

# INEF

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### **The "Market-Friendly Approach to Development" vs. an "Industrial Policy"**

A Critique of the  
World Development Report 1991

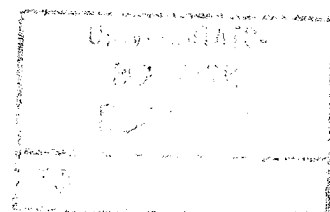
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**INEF-REPORT Heft 4/1993**

**The "Market-Friendly Approach to Development" vs. an "Industrial Policy"**

A Critique of the World Development Report 1991 and an Alternative Policy  
Perspective \*

by

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\*This paper was presented at the joint World Bank/UN University Symposium on Economic Reform in the Developing Countries: Issues for the 1990's, held in Washington DC, on 6 February, 1993, under its full title *"Close" vs. "Strategic" Integration with the World Economy and the "Market-Friendly Approach to Development" vs. an "Industrial Policy"*.

## Foreword

The importance of World Bank's annual World Development Report can hardly be overestimated. Inside the organisation, it implicitly contributes to the "corporate identity" of one of the most powerful international financial institutions. Outside the World Bank, it has a strong impact on (government) agencies, ministries and individuals concerned with development policy in the so-called donor countries, and policy makers in the developing world necessarily have to take it very seriously. Together with the 1990 Report on poverty and the 1992 Report on environment, the 1991 Report "seeks to provide a comprehensive overview of the development agenda", as World Bank President Barber Conable noted in his foreword to the Report. More specifically, in advocating a "market-friendly" approach to development in the 1991 Report, the World Bank claims not only to synthesize and interpret the lessons of more than forty years of development experience, but suggests also that there is a growing consensus in favour of this specific "market-friendly" approach to development.

Ajit Singh, Director of Studies in Economics at the University of Cambridge and an outstanding fellow in the field of development economics who originates from the "South", has a number of reservation about the Report's analysis and conclusions. In his paper which originally was presented at a joint World Bank/United Nations University Symposium earlier this year, he formulates his critique in an impressive way and offers an alternative policy perspective. The Institute for Development and Peace is very grateful to Professor Singh for the permission to disseminate the views he expressed in his article among both, scholars and policy makers in Germany, and hopes to stimulate fruitful discussions on the future development policy agenda.

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## I.

As Mr. Barber Conable observes in his Foreword, the World Development Report 1991 "synthesises and interprets the lessons of forty years of development experience" (p. iii). In view of the World Bank's leading role in development financing for poor countries around the globe over much of this period, this is clearly an important document. The Report is necessarily being taken very seriously in policy making circles throughout the developing world. It is therefore essential that there should be a full analysis of its intellectual approach and the evidence underlying its conclusions.

The starting point for the Report is the question: why during the last four decades some developing countries have been successful - in the narrow but important sense of substantially raising their per capita incomes - whilst other have not. The central analytical argument is that economic growth is determined essentially by the growth of total factor productivity of capital and labour. The Report's analysis comes to the conclusion that the more open an economy, the greater the degree of competition and the higher its investment in education, the greater would be its growth of total factor productivity and hence its overall economic growth. Although the significance of the international economic factors is recognised, a major argument of the Report is that domestic policy matters far more for raising per capita incomes than world economic conditions.

The centre-piece of the Report's policy conclusions is its recommendation of a so-called 'market-friendly' approach to development. The Report states: "Economic theory and practical experience suggest that (government) interventions are likely to help provided they are market-friendly" (p. 5). 'Market-friendly', it is explained, means the following:

- a. *Intervene reluctantly.* Let markets work unless it is demonstrably better to step in . . . [I]t is usually a mistake for the state to carry out physical production, or to protect the domestic production of a good that can be imported more cheaply and whose local production offers few spillover benefits.
- b. *Apply checks and balances.* Put interventions continually to the discipline of international and domestic markets.
- c. *Intervene openly.* Make interventions simple, transparent and subject to rules rather than official discretion.

The state's role in economic development in this market-friendly' approach is regarded as being important but best limited to providing the social, legal and, economic infrastructure and to creating a suitable climate for private enterprise. The Report implicates other development economists in its policy recommendations by suggesting that there is now a growing consensus around the 'market friendly approach' to development (p. 1).

## II.

I have a number of reservations about the Report's analysis and its conclusions. However, it would be best to begin with significant points of agreement. I concur with the general methodological approach of examining the question why over the last four decades some countries were able to achieve high rates of economic growth and others not. Secondly, I agree with the Report's generally optimistic outlook on the possibilities for development for the poor countries. I also read the last forty years of development experience as indicating that these countries have an enormous potential for economic growth. In right international economic circumstances, and with appropriate economic policies, these countries can in general achieve what may be called their 'socially necessary' rates of economic growth. The latter represent the rates of economic expansion which developing countries require to provide employment for their fast growing labour forces and to meet the minimum basic needs of their people for food, clothing, shelter, etc over a reasonable time span. Such growth rates, which are estimated to be of the order of five to six percent per annum need not be out of reach of the developing countries.<sup>1</sup> I also welcome the Report's recognition that there is no automatic trickle down of the fruits of economic progress in a market economy, and that it is therefore necessary for the governments to provide a 'safety net' for the most disadvantaged in society during the course of economic development. Moreover, the Report's emphasis on the importance of the objective of establishing stable macroeconomic conditions in developing countries is also common ground.

My principal reservations concerning the Report are summarised below. These will be elaborated in the following sections.

1. I have difficulty in accepting the Report's analysis of the relative importance of the international conditions and domestic policy in determining economic outcomes in developing countries. The Report, in my view, does not give adequate recognition to the fact that during the

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<sup>1</sup> See further Singh (1984, 1992a) and Taylor (1991).

1980s the world economic forces had a far greater adverse impact on countries in Latin America and Sub-Saharan Africa relative to these in Asia; this was a main reason for the poor performance particularly of the Latin American countries during the last decade. There are a number of important implications of this point which are ignored in the Report, thus leading to incorrect conclusions being drawn with respect to some of its central themes.

2. A fundamental argument of the Report is that the greater the degree of international economic integration (e.g. the larger the share of trade), the better it is for any particular economy or for the world economy as a whole. A corollary of this view is that the less the distortions from international competitive prices in an economy, the greater would be its economic growth. I am afraid I cannot accept these propositions either at a theoretical level or empirically.

3. The intellectual foundation of the Report is the total factor productivity approach to economic growth. The implicit underlying paradigm here is that the more competitive the product, labour and capital markets in an economy, the more efficient will be the utilisation of resources, the faster will be its technical progress and hence economic growth. In my view this paradigm is analytically flawed; it is also not as good at explaining empirical evidence as an alternative theoretical approach which does not regard greater market competition as an unalloyed good, and which gives a far bigger role to demand factors and to overall national and world economic growth, to account for changes in productivity growth.

4. I find it particularly difficult to accept the Report's account of the economic history of the successful East Asian economies-Japan, South Korea and Taiwan. Nor am I at all comfortable with the Report's analysis of, and the lessons to be learnt from the experience of the 'unsuccessful' countries.

In addition to these analytical differences, I also find that there are important omissions from the Bank economists' examination of forty years of development experience (e.g. what lessons do the bank economists draw from the Bretton Wood institutions' own role in the international debt crisis of the 1980s?). There are also a number of relatively minor points of disagreement-interpretations of the econometric evidence which is presented, places where even in its own terms the Report's conclusions do not follow from the data put forward. These points will be referred to as appropriate in the course of the analysis below.

In view of the above reservations, it is no surprise to say that I would arrive at very different policy conclusions from those contained in the Report.

### III.

I begin with the Report's analysis of the development experience of the successful East Asian economies. The Report observes (pp. 13-14):

Extraordinary progress is possible even when countries seem doomed to fail. Forty-three years ago an influential government report in an important developing country observed that labour today shunned hard, productive jobs and sought easy, merchant-like work. The report showed that workers' productivity had fallen, wages were too high, and enterprises were inefficient and heavily subsidized. The country had virtually priced itself out of international markets and faced a severe competitive threat from newly industrializing China and India. It was overpopulated and becoming more so. This would be the last opportunity, concluded the prime minister in July 1947, to discover whether his country would be able to stand on its own two feet or become a permanent burden for the rest of the world. That country was Japan. The central question of this Report is why countries like Japan have succeeded so spectacularly while other have failed. [Underlining added]

The Report is quite right to stress the case of Japan since the experience of that country in the period following the Second World War is highly relevant to the developing countries, particularly the large semi-industrial economies. In the early 1950s, Japan produced less steel (about 5 million tons) and fewer cars (about 50,000) than countries like Brazil, India and Mexico do today and it was largely an exporter of labour-intensive products. The U.S. annual steel output at that time was about a hundred million tons and the American automobile industry produced around six million cars every year. Yet less than two decades later Japan was producing more steel, and by 1980 more cars than the U.S. The Japanese workers, starting from Asian wage levels in the 1950s, were well on their way to reaching European standards of living twenty-five years later (Singh, 1989).

