OCCASIONAL PAPERS

Number 35

PN-ABN-859
91909

ESSAYS ON DEVELOPMENT IN A LIBERAL ECONOMIC ORDER

H. W. Arndt

INTERNATIONAL CENTER FOR ECONOMIC GROWTH

Since 1985 the International Center for Economic Growth, a nonprofit organization, has contributed to economic growth and human development in developing and post-socialist countries by strengthening the capacity of indigenous research institutes to provide leadership in policy debates. To accomplish this the Center sponsors a wide range of programs—including research, publications, conferences, seminars, and special projects advising governments—through a network of more than 230 correspondent institutes worldwide. The Center's research and publications program is organized around five series: Sector Studies; Country Studies; Studies in Human Development and Social Welfare; Occasional Papers; and Working Papers.

The Center is affiliated with the Institute for Contemporary Studies, and is headquartered in Panama with the administrative office in San Francisco, California.

For further information, please contact the International Center for Economic Growth, 243 Kearny Street, San Francisco, California, 94108, USA. Phone (415) 981-5353; Fax (415) 986-4878.

ICEG Board of Overseers

Essays on Development in a Liberal Economic Order

H. W. Arndt

An International Center for Economic Growth Publication

ICS Press
San Francisco, California

Publication signifies that the International Center for Economic Growth believes a work to be a competent treatment worthy of public consideration. The findings, interpretations, and conclusions of a work are entirely those of the authors and should not be attributed to ICEG, its affiliated organizations, its board of overseers, or organizations that support ICEG.

Inquiries, book orders, and catalog requests should be addressed to ICS Press, 243 Kearny Street, San Francisco, California 94108, USA. Telephone: (415) 981–5353; Fax:(415) 986–4878; book orders within the United States: **(800) 326–0263.**

Library of Congress Cataloging-in-Publication Data

Arndt, H. W. (Heinz Wolfgang), 1915–
Essays on development in a liberal economic order / H. W. Arndt.
p. cm. — (Occasional papers ; no. 35)
Includes bibliographical references.
ISBN 1-55815-237-7
1. Economic development. 2. Pacific Area—Economic conditions.
3. Developing countries—Economic conditions. I. Title.
II. Series: Occasional papers (International Center for Economic Growth) ; no. 35.
HD75.A76 1992
338.9—dc20 92-34710
CIP

Contents

PREFACE

The International Center for Economic Growth is pleased to publish *Essays on Development in a Liberal Economic Order* as the thirty-fifth in our series of Occasional Papers, which feature reflections on broad policy issues by noted scholars and policy makers. This work comprises two papers by H. W. Arndt, Emeritus Professor of Economics at the Australian National University.

In his first essay, Professor Arndt discusses in detail the evolution of the development paradigm, concluding that what we need, rather than new paradigms, is a recognition of the importance of economic growth as a goal of development. In his second essay, he details the possible consequences—and dangers—of recent world economic developments for the Asia-Pacific region. Although focusing on two different aspects of the development question, Professor Arndt's essays are united in the underlying theme of the necessity for economic liberalization and by a belief in a liberal economic order for the world economy.

We believe these essays will make a timely and important contribution to our understanding of the challenges facing developing nations amid the rapid changes in the economic and political world picture.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

Panama City, Panama
December 1992

ABOUT THE AUTHOR

H. W. Arndt is Emeritus Professor of Economics at the Australian National University (ANU) in Canberra. He was professor of economics from 1951 to 1963 in the School of General Studies at ANU and from 1963 to 1980 in the Research School of Pacific Studies at ANU, where he has also been a visiting fellow in the Development Studies Centre since 1981.

Professor Arndt was president of the Economic Society of Australia and New Zealand from 1957 to 1959, editor of the *Bulletin of Indonesian Economic Studies* from 1965 to 1982, and has been editor of the journal *Asian-Pacific Economic Literature* since 1986.

Professor Arndt has published many books, including *The Rise and Fall of Economic Growth* and *Economic Development: The History of an Idea* (University of Chicago Press, 1978 and 1987 respectively) as well as *A Course through Life: Memoirs of an Australian Economist* (National Centre for Development Studies, Australian National University, 1985).

Professor Arndt studied at Oxford University from 1933 to 1938. He was born in 1915 and is an Australian citizen.

H. W. Arndt

Introduction

The two essays brought together in this Occasional Paper were written for very different occasions. The first was written for a conference of the Fundación para el Desarrollo Económico y Social (FUNDES) in Zurich in August 1991, the second for a conference of the Association for Development and Research Institutes of Asia and the Pacific (ADIPA) in Macao, October 8–11, 1991. Medical force majeure prevented either from being given. They are here published with permission from the two sponsoring organizations.

On the face of it, the two essays have little to do with each other. The first, essentially a summary of a book published some years ago, deals with the broad theme of the objectives of economic development as conceived over time, over decades, indeed centuries, throughout the world. It takes a skeptical look at the perennial search for new development paradigms—from the dominant emphasis on economic growth in the 1950s to the social objectives of the 1960s, from the new international economic order in the 1970s to sustainable development in the 1980s—and concludes that there is no need for a new paradigm. Because freedom of choice about the allocation and distribution of goods and services is conditional upon the capacity to produce goods and services, economic growth, properly interpreted, is still the sine qua non of economic development in any sense.

The second essay focuses on the coming decade and specifically on the Asia-Pacific region. It discusses three world economic developments which are widely believed to endanger the economic interests of developing countries: (1) the threat to the multilateral world trading system of protectionist tendencies and emerging trade blocs; (2) a looming world capital shortage; and (3) potential factor reversal, or loss of comparative advantage in traditionally labor-intensive industries by countries with abundant labor. The essay concludes that the resilience of the Asia-Pacific economies renders them relatively less vulnerable to these threats than other parts of the developing world.

