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EXPORT EXPANSION:
DEMAND AND SUPPLY CONSIDERATIONS

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EXPORT EXPANSION: DEMAND AND SUPPLY CONSIDERATIONS

The facts surrounding the export performance of less developed countries (LDCs) in the last decade are well known: LDC exports in the 1960s grew almost twice as fast as in the 1950s, 6.6% versus 3.5%, but more slowly than exports of developed countries (DCs) (9.6%). However, there is considerable controversy about the factors responsible. In particular, there is disagreement about the relative importance of DC and LDC trade policies in determining the growth of LDC exports. As a result, policy prescriptions on how LDCs can expand exports hinge greatly on the conclusions one reaches about what has impeded LDC export growth in the past.

In general, the factors affecting LDC export expansion fall into two broad categories: those that affect demand and those that affect supply. Within each category it is possible to distinguish the effects of policy and the effects of markets and institutional forces.

Since DCs provide by far the largest markets for LDC exports, LDCs have generally emphasized that factors, and particularly DC policies, which adversely affect demand for LDC exports are primarily responsible for the slow LDC export growth. By contrast, DCs have stressed LDC supply of exportables and LDC policies affecting supply as the main determinant of LDC export growth. The debate has often been acrimonious, particularly in international bodies such as UNCTAD, with DCs and LDCs blaming each other for the problems afflicting LDC export growth. As is the case in most such instances, there is merit in the argument of both sides.

It is extremely important that the factors affecting LDC exports be placed in the proper perspective: Evidence is accumulating that there is a strong positive correlation between LDC export performance and overall LDC output growth. While the interaction between export and output growth is quite complex, policies affecting export growth are crucial to LDC attainment of overall growth objectives. The present paper discusses the factors affecting LDC export performance as they pertain to various categories of LDC exports. I intend only to illustrate areas where shifts in DC or LDC trade policy will result in increased LDC exports, rather than undertake the more difficult task of assessing the relative importance of such policy shifts.

A. Demand

Sluggish demand is mainly present in LDC exports of primary commodities. The main reasons are: (a) a low income elasticity for foodstuffs; (b) the development of synthetic substitutes; and (c) the presence of high trade barriers in the developed countries. These three factors have been responsible for creating an atmosphere of export pessimism in LDCs about the prospects of their primary exports.

The low income elasticity of demand for primary exports has been well documented. In the U.S. the income elasticity for raw materials and foods has been estimated to be .6 and .3 respectively, compared to an elasticity of 2.6 for finished manufactures.[1/] UNCTAD projections of

[1/] H. S. Houthakker and S. P. Magee, "Income and Price Elasticities in World Trade," The Review of Economics and Statistics, May 1969

LDC exports to DCs based on the latter's projected income growth show that over the 1970s developed countries' imports of manufactures will increase at an annual rate of at least 10% compared to only 2% for foodstuffs and 1% for raw materials excluding petroleum. Underlying these projections are three well known phenomena: (a) Food consumption grows proportionately less as income grows. (b) DCs impose trade controls to protect their domestic agriculture. U.S. and EEC price support programs in several commodities encourage expansion of agricultural output to the detriment of competing products produced more efficiently by LDCs. Sugar is a good example of such a commodity. (c) As far as raw materials are concerned, there is a long-term technological trend of declining amounts of raw materials used per unit of finished product. At the same time, several commodity exports are subject to considerable pressure from synthetics. The pressure is felt primarily in five commodity groups: rubber, cotton, jute, wool and hides. These commodities account for less than 8% of total LDC exports, but they often constitute the major source of foreign exchange receipts in individual countries.

