports" often represent the source of spectacular gains when the bias against exports, typical of IS regimes, is removed.

Fourth, trade economists have increasingly appreciated the potential for intraindustry specialization as trade opportunities open. The progressive dismantling of trade barriers within the European Communities (EC), for instance, led to increased mutual trade in similar products rather than to massive reductions in the scale of output in industry groups within industrial member states.9 There is no reason to doubt that such intraindustry trade in manufactures among developing countries and between them and the industrial countries can also develop significantly.

Finally, if we reckon with the potential for trade between developing countries where policies can change to permit its increase, and the possibility of opening new sectors such as agriculture and services to freer trade, then the export possibilities are even more abundant than the preceding arguments indicate.10

Therefore, although the postwar export pessimism was unjustified, it provided a rationale for the adoption of inward-looking trade policies in many developing countries. In addition, trade restrictions were adopted to protect the industries that had grown up fortuitously in Latin America because World War II had provided artificial induce
to set up domestic capacities to produce uninterrupted supplies from traditional, competitive suppliers abroad.11 Often, chiefly in Latin America, there was also a reluctance to devalue. Combined with high rates of inflation, this caused continuously overvalued exchange rates that amounted to a de facto IS trade policy (see the appendix).12
What Is an Export-Promoting Trade Strategy?

What exactly is meant by an export-promoting trade strategy? Clarification of the question is important, especially as the everyday usage of this phrase evokes many unrelated notions.

The definitions of EP and IS that are most widely accepted, and are used by economists who have long studied these matters, relate to incentives. The IS strategy is defined as the adoption of an effective exchange rate for the country’s exports (EER_x) which is less than that for imports (EER_m). EER_x would include, for a peso currency country, not just the pesos earned at parity from a unit dollar’s worth of export, but also any export subsidy, tax credits, and special credits. (It would also include, say, for tractor export the subsidy on the input of steel that is used in the exported tractor, so that there is no distinction between EER comparisons defined on value added or gross value, for the purpose at hand.) Similarly EER_m would add to the parity any import duty, import premiums resulting from quantitative restrictions (QRS), and other charges. If a dollar’s worth of exports fetches altogether 100 pesos, whereas a dollar’s worth of imports fetches 130 pesos, the incentive structure implies EER_x < EER_m. This constitutes a “bias against exports,” a concept that seems to have come independently into use in Bhagwati (1968), Little, Scitovsky, and Scott (1970), and Balassa (1971). This is also the hallmark of the IS strategy: it creates a net incentive to import-substitute relative to what international prices dictate.

Suppose, however, that EER_m yields 100 pesos per dollar’s worth of imports, while EER_x is also 100 pesos. Then, the home market sales will give a producer as much as exporting will: the incentive structure then implies EER_x = EER_m. Thus bias against exports will have been eliminated. This is defined as the EP strategy.

These definitions of EP and IS strategies are now in common usage. But they do raise a question: how do we christen the case where there is a significant excess of EER_x over EER_m? Where the effective exchange rate is more favorable for exports than for imports, should we not call that EP instead of the one where EER_x ≈ EER_m, as the above definitions do, and instead call the case with EER_x ≈ EER_m simply the trade-neutral or bias-free strategy? Perhaps that might have been the ideal way to do it. But the EP strategy came to be defined in the academic literature as the one with bias-free incentives simply because the empirical studies of the four Far Eastern economies, particularly in the NBER project, strongly suggested that these successful outward-oriented developers were closer to neutrality than to a substantial positive bias in favor of exports. Furthermore, countries that went from an IS strategy to a neutral strategy, which eliminated the bias against exports and improved their export performance, prompted researchers to define EP strategy in terms of neutrality. Given the now common
usage of these terms, therefore, I have suggested recently the following terminology that does least violence to what has been the practice to date:14

| IS strategy: | EER$_x$ < EER$_m$ |
| EP strategy: | EER$_x$ ≈ EER$_m$ |
| Ultra-EP strategy: | EER$_x$ > EER$_m$ |

Nonetheless, it is not uncommon, especially among policymakers, to find references to EP (or outward-oriented) trade strategy as including both the neutral and the pro–export bias strategies.15 The reader must be alert to see what exactly is the implicit definition being used in a particular context.

These definitions clearly relate to average incentives. Nonetheless, it is obvious that, within EP for instance, some activities may be import-substituting in the sense that their EER$_m$ exceeds the average EER$_x$. Thus, the pursuit of either the EP or the ultra-EP strategy does not preclude import-substituting in selected sectors. This is true for most of the successful Far Eastern developers. Nor does this fact render meaningless the distinction among the different trade strategies, as is sometimes contended. As I have argued elsewhere (Bhagwati 1986c):

We also need to remember always that the average EER$_x$ and EER$_m$ can and do conceal very substantial variations among different exports and among different imports. In view of this fact, I have long emphasized the need to distinguish between the questions of the degree of import substitution and the pattern of import substitution. Thus, within the broad aggregates of an EP country case, there may well be activities that are being import-substituted (i.e., their EER$_m$ exceeds the average EER$_x$). Indeed there often are. But one should not jump to the erroneous conclusion that there is therefore no way to think of EP versus IS and that the distinction is an artificial one—any more than one would refuse to acknowledge that the Sahara is a desert, whereas Sri Lanka is not, simply because there are some oases (p. 93).

Nor should one equate the EP strategy with the absence of government intervention, as is often done by proponents of the IS strategy and sometimes by advocates of the EP strategy as well. It is true that a laissez-faire policy would satisfy the requirement that EER$_x$ = EER$_m$. This is not a necessary condition for this outcome, however. The Far Eastern economies (with the exception of Hong Kong) and others that have come close to the EP strategy have been characterized by considerable government activity in the economic system. In my judgment, such intervention can be of great value, and almost certainly has been so, in making the EP strategy work successfully. By publicly supporting the outward-oriented strategy, by even bending in some cases toward ultra–export promotion, and by gearing the credit insti-
tutions to supporting export activities in an overt fashion, governments in these countries appear to have established the necessary confidence that their commitment to the EP strategy is serious, thus inducing firms to undertake costly investments and programs to take advantage of the EP strategy.