The two essays are linked by the belief in a liberal economic order which underlies both, the belief that all mundane human aspirations, including social justice and protection of the environment, are most effectively pursued if people are free, with the aid of technical progress, to seek, as Adam Smith thought they were universally and continually inclined to seek, "to better their own condition."

The Search for a New Development Paradigm

People did not think economic development, in the sense of sustained improvement in living standards, desirable until events proved that it was possible. In the West this happened in the seventeenth century, the age of Bacon and Newton. As the economic historian, R. H. Tawney, put it in a book on China:

> Rapid economic change as a fact, and continuous economic progress as an ideal, are the notes, not of the history of the West, but of little more than its last four centuries. . . . [Previously in the West, as still in the East] the common man looked to the good days of the past, not to the possibilities of the future, for a standard of conduct and criterion of the present; accepted the world, with plague, pestilence and famine, as heaven made it; and were incurious as to the arts by which restless spirits would improve on nature.

Material Progress

By the middle of the eighteenth century, material progress, as it was called, had, in Britain at least, come to be regarded as both possible and desirable. Adam Smith articulated this widening consensus when he referred to his fellow citizens' "universal, continual and uninterrupted effort to better their own conditions" and expressed the hope that "the progress of England towards opulence and improvement" would continue "in all future times."

This essay is drawn from the books *Economic Development: The History of an Idea* and *The Rise and Fall of Economic Growth*, both published by the University of Chicago Press, 1978 and 1987 respectively.

In the nineteenth century, material progress came to be seen as intimately linked with advances in science and technology, the Promethean conquest of nature by man, and by none more explicitly than Karl Marx. Marx, the Hegelian, was not very interested in the greatest happiness of the greatest number. He extolled capitalism not because it raised living standards but because it had created "more massive and more colossal productive forces than have all preceding generations together." With capitalist development had come urban civilization, which would rescue "a considerable part of the population from the idiocy of rural life."

Even while Marx was proclaiming the Promethean idea—"the development of the productive power of man and the transformation of material production into a scientific domination of natural agencies"—intellectuals like John Stuart Mill were beginning to voice doubts. Mill declared himself

> not charmed with the ideal of life held out by those who think the normal state of human beings is that of struggling to get on; that the trampling, crushing, elbowing, and treading on each other's heels, which form the existing type of social life, are the most desirable lot of human kind.

But during the decades when material progress was proceeding by leaps and bounds in the West, it did not seem necessary to defend its desirability. From around 1870, long-term economic growth dropped out of professional and public economic concerns, displaced first by issues of efficient resource allocation, such as free trade versus protection and antitrust legislation, income distribution, and in the interwar years by the problem of instability, depression, and unemployment. It then suddenly reemerged during and after World War II, partly because the spectre of mass unemployment seemed to have been laid to rest, but mainly because of the changed constellation of the world political scene and the challenge to Western hegemony from the Soviet Union and from the colonial and semicolonial countries of Asia, Africa, and Latin America—the East and South, or the second and the third world, as they later came to be called.

It was during World War II, in the formulation of Western aims for the postwar world, that the term "economic development" first came into general use. (Schumpeter in 1911 had been a lone voice.) As an objective it had for decades formed part of the programs of leaders of movements for independence from, or resistance against, Western domination in Asian countries—Japan, China, India, and others—but their primary motive had been national power, and as a necessary means of modernization, rather than higher living standards. The driving force had, in W. W. Rostow's phrase, been "reactive nationalism." Now economic development was defined, in the words of the charter of the United Nations, as the promotion of "higher standards of living, full employment, and conditions of economic and social progress and development" in the underdeveloped countries of the world.

Economic Growth

In the following years, a huge literature began to pour forth, much of it in the documentation of the United Nations and its agencies, but intellectually derived from the writings of the first generation of development economists: Singer, Rosenstein-Rodan, Nurkse, Prebisch, Myrdal, and Lewis. As the title of Arthur Lewis's great book indicated, economic development was conceived as the subject matter of *The Theory of Economic Growth*. This partly reflected the concurrent emergence of growth theory and of economic growth as the preeminant objective of economic policy in the developed countries. But it also seemed to make sense. In Lewis's words, "There is basically only one way in which 'all the men in all the lands' can approach freedom from want, namely, through vastly increased production." In this sense, it was not unreasonable to think of economic development as "primarily a combination of methods by which the capacity of a people to produce (and hence to consume) may be increased." None of the early development economists was so foolish as to want economic growth for its own sake. Every one of them went out of his way to warn his readers that economic development means more than growth in national product. As Myrdal put it, economic development is much more than higher material living standards; it is "new men, modern men." But economic growth was seen as central because freedom of choice about the allocation and distribution of goods and services is conditional upon the capacity to produce goods and services.

Throughout the 1950s, while economic development was largely equated with economic growth, the economics of development focused on the determinants of economic growth. At first, in the tradition of classical and Keynesian macroeconomics, the emphasis was on capital formation, and therefore on the capital requirements of underdeveloped countries. Around 1960, as internationally comparable national accounts data became available, Angus Maddison, E. F. Denison, and others found to their own surprise that differences in rates of capital formation, and indeed of factor inputs including labor, contributed little to the explanation of differences in growth rates. There was a large residual factor, which was soon attributed to human capital and particularly to technical progress, although quality differences and statistical quirks as well as structural change were found to play a part. The notion of "investment in man," with its stress on the importance of education and cultural factors, was a first step toward a less purely economic concept of development.