In analyzing this arguably the most spectacular case of successful industrial development in the history of mankind, the relevant question in the present context is to what extent, if any, the Japanese followed the Report's prescriptions and a 'market-friendly' approach to development. Did the Japanese government intervene in the markets 'reluctantly': did it for example leave the prices and production priorities to be determined by market forces and simply provide the necessary infrastructure for private enterprise to flourish? How 'transparent' was the government intervention in Japanese industry? To achieve this colossal economic success, how closely did the Japanese economy integrate with the world economy? The Report does acknowledge the inescapable fact that there was



considerable government intervention in the course of post-War Japanese development. The important issue, however, is whether the Report's characterisation of this intervention and the lessons to be drawn from it are valid.

There is overwhelming evidence and it is generally accepted among the scholars in the field that the government in Japan did not intervene in the markets 'reluctantly'. On the contrary, it pursued a forceful and aggressive industrial policy to change the unsatisfactory economic situation faced by that country—so eloquently described in the Report's paragraph quoted above. The cornerstone of this industrial policy was the so-called 'structural policy' aimed at adaptation and technological development of certain specific industries (steel, chemicals, machinery and other heavy industries) thought to be vital for the rapid growth of productivity and per capita incomes (Singh, 1979). The role of the government in promoting these industries and hence bringing about Japanese economic success has been so crucial that, as the Japanese industrial economist Professor Nino (1975), remarked, "whereas [the] USA is said to be a country of [the] military industrial complex . . . in this sense, Japan may be called a country of the Government industrial complex."

At the end of World War II, the bulk of Japanese exports consisted of textiles and light manufactured goods. In the view of the Ministry of International Trade and Industry [MITI], although such an economic structure may have conformed to the theory of comparative advantage (Japan being a labour-surplus economy at the time), it was not viable in the long run. It is worth quoting in full Vice-Minister Ojimi's rationale for the Ministry's industrial policy<sup>2</sup>:

The MITI decided to establish in Japan industries which require intensive employment of capital and technology, industries that in consideration of comparative cost of production should be the most inappropriate for Japan, industries such as steel, oil-refining, petro-chemicals, automobiles, aircraft, industrial machinery of all sorts, and electronics, including electronic computers. From a short-run, static viewpoint, encouragement of such industries would seem to conflict with economic rationalism. But, from a long-range viewpoint, these are precisely the industries where income elasticity of demand is high, technological progress is rapid, and labour productivity rises fast. It was clear that without these industries it would be difficult to employ a population of 100 million and raise their standard of living to that of Europe and America with light industries alone; whether right or wrong, Japan had to have these heavy and chemical industries. According to Napoleon and Clausewitz, the secret of

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<sup>2</sup> OECD (1972), quoted in Singh (1979, pp. 217-8).

a successful strategy is the concentration of fighting power on the main battle grounds; fortunately, owing to good luck and wisdom spawned by necessity, Japan has been able to concentrate its scant capital in strategic industries.

The government used a wide variety of instruments to bring about this extraordinary structural transformation of the Japanese economy between 1950-73, the period of its most rapid growth. The most important of these were bank finance and directed credit, import controls and protection, restrictions on entry and exit of firms in the domestic market, control over foreign exchange and importation of foreign technology (Caves and Uekusa, 1976; Boltho, 1975; Nino, 1975; OECD, 1972; Dore 1986; Yamamura 1988).

The significance of these policies, and particularly the economic rationale underlying them, will be considered further in the next two sections. In the meantime we note that the Japanese government did not only use these methods of intervention to concentrate resources to promote specific industries, its role in the country's industrial development was deeper and even more intrusive. It extended to the level of the individual firm: MITI accorded favourable treatment in a variety of ways to the specific firms which were thought to best fulfil its aims and were therefore in its good books. As for the 'transparency' of this intervention, it was the exact opposite of the 'market-friendly' specification. Thus Professors Caves and Uekusa (1976) on the operations of the Japanese industrial policy:

Each sector of the Japanese economy has a cliental relation to a ministry or agency of the government. The ministry, in addition to its various statutory means of dealing with the economic sector, holds a general implied administrative responsibility and authority that goes well beyond what is customary in the United States and other Western countries. While the Ministry of International Trade and Industry (MITI) plays the most prominent role, its operations are not distinctive. "The industrial bureaus of MITI proliferate sectoral targets and plans; they confer, they tinker, they exhort. This is the economics by admonition to a degree inconceivable in Washington or London. Business makes few major decisions without consulting the appropriate governmental authority; the same is true in reverse." (p. 149; quotes in the original from Lockwood, 1965)

Moreover, as we shall see in Section IV, the Japanese government did not seek "close," but rather what may be called a "strategic" integration with the world economy. For example, it made extensive use of formal or informal import controls and protection. It also restricted foreign direct investment by

multinationals. These points will be taken up further when the concept of "strategic integration" is developed below.

### III.1

As several scholars have noted, the other East Asian tigers, notably South Korea and Taiwan, have also each followed a purposive and comprehensive industrial policy (see among others Johnson, 1987; Amsden, 1989; Wade, 1990). These countries have been greatly influenced by the Japanese example and practice. In view of their relative backwardness compared with Japan, state intervention in these economies has been even more far-reaching than in Japan. Very briefly, in case of S. Korea, attention may be drawn to the following aspects of the country's industrial policy.

- i. The use of long-term credit at negative real interest rates to foster particular industries.
- ii. The "heavy" subsidization and the "coercion" of exports.
- iii. The strict control over multi-national investment and foreign equity ownership of Korean industry.
- iv. A highly active state technology policy.
- v. State promotion of large scale conglomerate firms, government encouragement of mergers of specific corporations, and in general state restrictions on the free entry and exit of firms.

Table 1 summarises the industrial policy instruments used in the development of some core Korean industries (as well as textiles) in the late 1960's and 1970's.

Similarly, for Taiwan, Wade (1990) documents the widespread and intensive use of state industrial policy to purposefully guide the market economy. It is certainly not a picture of some nightwatchman state intervening "reluctantly". Until the early 1980s, both South Korea and Taiwan had nationalised banks (and most of their banks are still state-owned), and in both countries, state-directed credit to favoured sectors and firms was an important device for planned industrial development. Moreover, the authors of the Report overlook the fact that the public enterprise sector in Taiwan is one of the largest among the developing mixed economies. It is bigger than India's or that of Argentina, Brazil or Mexico. The public enterprises have contributed 13-4% of GNP and a third of gross fixed capital formation in Taiwan throughout the years 1950 to 1975, a period which

*Table 1: The Chief Provisions of Industrial Promotional Laws in Korea*

Major Content (year of enactment)	Machinery (1967)	Ship-building (1967)	Electronics (1969)	Petro-chemical (1970)	Iron & Steel (1970)	Non-ferrous metal (1971)	Textile (1979)
<b>REGULATIONS</b>							
<b>Entry Restriction</b>	x	x	x	x	x	x	x
<b>Capacity Regulations</b>							
Setting up Facility Standard	x	x					
Capacity Expansion Approval				x	x		x
Incentives to use Domestically Produced Facilities	x		x				
<b>Production Regulation</b>							
Regulation of Material Imports					x	x	
Production Standard and its Inspection	x	x	x		x	x	
Restriction on Technology Imports	x		x				
<b>Price Control</b>							
<b>Reporting and Inspection</b>	x	x	x	x	x	x	x
<b>RATIONALISATION</b>							
Rationalisation Programmes	x	x	x	x			x
<b>R&amp;D SUPPORT</b>							
Subsidies to R&D	x		x	x	x		
Joint R&D Projects			x				
<b>FINANCIAL SUPPORT</b>							
<b>Special Purpose Fund</b>	x	x	x		x	x	x
<b>Financial Assistance</b>	x	x	x		x	x	x
<b>Subsidies</b>							
Direct Subsidy	x					x	
Reduced Public Utility Rates	x				x		
<b>Tax Preferences</b>							
Special Depreciation	x					x	
Tax Reduction/Exemption	x	x	x	x	x	x	
<b>SPECIAL INDUSTRIAL COMPLEX</b>							
	x		x	x			x
<b>ADMINISTRATIVE ASSISTANCE</b>							
Facilitating Overseas Activities			x		x		
Purchase of Raw Materials					x	x	
<b>PRODUCERS' ASSOCIATION</b>							
	x	x	x				x