The laissez-faire model does not quite capture this aspect of the problem since governments, except in the models of Friedman and Bakunin, fail to abstain or self-destruct; they will invariably find something, indeed much, to do. Therefore, explicit commitment to an activist, supportive role in pursuit of the EP strategy, providing the assurance that it will be protected from inroads in pursuit of numerous other objectives in the near future, would appear to constitute a definite advantage in reaping the benefits of this strategy.

Some other caveats are also in order.

Development economists such as Chenery and his many associates have used the terminology of IS and EP in a wholly different fashion. They have typically used identities to decompose observed growth of output in an industry or the economy into components attributable to export promotion, import substitution, and other categories. Quite aside from the fact that such decompositions are, except under singular circumstances, statistical descriptions without analytical significance, they also have no relationship to the incentives-related definitions of trade strategy that have been set out here. Unfortunately, this distinction occasionally gets confused in popular discussions, especially as economists sometimes deploy both usages simultaneously (that is, using the incentives-based definition to group countries into alternative categories and the Chenery-type terminology to explain their economic performance, as in Balassa 1983).

The incentives-defined EP strategy also has to be distinguished from the traditional concept of “export-led” growth, in which a country’s exports generate income expansion attributable to direct gains from trade and indirect beneficial effects. The notion of export-led growth is closer to Nurkse’s and Lewis’s export pessimism that was dissected earlier. The incentives-related EP definition has literally nothing to do with such beneficial external phenomena. Whether the success of an EP strategy, defined in terms of freedom from bias against exports, requires the presence of a beneficial external environment is a separate issue that will be treated again in a later section that focuses on the revived export pessimism.

Finally, it is worth stressing that the concept of EP or outward orientation relates to trade incentives (direct trade policies or domestic or exchange rate policies that affect trade) but does not imply that the EP strategy countries must be equally outward-oriented in regard to their policies concerning foreign investment. Hong Kong and Singapore have been more favorable in their treatment of foreign investors
than the great majority of the IS countries, but the historic growth of Japan, presumably as an EP country, was characterized by extremely selective control on the entry of foreign investment. Logically and empirically, the two types of outward orientation, in trade and in foreign investment, are distinct phenomena, though whether one can exist efficiently without the other is an important question that has been raised in the literature and is surrounded by far more controversy than the question of the desirability of an EP strategy in trade.

With the EP strategy defined in terms of the incentive structure, the substantive conclusion that has emerged from the major research projects listed earlier is that the economic performance of the EP countries has been remarkably strong, although they had no one rooting for their success when development efforts were being initiated in the early 1950s. Here, as elsewhere, history has turned up surprises.

In evaluating this outcome, we have to distinguish between two questions: (a) why should the EP strategy have been helpful in accelerating economic development, and (b) could the acceleration have been caused by factors other than the EP strategy?

The Evidence

The serious evidence on the successful impact of the EP strategy on economic performance, as measured by an improved growth rate, has to be found in the country studies of the research projects on trade and development (listed earlier). Among these, the most compelling evidence is in the analyses in the NBER project where the EP strategy was carefully defined and transitions to it from an IS strategy by various phases were systematically investigated.17

There is also much cited evidence that relates largely to associations between growth rates of exports and growth rates of income, as in the work of Michaely (1977) who used data for 1950–73 for forty-one countries, and the further extension of this type of work by Balassa (1978) and Feder (1983).18 Complementing this approach is the altogether different statistical formulation in Michalopoulos and Jay (1973). This study takes a very different approach to the problem by using exports as an argument in estimating an economywide production function from aggregate output and factor use data. Using data for thirty-nine countries this study argued that exports are an independent input into national income.19

Neither the Michaely-Balassa-Feder nor the Michalopoulos-Jay findings, however, bear directly on the question whether the EP strategy is productive of more growth, because the incentive-related EP

Why Does an Export-Promoting Strategy Aid Development?
strategy is not the one used to examine the question of income or growth performance. It is necessary to identify whether the superior export growth rates (or higher export magnitudes) belong to the EP countries.

This is particularly worrisome since high growth rates of exports may have been caused by high growth rates of output (which, in turn, may have resulted from other exogenous factors such as a higher savings effort), rather than the other way around. Thus, if IS does not parametrically reduce trade greatly, it is conceivable that this reverse causation could lead the rapidly expanding countries, whether EP or IS, to show higher export growth rates than less rapidly expanding economies.

Hence, while these cross-country regressions are certainly interesting, valuable and suggestive, they cannot be considered compelling on the issue in question, especially as they (and conclusions based on them) are likely to be critically dependent on the period, sample of countries, and variables chosen. By contrast, the detailed country studies are methodologically superior and more persuasive. And, as noted already, they do indicate the superiority of the EP strategy.

The Reasons

Economists have been preoccupied with the reasons why the IS strategy has been generally dominated by the EP strategy, and why the countries that rapidly made the transition from the former to the latter have done better. The following hypotheses have been advanced, based on the usual mix of analytical insights, casual empiricism, and econometric evidence.20

Resource Allocation Efficiency. The first set of reasons for the success of the EP strategy relies on the fact that it brings incentives for domestic resource allocation closer to international opportunity costs and hence closer to what will generally produce efficient outcomes. This is true, not merely in the sense that there is no bias against exports and in favor of the home market (that is, EERs ≈ EERm) under the EP strategy, but also in the sense that the IS countries seem to have generally had a chaotic dispersion of EERs among the different activities within export and import-competing activities as well. That is, the degree of IS goes far and the pattern of IS reflects widely divergent incentives. By contrast, the EP strategy does better both on degree (since EERs ≈ EERm) and on pattern.

Why is the degree of bias so large and the pattern wrong under IS? The answer seems to lie in the way in which IS is often practiced and in the constraints that surround EP. Thus IS could, in principle, be contained to modest excess of EERm over EERs. But typically IS arises in the context of overvalued exchange rates and associated exchange
controls. So there is no way in which the excess of domestic over foreign prices is being tracked by government agencies in most cases, and the excesses of $E_{ERm}$ over $E_{ERx}$ simply go unnoticed. The non-transparency is fatal. By contrast, EP typically tends to constrain itself to rough equality, and ultra-EP also seems to be moderate in practice, because policy-induced excesses of $E_{ERx}$ over $E_{ERm}$ often require subsidization that is constrained by budgetary problems.