Social Objectives

Toward the end of the 1960s, the decade of Mao's great Cultural Revolution, Fidel Castro, the Nonaligned Movement, UNCTAD I and the new international economic order (NIEO) in the third world, the student revolt, the civil rights movement and the first stirrings of feminism in the West, and the Vietnam War, voices were raised questioning the equation of economic development with economic growth. At a Delhi congress of the Society for International Development, the English economist Dudley Seers issued a trumpet call on the meaning of development: "We have misconceived the nature of the main challenge of the second half of the twentieth century" by making a 5 percent growth rate of GNP the target for the First Development Decade.

> [It was] very slipshod of us to confuse development with economic development and economic development with economic growth. . . .

> The questions to be asked about a country's development are: What has been happening to poverty? What has been happening to unemployment? What has been happening to inequality?

In the following years the Western development literature dethroned GNP. Development was redefined in terms of social objectives. The quick succession of formulations, from "social development" to "employment orientation," "equity," "poverty eradication," and finally "basic needs" invited Ronald Dore's unkind reference to "the accelerating rate of slogan obsolescence."

A prolonged debate about Kuznets's inverted U-curve and on whether the benefits of economic growth were or were not trickling down to the poor ended in a consensus that economic growth may indeed be accompanied by increasing inequality, but that in the long run rapid economic growth is the surest remedy for poverty and that some of the fastest growing LDCs, such as Taiwan and Korea, also had the most equal distribution of income. A succession of International Labour Organisation missions designed to focus on unemployment and "employment-oriented" development ended up with the finding that "the unemployment concept was quite unsuited to the developing countries" where the main problem was that of "the working poor [who] work long hours for low incomes."

The World Bank's "basic needs" approach was soon overtaken by changes in the world scene, stagflation in the developed countries, OPEC oil shocks, and a slowdown of economic growth. In 1976, Robert McNamara, while still concerned about absolute poverty, pointed to the need to "recapture the momentum of economic growth." When eminent experts came up with the notion of a "unified approach" which rejected growth of national income as the sole objective of development planning and stressed the need "to plan directly and simultaneously for all objectives of development with full cognizance of interactions and feedbacks among them," it sounded like a caricature of development planning.

In retrospect, it is clear that the shift toward social objectives in Western thinking about economic development during the 1960s largely reflected the political turbulence and questioning of "growthmanship" in the West itself during that decade, associated with the

Vietnam War, alienation of many young people from the consumer society, and concerns about "private affluence and public squalor." With the end of the Vietnam War the intellectual climate changed. The legacy in development thinking was the "growth with equity" paradigm on which agreement was easy so long as the trade-offs were left undefined.

A New International Economic Order

The pursuit of social objectives by Western development economists and international organizations at no stage evoked much interest in the developing countries themselves. There was something inherently paradoxical in the admonitions of Western development economists and elites to the governments of less-developed countries (LDCs) to pursue growth with redistribution. LDC delegates to a Cambridge conference, we are told, did not see an appeal for fundamental redistribution of resources as a sensible message to take back to their political masters. The Indonesian scholar, Soedjatmoko, seeing "more and more donor countries jumping on the Basic Needs band wagon," asked pointedly, "Are the donor nations prepared to accept the political consequences of such deep intrusion on their part in the life of other nations?" In any case, as Ronald Dore pointed out, it was doubtful how receptive LDC governments would be to developed countries' egalitarian preaching. In the minds of third world rulers, "a major motive, over and above survival, is to increase national strength and prestige, to raise the nation's position in the international pecking order and thereby their *own* position in the ranks of the world's rulers."

All through the 1960s and 1970s, the priority objective of political leaders in the third world was not equity between rich and poor in their own countries but equity, as they saw it, between rich and poor countries, between the North and the South, as formulated in their NIEO program. This had its intellectual antecedents in the dependency theory developed around the ideas of Raúl Prebisch at the Economic Commission for Latin America (ECLA) in Santiago, increasingly radicalized through infusion of neo-Marxist ideas and rhetoric. It reached its apogee when, encouraged by Club of Rome prophesies of impending exhaustion of the world's oil reserves, the Arab oil producing countries staged the OPEC oil price coups of 1973–74 and 1979–80. The South, it seemed, had the economic muscle, but the euphoria was short lived. The world debt problem, recession, and the collapse of oil and other commodity prices in the following years dictated new priorities to LDC governments.

Even more damaging to the NIEs was the mounting evidence during the 1980s of the heterogeneity of the third world. While the gap between rich and poor countries narrowed—average per capita income grew faster during this decade in developing countries than in developed countries—there was an ever widening gap between the phenomenally successful export-oriented development in the East Asian newly industrializing countries and the failure of inward-oriented policies in most of South Asia and Latin America and the desperate conditions in Sahel, Africa. At the end of the decade, with the collapse of communism in the second world and the movement toward market-oriented policies there and in much of the rest of the world, the NIEO paradigm had become irrelevant.

Sustainable Development

By then, another facet of economic development had come into prominence—the environment.

In 1962, U Thant, secretary-general of the United Nations, in his speech launching the First Development Decade, contrasted the daunting problems of the LDCs with the situation in the developed countries as he then saw it:

> The truth, the central stupendous truth about developed economies today is that they can have—in anything but the shortest run—the kind and scale of resources they *decide* to have. . . . It is no longer resources that limit decisions. It is the decisions that make the resources. This is the fundamental, revolutionary change—perhaps the most revolutionary mankind has ever known.

