

**The Policy Space Question: An Alternative Approach  
to Trade and Industrial Policies;  
Implications for the World Trading System**

*S.M. Shafaeddin*

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**THE POLICY SPACE QUESTION:  
AN ALTERNATIVE APPROACH TO TRADE AND INDUSTRIAL POLICIES;  
IMPLICATIONS FOR THE WORLD TRADING SYSTEM**

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***Abstract***

*The purpose of this paper is to present an alternative framework for trade and industrial policies bearing in mind the failure of the traditional, i.e. across-the-board, import substitution (MS) strategies of 1950s to 1970s and out-ward orientation strategies through the across-the-board trade liberalization of 1980s. To do so the author draws on the experience of developing countries, both successful and failure cases, in the recent decades as well as during the course of the many stages of industrialization of early industrializing countries. While introducing a development oriented, flexible and dynamic trade and industrial policy framework, the author also briefly argues for the need for corresponding changes in the international trading system that are conducive to development. Such a bottom-up approach, he argues, should replace the present top down approach where developing countries are subjected to a one-size-for all policies designed at the international level by international financial institutions and the WTO.*

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\* The author is development economist, a free-lance consultant and a former head of Macroeconomics and Development Policies Branch, Globalization and Development Strategy Division of UNCTAD. The study is drawn to a large extent on the recently published book by the author: “*Trade Policy at the Crossroads: The Recent Experience of Developing Countries*”, Palgrave Macmillan, 2005. A shorter version of this paper was published under the title “Towards an Alternative Perspective on trade and Industrial Policies” in *Development and Change*, Dec.2005. Comments are most welcome and can be sent to [MShafaM@Netscape.net](mailto:MShafaM@Netscape.net).

“The failed WTO meeting in Cancun should serve as a warning: something is fundamentally wrong with how the global trading system is managed-and with the global financial system ...” (J. Stiglitz, *The Guardian* 2 October 2003).

## INTRODUCTION

Trade policy is at the crossroads. So is trade diplomacy, i.e. trade negotiations under the auspices of the WTO. The traditional, i.e. across-the-board import substitution (MS) strategies of 1950s to 1970s failed. So did outward orientation through across-the-board trade liberalization of the 1980s and 1990s by the developing countries. What is next? I have studied extensively elsewhere the experience of developing countries in trade liberalization and economic reform in recent years as well as the history of industrialization of early industrializing countries (Shafaeddin 2005a). By drawing on those experiences, both with its successes and failures, I have tried to develop an alternative approach to trade and industrial policy by taking what I call a bottom up approach in the final section of this paper.

In other words, in presenting a national policy framework, I will suggest in general terms corresponding changes that are necessary in international rules. Section I is allocated to the argument on the need for an alternative approach. Section II summarizes the experience of economic reform and across-the-board trade liberalization based on Shafaeddin (2005a). Subsequently the reasons for the failure of trade liberalization will be discussed in section III before an alternative approach is presented in the final section.

### I. WHY IS AN ALTERNATIVE APPROACH NEEDED?

The controversy on trade and industrial policies has been intensified since the publication of *Industry and Trade in some Developing countries* by Little et al. (1970). The origin of the controversy goes back, however, to Adam Smith and consists of four main interrelated issues. The first is the concern with “interchangeable value” (international trade) as against “productive power” [economic development] (List 1856:253). The second issue is “focusing attention on the allocative functions of the markets to the exclusion of their creative functions – as an instrument for transmitting impulses to economic change” (Kaldor 1972:1240). Third, Adam Smith introduced his universal theory of free trade for a “cosmopolitan economy”, i.e. the economy of mankind as a whole. He in fact did not distinguish differences between the interest of individuals, nations and mankind as a whole. Not only did he not take into account the divergence of the interest of individuals and the society, but he also ignored the fact that some nations may give more weight to their own welfare than to the collective welfare of humanity. Yet he had the interest of the United Kingdom in mind when he advocated universal free trade. (List, *ibid*:74, 245–246 and 261). Finally, Adam Smith implied that all countries were at the same level of development and industrialization by ignoring the existence of the “competence gap” among various nations, particularly the industrialized one (United Kingdom), and the latecomers.

Jacob Viner (1953:4–5) correctly maintains that Smith and other classical economists took a cosmopolitan approach because they thought that what was in the interest of England was also in the interest of the world as a whole. Nevertheless, Viner argues that what was relevant to their time and country may not necessarily be relevant for other times and other countries, and, in particular, it may

not be relevant for “economically less advanced countries” at any time. Hence, “it is today always necessary, as it was for the English classical economists, to be perfectly clear whether we are considering a problem, say, commercial policy from a national or from a cosmopolitan point of view” (Viner 1953:5).