In the same way, the pattern of $E_{ERm}$ can be terribly chaotic because exchange controls and QRSs on trade will typically generate differential premiums and hence differential degrees of implied protection of thousands of import-competing activities. By contrast, the EP strategy will typically unify exchange rates, which avoids these problems and, when it relies on export subsidization, will be handled both with necessary transparency and with budgetary constraints that would then prevent wide dispersions in EERS.

The chaotic nature of differential incentives among diverse activities in IS regimes has been documented by estimates of effective rates of protection (ERPs) (though these estimates can be misleading in quantitative restrictions regimes where the import premiums may reflect effects of investment controls, indicating therefore resource denial rather than resource attraction to the high-premium and therefore, other things being equal, the high-ERP activities. The estimates of cross-sectional domestic resource costs (DRCs), which provide instead a guide to differential social returns to different activities, have also underlined these lessons. The conceptual and measurement analyses of several distinguished economists, including Michael Bruno, Max Corden, Harry Johnson, and Anne Krueger, have contributed greatly to this literature.

Directly Unproductive Profit-Seeking and Rent-Seeking Activities. Yet another important aspect of the difference between EP and IS strategies is that IS regimes are more likely to trigger what economic theorists now call directly unproductive profit-seeking (DUP) activities (Bhagwati 1982b). These activities divert resources from productive use into unproductive but profitable lobbying to change policies or to evade them or to seek the revenue and rents they generate.21 Rent-seeking activities (Krueger 1974), where lobbies chase rents attached to import licenses and other quantitative restrictions, are an important subset of such DUP activities. The diversion of entrepreneurial energies and real resources into such DUP activities tends to add to the conventionally measured losses from the high degree and chaotic pattern of IS.22

It must be admitted that, although economists have now begun to make attempts at estimating these costs, they are nowhere near arriving at plausible estimates simply because it is not yet possible to estimate realistically the production functions for returns to different
kinds of lobbying. But, as Harrod once remarked, arguments that cannot be quantified are not necessarily unimportant in economics, and the losses arising from DUP and rent-seeking activities seem presently to illustrate his observation.23

Foreign Investment. If IS regimes have tended to use domestic resources inefficiently in the ways that were just outlined, the same applies to the use of foreign resources. This is perhaps self-evident, but substantial theoretical work by Bhagwati (1973), Brecher and Diaz-Alejandro (1977), Uzawa (1969), Hamada (1974), and others has established that foreign investment that comes in over QRs and tariffs—the so-called tariff-jumping investment—is capable of immiserizing the recipient country under conditions that seem uncannily close to the conditions in the IS countries in the postwar decades. These conditions require capital flows into capital-intensive sectors in the protected activities. It is thus plausible that, if these inflows were not actually harmful, the social returns on them were at least low compared with what they would be in the EP countries where the inflows were not tariff-jumping but rather aimed at world markets, in line with the EP strategy of the recipient countries.

In addition, I have hypothesized (Bhagwati 1978 and 1986a) that, other things being equal, foreign investments into IS countries will be self-limiting in the long run because they are aimed at the home market and therefore constrained by it. If so, and there seems to be some preliminary evidence in support of this hypothesis in ongoing econometric analysis,24 then IS countries would have been handicapped also by the lower amount of foreign investment flows and not just by their lower social productivity compared with the EP countries.

Gray Area Dynamic Effects. Although the arguments so far provide ample satisfaction to those who seek to understand why the EP strategy does so well, dissatisfaction has continued to be expressed that these are arguments of static efficiency and that dynamic factors such as savings and innovations may well be favorable under an import-substituting trade strategy.

Of course, if what we are seeking to explain is the relative success of the EP countries with growth, this counterargumentation makes little sense since, even if it were true, the favorable effects from these "gray area" sources of dynamic efficiency would have been outweighed in practice by the static efficiency aspects. But the counterargumentation is not compelling anyway. Overall, it is not possible to claim that IS regimes enable a country to save more or less than EP regimes: the evidence in the NBER project, for instance, went both ways. Nor does it seem possible to maintain that EP or IS regimes are necessarily more innovative. It is possible to argue that EP regimes may lead to more competition and less-sheltered markets and hence
more innovation. But equally, Schumpeterian arguments suggest that the opposite might also be true.25

The few recent studies that have appeared do suggest that the EP strategy may encourage greater innovation. Krueger and Tuncer (1980) examined eighteen Turkish manufacturing industries during the 1963–76 period. They found that periods of low productivity growth roughly occurred during periods when foreign exchange controls were particularly restrictive and hence the IS strategy was being accentuated. The overall rate of productivity growth was also low throughout the period during which Turkey pursued an IS strategy. In an analysis of productivity change in Japan, Korea, Turkey, and Yugoslavia, Nishimizu and Robinson (1984) argue that if growth is decomposed into that due to “domestic demand expansion,” “export expansion,” and “import substitution,” the interindustrial variation in factor productivity growth reflects (except for Japan) the relative roles of export expansion and import substitution, the former causing a positive impact and the latter a negative one. However, as the authors recognize, export expansion may have been caused by productivity change rather than the other way around, the regressions begging the issue of causality.

What is the influence of economies of scale in EP and IS regimes? Theoretically, the EP success should be increased because world markets are certainly larger than home markets. But, systematic evidence is not yet available on this question. For instance, evidence is lacking to indicate whether firms that turn to export markets are characterized by greater scale of output than those firms that do not. Experience in the case of the EC suggests that trade may lead not to changes in the level of output so much as to product specialization.

Suppose however that we do assume that economies of scale will be exploited when trade expands. The cost of protection, or the gains from trade, will then rise significantly. Harris (1986) has calculated for Canada that a 3.6 percent rise in GNP could follow from the unilateral elimination of Canadian tariffs, if the economies of scale are fully exploited.

Finally, in the matter of X-efficiency, it is again plausible that firms under IS regimes should find themselves more frequently in sheltered and monopolistic environments than those under EP regimes; a great deal of such evidence is available from the country studies in the several research projects discussed. X-efficiency therefore ought to be greater under the EP regime. However, as is well known, this is a notoriously gray area where measurement has often turned out to be elusive.

Although the arguments for the success of the EP strategy based on economies of scale and X-efficiency are plausible, empirical support for them is not available. The arguments on savings and innovation
provide a less than compelling case for showing that EP is necessarily better on their account than IS.