Source: Reproduced from Chang (1992), p. 153.

witnessed the most rapid economic and industrial growth in that country (Chang and Singh, 1992; Short, 1984). Wade observes that:

In many sectors public enterprises have been used as the chosen instrument for a big push. This is true for the early years of fuels, chemicals, mining, metals, fertilizer, and food processing; but even in sectors where public enterprises did not dominate, such as textiles and plastics, the state aggressively led private producers in the early years. Later, during the late 1950s and 1960s, public enterprises accounted for a large part of total investment in synthetic fibers, metals, shipbuilding, and other industries...To say that public enterprises have often played a central role in creating new capacities is not to say that private firms have been left alone. Incentives and pressure are brought to bear on them through such devices as import controls and tariffs, entry requirements, domestic content requirements, fiscal investment incentives, and concessional credit. Even in the case of machine tools, a small-scale industry relatively neglected until recently, the state nevertheless has provided subsidized design help, subsidized credit, and quantitative import restrictions. And large-scale private firms are often exposed to more discretionary government influence, taking the form of what in Japan is called "administrative guidance" (pp. 110-11).

In view of the useful and important role played by public enterprises in Taiwan as well as in Korea, the Report's blanket admonition to the states in developing countries not to engage in 'direct production'-not to produce steel and cement (p. 31)-would appear to be misconceived. The reference to steel is particularly inappropriate since Posco, the Korean state-owned steel company, is the most efficient steel producer in the world. In 1986, Posco produced 467 tons of crude steel per person compared with an average of 327 tons for Japan's five biggest steel producers. The company's efficiency advantage is passed on to its Korean customers. It charged domestic steel consumers \$320 per ton-far less than American or Japanese car makers who (according to Posco) paid \$540 and \$430, respectively (The Economist, 21 May 1988; for a more detailed discussion of Posco's efficiency advantage over other steel producers, see Amsden, 1989, pp. 298-99).

### III.2

To sum up, between them, Japan, South Korea and Taiwan did all the things which the 'market-friendly' approach to development is not supposed to do. Above all, all three countries followed an 'industrial strategy'-a set of policies to deliberately change the market prices and production priorities-which is explicitly ruled out by this approach. The Report acknowledges that there was heavy state intervention in all these three countries but argues that 'these economies refute the case for thorough going dirigism as convincingly as they refute the case for laissez-faire' (p. 5). The experience of these countries is certainly an argument against laissez-faire; it also does not provide any support for "command" planning of production of the Soviet-type, which in effect supplants the market altogether. However, for mixed-economy third world countries, it is unequivocally an argument for adopting an industrial strategy, for guiding the market, and not following a hands-off 'market-friendly' approach as enunciated in the Report. Moreover, as mentioned in the case of Japan, it will be suggested below that the experience of all three East Asian countries is an argument against seeking 'close integration' with the world economy; rather it is an argument for choosing 'strategic integration' with the latter. These concepts of "guiding" the market and of "strategic integration with the international economy" will become clearer when we discuss the role of domestic and international competition in these economies in the following sections.

Other neoclassical accounts, not just the WDR, also have a difficult task in accommodating the facts of pervasive interventions of the East Asian states in their internal and external economies, with the theoretical and policy framework used in such analyses. Some have even argued that these countries would have grown faster still if the state had not intervened in these economies (Lal, 1983). Others have suggested that in countries like Korea, the state has followed a 'prescriptive' rather than a 'proscriptive' policy and that accounts for the success of state intervention in that economy (Bhagwati, 1988). Still others have suggested that the essential reason for the state's success in these countries is that it has followed the market rather than leading or guiding it. Such arguments have been carefully analyzed by Wade, Amsden, Chang (1992), and others and found to have very little merit.

What does distinguish the industrial policy of Japan, South Korea, and Taiwan from that of many other countries, both developed and developing, is the ability of the state in the former countries to use not only 'carrots' (incentives, subsidies, etc.) but also 'sticks' (punishments) to influence firm behaviour. In that sense, the

state in these countries has been much more powerful and has, what the political scientists call, greater 'autonomy' than in many other economies. (See further Fishlow, 1991a; Wade, 1990; Amsden, 1989).

#### IV.

We turn now to the central analytical argument of the Report, based on the total factor productivity approach to economic growth. It is suggested that inter-country and inter-temporal variations in growth rates are caused by variations in total factor productivity of capital and labor. Changes in the latter variable are thought to be determined mainly by economic policy-the degree of openness of an economy, the extent of competition in the product and factor markets, and investment in physical and human capital (education), particularly the latter. The underlying chain of causation is that competition and education promote technical progress, and therefore total factor productivity growth and hence economic expansion. "Free mobility of people, capital, and technology" and "free entry and exit of firms" are regarded as being particularly conducive to the spread of knowledge and technical change.

The role of "openness" and international competition, as well as domestic competition, as critical determinants of productivity growth is repeatedly stressed throughout the Report (See chapters 1, 2, 4, 5, and 8). In relation to domestic competition, the Report notes: "systems of industrial licensing, restrictions on entry and exit, inappropriate legal codes concerning bankruptcy and employment, inadequate property rights, and price controls-all of which weaken the forces of competition-have held back technological change and the growth of productivity" (p. 7). In the analysis below, I shall concentrate mainly on the Report's arguments with respect to the role of competition. Questions of external competition, "openness" and "the integration of countries with the global economy" will be examined in the following section (V), and those relating to domestic competition in the product, labor, and financial markets in Section VI. In addition to an analysis of the role of competition, there are, however, two other issues which deserve comment. These will be taken up below in the rest of this section.

#### IV.1

The first point concerns the Report's underlying causal model and the total factor productivity (TFP) approach to economic growth. At a theoretical level, there are several well-known objections to this type of analysis. The model assumes for

example full employment of resources and perfect competition, none of which obtain in the real world. Moreover, it is a wholly supply-side model which ignores altogether the role of demand factors.<sup>3</sup>

Further, even a cursory consideration of the empirical evidence presented by the Report itself reveals the serious limitations of the TFP approach. Table 2.2 on page 43 provides figures for total factor productivity growth, separately for each developing region and for each of the two sub-periods 1960-73 and 1973-87. The table shows that in every region, except South Asia, the rate of growth of total factor productivity fell substantially in the second sub-period, compared with the first. In terms of the analysis of the Report, this would be due to policy mismanagement-low rates of technical progress caused by distortions, lack of competition, lack of integration with the world economy, etc.. The evidence, however, is not compatible with such an analysis, since as the Report itself notes elsewhere there has actually been more competition, greater integration of the world economy, less distortions in most developing countries in the later period (particularly in the 1980s) than in the former.<sup>4</sup>

These facts are much more in accord with an alternative theoretical paradigm which would suggest that the fall in the world and the national economic growth rates in the post-1973 period was responsible for the decline in the rate of growth of productivity in most regions (Verdoorn's Law).<sup>5</sup> The decline in world economic growth after 1973, in terms of this paradigm, was due to a lower rate of growth of world and national demand caused by a whole range of factors (e.g. the collapse of the Bretton Woods system, the growth of real wages in a number of industrial countries outstripping productivity growth in the wake of the first oil shock) connected with the fall of the Golden Age of development of the OECD economies.<sup>6</sup>

It is a serious shortcoming of the Report that it does not even consider this alternative causal model, let alone systematically test it against empirical evidence.

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<sup>3</sup> There is an enormous literature on the subject. For a lucid analysis of the relevant issues under discussion here, see Nelson (1982).

<sup>4</sup> See also Singh (1989, 1990) on this point.

<sup>5</sup> The classic references here are Verdoorn (1949) and Kaldor (1966).

<sup>6</sup> The period 1950-73, when the OECD economy grew at an unprecedented rate of almost 5% per annum-twice its historic trend rate of growth-has been termed by my colleagues Andrew Glyn, Alan Hughes, Alain Lipietz and I "the Golden Age of capitalism". (Glyn, Hughes, Lipietz and Singh, 1990). This essay provides a detailed analysis of why the Golden Age rose in the first place and why it fell following the 1973 oil shock. See also Maddison (1982); Bruno and Sachs (1985).