For manufactures there is little reason to believe that overall demand considerations pose constraints to LDC export expansion. The main concern on the demand side stems from the structure of DC tariff protection and the stringency of non-tariff barriers that DCs impose on imports from LDCs in selected categories of commodities. DCs, just as LDCs, tend to protect finished manufactures more than intermediates, and intermediates more than raw materials. Such a structure discriminates

against imports of manufactures by raising the rate of effective protection to domestic producers of finished goods. The non-tariff barrier problem is particularly acute in textiles, where the long-term cotton textile agreement has tended to limit LDC export expansion. Similarly, in more recent periods the U.S. has imposed quantitative controls of synthetic textile imports. LDCs interpret such restrictionist measures to mean that if they attempt to penetrate DC markets of manufactures, their efforts will soon be frustrated by the imposition of restrictions. This is an attitude that parallels the export pessimism on the primary side but is much less justified by the facts. Individual LDCs' exports of manufactures to DCs have been growing at a rate of close to 14% per annum in the 1960s and are likely to grow at a similar pace in the 1970s despite restrictions imposed by DCs.

Given these demand conditions, what counter measures can the LDCs take? Clearly, there is little LDCs can do about DC restrictionist policies. Most of these policies are designed to protect the DC agricultural sector or isolated ailing manufacturing sectors. The problem here for the DCs is to devise adjustment assistance measures designed to move resources out of the protected sectors. But this problem by its very nature will take time to solve. In the meantime LDCs can take action to deal with adverse demand trends in primary exports.

First, since demand conditions are generally adverse, it is even more important that they maintain their competitive position and <u>at least not lose ground to DCs</u> in terms of the share of world exports of primary goods that they supply. Maintenance of a strong competitive position is

also important in resisting pressure from synthetics. Substitution by synthetics is partly a result of autonomous technological changes and partly induced by lower prices and better merchandising by DC exporters.

Second, LDCs can combat the effects of low income elasticity for foodstuffs in a number of ways: (a) They can increase the level of processing. The income elasticity of demand for processed foods is four times larger than that of crude foodstuffs. (b) They can move into lines with higher elasticity, such as livestock production or vegetables.

B. Supply

On the supply side, developing countries face two main tasks: First, they must see to it that their supply of primary commodities adjusts properly to changing world demand conditions. Second, given the overall stagnant demand for primary goods, they must devote their attention to developing new exportables, particularly in the area of manufactures. Unfortunately, it seems that LDCs' export policies in the last decade have not been successful in attaining these objectives and that, in fact, the most important constraint limiting LDC exports from the supply side is the LDCs' own export policies. A consensus has been emerging among economists that a good many developing countries, in their efforts to promote industrialization, have unwittingly discouraged export growth.[2/]

[2/] See for instance: B. Ballassa, The Structure of Protection in Developing Countries, Baltimore: The Johns Hopkins University Press, 1971, and I. Little, T. Scitovsky and M. Scott, Industry and Trade in Some Developing Countries; A Comparative Study, London: Oxford University Press, 1970.

Two sets of policy measures have hurt their export potential. The first, with the most obvious detrimental effects, has been the taxing of traditional primary exports. Taxation has been levied either directly on exports, or indirectly by unfavorable exchange rates for traditional exports within a multiple exchange rate framework. For example, in India most important primary commodity exports are taxed. In 1968 the ad valorem equivalents of export duties ranged from 16% on tea to 22% on some jute products. In Ghana the effective exchange rate on cocoa exports in 1969 was .54 cedis to the dollar compared with 1.01 C/$ for all other exports. Brazil has taxed coffee exports for a long time, in part because of revenue considerations.

The main reason for such taxes, in addition to the desire to raise government revenue, has been the LDC belief that they possess considerable monopoly power in the international markets for primary products. This implies that the price elasticity of demand for their commodities is low and that, as a result, a high exchange rate (one which raises external prices) would maximize total foreign exchange receipts.

It may be true that the price elasticity of demand for primary goods is lower. Nevertheless, the important factor is that while the overall price elasticity for primary commodities may be low, the elasticities facing individual countries could be quite high, if there are a number of countries producing the commodity.