Growth and Other Objectives

A final word is necessary on the superior economic performance of the EP strategy. Much like the die-hard monetarists who keep shifting their definitions of money as necessary in order to keep their faith, the proponents of IS have tended to shift their objections as required by the state of the art.

When it became evident that the EP strategy yielded higher growth and that the static versus dynamic efficiency arguments were not persuasive and probably went in favor of the EP strategy, the IS proponents shifted ground. They took to arguing that the objective of development was not growth but the alleviation of poverty or unemployment and that EP might be better for growth but was worse for these other objectives. This was part of a larger argument that became fashionable during the 1970s in certain development circles: that growth had been the objective of development to date; that the objective was wrong; that the true objective of poverty amelioration was ill served by development efforts directed at growth; and that growth even harmed (in certain formulations of such critics) the poor.

The evidence does not support the views that growth was desired in itself, that poverty elimination was not a stated objective which was pursued by the acceleration of growth rates to "pull up" the poor into gainful employment, and that growth on a sustained basis has not helped the poor. These orthodoxies are no longer regarded as plausible, as I have argued at length elsewhere.26

In regard to the narrower question at hand, that is, whether the EP strategy procures efficiency and growth but adversely affects poverty and employment, evidence has now been gathered extensively in a sequel NBER project, directed by Krueger (1982). Essentially, she and her associates document how investment allocation under EP requires the expansion of labor-intensive activities, because developing country exports are typically labor-intensive. Therefore, EP strategies tend to encourage the use of labor and hence the growth of employment and the alleviation of poverty in countries that typically have underemployed labor.

Moreover, after more than two decades of successful growth in the EP regimes, especially in the four Far Eastern economies, it has become easier for economists to contemplate and comprehend the effects of compound rates and the advantages of being on rapid escalators. Even if it had been true that the EP strategy yielded currently lower employment or lower real wages, the rapid growth rates would overwhelm these disadvantages in the time of simply one generation. It
would appear therefore that both the employment-intensive nature of EP growth in developing countries and the higher growth rates in the EP countries have provided a substantial antidote to the poverty and underemployment that afflicted these countries at the start of their development process.

These lessons were important. Many developing countries learned them the hard way: by following IS policies too long and seeing the fortunate few pursuing the EP strategy do much better. Perhaps learning by others’ doing and one’s own undoing is the most common form of education!

But just as these lessons were widely accepted, and a “new orthodoxy” in their favor was established, a new wave of export pessimism arrived on the scene. This second export pessimism, which is paradoxically both more serious and more tractable in principle, tends to undermine the desired shift to the EP strategy in the developing countries.

There are two sets of factors generating this pessimism: (a) objective events such as the slowing down of the world economy since the 1970s and the resurgence of powerful protectionist sentiments in the industrial countries, and (b) new intellectual and academic arguments in support of inward-looking trade policies in the developing countries. The two are not entirely unrelated since theory, especially international trade theory, does not grow in a vacuum. But they can be dealt with sequentially nonetheless.

In essence, the second export pessimism rests on the view that, whatever the market-defined absorptive capacity for the exports of the developing countries, the politics of protectionism in the industrial countries (which still constitute the chief markets of developing country exports) is such that the exports from developing countries face serious and crippling constraints that make the pursuit of an EP strategy (with $\text{EER}_x \approx \text{EER}_m$) inefficient, if not positively foolish.

If this assessment is correct, then the EP strategy’s premise that foreign markets are available at prices largely independent of one’s own exports is certainly not valid. But this must be correctly understood. If Brazil successfully exports footwear, for example, and the importing countries invoke market-disruption-related QRS, or frivolous countervailing duty (CVD) retaliation, then Brazil faces a less than perfectly elastic market for footwear, and an optimal tariff (that is, a shift to IS strategy) in this sector is called for. This should justify only selective protection, carefully devised and administered, not a general IS strategy. If, however, this response is feared no matter what is exported, that is, the fear of protectionism is nearly universal in scope, a generalized shift to IS strategy unfortunately would be appropriate.

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The second pessimism, like the first, takes the latter, vastly more fearsome form, extending to exports generally. The resulting case for a general shift to the EP strategy then collapses only if the protectionist threat can be shown to be less serious than it appears or if the threat, even though serious, can be contained by multilateral efforts or other policy options that ought to be undertaken along with the EP strategy. As it happens, a case can be made in support of both these responses.

**How Serious Is the Protectionist Threat?**

In assessing the extent to which the protectionist threat must be taken seriously, one may first make the prudential statement that it should never be regarded lightly. Sectional interests have always provided the political momentum through congresses and parliaments to protectionist responses to import competition. The postwar history of trade barriers also shows, however, the important role that executive branches have played in upholding the national interest, broadly served by freer trade and specialization. The real question is: has the threat become sufficiently more serious so that the developing countries ought to turn away from embracing the EP strategy?

First, a few facts need to be noted. As table 1 briefly indicates, trade expansion has certainly slowed considerably since the 1970s. But even so, world trade has grown faster than world income during the 1970–83 period. More compelling is the fact that the developing countries’ exports of manufactures to the industrial countries have grown almost twice as fast as the exports of these countries to one another, showing even during the 1970s a growth rate of more than 8 percent annually. This has happened during a period when nontariff barriers (NTBS), such as voluntary export restraints (VERS), began to proliferate and when the OECD countries showed sluggish growth rates and increased unemployment.

That exports from the developing countries continued to grow in this fashion was first highlighted by Hughes and Krueger (1984) who thought that it was a puzzle since a large amount of actual protection seemed to have already been adopted. This puzzle has stimulated Baldwin (1982 and 1985) into developing an interesting thesis: that protection is far less effective than one thinks simply because there are many ways in which exporting countries can get around it in continuing to increase their export earnings. Thus, Baldwin has written:

Consider the response of exporting firms to the imposition of tighter foreign restrictions on imports of a particular product. One immediate response will be to try to ship the product in a form which is not covered by the restriction... One case involves coats with removable sleeves. By importing sleeves unattached, the rest of the coat comes in as a vest, thereby qualifying for more favorable tariff treatment...
The use of substitute components is another common way of getting around import restrictions. The quotas on imports of sugar into the United States only apply to pure sugar, defined as 100 percent sucrose. Foreign exporters are avoiding the quotas by shipping sugar products consisting mainly of sucrose, but also containing a sugar substitute, for example, dextrose... At one time, exporters of running shoes to the United States avoided the high tariff on rubber footwear by using leather for most of the upper portion of the shoes, thereby qualifying for duty treatment as leather shoes” (1985, p. 110).