Without such an examination of the data in terms of competing causal hypotheses emanating from these two paradigms-both of which have well established pedigrees in the subject-the Report's policy conclusions are unconvincing. Regrettably, the failure to consider different causal explanations of the data is commonplace in the Report, leading often to misleading and erroneous policy conclusions. Some further examples of this will be provided below and in the following sections.

## IV.2

Secondly, with respect to the Report's analysis of the relationship between education and economic growth, I briefly note here that the Report's empirical results, based on a cross section study of sixty countries over the period 1965-87, suggest that a "three-year-higher initial level of education is associated with an increase of 0.4 per cent in the annual growth rate." Although the Report correctly observes that such correlations do not imply causation, it nevertheless goes on to draw the conclusion that: "Both better policies and more education contribute to growth. Furthermore, they seem to interact. Thus, the effect on growth of better policy and more education together is greater than that of each separately (Table 2.4). Similar results are obtained for changes in education and for investment" (p. 46).

Such policy conclusions are unfortunately misleading. To illustrate, the poor economic performance of the Latin American countries during the "lost decade" of the 1980s can hardly be ascribed to a deficit in education. It will be difficult to argue that education, let alone primary or secondary education as the Report's overall analysis of this issue suggests, is a constraint on economic growth of these countries; or that expanding such education will significantly increase economic growth on this developing continent. Even for African countries, where the Report's policy conclusions in this area may be regarded as being more applicable, a detailed investigation is required to show that it is the lack of primary or secondary education, rather than other factors (e.g., world economic conditions or for instance deficiencies in university education) that has been a major factor responsible for slow economic growth in these countries during the last decade. The Report does not provide such an analysis. Any policy conclusion that expansion of primary education will increase economic growth in the medium term or for that matter during the rest of this decade, even for the African countries, is therefore hazardous.

The above examples suggest two basic flaws in the Report's analysis and policy conclusions with respect to the role of education. One, the Report implicitly assumes that there will be full employment of resources-that those who are educated will find appropriate employment. Two, here, as indeed at a number of other places, the Report's empirical conclusions are based on cross section regression analyses of countries from different continents and over time periods which, from an economic point of view, it may be inappropriate to aggregate. This point will be taken up further in Section VII where the differential impact of world economic conditions on countries in different developing continents, particularly Asia and Latin America in the 1980s is explored.

The Report is of course right to note that "progress in education is to be sought mainly as an end in itself" (p. 56). However, for the reasons outlined in the previous paragraphs, its general policy conclusion that education will promote economic growth is unlikely to be valid for many developing countries in the next five to ten years.

## V.

The Report's assertions with respect to the role of openness, external competition and closer integration with the world economy do not stand up to serious examination either at a theoretical level or empirically, particularly in terms of the experience of the East Asian countries it holds up as models of successful development. In the discussion below, I shall first comment on the empirical evidence presented by the Report itself to support its contention of an important positive relationship between these variables. Next, I shall provide information bearing on these issues for the East Asian economies. It was suggested earlier (Section III) that these countries had sought a "strategic" but not a "close" integration with the global economy-i.e., they integrated up to the point where it was useful for them to do so for promoting national economic growth. I shall put forward an alternative theoretical paradigm with respect to the relationship between openness, international economic integration, and economic growth. This will help to provide an analytical rationale for the "strategic integration" path pursued by Japan, South Korea and Taiwan.

The Report's own empirical analysis of the relationship between trade openness, "distortions" from international prices, and productivity growth is presented in Chapter 5. This evidence (see Figure 5.3 on p. 100 and Table note 5.3 in the technical Appendix, p. 163), even in its own terms is extremely weak.

Notwithstanding countless permutations of the indicators used to denote distortions and openness, only 12 of the 37 regression coefficients reported in Table note 5.3 are statistically significant at the 5% level. The R<sup>2</sup>'s range between 0.03 and 0.3. The interpretation of the econometric results on page 164 is less than exemplary: it is implied, for instance, that it makes no difference to the verification of the economic hypotheses under discussion whether one considers "levels" of or "changes" in the values of some of the independent variables. The tentative character of this empirical evidence are acknowledged in the text of Chapter 5, but, despite that, far-reaching and firm policy conclusions are drawn from it in the Report's overview chapter.<sup>7</sup>

With respect to the nature and extent of "openness" practiced by the East Asian economies, I provide here some relevant data on Japan. Table 2 gives comparative figures on imports of manufacturers into Japan and other industrial countries between 1961 and 1978. During this period, as a proportion of GDP, Japanese imports rose by 66 percent. This compares with a threefold increase in the corresponding U.S. imports, more than tripling of the U.K. imports and a nearly 250 percent growth in the imports of other European Economic Community countries. In 1978, manufactured imports constituted only 2.4 percent of the Japanese GDP; the corresponding proportion in Britain and other countries of the EEC was five to six times larger. Even in the United States which traditionally, because of its continental size, has a relatively closed economy, the volume of imported manufacturing goods in the late 1970s was proportionally almost twice as large as in Japan. Clearly, during the 1960s and 1970s (and even more so in the 1950s) the Japanese economy operated under a regime of draconian import controls, whether practised formally or informally.

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<sup>7</sup> In relation to other empirical studies on this subject, the Report states in the text on p.98: "Most of the studies which have analysed GDP growth and openness to trade have found a positive relation (Box 5.3)." (Underlining added). However, when one turns to Box 5.3, the conclusion is much more tentative. We are told: "The majority of the evidence now available shows a positive relation between openness-however measured-and growth" (p.99, Underlining added). For the record, I note here that other recent surveys of the empirical evidence on this issue by independent scholars (see Pack, 1988; Rodrik, 1991) are even more skeptical about a positive relationship between openness and economic growth.

*Table 2: Import-Penetration in Manufactures in Advanced Industrial Countries, 1961-1978 (Ratio of Manufactured Imports to GNP)*

	1961	1965	1969	1973	1978
U.S.A.	1.5	2.1	3.4	4.0	4.5
U.K.	4.6	6.7	8.0	11.7	14.2
Rest of EEC 9	6.1	7.6	10.1	13.0	15.8
Japan	1.8	1.5	2.2	3.0	2.4

SOURCE: CEPG (1979).

With respect to the questions of overvalued exchange rates and distortions, the Japanese Government maintained exchange controls and kept a steady nominal exchange rate with respect to the U.S. dollar over almost the whole of the period of that country's most rapid growth (1950-73). Purchasing power parity calculations by Sachs (1987), using Japanese and U.S. price indices, show a 60 percent real appreciation of the exchange rate between 1950 and 1970. As for close integration with the international capital markets and foreign direct investment, Sachs notes that domestic capital markets were highly regulated and completely shut off from the world capital markets for most of this period. Only the government and its agencies were able to borrow from and lend abroad. Foreign direct investment was strictly controlled. Foreign firms were prohibited, either by legal or administrative means, from acquiring a majority ownership in Japanese corporations.

To appreciate how the Japanese policy of protection worked at a microeconomic level, consider the specific case of the celebrated Japanese car industry. Magaziner and Hout (1980) point out that "government intervention in this industry was characterized by three major goals: discouragement of foreign capital in the Japanese industry and protection against car imports, attempts to bring about rationalization of production, and assistance with overseas marketing and distribution expenditure (p. 55)". They point out that the government imposed comprehensive import controls and adopted a variety of measures to discourage foreign investment in the car industry. Quotas and tariffs were used to protect the industry; the former were applied throughout the mid-1960s, and prohibitively high tariffs till the mid-1970s. Moreover, "the government controlled all foreign licensing agreements. To make technology agreements more attractive to the licensor, it guaranteed the remittance of royalties from Japan. The policy

stipulated, however, that continued remittances would be guaranteed only if 90 percent of the licensed parts were produced in Japan within five years" (p. 56) -about as powerful a domestic content arrangement as you can get.

