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So What Kind of Economic Growth?

Today we examine three different models of economic development: import-substitution; export-led growth; and a new model based on domestic demand and formulated in response to current global economic troubles.

Prepared by: ISN staff

Yesterday we considered some of the tensions the international economic and financial systems might face if nation-states convert themselves into 'green' economies. To say that different conceptions of what makes up green economics will complicate the monetary foundations of social policy is an understatement. Take the intertwined cases of social and economic development, for example. There are three historically significant models of development – the import-substitution model that became prevalent after World War II; the export-led development characterized by post-war Germany, Japan, the 'Asian Tigers' and China; and a model based on domestic demand as discussed in Thomas Palley's "The Rise and Fall of Export-led Growth." How these models will actually be applied within the evolving economic and financial systems of today is an open question. It is also a worthy topic of discussion for today.

Import substituting industrialization

As well as embodying the geopolitical struggle between two hostile "ism's" (communism and capitalism-constitutionalism), the second half of the 20th century also reflected a collision between two competing models of development. The first of these models was "import-substituting industrialization" (ISI). The main difference between poor countries and rich countries, proponents of ISI observed, was that rich countries were industrialized whereas poor countries were not. Richer economies were based on manufacturing, whereas poor countries relied solely upon primary industries such as agriculture and raw materials. And while the classical theory of comparative advantage argued that all countries should benefit from a system of economic specialization, new evidence surfaced in the 1950s to suggest that this might not always be the case.

According to economists Raul Prebisch and Hans Singer, poor countries exporting primary goods and products would always face "deteriorating terms of trade" vis-à-vis rich countries. While it did not strictly matter that Portugal produced wine and England wool (in Ricardo's famous example), in the real world it mattered enormously that America produced cars while Brazil produced sugar and rubber. In other words, free trade was actually a trap for poorer nations. In economic parlance, the income elasticity of demand for manufactured goods was far greater than that for primary goods. International trade thus made everyone richer in absolute terms, but people tended to buy more cars

than they did sugar and rubber, thereby resulting in Americans becoming relatively richer and Brazilians comparatively poorer.

The obvious solution for this was for poorer nations to industrialize, and thereby produce value-added products that would reap greater returns. Accordingly, the ISI model called upon poor countries to industrialize in the same way the developed world had done – i.e., by 'substituting' domestically manufactured products for foreign imports. But because these ‘infant industries’ could not initially compete in the global market, they had to rely on government-sponsored protective tariffs and the maintenance of a strong currency. Eventually, or so the logic went, the industries would be able to compete internationally and increase the national welfare. Whether this logic proved to be true or not, it is important to remember that the ISI model was indeed a powerful one. With the notable exception of the United Kingdom, every country that industrialized before World War II followed a variation of the model.

Export-led growth

Despite its historical pedigree, it’s fair to say that the ISI model is not generally regarded as a great success. Indeed, by the 1980s it had been mostly abandoned in favor of the export-substitution (ESI) model. Adopted initially by post-war West Germany and Japan, ESI encouraged economic openness rather than shielding infant domestic industries from foreign competition. In fact, developing nations were encouraged to expose themselves to international market forces while relying on currency devaluations to become competitive. By opening itself up to competition, or so the argument went, the nation in question would quickly adopt current best practices, encourage the diffusion of technology, and enhance its productivity. Protective tariffs, it was further argued, were out. They only promoted rent-seeking activities (bribery, smuggling, corruption and black-marketeering) that continue to have high social costs.

To avoid these problems, poor countries first needed to identify those products which would give them a global comparative advantage. This meant the products that they could produce at lower opportunity cost than rich countries, not necessarily the products they could make the most efficiently. Next, they needed to structure their economies around the export of these advantaged products to the global marketplace, while remaining safe in the knowledge that any deterioration in trade could be mitigated by prudent government policies. (Ironically, this problem turned out to be much smaller than anticipated because of the legacy of import-substitution itself, which meant that by the 1980s there were only a handful of countries that exported only primary goods).

According to Thomas Palley, the real-world application of export substitution can be broken down into four historical stages. After initially being associated with Germany and Japan, Stage II (between 1970 and 1985) saw the emergence of the Four ‘Asian Tigers’– South Korea, Taiwan, Hong Kong and Singapore. Throughout this period, all four Tigers experienced growth rates in excess of seven percent per annum, and became advanced high-income economies in the process. Stage III was epitomized by Mexico in the late 1980s and 1990s. Unlike Stage II, export substitution here focused on enticing foreign multi-national corporations (MNCs) through the “suppression of wages and social standards.” This, Palley argues, turned areas of the developing world into ‘global production zones’ (such as Mexico’s ‘maquiladora zone’) for markets in rich countries. The last stage of export substitution – as characterized by China’s economic growth – bears many of the same hallmarks as Stage III. Social standards remain depressed, poor countries become global ‘production zones’ and MNCs remain central to export substitution. The major difference between Stages III and IV, Palley tells us, is how aggressively the state promotes economic growth and development. In the case of China, this includes strategic import tariffs, capital controls, currency manipulation and forced technology-sharing.

Domestic demand- led growth?

As dominant as ESI has been in recent history, like its ISI predecessor it is showing signs of fraying and may even be on the verge of ‘exhaustion.’ While China’s export substitution policies have been successful, Mexico’s policies have led to poorer results. More significantly, the recent global economic recession may signal the end of the road for China too. Export substitution, quite clearly, relies fundamentally on Western consumer demand, which has been in short supply since 2008. With the US “debt-saturated” and Europe and Japan both wedded to export-oriented strategies, the demand for goods in the industrialized world is simply not there, nor likely to return in the foreseeable future. For twenty-five years, Palley writes, those markets were artificially strong and fuelled by rising debt and asset-price inflation. And as this pattern has proved unsustainable, the logic of the export-led model has been increasingly subject to criticism.

So what’s next for economic development? Palley suggests a new development strategy based on cultivating demand in poor countries themselves. In a global economy where Western consumers can no longer be counted on to buy enough of whatever the rest of the world can produce, poor countries will have little choice but to create demand indigenously. This will ultimately entail creating consumers in their own countries who can actually buy the products produced. This, of course, will not be an easy task. From the standpoint of domestic policy, it involves improving social safety nets and raising labor standards, investing in infrastructure, and raising taxes on the rich and lowering them for the poor. Internationally, it means putting an end to policies of currency devaluation, implementing global labor and environmental standards, as well as limiting incentives that attract export-oriented foreign direct investment. Obviously, the political obstacles to such measures are immense. As Palley admits, the adoption of the development strategies based on domestic demand is highly unlikely. Indeed, he sadly concludes that the parties in question will likely persist with export-led strategies until the global economy lurches into a much deeper crisis than the current one we are in.

Editor's note:

For more content on "Development: Describing and Prescribing Progress," please see our dossier on the topic.

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ISN, Center for Security Studies (CSS), ETH Zurich, Switzerland