Yoffie (1983) has also recently examined the VERS on footwear and textiles from a political scientist’s perspective and found that the dynamic exporting economies such as Korea and Taiwan have embraced them with considerable ingenuity, much like what Baldwin has documented, to continue expanding their exports significantly.

There is also a more subtle factor at play here which relates to why VERS may have provided the mechanism by which the executive branches of government interested in maintaining freer trade may have succeeded in keeping trade expanding. VERS are, in that view, a “porous” form of protection that is deliberately preferred because of this nontransparent porousness. I have argued recently (Bhagwati 1986b) that in industries such as footwear, two characteristics seem to hold that lend support to this porous protection model as an explanation for why protection is ineffective: (a) undifferentiated products (that is, cheaper varieties of garments and footwear) make it easy to “transship,” that is, to cheat on rules of origin, passing off products of a country restricted by VERS as products of countries not covered by VERS; and (b) low start-up costs and therefore small recoupment horizons apply in shifting investment and hence products to adjacent third countries that are not covered by VERS, so that an exporting country can get around (admittedly at some cost) the VERS by “investment-shunting” to sources unaflected by VERS. This strategy allows the exporter to recover his investment costs, since it is usually some time before the VERS get around to covering these alternative sources, or VERS are eliminated as the political pressure subsides (as was the case with U.S. footwear).27

In both ways, therefore, VERS in these types of industries can yield a “close-to-free-trade” solution for the exporting countries. These countries can continue to profit from their comparative advantage by effectively exploiting, legally (through investment-shunting) and illegally (through transshipments), the fact that VERS leave third countries out whereas importing country tariffs and quotas do not.28

But the question then arises: why would the protecting importing countries prefer this porous protection? Does it not imply that the

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market-disrupted industry fails to be protected as it would under a corresponding import trade restraint? Indeed it does. But that is precisely its attractiveness.

If executive branches want free trade in the national interest whereas legislatures respond to the sectoral interests—definitely the stylized description of the “two-headed” democracies in the United States and the United Kingdom—then it can be argued that executives will prefer to use a porous form of protection which, while ensuring freer market access, will nonetheless manage to appear as a concession to the political demands for protection from the legislature or from their constituencies. Undoubtedly, these protectionist groups and their congressional spokesmen will eventually complain about continuing imports. But then the executive branch can always cite its VER actions, promise to look into complaints and perhaps bring other countries into the VER net, and continue to obfuscate and buy time without effectively protecting.29

If the foregoing arguments suggest that executives have been clever enough, both in exporting and importing countries, in keeping markets much more open than the casual reading of the newspapers would suggest, there are also additional forces in favor of freer trade that have now emerged in the world economy which need to be considered in making a reasonable assessment of the prospects for increased protectionist measures. I believe that the international political economy has changed dramatically in the last two decades to generate new and influential actors that are supportive of freer world trade.

A fairly common complaint on the part of analysts of the political economy has been the asymmetry of pressure groups in the tariff-making process. The beneficiaries of protection are often concentrated, whereas its victims tend to be either diffused (as is the case with final consumers) or unable to recognize the losses they incur (as when protection indirectly affects exports and hence hurts those engaged in producing exportables).30

Direct foreign investment (DFI) and the growing maze of globalized production have changed this equation perceptibly. When DFI is undertaken, not for tariff-jumping in locally sheltered markets, but for exports to the home country or to third markets, as is increasingly the case, protectionism threatens the investments so made and tends to galvanize these influential multinationals into lobbying to keep markets open. For example, it was noticeable that when the U.S. semiconductor suppliers recently gathered to discuss antidumping legal action against Japanese producers of memory microchips known as EPROMS (or erasable programmable read-only memories), noticeably absent were Motorola Inc. and Texas Instruments Inc. who produce semiconductors in Japan and expect to be shipping some back to the United States.31
Almost certainly a main reason why U.S. protectionism has not translated into a disastrous Smoot-Hawley scenario, despite high unemployment levels and the seriously overvalued dollar (in the Dutch Disease sense), is that far fewer congressmen today have constituencies where DFI has not created such protrade, antiprotectionist presence, muddying waters where protectionists would have otherwise sailed with great ease. The “spiderweb” phenomenon resulting from DFI that criss-crosses the world economy has thus been a stabilizing force in favor of holding the protectionists at bay.

It is not just the DFI in place that provides these trade-reinforcing political pressures.\textsuperscript{32} The reaction against import competition has been diluted by the possibility of using international factor mobility as a policy response. Thus, the possibility of undertaking DFI when faced with import competition also provides an alternative to a protectionist response. Since this is the capitalist response, rather than a response of labor to “losing jobs abroad,” the defusion of the protectionist threat that is implied here works by breaking the customary alliance between capital and labor within an industry in their protectionist lobbying, a relationship with which Magee has made us long familiar.

Labor today seems also to have caught on to this game and is not averse to using threats of protection to induce DFI from foreign competitors instead. The United Auto Workers labor union in the United States appears to have helped to induce Japanese investments in the car industry. This is quite a generic phenomenon where DFI is undertaken by the Japanese exporting firms to buy off the local pressure groups of firms or unions that threaten legislative pressures for tariffs to close the import markets. This type of induced DFI has been christened “quid pro quo DFI” (Bhagwati 1985c) and appears to be a growing phenomenon (certainly on the part of Japanese firms), representing a new and alternative form of response to import competition than provided by old-fashioned tariff-making.\textsuperscript{33}

In short, both actual DFI (through the spiderweb effect) and potential DFI (outward by domestic capital and quid pro quo inward by foreign capital) are powerful forces that are influencing the political economy of tariff-making in favor of an open economy. They surely provide some counterweight to the gloom that the protectionist noises generate today.