The Report acknowledges that the Japanese protected their industry (as did Taiwan and Korea) but it is silent on the question of restrictions on foreign direct investment and government controls over foreign capital inflows for industrial development. Even with respect to protection, the Report does not tell you how large and pervasive its use in effect was in a country like Japan. In general, the Report is embarrassed by the East Asian protection; its overall tone is to suggest that it is a miracle that these economies did as well as they did despite the protection. There is little recognition of the fact that protection has played an extremely important, positive role in promoting technical change, productivity growth and exports in a country like Japan. Protection provided the Japanese companies with a captive home market leading to high profits which enabled the firms to undertake higher rates of investment, to learn by doing and to improve the quality of their products. These profits in the protected internal market, which were further enhanced by restrictions on domestic competition (see Section VI), not only made possible higher rates of investment but also greatly aided exports. Yamamura (1988) explains the mechanism involved:

Because increased output meant reduced cost per unit it translated into increased profits on the product sold at high fixed prices in the domestic market, even if the increased output had to be exported at no profit or even at a loss. . . . Manufacturers enjoyed a margin of error when making . . . major investment decisions. Essentially, even in the face of the high probability that the increase in output would have to be sold unprofitably on the international market the expansion was still worth the risk. The stronger the "home market cushion"-or the more effective the cartels and protection on the domestic arena-the smaller the risk and more likely the Japanese competitor was to increase capacity boldly in anticipation of demand growth. This can give the firm a strategic as well as a cost advantage over a foreign competitor operating in a different environment who must be more cautious (p. 177).

The Report echoes the view of some neoclassical analysts who suggest that although the governments in East Asian countries imposed protection, they were careful "to offset the bias against exports that is usually a feature of trade protection" (p. 39). This suggests that the governments maintained a rough neutrality of incentives between selling in the home and the foreign markets, i.e. despite intervention, there were "level playing fields" between different sectors of

the economy and between internal and external markets.<sup>8</sup> However as Scott (1992) rightly points out, this is simply an incorrect characterization of the commercial and industrial policies pursued in the East Asian economies. Scott notes that the level playing fields between selling in the national and international markets prevailed in the U.S. and the U.K. economies which have been relatively unsuccessful in world competition. Countries like Japan and Korea on the other hand, particularly during their periods of rapid growth, had a positive bias in favor of exports through the wide panoply of industrial policy instruments discussed above, including notably the use of performance criteria on exports and market share. The Japanese and Korean corporations could only receive favored government treatment in terms of loans, foreign exchange allocations, etc., if they met such criteria. Thus despite often low short-run financial returns on exports, they were obliged to fulfil their export targets.

To sum up the experience of Japan comprehensively contradicts the Report's central thesis that the more open the economy, the closer its integration with the global economy, the faster would be its rate of growth. Although, for reasons of space, the cases of the other East Asian countries (Taiwan and South Korea) have not been considered above, their stories, subject to certain modifications, also point in the same direction.<sup>9</sup> If, as stated, the Report's central purpose was to find out why countries like Japan have been so successful in economic development during the last forty years, it has clearly been using the wrong paradigm for examining Japanese economic history. The basic problem is that the underlying assumptions of this paradigm are greatly at variance with the real world of static and dynamic economies of scale, learning by doing, and imperfect competition. In such a world, even neoclassical analysis now accepts that the optimal degree of openness for an economy is not "close" integration with the global economy through free trade.<sup>10</sup> In that case, what is the optimal degree of openness for the economy? This extremely important policy question however is not seriously addressed by orthodox theory.<sup>11</sup>

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<sup>8</sup> Some neoclassical economists take this argument even further and suggest that the government intervention in the East Asian economies did no more than what the market would have done anyway, i.e. the government policy was simply simulating the market. There are serious analytical and empirical flaws in this market simulation thesis. See Wade (1990).

<sup>9</sup> For a detailed analysis, see Wade (1990) and Amsden (1989).

<sup>10</sup> See for example Krugman (1987) and Rodrik (1992).

<sup>11</sup> On this point, see the interesting review by Lucas (1990) of Helpman & Krugman (1989).

Chakravarty and Singh (1988) provide an alternative theoretical paradigm for considering this issue. Very briefly, they argue that "openness" is a multi-dimensional concept; apart from trade, a country can be "open" or not so open with respect to financial and capital markets, in relation to technology, science, culture, education, inward and outward migration. Moreover a country can choose to be open in some directions (say trade) but not so open in others such as foreign direct investment or financial markets. Chakravarty and Singh's analysis suggests that there is no unique optimum form or degree of openness which holds true for all countries at all times. A number of factors affect the desirable nature of openness: the world configuration, the past history of the economy, its state of development, among others. The timing and sequence of opening are also critical. Chakravarty and Singh (1988) point out that there may be serious irreversible losses if the wrong kind of openness is attempted or the timing and sequence are incorrect. The East Asian experience of "strategic" rather than "close" integration with the world economy makes perfect sense within this kind of theoretical framework.

## VI.

Contrary to the Report's homilies about the virtues of "free mobility of capital and labor" and "free entry and exit of firms" and the importance of competition in the domestic markets, the practice of the successful East Asian countries has been rather different. As in relation to the question of integration with the world economy, these countries appear to have taken the view that from the dynamic perspective of promoting investment and technical change, the optimal degree of competition is not perfect or maximum competition. The governments in these countries have therefore managed or guided competition in a purposeful manner: it has both been encouraged, but notably also restricted in a number of ways.

In Japan, although after the war, the Zaibatsu were disbanded, and anti-trust laws of the U.S. type were enacted under the tutelage of the occupation authorities, these pro-competition measures were greatly diluted over time. The government permitted or encouraged a variety of cartel arrangements in a wide range of industries-export and import cartels, cartels to combat depression or excessive competition, rationalization cartels, etc.. Table 3 provides information on cartels which were exempted during 1964 to 73 from Japan's anti-monopoly laws. According to Caves and Uekusa (1976), cartels accounted for 78.1 percent of the value of shipments in textiles; 64.8 percent in clothing; 50.0 percent in non-ferrous metals; 47 percent in printing and publishing; 41.2 percent in stone, clay and glass; 34.5 percent in steel products, and 37.2 percent in food products. Caves and

Uekusa note that although these cartels varied in their effectiveness, "their mere presence in such broad stretches of the manufacturing sector attests to their importance." (p. 147).

*Table 3: Japanese Cartel Agreements Exempted from Antimonopoly Law by Fair Trade Commission or Competent Ministry, by Exempting Statute, 1964-73<sup>a</sup>*

Statutory basis for exemption	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
Depression cartels	2	2	16	1	0	0	0	0	9	2
Rationalization cartels	14	14	14	13	13	12	10	13	10	10
Export cartels	201	208	211	206	213	217	214	192	175	180
Import cartels	1	2	3	4	3	4	4	3	2	2
Cartels under Medium and Small Enterprises Organization Act	588	587	652	634	582	522	469	439	604	607
Cartels under Environment Sanitation Act	106	122	123	123	123	123	123	123	123	123
Cartels under Coastal Shipping Association Act	15	14	16	15	22	22	22	21	19	19
Cartels under other statutes	43	50	44	44	47	48	56	53	34	42
Total	970	999	1,079	1,040	1,003	948	898	844	976	985

Source: Japanese Fair Trade Commission, Staff Office, *The Antimonopoly Act of Japan (1973)*, p. 27. Reproduced from Caves & Uekusa (1976), p. 158.

<sup>a</sup>Number in force in March of each year.

More importantly, the Japanese government has regarded the anti-trust laws as a part and parcel of its overall industrial strategy. As Magaziner and Hout (1980) point out, in young industries, during the developmental phase, the government discouraged competition in order to provide firms with a secure environment for profitable investment. When these industries became technologically mature, competition was allowed to flourish. Later, when industries are in competitive decline, the government again discourages competition and attempts to bring



about an orderly rationalization of the industry. Magaziner and Hout observed that "MITI's greatest strength appears to be its understanding of the competitive stages through which an industry moves and its ability to fashion appropriate policy" (p. 38).

Students of Japanese economy provide many examples of the above pattern from a number of different industries. In steel, for example, Scott (1992) observes that during the expansion phase of the industry, individual companies were not allowed to build new plants except at world class scale. This meant "spacing out investments to build large-scale plants without at the same time generating an excess capacity. Japanese firms were required to wait their turn to build a new plant while a competitor built new capacity and achieved high volumes. Next time the roles will be reversed. This kind of coordination was carried out under the aegis of the government-by MITI. Later the system required the scrapping of old capacity as a condition for permission to build new. As a result Japan with a smaller home market than the U.S. built ten plants larger than any in the U.S" (p. 54).