Ten years later such optimism was becoming rare. There was widespread concern in the industrial countries about the damage economic growth was doing to the environment. Influential voices were trying to persuade public opinion that the world was rapidly approaching the limits of growth set by destruction of the biosphere, exhaustion of nonrenewable resources, or both.

Prophecies of doom that had cropped up from time to time in the preceding century regarding exhaustion of nonrenewable resources suddenly received worldwide publicity through a book entitled *The Limits to Growth*, sponsored by the Club of Rome and published in 1972. Using econometric extrapolations from a mass of statistical data, the authors concluded that "if the present growth trends in world population, industrialization, pollution, food production, and resource depletion continue unchanged, the limits to growth on this planet will be reached sometime within the next one hundred years." As critics were quick to point out, these extrapolations were abstracted from technical progress and from feedbacks—such as self-correcting mechanisms in response to price distortions. It is misleading to speak of resources as finite. Investment of capital and advances in technology have throughout modern history created new resources. As demand for any given resource begins to outrun supply, the price rises. Supply increases, demand contracts, and both shift toward alternative ways of meeting the same need. Market feedbacks are reinforced by sociopolitical ones, of which the environmentalist movement is itself the most obvious example.

The Club of Rome book did enormous damage because it provoked the OPEC oil shocks with all their calamitous consequences for the world economy. But the vogue did not last long. By now, prophecies of doom about exhaustion of nonrenewable resources have largely been discredited, although populist versions still have their adherents.

Management of the environment, of renewable resources—soil, air, water, forests, fisheries—is another matter. The conservation movement in the West goes back over a hundred years, and modern environmentalism at least to Rachel Carson's study of the misuse of pesticides published in 1962. Problems of air pollution in Western cities and of waters in Western lakes and rivers began to be tackled seriously—and increasingly effectively—in the 1960s. In the past decade, emphasis has shifted toward threats to the earth's atmosphere and climate from emission of chlorofluorocarbons (CFCs) and carbon dioxide. While the scientific evidence about damage to the ozone layer by CFCs is substantial (and their use is in fact being phased out) the greenhouse effect is still questioned by many reputable scientists. But even skeptics agree that it may be sensible to err on the side of caution, and political pressure from popular environmentalism has in fact become virtually irresistible, at least to the point of acceptance of Toronto targets for reduction of "greenhouse gas" emission and other declarations of good intention.

Much like the pursuit of social objectives in the wake of the political tensions of the 1960s, the Green movement in the West provides an outlet for the radical idealism among the New Class—as defined by Irving Kristol—and among young people for which previously the Vietnam and Cold wars had been ready targets. It may also be associated with the decline in organized religion, the reemergence of feminism, and attitudes of fear and suspicion toward science and technology that are widespread among the less well educated in Western societies.

In its extreme versions, environmentalism has potentially adverse effects on economic growth and prosperity in Western countries by slowing down investment through insistence on interminable environmental impact studies, effective opposition to almost all mineral exploration, and excessive restrictions on the forestry and fishing industries. One answer to such criticism is that in Western politics one has to scream to be heard and that the Greens provide a counterweight to vested interests that stand in the way of responsible resource management.

In developing countries environmentalism as an ideology found no more favor than the basic needs strategy. The Indian delegate to the 1972 Stockholm conference, Pitambar Pant, said bluntly that in his country "the worst pollution is poverty." Third world governments remain unconvinced that they should hold back their own economic growth, whether through exploitation of their mineral resources, expansion of food production, or industrial use of fossil fuels, when economic growth in the high-income countries makes far greater demands on resources. They are no longer sure that they were wise to phase out the use of DDT, on Western advice, at the price of a resurgence of malaria. They resent pressure from Green activists in the West against logging of their rain forests, or at least feel entitled to adequate compensation, for example in the form of aid in exchange for reducing clear-cutting.

But this does not mean that LDC governments are unaware of, or unresponsive to, their own environmental problems. In the long run, the most serious problem is the pressure of population growth on agricultural land and urban living conditions. Most LDC governments now have population control policies, but they also know that the will to limit fertility largely depends upon economic growth, rising standards of education, and income, especially for women. Most governments, at least in the better managed middle-income countries, now have environmental protection agencies with ambitious programs for environmentally sound management of their renewable resources, though how effectively regulations can be enforced, resource rents collected, and polluters made to pay remains in most of these countries open to doubt. Some may even be persuaded to introduce "natural resource accounting" into their national accounts, but here again it is difficult to be sure what difference it makes to policy, and indeed whether it is good economics to pretend to be able to predict how the price of, say, oil will be affected by market and technological trends decades ahead. It may also not be easy to persuade LDCs to accord high priority to items of luxury consumption of the middle class in affluent countries such as wilderness and biodiversity.

The Brundtland Commission, in its 1987 report, gave the world another development paradigm: sustainable development. Like "growth with equity," it commands ready acceptance because it is so vague. The trade-offs are not specified. Does sustainable development require a 10 percent, 20 percent, or 25 percent reduction in hydrocarbon emission by the year 2000 or the year 2100? Does it really require a sharp reduction, or complete cessation, of logging of tropical rain forests, or merely adequate replanting? What sort of population policy for China is implied by sustainable development—one-child, two-child families, or what? Does sustainable development imply expansion or elimination of the nuclear power industry? Is there any case to be made on sustainable development grounds against uranium mining, or indeed against mining of any mineral deposits?

Everyone's Own Utopia?

I began the last chapter of my 1987 book with the following somewhat nihilistic statement:

> Almost everyone considers development—even economic development—a desirable objective for the countries and people of the Third World. But so diverse have the interpretations of "development" become that one sometimes wonders whether it now stands for anything more substantial then everyone's own utopia.