The intensification of the controversy on trade and industrial policies in the early 1970s was followed by the advocacy of the across-the-board trade liberalization as a reaction to the failure of traditional import substitutions strategies (MS) of the 1950s to the 1970s. Such advocacy started through structural adjustment programme (SAPs) and stabilization programmes (SPs) of the international financial institutions (IFIs) in early the 1980s followed by recommendations through the “Washington Consensus” in the early-1990s. The Uruguay Round of trade negotiations also provided an internationally agreed framework for trade liberalization in 1995.

Nevertheless, after nearly a quarter of century of the implementation of the neo-liberal approach, it is clear that the failure in traditional MS strategies has been followed by the failure of “out-ward orientation strategies” through the across-the-board trade liberalization of 1980s and 1990s by developing countries (Shafaeddin, *ibid*, the reference therein<sup>1</sup> and Rodrik 2001).<sup>2</sup>

Faced with the failure in across-the-board trade liberalization and free market orientation policies in most developing countries, the neo-liberals and their opponents have reacted in different ways. The former blame the failure mainly on inadequate and incomplete reform and ask for more liberalization. Some opponents of neo-liberalism, on the other hand, argue that industrial policy is not dead but provides preferential policies in favour of exports and FDI because it is presumed that “important externalities reside in exports and direct foreign investment” (Rodrik 2004:29 and 30). He then advocates that there is need for “getting the policy process right” and maintains that this can be done through a “discovery process” by which “private and public actors come together to solve problems in the productive sphere, each side learning about opportunities and constraints faced by other ...” (Rodrik 2004:3). In such a process “firms and government learn about underlying costs and opportunities and engage in strategic coordination” (*loc. cit*) to remedy market failures which restrict self-discovery (*ibid*.:10). Referring to external constraints, and the lack of policy space imposed by international rules and conditionalities, Rodrik argues that [external] restrictions are exaggerated. His proposal to establish a mechanism for public-private collaboration is welcome; it has worked relatively speaking well in East Asia (see e.g. Wade 1990, Amsden 1989 and Shafaeddin 2004a). Moreover, it is true that there are still some limited rooms for manoeuvre in implementing industrial policy (Amsden 2000). Nevertheless, it is important to note that the restrictions have two facets. One is institutional-restrictions imposed by IFIs, commercial banks, the WTO, bilateral donors, etc. The other, perhaps somewhat more important, is educational. It is educational in the sense that many politicians, not only in developed countries but also in developing countries, have believed in the so-called “free market oriented” approaches and the Washington Consensus. One case in point is the number of Latin American countries who have implemented Washington Consensus voluntarily (Shafaeddin 2005a, Chapter 2).

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<sup>1</sup> See also Wade (2003 and 1990) and Easterly (2001).

<sup>2</sup> Rodrik (2001) concludes that “... there is no convincing evidence that trade liberalization is predictably associated with subsequent economic growth” (*ibid*.:6). I do not agree with such a wholesale conclusion as it depends on how and when, during the course of industrialization, liberalization does take place. I do not, however, favour any type of protection either as will be explained in the last section (see also Shafaeddin 2005b and 1991).

A similar approach, taken by some other opponents of neo-liberals, advocates government intervention to address market failures which create obstacle to “capacity building”, but concludes that certain things cannot be done because of restrictions imposed by international regulations (see e.g. Lall 2004). Further, the approach taken by developing countries in the new round of negotiations in the WTO is rather piecemeal in that it does not address the fundamental problems inherent in the WTO rules and modalities, i.e. the lack of attention to the creative function of the market.

A number of scholars refer to the success of East Asian countries as an example of the need for industrial policy (e.g. Wade 1990, Amsden 2001, Singh 1992, Wade 2003 and the reference herein: xiv, footnote 3). Yet their opponents claim that the East Asian experience is not replicable elsewhere and that even if industrial policy is to have any role to play in the industrialization of developing countries, its time is past since the current development philosophy, and particularly WTO rules, would not allow for it.

Instead of taking such a top-down approach, i.e. formulating international rules on trade and industrialization and expecting developing countries to act within their framework, we will take a bottom-up approach in this study. In other words, we will present what is needed, in our view, at the national level to catch up on the process of industrialization and on that basis argue for changes in international rules. In doing so, we will draw on history, i.e., on the experience of both early industrializers and NIEs who have succeeded in catching up and those who failed to do so after across-the-board and universal trade liberalization of the recent decade. There will be two starting points. One is that no country, with the exception of Hong Kong (China), has industrialized without government intervention. Nevertheless Hong Kong (China), which is only a city state, has not been able to upgrade and deepen its industrial sector as did other Asian NIEs. The other point is that “comparative advantage is arbitrary”; it has to be created over time (see e.g. Cline 1983, Gomery and Baumol 2000 and Shafaeddin 2005a).