Yamamura (1988) provides a useful model of Japanese industrial policy and the role of competition within it. The government essentially organized an "investment race" among large oligopolistic firms in which exports and world market share were significant performance goals. As in the real world markets are always incomplete, such a race without a coordinator will lead to ruinous competition, price wars and excess capacity, inhibiting the inducement to invest. In the Japanese economic miracle, MITI provided this crucial coordinating role (with the help of industry associations) and orchestrated the dynamic combination of collusion and competition which characterizes Japanese industrial policy. "In a nutshell," Yamamura observes "what MITI did was to 'guide' the firms to invest in such a way that each large firm in a market expanded its productive capacity roughly in proportion to its current market share-no firm was to make an investment so large that it would destabilize the market. The policy was effective in encouraging competition for the market share (thus preserving the essential competitiveness of the industrial markets) while reducing the risk of losses due to excessive investment. Thus it promoted the aggressive expansion of capacity necessary to increase productive efficiency in output" (p. 175).

## VI.1

Again for reasons of space, I briefly note here that Korea also did not follow a policy of maximum domestic competition or unfettered market-determined entry and exit of firms. The Korean government, if anything, went one step further than the Japanese in actively helping to create large conglomerates, promoting mergers, and directing entry and exit of firms according to the requirements of technological scale economies and domestic and world demand conditions (see Table 1 in Section III and Chang, 1992). It also helped organize the "investment race" among the Korean giant conglomerates along the Japanese lines. It is sometimes argued that competitive market forces have played a relatively greater role in Taiwan's domestic economy, but I note that both Taiwan and South Korea possess some of the most highly concentrated industrial structures among market economy countries (see Table 4).<sup>12</sup>

## VI.2

Turning to the factor markets, in Japan, both the domestic labor and capital markets have operated rather differently than envisaged in the Report's recipes for faster economic growth and successful development. Although in South Korea and Taiwan, the labor market may have worked with "minimum labor laws," as the Report approvingly notes (p. 80), the situation in Japan has been quite different. A large proportion of the labor force has effectively a lifetime security of employment. Many leading scholars of the Japanese economy ascribe the international competitive success and technical leadership of the Japanese corporations precisely to these "rigidities" in the labor market. Security of employment encourages workers to undertake firm specific investments in human capital, to promote technical change rather than to thwart it (for the fear of being made redundant). Not least, it also lets workers identify their interests with those of the corporation (see further Aoki, 1990; Dore, 1986, among others).

Similarly, in relation to the capital market, a growing number of scholars in the U.S. and the U.K. today believe that the Japanese economic success is also in part due to the fact that the Japanese industrial corporations have been spared, unlike their Anglo-Saxon counterparts, the tender mercies of a stock market and a freely functioning market for corporate control (see Dore, 1985; Odagiri and Hase, 1989;

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<sup>12</sup> For different perspectives on the relative role of large and small firms in Taiwan's economic development, see Scitovsky (1986) and Amsden (1985, 1989).

*Table 4: Percent Distribution of Manufacturing Value-Added<sup>a</sup> by Firm Size, Selected Countries, 1973*

Country	Number of Workers			
	1-9	10-99	100-499	500 or more
Korea	5.8	13.8	27.7	52.7
Taiwan <sup>b</sup>	4.4	16.7	22.5	56.4
Hong Kong	7.4	30.2	32.1	30.2
Brazil	3.4	23.7	36.1	36.6
Turkey <sup>c</sup>	11.7	10.1	27.5	48.4
Peru	4.0	23.9	46.4	25.7
Japan <sup>d</sup>	8.7	28.4	24.9	37.9
Canada <sup>d</sup>	2.0	21.1	37.4	39.3
Czechoslovakia	0.2	5.4	18.2	76.1
Austria	0.8	21.5	36.2	41.5
United Kingdom		15.7 <sup>e</sup>	24.4	60.0
United States <sup>d</sup>	2.4	18.3	30.5	48.7

Source: All countries except Taiwan: United Nations (1979). Taiwan: Executive Yuan, The Report of Industrial and Commercial Census of Taiwan and Fukien, District of the Republic of China, 1971, quoted in S. Ho (1980). Reproduced from Amsden (1989).

<sup>a</sup>Generally, value-added in producers' values.

<sup>b</sup>Value-added in factor values, 1971.

<sup>c</sup>1970.

<sup>d</sup>Net value-added in factor values.

<sup>e</sup>1-99.

Cosh, Hughes, and Singh, 1990). There are powerful analytical and empirical reasons for believing that the stock-market-based competitive financial systems are not conducive to promoting industrial investment, technical progress and productivity growth.<sup>13</sup> In none of the exemplar East Asian countries did a competitive capital market play a significant role in financing industrial growth. As mentioned earlier, the banks in South Korea were state-owned until the early 1980s. Although some of them are now under majority private ownership, the state has enormous influence and control over their activities. Taiwan's leading banks continue to be under state ownership even today. The Japanese financial system,

<sup>13</sup> There is a large and growing literature on the subject in both the US and the UK. See, for example, Singh (1992b) and Dertouzos, Lester & Solow (1989).

during the period of the economic miracle (1950-73), although not under state ownership, was bank-based, oligopolistic and subject to considerable state direction.

In conclusion, I turn to the Report's argument that "[government] intervention in the market in East Asian economies was, in an overall sense, more moderate than in most other developing economies" (p. 39). How does one quantify the extent of government intervention-for example the crucial coordinating role of MITI in Japanese industrial investment outlined above? Such government support for the industry is much more significant than cash expenditure or subsidies. Moreover, MITI's coordinating functions were not simply ones of completing the "incomplete" markets in the neoclassical sense. Rather, it was a much broader role in the political economy of Japan, to help create a social and business consensus in favour of MITI's specific restructuring and developmental goals. Thus, as Magaziner and Hout (1980) note: "The process of discussion and debate between MITI and the companies in response to developments in the marketplace creates a dynamic decision making process. MITI aptly refers to Japan as a 'plan-oriented market economy'" (p. 39).

## VII.

Another central thesis of the Report is that domestic policy matters far more than international conditions in determining a country's economic performance. This proposition ignores the far-reaching consequences of the historically unprecedented and massive external shocks which many Third World countries suffered at the end of the 1970s and into the 1980s. These shocks had a devastating effect on production, employment, inflation, as well as the political economy of these nations. It will be suggested below that if rich countries like the U.K. and the U.S. had been subjected to international economic disturbances of a similar magnitude, they would most likely have fared worse and suffered a decade-long depression. Although the Report recognises that during the last decade, the Latin American and Sub-saharan African countries were subject to greater external shocks than the Asian countries, it does not adequately consider the differential impact of these shocks for respective economies on the three continents.

The above points are best illustrated by considering the case of Asian and Latin American economies. Between 1960 and 1980, the Latin American countries grew at much the same rate as the Asian countries-at about 5.5 percent per annum on average. On the basis of the growth rates in that period, the two groups of

countries could not be statistically distinguished.<sup>14</sup> However, during the 1980s the Latin American growth rate collapsed to about 1.5 percent per annum while the Asian countries continued to grow at much the same rate as before (Singh, 1992a). An important question, therefore, is what part of this reduction in Latin American growth was due to international forces and what due to domestic policy mismanagement and other internal factors. A significant related issue is that if external economic shocks were largely responsible for the Latin American decline during the 1980s, how come the Asian countries continued to prosper in that decade?

The reasons for this differential economic performance of Asian and Latin American countries in the wake of the post 1979 world economic slow-down have been the subject of considerable controversy. (See Balassa, 1984; Sachs, 1985; Maddison, 1985; Singh, 1986; Ros, 1991; Hughes and Singh, 1991; Fishlow, 1991). In the present context, the treatment of this question will necessarily be brief.

*A priori*, there are three main factors which may help to explain the superior economic record of the Asian countries relative to those in Latin America: (a) differences in economic structure and other initial conditions; (b) differences in the economic policies pursued; (c) differences in the size of the economic shocks experienced by the countries on the two continents. Balassa (1984) and Sachs (1985)-and the Report endorses their analysis-suggest that a very important reason for the better Asian economic performance is that these countries have more open and export-oriented economic structures, compared to those in Latin America. Differences in economic and industrial structures between the Asian and Latin American economies have been examined in detail in Singh (1985) and Hughes and Singh (1991). However, this analysis reveals very little evidence in support of the Balassa-Sachs openness hypothesis. The least open Asian economies like China and India, for example, were able to cope at least as effectively with the world economic crisis in the 1980s as the highly export-oriented Korean economy.<sup>15</sup>

Hughes and Singh (1991) and Singh (1986) argue that certain exogenous shocks emanating from the post-1979 world economic crisis had a much greater impact on

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<sup>14</sup> Unless otherwise indicated, the source of the figures cited in this section is Hughes and Singh (1991), which is based on a comparative analysis of the records of 10 Asian and 9 Latin American countries over the periods 1960-70, 1970-80, and 1980-85.