The history of thought about economic development which I have here summarized is a litany of new development paradigms: investment in man, employment orientation, basic needs, growth with equity, a new international economic order, sustainable development, and others waiting in the wings—women in development, regional development, spatial development, community development. I do not think we need any more.

Certainly, mere growth is not enough. But economic growth, however qualified to accommodate reasonable concerns about equitable distribution of the benefits of growth and about protection of the environment, is still essential. Let me end by quoting one more (slightly edited) passage from my book:

> Not everyone is unreservedly and continuously in favour of economic development in this sense. There are few thoughtful people anywhere who would not confess to reservations, to difficulties in weighing all the imponderables that must go into a design for living, for nations as well as for individuals. But even in western countries, these doubts do not deter voters and politicians from the pursuit of economic growth. The continuing incidence of massive poverty and the continuing wide gap between the great majority and the even moderately well-to-do in standards of comfort and of health, education, and other services makes satiety (or bliss) still appear no nearer than it seemed to Keynes in the 1930s when he contemplated the economic future of our grandchildren. A fortiori, any suggestion that economic growth is no longer urgent in the Third World because consumers will soon have all they want is hardly persuasive.

Living Dangerously?

Implications of World Economic Developments for the Asia-Pacific Region

Anyone given to economic forecasting must have learned many lessons in the past three years. Who would have predicted the fall of the Berlin Wall, the collapse of communism in the Soviet Union and its Eastern European satellites, the Gulf War and the vagaries of the price of oil, the course of the GATT Uruguay Round, to mention only the more startling events? In this paper I shall not stick my neck out, at least not very far.

What I propose to do is to discuss the implications of world economic developments for the countries of the Asia-Pacific region. There is a good deal of apprehension about what the 1990s will hold for these countries. I will group these concerns under three main headings: threats to the open multilateral world trading system; the likelihood of increasing world capital shortage; and the consequences of the "third industrial revolution" for the labor-surplus countries of the region. I shall suggest that, while there are significant risks, the resilient economies of the Asia-Pacific region can look forward to the coming decade and beyond with measured optimism.

Threats to Open Multilateral Trade

At the end of World War II, the United States secured acceptance among the world's market economies, at least in principle, of an open multilateral world trading system as a desirable objective, incorporated in the General Agreement on Tariffs and Trade (GATT). The objective was never fully realized, but there was by and large steady progress toward it for some three decades. In the past decade optimism about further progress has given way to pessimism.

The pessimists can point to much alarming evidence to support their case. The Uruguay Round of Multilateral Trade Negotiations on which GATT members embarked in 1986 has been in danger of collapse and, although extended by two years, is not yet assured of worthwhile results. In the meantime, with Europe 1992 on the verge of accomplishment, a single market which seems likely to absorb the European Free Trade Association (EFTA) countries and possibly to extend into Eastern Europe, there are fears in the United States and elsewhere about "Fortress Europe," a single market buttressed by nontariff barriers against outside competition in manufactures as well as agricultural products. There is much talk about a world increasingly divided into trading blocs, specifically a tripolar world economy revolving around three economic power centers: the United States, Europe, and Japan. The idea derives support both from persistent pressures, frequently accompanied by strident rhetoric, for protection of Western manufacturing industries from Japanese and other East Asian competition and from U.S. schemes for regional groupings under the title of free trade areas (FTAs). Even initiatives such as that for Asian Pacific Economic Cooperation (APEC) are sometimes (mistakenly, as I hope to show) viewed as steps in the same direction.

The threats to open multilateral trade are real, not to be lightly dismissed. But pessimism can be overdone. There is much to cheer about, and there are ways in which the threats can be contained.

For one thing, all the tariffs, nontariff measures (for example NTBs, VERs, and MFAs), safeguard clauses, and other protectionist measures adopted by the Western industrialized countries did not prevent the East Asian newly industrialized economies (NIEs) and near-NIEs from recording spectacular growth in exports of manufactures to these Western markets during the 1980s. Exports from relatively small countries can usually find a niche in large markets, and the bark has, much of the time, been worse than the bite.

Moreover, there can be no doubt that the free-trade cause is registering striking gains as well as actual and potential losses. Most obvious and important, there is the collapse of communism as an ideology and with it the conversion of the former centrally planned economies (CPEs) to increasingly open and market-oriented ones. There is still a long way to go before the former Soviet Union and the countries of Eastern Europe are integrated into the world system of substantially nondiscriminatory trade and freely convertible currencies, although Hungary and perhaps Poland and Czechoslovakia are getting there. Similarly, while the People's Republic of China is in some respects further ahead in opening up its economy, its prospects for advancement toward a market economy are still clouded by political uncertainties, and this applies even more to Indochina and North Korea. But compared with the actual situation and reasonable expectations of even five years ago, the improvement that has already occurred is astonishing.

Hardly less surprising is the recent trend in much of Latin America—especially Chile, Mexico, and Argentina—away from highly regulatory, inward-looking economic policies toward export- and market-oriented ones. Similar tendencies are apparent in other parts of the third world, most significantly in India where such reforms, if they prevail, will mean breaking with the socialist ideology and structuralist policies that have dominated since independence.

Concurrent with resorting to further protection in some cases, there has also been considerable liberalization of trade, largely unilateral, in others. This applies especially to Japan, which now has the lowest tariffs on imports and the least formal NTBs among OECD countries. Japan is also taking steps, admittedly under a good deal of pressure from the United States, to deal with alleged structural impediments to imports. It also applies to some formerly highly protectionist countries in the Asia-Pacific region, such as Indonesia and Australia. And whatever fears may be held about possible trade-diversion effects of Europe 1992, the abolition of all barriers to trade in goods and services between some twenty or more high-income countries, ultimately leading to a single economy with a single currency, would surely represent a giant step in the liberalization process.