But all these arguments could collapse under the weight of the contention that if many countries were indeed to shift to the EP strategy, whether through conversion to the view or through conditionality such as that envisaged under the plan put forth by U.S. Treasury Secretary James Baker III in 1985, the pressures to close markets would multiply owing to the magnitude of the absorption of exports that this would imply for the industrial countries.

This takes us back partly to the Cline (1982) estimates and the
several refutations of the pessimism engendered by them that were set out earlier. But it remains true that, even if the estimates in Cline are not to be taken seriously, the addition of any kind of trade pressure in a significant degree could touch off a wider range of sectoral, safeguard moves in the industrial countries in the present climate. It is indeed possible to argue that (a) Cline-type estimates are not plausible and exaggerate what would happen; (b) there is a great deal of absorptive capacity in the market sense in the world economy which can readily handle improved export performance resulting from the shift of many developing countries to the EP mode of organizing trade; and (c) there are powerful new forces in the international political economy that may make the protectionist bark worse than the protectionist bite. Nonetheless, the danger of protectionism does remain acute, especially in the present macroeconomic situation of sluggish growth and the continuing trade deficit in the United States. The capacity of the U.S. executive branch to hold the line against protectionism has been significantly eroded by the neglect of fiscal deficits and the upsurge in congressional support for protection and fair trade. The fragility of the situation requires serious attention to other policy instruments such as the multinational trade negotiations (MTN), as discussed below.

An important consequence of the second wave of export pessimism, which is based on this protectionist threat rather than on the belief in market-determined forces that limit export prospects, is that developing countries can join in the process of trying to contain this threat and thereby change the very prospects for their trade. This suggests that they join hands with the industrial countries in efforts such as the MTN to contain the threat to the world trading system and to keep markets open to expanding trade levels. Shifting to the IS strategy, therefore, based on export pessimism reflecting protectionist sentiments simply makes no sense from an economic viewpoint unless the developing countries are convinced that protectionism is here to stay and will be translated into actuality no matter what is done—an assumption that seems to be wholly unwarranted in light of the discussion earlier in this section. A far more sensible policy approach seems rather to be to join with the executives of countries that support freer trade initiatives, among them certainly the United States, in containing the protectionist sentiments through strategies such as entering into trade negotiations.

**New Arguments for the IS Strategy**

It may be useful to address some new intellectual defenses of the IS strategy that have recently emerged in the academic literature.

*Labor Market Imperfections.* In recent articles, especially Fields (1984), it has been argued that the EP strategy is not appropriate when

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there are excessively high wages in the economy and that EP countries such as Jamaica have done badly by ignoring this caveat. Now, the theoretical literature on market imperfections and optimal policy that emerged in the postwar period, with the independent contributions by Meade (1951) and Bhagwati and Ramaswami (1963) setting off the spectacular growth of the subject during the 1960s, has shown that factor market imperfections are best addressed by domestic, rather than trade, taxes and subsidies. It is true, however, that the second-best policy measures in such a case could be trade tariffs and subsidies.

There are two other problems with Fields's argument. First, he does not establish that countries such as Jamaica have been following the EP strategy in the incentive-related sense that is relevant. As it happens, Jamaica certainly has not and has for long periods been in the IS mode instead. This confusion of concepts and hence conclusions is not confined to Fields's analysis, but afflicts even the proponents of EP strategy in some cases. Second, it is not at all clear from Fields that the high wages constitute a market imperfection in the sense required for departure from unified exchange rates in the form of the IS strategy.

In my view, wages are relevant in a different sense that is macrotheoretic, rather than microtheoretic as Fields suggests. If overall wages are "too high," that can only mean that somehow they, and therefore the price level as well, are out of line with the exchange rate. That is, the country is suffering from overvaluation. In short, if that is so, we have already seen that the country is pursuing an IS strategy, whether it intends to or not. Therefore, a country simply cannot hold on to any EP strategy if it continues to experience excessive wages. The sustained pursuit of EP, so that investors respond to the incentives that EP defines, thus requires a sound macro policy as its foundation. Sound macro policies may then also bring, in turn, their own other rewards that supplement those that follow from the export-promoting strategy.

Satisficing Theory of IS. An interesting thesis has been proposed by the political scientist Ruggie (1983), which seems to argue that the advantage of an EP strategy cannot be enjoyed by many developing countries because they simply do not possess the flexibility of resource movements and the necessary political capacities to manage such flexibility that the pursuit of EP requires. I would call this therefore the "satisficing" theory of the IS strategy: developing countries in this predicament must make do without the gains from trade and efficiency improvements that EP strategy brings.

This is a difficult argument to judge since, even if it were valid within its premises, I do not find it compelling if such political constraints are equated with the fact of being less developed economically. In fact, given the lack of democratic structures with pressure group politics and attendant constraints on economic action by the
government, it is doubtful whether developing countries are not the ones at advantage in this matter!

Again, is it clear that tensions and distributional conflicts are necessarily more difficult under an EP strategy? An IS strategy, while insulating the economy relatively from external disturbances, may create yet more tensions and conflicts if the resulting stultification of income expansion accentuates the zero-sum nature of other policy options in the system. The correct statement of the Ruggie thesis would then seem to be that, in the pursuit of any development strategy, the compatibility of it with the political structure and resilience of the country needs to be considered. And this caveat needs to be addressed not only to the EP proponents.

Coping with External Instability. A similar economic concern has been that, while EP may be better under steady-state conditions, it exposes the economy to the downside in the world economy and makes it more vulnerable to instability.

Of course, the downside effects have to be set off against the upside effects. When this is done, it is not evident that countries pursuing EP strategies are necessarily worse off. As it happens, even the downside experience of EP strategy countries during the years after the oil shock seems to have been more favorable than the experience of the IS strategy countries, according to statistical analysis by Balassa (1983 and 1984). The reason seems to have been their greater capacity to deal with external adversity by using export expansion more successfully to adapt to the world slowdown and thus avoiding import contraction.

Conclusion

Export promotion policies emerge with success from the detailed scrutiny offered in this article. Equally important is the fact that their successful adoption will require collaborative and intense efforts to ensure that the protectionist threat, recently escalating, is not allowed to break out into actual protection on a massive scale.

The multilateral trade negotiations offer the only reasonable prospect for maintaining a momentum in favor of a freer world trading system. Failure to pursue them successfully, in a spirit of accommodation and mutual understanding of constraints and needs, will only undermine what seems like the best mechanism for containing the protectionist threat.