Less developed countries have tended consistently to overestimate the degree of monopoly control and underestimate the price elasticity of demand facing their international markets. At the same time, taxing

of primary exports has tended to discourage allocation of resources to that sector by reducing profits. The results have been supply limitations and overpricing which have reduced the share of developing countries in world exports of primary commodities and encouraged the development of synthetics. If developing countries as a group had maintained the percentage of world exports of primary commodities in 1970 that they had a decade earlier, their total exports would have been $1 billion higher.

A country's export growth depends both on world demand for the commodities it produces and its competitive position in the market for these commodities. If demand is rising, and the country's market share is constant, its total exports will rise; they may rise rapidly even if its share is in fact declining. However, if demand is stagnant or rising very slowly, as has been the case with primary commodities, a country can expand its exports vigorously only by increasing its share of the market. Many LDCs did not keep their share of the market due to the price policies they pursued. Since demand had been stagnant, this meant that their exports stagnated, or in some instances fell absolutely.

Export taxes should be imposed only after a very careful examination of the alleged monopoly position that the country enjoys in international trade of individual primary commodities. Efforts must also continue to increase direct income taxation and reduce the reliance of government on trade taxes for the bulk of their revenue. Export taxes may be both inequitable because they arbitrarily penalize only one sector in the economy and potentially inefficient in that they penalize a sector crucial to the economic development effort because of the foreign exchange earnings it generates.

Various studies have shown that the developing countries with the more successful export records expanded exports to a large extent by increasing their share of trade in traditional commodity groups, at least partly in direct competition with products from developed countries rather than by riding the crest of an expanding world demand for specific commodities [3/] These findings attest to the importance of maintaining an exchange rate and overall pricing policy that enables the country to compete internationally as a means of increasing overall exports.

The second and perhaps most important impediment to LDC export expansion has been the establishment in LDCs of extensive import controls. The latter have been imposed for two fundamental reasons: (a) to contend with LDC balance of payments disequilibrium, and (b) to promote industrialization by providing a protected market to domestic industry.

Developing countries have placed far more emphasis on saving foreign exchange through import substitution than on earning foreign exchange through export expansion, and the last 20 years have witnessed the imposition of numerous controls ranging from tariffs to quantitative restrictions, licensing and total import bans.

Both the stimulus to industrialization and the consequent balance of payments adjustment could be provided through lowering exchange rates; yet most developing countries have, until recently, eschewed this approach in favor of import controls. These, in turn, adversely affect exports in

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[3/] I. Kravis, "External Demand and Internal Supply Factors in LDC Export Performance," Agency for International Development, 1969

various ways: (a) Inputs whose importation is restricted become more expensive and, as a result, domestic production costs of exportables get higher. (b) More importantly, the existence of import controls makes it possible for the foreign exchange rate for exporters to be higher than would have been the case if balance of payments equilibrium were to be maintained without controls, so that the exporter receives less domestic currency for a given quantity of exports. As a result both traditional primary exports and potential industrial exports have suffered. (c) There are few incentives to increase productivity in industries operating in a sheltered market; hence it is difficult for such industries to make the transition from selling domestically to selling abroad and the expansion of exports in new lines of manufactured goods is inhibited.

Governments of LDCs have undertaken a number of measures to redress this imbalance of incentives: Tariff rebates are offered to bring down the cost of imported inputs to exporters to that of their foreign competitors; where imports are licensed or banned, exporters often obtain special exemptions allowing them to import such commodities freely. Some countries have tried to deal with the higher profitability of the domestic market by legislation stipulating that given industries are required to export a certain percentage of their output if they are to obtain licenses to import inputs used in their production for the domestic market. But this is not the way to promote economic efficiency or develop a sound export program; producers may simply dump their output in the foreign market for what they can get, relying on the high profits they enjoy in their protected markets to offset losses they incur when they sell abroad.