One major stumbling block, both in Europe and in East Asia, remains agricultural trade. In Europe, external and internal pressures on the Common Agricultural Policy (CAP) are mounting. The farm lobby still wields powerful political clout, especially in the higher-cost producing countries. But there are grounds for hope that the ever increasing burden of agricultural price supports on taxpayers will induce a compromise around the plan for drastic reduction of support prices drawn up by the EC agricultural commissioner. In East Asia, particularly in Japan and Korea, there are signs of similar loosening of the tight restraints on food imports, especially rice. Such liberalization is as much in the interest of these countries' own consumers as it is in that of farmers in the food exporting countries.

The battle is by no means yet won. To continue pressure for liberalization of agricultural trade within the framework of the Uruguay Round is the raison d'etre of the Cairns Group of agricultural exporting countries.

Whether the United States's free trade area (FTA) schemes constitute grounds for optimism or pessimism will depend on how they are implemented by U.S. policy. The creation of a North American FTA including Canada and Mexico, will substantially stimulate trade and economic growth if it takes place in the context of a liberal U.S. trade regime. Conversely, it could prove to be trade diverting and distorting if it merely brought Canada and Mexico inside a wall of U.S. trade barriers. The same holds, a fortiori, for a less likely FTA embracing all of Latin America.

This is where APEC fits in (Elek 1992). This initiative, which was taken by the Australian prime minister Bob Hawke in Seoul in January 1989, does not aim, as some have suggested, at another trading bloc. It is intended as a low-key and initially informal forum for the promotion of freer trade (and cooperation on sectoral issues, such as energy and technology transfer) among the countries of the Pacific and on the most-favored-nation (MFN) principle with the rest of the world. A primary objective is to bring both Japan and the United States into this process and thus allay concerns that might be felt among the Association of Southeast Asian Nations countries (ASEAN) and other East Asian countries about a western Pacific grouping dominated by Japan. (Such concerns are probably one reason why Malaysian prime minister Datuk Seri Dr. Mahathir bin Mohamad's proposal for an East Asian economic grouping, including Japan but excluding Australia, New Zealand, the United States, and Canada, has not found favor among Malaysia's ASEAN partners.) Resolution of the vexing problem of membership of the "three Chinas," which was achieved at the Ministerial Meeting in Seoul in November 1991, is clearly also helpful.

Looming World Capital Shortage

A dominant theme in international economic discussion in the 1980s was the problem of "macroeconomic imbalances." This referred to large and growing current account surpluses in Japan, the East Asian NIEs, Germany, and one or two other European countries and large and growing current account deficits in the United States, Australia, and several other OECD countries, as well as much of the third world. In the United States, in particular, there were loud complaints about undervaluation of the yen, denunciation of unfair trade practices, and threats of retaliation. The Plaza Accord of September 1985 was viewed as a major step toward correction of these imbalances through a sharp appreciation of the yen and subsequently of the Korean won and the Taiwanese NT dollar.

The 1990s, it is now widely believed, will put things in a very different light. The correction is well under way, but there is now concern about a decline in world savings. To quote a statement by J. J. Polak, veteran economic adviser to the IMF:

> In the last few years, economists and others have become acutely aware of the inadequacy of the world's savings. In many developing countries, the ratio of investment to GDP has fallen by a third compared to the level prevailing in the 1970s, as national savings had to be sent abroad for service of the debt, domestic capital sought refuge abroad and capital inflow ceased. At the same time, the United States swallowed a large part of the savings in the rest of the industrial world, as reduced private U.S. saving and a persistent government deficit created a huge current account deficit. On top of this, the developments of the past year have laid bare an enormous need for investment in Central Europe and the Soviet Union. . . . In the industrial countries, the ratio of aggregate saving to GDP in the 1980s was about 20 percent, as against 25 percent in the early 1970s. Although savings rates differ widely among countries, their decline was universal, with some of the largest declines in Japan and Germany. (Polak 1990)

The evidence from the Asia-Pacific region is unmistakable. The current account surpluses of the surplus countries have been declining as they have restructured, assisted by the impetus of currency appreciation from export- to home demand–led growth. Japan's current account surplus fell from U.S. $87 billion in 1987 to U.S. $36 billion in 1990 (OECD 1991); Korea's from U.S. $10 billion to U.S. –$2 billion; Taiwan's from U.S. $18 to U.S. $10 billion (Asian Development Bank 1991). These figures represent a total decline in the supply of savings to the rest of the world over four years by U.S. $72 billion or 62 percent.

While the supply of savings has contracted, the capital needs of the developing countries, especially in South Asia and Africa but also still in much of Latin America and parts of East Asia, are as great as ever and to these have been added the consequences of the Gulf War and the enormous capital requirements of the broken-down economies of the former Soviet Union and other Comecon countries. In Germany alone, restructuring of the former East Germany is expected to cost some U.S. $80 billion a year for years to come and has already wiped out the current account surplus.

U.S. claims on the surplus savings of the rest of the world did decline markedly during the second half of the 1980s in response to the Plaza currency realignment and some reduction in the fiscal deficit. The U.S. current account improvement was further assisted by domestic recession. But recovery from recession, appreciation of the dollar as capital seeks refuge in the United States from political uncertainties elsewhere, and the prospect of a renewed blowout of the fiscal deficit under the impact of S&L and bank-bailout demands cast doubt on whether the improvement will last. As yet there is little sign of an upturn in the domestic household saving performance of the United States or, for that matter, of other OECD deficit countries, such as Australia.