Appendix: Theoretical Clarification of Key Concepts

Definitions

Figure 1 illustrates, in the two-good model, the definitions of the export-promoting (EP), import-substituting (IS), and ultra-export-promoting (ultra-EP) trade strategies.
AB is the country’s production possibility curve. With given international prices $P^*S$, equilibrium production would be reached at $P^*$ under unified exchange rates which ensure that the relative goods prices domesticaly are equal to $P^*S$. Therefore, at $P^*$, we have $EER_x = EER_m$, where $EER$ refers to the effective exchange rate. This is defined as the EP strategy.

When the incentive to produce the import-competing good exceeds that to produce the exportable good, because of a tariff or overvalued exchange rates, for example (as shown below), production shifts to $P_m$. Here, $EER_x < EER_m$. This is the IS strategy.

If the biased incentive goes in the other direction, the relative incentives imply $EER_x > EER_m$ and production shifts to the right of $P^*$, to say $P_m$. This is defined as the ultra-EP strategy.

Overvalued Exchange Rates and IS Strategy

An overvalued exchange rate will imply the pursuit of the IS strategy. Figure 2 demonstrates this with the standard supply and demand diagram for foreign exchange.

If the exchange rate is adjusted to clear the market, at $S$, then $EER_x = EER_m$ because an identical parity applies to both export and import transactions. But consider now an overvalued exchange rate with exchange controls in place. Under these circumstances the overvalued exchange rate $y_m$ leads to OW foreign exchange being earned, corresponding to R on the SS curve. This foreign exchange will then be rationed to users, fetching a market-determined price which exceeds $y_x$. That price is determined by $Q$ on the $DD$ curve, with $y_m$ representing then the price corresponding to quantity OW. Evidently then, $(y_m - y_x)/y_x$ represents the rate of premium that scarce foreign exchange commands in this overvalued exchange rate system.

It is also evident that $y_m = EER_x$ and $y_m = EER_m$ and therefore $EER_x < EER_m$ by the magnitude of the premium on rationed foreign exchange. The overvalued exchange rate therefore implies the pursuit of an IS strategy, whether it is intended or not.
The Cost of Protection with Tariff-Seeking

The new theory of directly unproductive profit-seeking (DUP) and rent-seeking activities, which incorporates lobbying and related policy-triggered and policy-influencing activities into formal economic theorizing, is illustrated in figure 3 by reference to the phenomenon of tariff-seeking lobbying.

\[ AB \] is the production possibility curve if there is no tariff-seeking activity. If, as in conventional analysis, we assume an exogenously specified tariff, equilibrium production shifts to \[ \tilde{P} \] (where, of course, \[ \text{EER}_x < \text{EER}_m \]).

Suppose now that this very tariff is instead arrived at by lobbying which uses up real resources, diverting these resources from being productively employed in producing the two goods. Then, the resources that are available to produce the two goods in this endogenous tariff, or equivalently tariff-seeking, equilibrium can be hypothetically seen to result in a “net-of-tariff-seeking” production possibility curve \( A_1B_1 \) at \( \tilde{P} \).

The total cost of protection is \( QS \), measured in the conventional equivalent variation fashion. By putting the given world price ratio tangent to \( AB \) at \( \tilde{P} \), we can then decompose this total cost of protection as follows: \( QS = QR + RS \) where \( QR \) is the conventional cost of protection (but measured along the net curve \( AB \)) and \( RS \) is the additional cost of tariff-seeking (representing the cost of diverting resources from productive use to tariff-seeking lobbying).

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**Abstract**

This article evaluates recent arguments against the adoption of an export-promoting (EP) trade strategy. It reviews past experience with trade strategies, and distinguishes between the old and new export pessimism. The former was based on an (unwarranted) assessment of “natural” or market forces. The latter, by contrast, reflects “man-made” protectionism. This review finds that an EP policy remains the preferred option provided developing countries forcefully join with the industrial countries in strategies to contain protectionist threats and to preserve and expand an open trading system.

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**Notes**

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1. The chief studies were directed by Little, Scitovsky, and Scott (1970) at the Organisation for Economic Co-operation and Development (OECD), Balassa (1971) at the World Bank, Bhagwati (1978) and Krueger (1978) at the National Bureau of Economic Research (NBER) in the United States, and Donges (1976) at the Kiel Institute in Germany. Complementing and overlapping each other, these studies represent a
comprehensive analysis of the central question that has preoccupied development economists from the very beginning of the discipline.

2. Among other reviews that complement this article, the reader may consult Behrman 1984, Bhagwati and Srinivasan 1979, Findlay 1984, and Srinivasan 1986a and 1986b.

3. Prebisch may have subsequently embraced the Nurkse view that primary product markets were also price inelastic, according to Balassa. I refer here to the main Prebisch thesis as originally propounded and widely attributed to him.

4. In technical jargon, we have here the classic case for an optimal tariff since the terms of trade vary with the level of trade.

5. This is an example of the dangers of using such regressions, with little underlying rationale, for predictive purposes. I have considered this issue at great length (Bhagwati 1985a, p. 2).


7. See again the results cited in the synthesis volumes of the research projects listed in note 1. The Goldstein-Khan (1982) analysis also bears directly on this issue.


9. There is a substantial empirical literature on this subject, with important contributions by Balassa, Grubel, and Lloyd. In addition, recent theoretical work by Dixit, Lancaster, Krugman, Helpman, and others has provided the analytical explanation for such intrahindustry trade.

10. All these arguments are effectively a rebuttal of Dornbusch’s (1986) restatement of the limited absorptive capacity thesis for developing country exports, which asserts that substantial terms of trade losses would follow from the simultaneous resort to EP strategy by many developing countries.

11. I am indebted to Vittorio Corbo for pointing this out to me.


13. The estimated excess of $EER_s$ over $EER_m$ appeared to be below 10 percent at maximum in the few careful cross-section estimates we had. This is reconfirmed for Korea in a more recent analysis by Nam (1986).

14. The strategies have been illustrated in the simplified two-goods model of traditional trade theory in figure 1 in the appendix.