In addition, more and more countries are resorting to subsidizing exports to offset the bias created by import controls, either by direct payments or indirectly through tax reductions for exporters. In theory a combination of export subsidies and import controls can be devised which is equivalent to a uniform reduction in the exchange rate. In practice, because of the multiplicity of controls on the import side, often carried out through quantitative restrictions whose effect on profitability is difficult to measure, it is very difficult to devise and almost impossible to administer a system of subsidies for exports and controls for imports which is directly equivalent to exchange rate adjustment.

Countries using export subsidies have tended to apply them as selectively as import controls. This stems from the fundamental belief of governments in developing countries that if the price mechanism is allowed to operate unhindered the resulting resource allocation would be incompatible with the national development objectives. Thus governments intervene to correct the price system by providing differential incentives, both for exports and for domestic products, according to their notions of the importance of different products in attaining development objectives.

The operation of unregulated prices and markets in most developing countries is, to be sure, deficient in many ways. However, the well-intentioned interventions of governments have in practice too often been based on arbitrary criteria and ad hoc decisions, so that overall priorities are unclear or ill-defined. The result has commonly been a set of incentives which do not improve the efficiency of resource

allocation or promote national development objectives. Furthermore, the system usually needs a large bureaucracy to administer the multitude of complex exemptions and incentives, so that entrepreneurs often find it more profitable to spend time and resources to deal with the administrative machinery than to devote these same resources to improving the productivity.

For a successful export development effort, experience has shown that it is necessary to make a drastic break from trade controls. The developing countries with the most successful postwar export performance, such as Mexico, South Korea, Taiwan and Greece, abandoned stringent import controls early in their industrialization efforts. A few others, such as Brazil, have done so only in recent years but with remarkable results in increased exports. Furthermore, the governments in all these countries have not been reluctant to lower their exchange rates as the need arose.

For the majority of the developing countries, however, where extensive import controls continue to exist, the shift to a non-discriminatory trade and exchange regime free of controls would not be an easy task. To eliminate the bias against exports, import controls must be reduced. But if import controls are reduced and the exchange rate remains overvalued, many of the industries established under the shelter of controls are likely to suffer severe disloc ations, and the balance of payments will be subject to severe strains from a rush of additional imports. Thus, a reduction of discrimination against exports, in most instances, would require a parallel currency devaluation; this would also provide a stimulus to exports, one that would render export subsidies unnecessary.

Liberalization of trade controls does not imply that countries ought to abandon efforts to promote industrialization. Rather, the promotion of industry should be undertaken primarily through fiscal measures which do not discriminate between production for the domestic or the foreign market. If a firm deserves assistance on infant industry grounds, the assistance should not be given through trade controls but, rather, through reduced rate of profit taxation or perhaps even direct subsidies to production, not to trade. In countries where the fiscal incentives the government can provide are limited, trade controls could be resorted to as a second best solution. But in such instances controls should take the form of uniform tariffs and subsidies of moderate level.

Economists have often demonstrated that the theoretically optimum trade policy for developing countries is the adoption of, at most, low-level uniform tariffs and subsidies in combination with easily adjustable exchange rates. However, reaching the optimum is always difficult. Given the height and disparity in existing LDC trade controls, it is probably wise that their overall reduction and standardization be taken in a series of steps over time to enable domestic producers to adjust. A gradual transition from rigid quotas and administrative controls to equivalent tariffs and a progressive reduction of tariffs accompanied by devaluation is the generally recommended procedure.

The success of a developing country's export development effort hinges in large measure on the adoption of appropriate overall trade and exchange policies. Trade and exchange policies act as the overall constraints within which export promotion efforts must operate.

Export promotion efforts can be useful in providing market information, improving quality control and generally establishing a favorable climate in which exporting is seen as a feasible, potentially profitable and hence desirable activity. However, if the limits set by trade and exchange policies are too narrow and existing trade controls introduce a basic bias against exports, export promotion efforts are likely to prove futile. On the other hand, good exchange rate and trade policy permits but does not guarantee successful export development. Export promotion activities can play an important role. Proper trade and exchange policies can thus be viewed as the necessary but not sufficient conditions for successful export development.