<sup>15</sup> There is a complex relationship between 'openness' and the vulnerability of an economy to external shocks. For a fuller analysis, see Hughes and Singh (1991).

the economies of the Latin American countries than on the Asian economies. First, it is suggested that the rise in interest rates had a far bigger effect on Latin American countries than on those in Asia since a larger proportion of the Latin American debt was of the floating rate variety. Moreover, the Latin American countries were starting from much less favourable initial conditions. In the period preceding the post-1979 world crisis, i.e., during 1973 to 1979, the median debt service to exports ratio of the Latin American countries was more than twice as high as that of the Asian countries-22.9 percent compared with 10.7 percent.

Sachs (1985) suggests that with a few exceptions the impact of the rise in interest rates on the developing economies was not particularly significant. He writes: "at the peak the measured U.S. real interest rate rises by about 10 percentage points and is multiplied by a debt/GDP ratio of the order of 20 percent, producing a peak annual loss of 2 percent of GDP and an average annual loss of about 1 percent of GDP." However, this is not a valid argument since, as Hughes and Singh (1991) report, the median current account deficit in the Latin American countries was only about 3 percent of GDP in the late 1970s. The impact of the increase in interest rates (whether measured in nominal or real terms) on the current balance of these economies was therefore highly significant. The dynamic consequences, (particularly in terms of capital flows) of an increase (or decrease) in the current account deficit by nearly a third for a balance of payments constrained economy, cannot be exaggerated.

Secondly, Hughes and Singh emphasise that the Latin American countries were far more subject to capital supply shocks than the Asian economies (on this point, see also the excellent detailed analysis of Fishlow, 1991). To illustrate the nature of these shocks, consider the case of Mexico. During the oil boom years, 1977 to 1981, the Mexican economy had been growing at a rate of 7 to 8 percent per annum with even the non-oil GDP rising at a roughly similar rate. However, despite the enormous increase in oil exports, the balance of payments position had been deteriorating. The current account deficit rose from nearly 5 billion dollars in 1979 to almost 7 billion dollars in 1980 and to 11.7 billion dollars in 1981. Notwithstanding this deterioration, the international banking community was happily willing to lend Mexico ever increasing amounts to finance the deficits. Thus from 1978 to 1981, while international bank loans to developing countries as a whole increased by 76 percent, they rose by 146 percent to Mexico, already a large debtor in 1978. To meet the Mexican government's increased demand for foreign loans to finance the current account deficit, the international banks accelerated their lending to Mexico in 1981, albeit with an increasing shortening of

the term structure of the new loans (Ros, 1986). In 1981, the capital account of the balance of payments indicate Mexico's net public short term liabilities rose by \$12.7 billion (compared with \$6 billion in 1980 and \$1.7 billion in 1979). However, in the crisis year of 1982, these capital flows were abruptly halted and the capital account shows that Mexico's net public external short term liabilities actually decreased by £614 million. Brailovsky and Barker (1983) rightly note that this capital supply shock had a devastating effect on the Mexican economy.

Most of the other Latin American economies were subject to similar capital supply shocks. These emanated from what Williamson (1985) has named the "contagion effect" whereby, following the Mexican debt crisis in 1982, voluntary private capital flows to most Latin American countries were greatly reduced if not stopped altogether. The important point is that because of the "contagion effect," capital flows were reduced much more to the Latin American than to the Asian economies. This in turn will have worsened the balance of payments constraint in the Latin American countries more so and more suddenly than in the Asian countries.

Thirdly, Hughes and Singh (1991) suggest that reduced world economic growth and world trade during 1980-82 had a differential impact on the normal export markets for countries in the two continents. In particular, the Middle Eastern market, which was the most rapidly expanding market during this period, was much more significant for many of the Asian countries than for Latin America. There are two important channels by which the Asian countries benefited from the economic prosperity in the Middle East: (i) workers' remittances and (ii) the growth of merchandise exports.

Relative to the Asian countries, it is argued that the above three factors together made the balance of payments constraint on the Latin American economies much more severe.<sup>16</sup> It may be appreciated that a deterioration in the balance of payments position of the developing country has extremely serious consequences for all spheres of the economy, real as well as financial. The effect on industrial

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<sup>16</sup> The terms of trade shock and the reduction in OECD economic activity in the 1980s had in general a larger impact on the Asian countries than on the Latin American countries. However, Fishlow's analysis shows that if the interest rate and the capital supply shocks are also included, as a proportion of exports, the magnitude of external shocks suffered by the Latin American countries was on average much greater than that experienced by the East Asian countries. Fishlow's sample did not include South Asian countries. He also did not consider the effects of workers' remittances and the growth of the Middle Eastern market.

production is direct and for many countries immediate. The external payments constraint can become so binding that the country has to curtail not only the import of luxuries, or other consumer goods, but also the essential imports required for maintaining the existing level of domestic production. Agricultural production is affected both directly by the foreign exchange constraint and indirectly by reduced industrial production. Reduced imports as well as lower domestic production of fertilizers and other agricultural inputs, together with lowered oil imports, hamper agriculture production directly. Indirectly there is an unfavorable effect on production because of the reduced availability of the so-called incentive goods to farmers (soap, bicycles, etc.). However, import compression not only threatens agricultural and industrial production but paradoxically also lowers exports. Khan and Knight (1988) provide empirical evidence in support of this phenomenon.

Import strangulation and a balance of payments constraint also generate inflation and disequilibrium in government finances. As sales and excise taxes on industrial production as well as import duties are a major source of government revenue in many developing countries, the balance of payments constraint is directly and indirectly responsible for the enormous increases in budget deficits or the public sector borrowing requirements which these countries have been experiencing in the 1980s. In the institutional circumstances of the heavily indebted Latin American economies, there is an important additional reason why such a constraint has generated a fiscal crisis. This arises from the fact that after the Debt Crisis foreign debt has been consolidated in these countries to become largely the liability of the government and there is therefore a huge burden of interest payments on the budget. Sachs (1987) provides data to show that in Argentina and Mexico, in the mid 1980s, interest payments represented nearly a third of the government's revenues.

As the government in many Latin American countries has a direct and major role in undertaking or financing industrial activity and investment, the fiscal crisis leads particularly to reduced industrial and infrastructural investment. A number of WIDER studies on macroeconomic adjustment in developing countries (see Taylor, 1988) have shown that in general, in the South, public investment 'crowds in' rather than 'crowds out' private sector investment. This compounds the effects of the fiscal crisis on long term economic development.

In view of all the direct and indirect effects of the foreign exchange constraint and the balance of payments crisis brought about by world economic developments, it is not surprising to observe the poor industrial and overall economic record of the



Latin American countries during the last three decades relative to the Asian countries.<sup>17</sup> There are, however, three other points which also deserve attention in this context.

First it should be observed that the external shocks which a wide range of developing countries suffered in the early 1980s were gigantic. It requires an enormous economic and social effort as well as a considerable period of time to recover from the disruptions caused by such shocks. To illustrate with an example from an advanced economy, it may be recalled that the impact of the adverse movements in the terms of trade for the U.K. (not then an oil exporter) as a result of the first oil shock in 1974-75, is estimated to have been equivalent to a reduction in GDP of about 4 percent. This led to an enormous redistributive conflict and to a near doubling of the rates of inflation and unemployment. The government was obliged to undertake extraordinary measures (including for an advanced economy

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<sup>17</sup> For reasons of space the questions of misallocation of resources and macroeconomic mismanagement by the Latin American economies are not discussed above. For an analysis of these issues, the reader is referred to Singh (1992b), Fishlow (1991), and Hughes and Singh (1991), where it is shown that the Latin American record was no worse in the former respect than of the Asian countries. For example, contrary to the mainstream conventional wisdom, Fishlow's analysis of the consumption functions indicates that the Latin American countries did not use external borrowings to finance current consumption any more than the Asian countries did. He notes: "At the margin, therefore, there was an expected substitution for domestic saving. But there seems to be no difference in this respect between Indonesia and Korea, on the one hand, and Brazil and Mexico, on the other" (Fishlow, 1991, p. 153). As far as the allocation of investment resources is concerned, with negative real interest rates, it was not just Mexico or Brazil but also South Korea which used foreign borrowings in the 1970s to launch an ambitious programme of import substitution and development of heavy industries. All these programmes ran into teething troubles of various kinds, but a major reason why the Korean programme nevertheless succeeded in the 1980s whilst the Brazilian and the Mexican ones failed was because of the far more severe foreign exchange constraints which the latter two countries were subject to. It is also important to remember in this context that, prior to the economic crisis of the last decade, during the 1970s, Brazil's rate of growth of manufactured export (in value terms) during the 1970s was much the same as that of South Korea, while those of Mexico and Argentina were significantly higher than that of India.