15. See also Krueger’s (1980) informal usage of the phrase in this fashion.

16. Compare Chenery, Shishido, and Watanabe (1962) for one such decomposition. For an analytical synthesis and evaluation of alternative measures of import substitution, see Desai (1979).

17. See, in particular, the synthesis volumes by Bhagwati (1978) and Krueger (1978).

18. Krueger’s (1978) synthesis volume also contains similar cross-country regressions for the ten semi-industrialized countries in the NBER project. See the extensive review in Lal and Rajapatirana (1987).

19. Balassa’s (1978) reestimation of Michaely-type regressions also incorporates the Michalopoulos-Jay approach, thus combining the two different methodologies under one rubric.

20. It is well known, of course, that factors that lead to improved efficiency and hence to income improvement need not necessarily lead to sustained higher growth rates. Thus, in the Harrod-Domar model, where labor supply is slack, a once-for-all improvement in efficiency will indeed translate into a permanent higher growth rate of income, but not so in the steady state in the Solow model, where the growth rate is determined

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by the growth rate of labor and the rate of technical change. In the text, however, we are explaining growth rates over a period of two or three decades, which makes these subtleties not particularly relevant, in my judgment. Moreover, it is important to note that, for any given growth rate, a more efficient economic regime will require less savings (and hence less blood, sweat, and tears) to sustain it than a less efficient economic regime.

21. See Bhagwati and Srinivasan (1983, p. 30) for a taxonomy of such lobbying activities.

22. The appendix to this article explains the manner in which the conventional cost of distorted production decisions resulting from protection is augmented by the cost of tariff-seeking lobbying when the protective tariff is the result of such lobbying. Costs of other kinds of lobbying, including the effects of DUP activities such as illegal trade (that is, tariff evasion), can be similarly illustrated. If the EP strategy reliea on exchange rate flexibility but simply on selective export subsidies to eliminate the bias against exports (as in Phase II, delineated in the Bhagwati-Krueger NBER project), the DUP activities can be expected to arise extensively in that regime as well.

23. Krueger’s (1974) classic article contains estimates of rent-seeking costs, that is, resources spent in chasing premiums or rents on quantitative restrictions. These high estimates, up to 15 percent of GNP, are based on the assumption that rents result in an equivalent loss of resources in equilibrium (the so-called one-on-one postulate in rent-seeking theory). Recently, computable general equilibrium models have begun to incorporate such DUP and rent-seeking activities, so that progress can be expected in assessing the magnitude of such costs. Compare Dervis, de Melo, and Robinson (1981) and Grais, de Melo, and Urata (1986).

24. See the discussion in Balasubramanian (1984) and in Bhagwati (1986a). In private communication, Balasubramanian has provided further results in support of this hypothesis.

25. See Bhagwati (1978), where some chapters summarize and evaluate these arguments with evidence from the ten country studies.

26. See Bhagwati (1985d) where I review the arguments and the evidence on these issues, drawing also on the valuable contributions of Surjit Bhalla, Pranab Bardhan, Paul Isenman, Ian Little, Irma Adelman, Montek Ahluwalia, Keith Griffen, Paul Streeten, and T. N. Srinivasan, among others.

27. The investment shunting need occur only insofar as it is necessary to meet value-added rules of origin, of course, making the cost of profiting from this porousness even less than otherwise.

28. Of course, the VERS in this instance represent only a partial and suboptimal approximation to the free trade solution, which remains the desirable but infeasible alternative. Moreover, not all exporting countries are capable of the flexible and shrewd response that underlies the model of porous protection sketched above.

29. This “two-headed” version of governments is what underlies the Feenstra-Bhagwati (1982) model of the efficient tariff. There, the model postulates that one branch of the government (pursuing special interests) interacts with a protectionist lobby to enact a political economy tariff. Then, another branch of the government (pursuing the national interest) uses the revenue generated by this tariff to bribe the lobby into accepting a less harmful tariff that nonetheless leaves it as well off as under the political economy tariff. When this model was presented to a scientific conference in 1978, the general reaction was that the model had a “schizophrenic” two-headed government! Traditional trade theory is so often modelled in terms of a monolithic government that what was obviously a realistic innovation was regarded as a bizarre feature of the model.

30. See, for example, Olson (1971), Finger (1982), and Mayer (1984).

31. See the report by Miller (1985).

32. Helleiner (1977) and most recently Lavergne and Helleiner (1985) have argued
that multinationals have become active agents exercising political pressure in favor of free trade. The structure of trade barriers has been related to patterns of DFI by Helleiner but the later work by Lavergne finds this relationship to be fairly weak. This hypothesis and research do not extend to the potential DFI effects in favor of freer trade (which would occur if DFI becomes an alternative response to import competition), which is discussed in Bhagwati (1982b and 1986a) and in the text.

33. In fact, the Ministry of International Trade and Industry of Japan has recently completed a survey of Japanese DFI abroad and found that a large fraction of the respondents cited reasons of the quid pro quo variety to explain their investment decisions. I am indebted to Professor Shishido of the International University of Japan for this reference. See also the theoretical modeling of such quid pro quo DFI in Bhagwati, Brecher, Dinopoulos, and Srinivasan (1987) and in Bhagwati and Dinopoulos (1986), the former using perfectly competitive structure and the latter using monopoly and duopoly structures instead.

34. See also the critique offered by Ranis (1985). Cline (1985) basically defends his position by arguing that the high ratios of trade to GNP typical of Far Eastern economies are likely to trigger difficulties and that he should not have been read to mean that the EP strategy would necessarily lead to such phenomenally high trade growth rates and trade ratios.

35. In the following, I select for treatment only the most important such arguments, given the central theme of this paper. For a more comprehensive review of recent arguments for protection, including those applying to industrial countries—as in Kaldor’s (1966) argument for protection to prevent British deindustrialization or Seabury’s (1983) advocacy of protection to prevent American deindustrialization for defense reasons—see my analyses in Bhagwati (1985c, 1985e, and 1986c). For a different emphasis, more skeptical of antiprotectist arguments and EP strategy, see Streeten (1982).

36. The theory has been synthesized in Bhagwati (1971), and there is also a splendid short treatment by Srinivasan (1987) in his entry on distortions for The New Palgrave.

37. For the original analysis of this problem, see Bhagwati (1980). Further discussion of the question can be found in Bhagwati, Brecher, and Srinivasan (1984).


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