Declining saving surpluses in both Germany and Japan chiefly reflect increasing public and private domestic investment demand. In Japan, however, the household saving ratio is expected to decline from its high level as consumption catches up with slower growth of income and as the aging of the population reduces net life-cycle saving.

On a longer historical perspective, what is at issue is balance between the capital needs of developing (and reconstructing Comecon) countries and the capital surpluses of developed countries. Throughout the nineteenth century, Great Britain (and later, to a smaller degree, other countries of Western Europe) supplied much of the capital required for the economic development of the United States and other non-European, resource-rich countries. In the first half of the present century, the United States became the chief supplier of external capital resources to the now developing countries of Asia, Africa, and Latin America. In the last two decades, while the United States (and some other OECD countries) became large capital importers, their demand was met, after the OPEC petrodollars interlude, from the saving surpluses of Japan, Germany, and the East Asian NIEs. The question now is how the capital needs of the developing countries, the former Soviet Union and Eastern Europe, and the postwar Middle East, on top of the continuing absorption of savings by the United States, are to be met.

There is of course a difference between need and effective demand. Much of the excess demand for capital is likely to be confronted by credit rationing, as countries with poor credit ratings find themselves unable to borrow. In part the problem is being resolved by debt relief and rescheduling. But the immediate symptom of worldwide excess demand for capital, already in evidence, is rising real interest rates. Developing countries may find it increasingly difficult to finance current account deficits, and rising costs of borrowing are liable to open up new debt traps.

Much depends on macroeconomic policy in the United States and Japan, given Germany's preoccupation with the former East Germany and its neighbors. The United States can alleviate the world capital problem—even if, as some seem to think the current account deficit and external debt do not matter to the United States (Corden 1991)—by raising the domestic saving rate. As for Japan, it is now obvious that the world needs its current account surpluses, however uncomfortable this may be for its competitors in international markets. Already, Japan can finance its direct foreign investment at current levels only by borrowing from abroad. Anything like a balanced current account would be inconsistent with Japan's desired and proper role as a major capital exporter through direct foreign investment and official development assistance, not to mention "burden sharing."

The other answer to the problem is increasing self-reliance for capital based on sustained economic growth in developing countries. This has already been achieved in the East Asian NIEs and is in varying degree on the way in the ASEAN countries (except, as yet, in the Philippines). There are good prospects that the new export- and market-oriented policies in Latin American countries, and perhaps also in India, will during the 1990s help them move in the same direction. Capital shortage, therefore, may become a diminishing problem, at least for most of the Asia-Pacific region.

The "Third Industrial Revolution"

First the steam engine, then the internal combustion engine, now the computer. The world, we are told, is on the threshold of a third industrial revolution. The information revolution, based on the computer chip, has begun to transform the pattern of world production and trade, and more drastic changes are predicted for the 1990s and beyond. First, a dramatic decline in information and transaction costs by increasing the mobility of factors of production—capital, technology, and to some extent labor—is said to herald "globalism," that is, the end of national economies. Second, with the new technology is coming a wave of organizational innovation in industry pioneered by Japan. Third, the new technology, by reducing the labor cost component in value added, is bringing about a "factor reversal"—loss of comparative advantage by labor-surplus countries in what used to be labor-intensive industries. How would these developments, if indeed they take place, affect the countries of the Asia-Pacific region?

The claims for globalism have, it seems to me, been much exaggerated. The greatly increased mobility of capital that has resulted from financial liberalization and the integration of national capital markets into virtually a single international market is certainly having far-reaching effects—on exchange rates, interest rates, and national autonomy in monetary policy. It is also arguable that the new technology has made management footloose, enabling multinational companies to "unbundle" production—that is, distribute the phases of production among offshore plants all over the world—to the point where the nationality of ownership is no longer obvious and matters little. Even labor has become more mobile, sometimes beyond the control of national governments, as the Vietnamese boat people and the flow of refugees from Eastern Europe have demonstrated. As

Europe progresses toward its single market, with a single currency and total freedom of movement for factors and products from one member country to another, one can, in moments of euphoria, believe that the end of national economies, with their national economic borders and national economic policies, is nigh. But to claim that "as almost every factor of production . . . moves effortlessly across national borders, the very idea of an American economy is becoming meaningless" (Reich 1991, p. 8) or that "increasing international mobility of information, capital and people is undermining the ability of governments to control national economies" (Kasper 1990) is straining credulity.

Even Europe is still some way from the single national currency and from the degree of coordination of national macroeconomic policies this requires. Any impetus that increased factor mobility lends to trade liberalization within and beyond regional groupings is very welcome. It is sure to improve the efficiency of resource allocation and is likely to stimulate economic growth. But economic efficiency and growth are not the only objectives of national economic policies. For better or worse, nation-states and national economic policies will remain the modules of the world economy for the foreseeable future, not least in the Southwest Pacific region.

There is more substance to the argument that the new technology is transforming national competitiveness, particularly in manufacturing. In the words of a recent World Bank study, an "entirely new approach to production management," fundamentally different from both the European craft tradition and the American mass production model, has been pioneered by Japanese manufacturing companies during the 1980s (Hoffmann 1989, p. 34). It is this, not unfair trade practices, dumping, and predatory pricing, that has given them the edge in world markets. It is based on three main principles: flexibility in product mix, output levels, and deployment of labor; production according to order rather than to stock; and pervasive concern for quality in all aspects of design and production. All three depend to some degree on the new information technology.