Similarly, questions of macroeconomic policy errors, issues of "inappropriate" exchange rates and "capital flight" are also examined in the above contributions to challenge the orthodox views on these matters. The capital flight, it is suggested, for example, was much more a consequence rather than a cause of the crisis in many of these countries. The basic argument is that the external shocks led to economic and social disruption and financial instability in these economies in the way outlined in the text here. This in turn was responsible for the capital flight. Hughes and Singh argue that the adoption of policies to stem the capital flight was not a simple technical matter, but involved complex questions of the political economy of macroeconomic management in the affected countries.

the rare step in 1976 of a recourse to the IMF) to restore economic stability. Yet the record indicates that the combined effect of the demand, the terms of trade, the interest rate, and the capital supply shocks on a wide range of developing countries, which are much poorer, was 3-4 times as large as the external shocks that the UK suffered in the mid-1970s (see further Singh, 1992a).

Secondly apart from the huge task of adjustment to these shocks at the beginning of the decade, it needs to be borne in mind that for many developing countries, particularly in Latin America and Africa, a number of the same adverse external factors continued to operate throughout the 1980s. (Singh, 1992c).

Third, an essential part of my analysis here is that it is not the case that the Latin American countries were incompetent or unaware of the desirability of balanced budgets, etc., but that the economic shocks many of them suffered were so gigantic that their social and political institutions simply could not deal with the ensuing redistributive struggles over a diminished national cake. Hence many of them experienced episodes of hyperinflation.

In view of the above, I find the Report's treatment of this subject-the impact of external shocks-for the developing countries to be very unsatisfactory. I also find that the Report is led into a number of other analytical errors by not properly considering the effects of world economic conditions for national economic performance. For example, if such shocks had a large impact on Latin American economies in the 1980s, it is not valid to aggregate for these countries, the 1980s with the period 1960-80 as that would produce misleading results. Rather different rankings of economic performance of developing countries and hence very different conclusions with respect to 'successful' economic policies emerge if the periods 1960-80 and 1980-90 are examined separately rather than together.

## VIII.

The last point above concerning incorrect aggregation bears on the Report's empirical analysis at several places (the reader may recall our earlier discussion in Section IV of the Report's evidence on the relationship between education and economic growth). It is also directly relevant to the Report's examination of the rates of return on investment projects carried out by the Bank and by the IFC over the previous twenty years (1968-87). The Report sets a great deal of store by the evidence presented on this issue (see Chapters 1 and 4; Table 4.2 and Figure 5).

This evidence purports to show that where the 'distortions' were low, the 'economic rates of return' (ERR) on these investment projects were considerably higher. It is further argued that the greater the rate of return on investment projects, the greater will be the overall economic growth. Thus the Report: "By every measure, ERRs are highest in undistorted markets, and lowest in distorted markets. Projects implemented in an undistorted policy climate can have, on average, an ERR that is at least 5 percentage points higher than in a distorted climate [Table 4.2]. To put this finding another way, with a few exceptions, undistorted policies makes an investment at least one and a half times as productive. The implication for growth is striking: a difference in the ERR of 5 percentage points, if achieved across the economy, would translate into a difference in the annual rate of GDP growth per capita of more than 1 percentage point every year" (p. 82).

There are two objections to this analysis. First, the robustness of the results to the time periods and countries chosen. For the reasons discussed above, because of the economic crisis in Latin America and Sub-Saharan Africa, during the 1980s, the rates of return on projects in these two developing continents during the last decade will be low; aggregating all countries and time-period together will therefore lead to incorrect inferences. The Report says that the results are robust with respect to industries and sectors, but it does not say anything about robustness with respect to time-periods and countries. Secondly, and more importantly, the causation may well be the other way round. The Report's causal chain is: the lower the distortions in an economy, the larger the economic rate of return on its investment projects, the greater its economic growth. The alternative Kaldorian causal model, mentioned earlier, is more plausible: the higher the rate of growth of aggregate demand in an economy, the greater its rate of economic growth and therefore the more productive the investment projects carried out in such an economy. Without an empirical analysis of such competing hypotheses, the Report's conclusion on this point cannot be accepted.

## IX.

As the main points of this paper were summarized at the start, it is not necessary to repeat them in this concluding section. The central message of the paper is in fact contained in its title! The chief lessons to be drawn from the experience of Japan, Korea, and Taiwan-countries which the Report holds up as models of successful development-is not some neutral, passive state with a "market friendly approach to

development." Nor did these nations seek or practice a deep and unconditional integration with the world economy during their periods of rapid growth.

Rather, the state in these economies played a vigorous role and followed a highly active industrial policy. The government did not supplant the market altogether as the "command" planning of production of the Soviet type did; nor did it simply follow the market. Instead, in line with MITI's description of Japan as a "plan-oriented market economy," the government guided the market towards planned structural change. Moreover the three East Asian countries integrated with the world economy in the directions and extent to which it was useful for them to do so.

This paper has argued that in a world of imperfect competition, economies of scale and learning by doing, there are sound analytical grounds for following such policies to promote technical change and economic growth. In such a world, the optimal degree of openness or the optimal degree of domestic competition for an economy is not maximum openness or perfect competition. The Report seems to have been led into a misinterpretation of the East Asian experience because it is wedded to a theoretical paradigm whose assumptions do not correspond to the real world of manufacturing. Its analysis and the lessons it purports to draw from the last forty years of development experience are not therefore helpful to developing countries.

It is important to emphasize that the present paper has mainly been concerned with the question of what are the correct analytical and policy conclusions which should be drawn from the historical experience of the 'successful' and 'unsuccessful' countries in the post-war period. The important issue of whether the successful East Asian model can, or even should be replicated in other developing countries is a large subject which has not been examined here. This must be left for another occasion.

In conclusion, I note that in a document which is supposed to reflect the synthesis and interpretation of the lessons of the last four decades of development experience by the World Bank's economists, there is a curious omission. There is very little explicit discussion of what lessons the Bank's economists draw from the Bretton Woods institutions' own important role in the developing countries' debt crisis during the last decade. Normally, the Bretton Woods Institutions (BWIs), and implicitly the present Report, view their intervention in the debt crisis in a very positive light and regard their so-called case-by-case approach to adjustment as not only being correct but also successful. However, from the point of view of

the developing countries, the role of these institutions is seen rather differently, as essentially being that of a debt collector for the private western banks. In the bargaining between creditors and debtors during the last decade, the IMF is thought to have been a powerful influence on the side of these banks with the result that the burden of adjustment has been one-sidedly borne by the debtor countries rather than being equitably shared with the banks and other parties. The case-by-case approach has involved the extraordinary spectacle of all the creditor banks banding together, de facto under the IMF auspices, and confronting each debtor country separately. It is notable that the BWIs discouraged the formation of debtors' cartels as a response to this situation.

The adjustment process in the debtor countries since 1982 can be regarded as successful only from the standpoint of the banks but not from that of the countries themselves. The debtor countries have certainly been able to achieve massive trade surpluses and a large turn-round in their current account balance, but this "success" has been obtained at enormous cost in terms of capacity utilisation, unemployment, low economic growth, reduction in real wages and rise in inflation. Instead of a normal flow of capital from the rich to the poor countries, the world has witnessed a reverse flow from South to North, amounting on average in the Latin American countries to as much as 4 percent of their GDP for several years in the mid and late 1980s.

The significant analytical questions about the BWI's role in the debt crisis are the following: has the BWI-inspired adjustment process been economically efficient from the point of view of either the debtor countries or that of the world economy? Would, for example, the losses to output and employment have been lower if the BWIs had acted differently? It is a pity that the Report does not address these issues, not least in order to draw appropriate lessons for the future.

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