Michael Porter, in his best-seller, *The Competitive Advantage of Nations* (1990), has generalized this idea to the point of arguing that factor proportions, relative costs, and price have lost their relevance to competitiveness in international trade. This seems to me as much of an overstatement as the claims of the globalists. Natural resource endowment still matters, most obviously for resource-rich, primary-exporting countries. How powerful a price the exchange rate continues to be has been demonstrated by the dramatic effect on the U.S.–Japan (and Korea–Taiwan) imbalances of the post-Plaza currency realignment. But there is no doubt that the new technology puts a premium on the Japanese principles of production management. Those countries will do best which are most prompt and effective in following the Japanese example. This is already happening in the East Asian NIEs, and there is evidence that it has played a part in the resurgence of U.S. manufacturing exports of the past few years, which has been led, not by the established large, capital-intensive, mass-production oriented corporations but by a whole new generation of smaller technology-intensive manufacturing firms producing an enormous range of intermediate and final goods.

Does this mean that China, Indonesia, India, and other low- and middle-income labor-surplus developing countries are losing the comparative advantage which has helped them achieve export-oriented industrial development based on the textile, clothing, and footwear industries and other labor-intensive industries? Certainly, new technology is transforming these industries: not through robotization but through computers and fax machines, which permit instant transmission of information about changes of fashion, product demand, design, inventories, and market trends so that new orders for Osaka or Chicago or Vienna can be filled in a few days from value added by workshops in Penang, Jakarta, and Guangzhou, perhaps even Barcelona or São Paulo. Innovative, flexible, quality-conscious management practices are the major determinants of competitiveness and comparative advantage here.

But price competitiveness and labor and other input costs still matter. In the unbundling that the new technology makes possible, comparative advantage in management shifts to the commercial and financial centers where the entrepreneurial and managerial decisions are made: Hong Kong, Taipei, Singapore, and beyond in Japan, Europe, or the United States. For the allocation of the bundles of value-adding activities to different countries, however, labor and other input costs are still important. It is the combination of Taipei, Hong Kong, and other *hua qiao* (overseas Chinese) management and technology with the low labor costs in the People's Republic of China that explains the burgeoning industrial development in and around the southern coastal provinces of China, a development that may soon be replicated in the Singapore-Johor-Batam triangle and in Northeast Asia. The same applies to much Japanese direct investment in China, Indonesia, and other developing countries. Factor reversal is not a toothless dragon, but neither is it as dangerous to the Asia-Pacific NIEs as is sometimes suggested.

Nor is there as much ground for concern as some claim about a "bunching up" problem—all these NIEs producing the same goods for limited markets in North America and Europe. East Asian exports of manufactures to the United States and Japan are growing, but so are U.S. and Japanese exports to East Asia and trade in manufactures among East Asian countries. An increasing proportion of world, and East Asian, trade in manufactures is intra-industry trade, based on shifting specialization among the myriad of differentiated products of modern industry.

Conclusion

The main conclusion of this broad-brush survey of the implications for the Asia-Pacific region of current world economic developments can be summarized in three propositions.

First, there are indeed dangers. I have focused on three: threats to the open multilateral world trading system; the growing world capital shortage; and some of the consequences of technological change. I could have mentioned others: endemic poverty and possibly growing inequality of income and opportunity; still inadequately contained population growth; and environmental problems which are often exaggerated but need to be taken seriously.

Second, thanks largely to the quality of their human capital and the consequent quality of their economic policies, most of the developing countries of the Asia-Pacific region are less vulnerable to these dangers than other parts of the third world. With few exceptions, they have shown themselves capable, through energetic enterprise, prudent macroeconomic management, high saving rates, and emphasis on education and training to sustain high rates of economic growth and international competitiveness, and seem likely to continue to do so.

Third, success in warding off the dangers will depend in no small measure on cooperation among the countries of the region and between them and the major players on the world economic scene. It is the smaller trading countries that have the most to gain from the maintenance of an open world trading system and the most to lose from trade wars and protectionism. It is in their interest to bring what influence they can to bear upon Japan to liberalize its own market further and to play an active role in a satisfactory conclusion to the Uruguay Round and on the United States to resist domestic protectionist pressures and to make its FTAs as nondiscriminatory and outward-looking as possible. For all these purposes, APEC may be a useful instrument.

-26-

REFERENCES

Arndt, H. W. 1991. "Saving, Investment and Growth: Recent Asian Experience." *Quarterly Review,* June. Banca Nazionale del Lavoro.

Asian Development Bank. 1991. *Asian Development Outlook 1991.* The Philippines: ADB.

Corden, M. W. 1991. "Does the Current Account Matter? The Old View and the New." Paper presented at the Conference in Honor of Jacques J. Polak. Washington, D.C.: International Monetary Fund (mimeo).

Elek, A. 1992. "Pacific Economic Co-operation: Policy Choices for the 1990s." *Asian-Pacific Economic Literature* 1.

Hoffman, K. 1989. "Technological Advance and Organizational Innovation in the Engineering Industry." Industry Series Paper no. 4, 5 May. Washington, D.C.: The World Bank, Industry and Energy Department.

Kasper, W. 1990. *The Defeat of Political Power.* Perth, W.A.: Institute for Public Policy.

OECD. 1991. *Economic Outlook* 49, July.

Polak, J. J. 1990. "The Decline in World Savings." *International Economic Insights* vol. 1, no. 2, September-October. Washington, D.C.: Institute for International Economics.

Porter, M. E. 1990. *The Competitive Advantage of Nations.* New York: Free Press.

Reich, R. B. 1991. *The Work of Nations: Preparing Ourselves for 21st Century Capitalism.* New York: Knopf.

27

ICEG Academic Advisory Board