## **II. RECENT EXPERIENCE IN TRADE LIBERALIZATION**

The experience of developing countries since early 1980s reveals that across-the-board and universal trade liberalization has failed (Shafaeddin 2005a, Chapters 2 and 3 and references therein). In that study, we have examined the economic performance of a sample of 50 developing countries which have undertaken trade policy and economic reforms during 1980s and 1990s. The sample consists of two different categories of countries as far as the trade policy reform is concerned: a minority group, consisting mostly of East Asian NIEs, and a majority group, mainly located in Latin America and Africa. In the case of the “minority group” economic reform, particularly trade liberalization, has taken place gradually and selectively, at least until recently, as a part of a long-term industrial policy. By contrast, the “majority group” was guided by the IFIs and/or “Washington Consensus”, embarked in the main on a process of universal, rapid uniform and across-the-board liberalization and structural reform. The main objectives of the reform were to achieve rapid expansion of exports and output and diversification of their structure in favour of manufactured products.

The results were mixed. First, only 40 per cent of the sample countries have shown rapid expansion of exports of manufactured goods. Secondly, in the case of the minority group, rapid export growth was also accompanied by fast expansion of industrial supply capacity and upgrading of their exports and industrial structure. By contrast, the experience of the majority group has not been promising. In most countries of these groups, not only growth of MVA but also growth of export of manufactures was

slow, or moderate. Third, the structure of exports and GDP has not changed in favour of the manufacturing sector. In fact, the pattern of static comparative advantage has intensified in these countries. Fourth, faced with severe import competition, many industries, including labour intensive ones in a number of countries suffered. While a significant number of firms closed down, few new companies started operation. Indeed, half of the sample countries faced de-industrialization – many of them in the low-income countries of Africa and some in Latin America. Further, not only their manufacturing sector, but also the whole economy has become more vulnerable to external factors including the flow of imports. Chile and Argentina in Latin America are notable examples in this respect. Brazil did not achieve acceleration of exports and faced considerable de-industrialization.<sup>3</sup> In the case of Mexico where exports grew extremely fast, acceleration of manufactured exports was not accompanied with an acceleration of MVA. Neither did much upgrading of the industrial base take place. The non-maquila industries which performed better than others were those which had enjoyed high investment during the import substitution era.

Generally speaking, the expansion of exports and investment for capacity expansion has taken place mainly in resource-based industries and the labour-intensive stage of production, i.e. assembly operations. In a few cases, the automobile industry and industries which had been dynamic and performed well during the import substitution era had contributed to upgrading. Otherwise, little investment took place for upgrading. It appears that industries that were near maturity when the reform started, such as aerospace in Brazil, benefited from liberalization as the emerged competitive pressure made them more efficient (Shafaeddin, 2005b). By contrast, inefficient ones, or those at infancy stage, could not survive well. Most African countries, including Ghana despite its two decades of reform, have become locked in production and exports of primary commodities and simple processing.

Finally, we have also shown that investment, rather than exports, has been the main contributory factor to the expansion of industrial activities; that in the case of the majority group, including many Latin American countries which attracted a significant amount of FDI, structural reform had a negative impact on investment particularly at the early stages of reform and that domestic investment has been crowded out in almost half of the sample countries. Further, although investment recovered during the later stages of reform, it could not be sustained as the economic crisis emerged by the end of 1990. In most cases, even at the height of recovery the investment-GDP ratio did not reach its pre-reform period level. Generally speaking, particularly in the case of Latin America, we have shown that investors took more interest in speculative activities, e.g. in real estate and in areas where there involved less risk than investment in manufacturing. The role of the public sector in the decision making on the allocation of resources declined and public investment suffered. Yet the private investment did not crowd-in, in most cases, to lift the I/GDP ratio.

### III. REASONS FOR THE FAILURE

Before explaining the reasons for the failure of trade liberalization in recent decades, let us mention a few words why traditional MS did not work. First and foremost is that across-the-board import

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<sup>3</sup> Between 1998 and end 2002, about 60 per cent devaluation of the national currency led to an annual average growth rates of 4.1 and 4.5 in manufactured goods, respectively. However, MVA and GDP picked up only by annual average rates of 1.9 and 2.1, respectively. The net flow of FDI declined from US\$26 billion in 1998 to US\$14.1 billion in 2002 and US\$9.9 billion in 2003. The gross fixed capital formation hardly grew in real terms (0.1 per cent in four years). As a result, the investment/GDP ratio fell from 19.8 for 1998/1999 to 19 for 2000/2002 in current terms and from 23.1 to 22.8 in 1990 prices. The current account of the balance of payments remained in the red until 2003 (based on UNCTAD database).

substitution which took place in many developing countries was often a reaction to balance-of-payment difficulties. This was the key problem. It was not a part of dynamic industrial and trade policies as practised in East Asian countries where temporary infant industry protection would be an element of dynamic trade and industrial policies. In these countries, import substitution provided a base for experience and learning that eventually made efficient export possible (Helleiner 1992).<sup>4</sup> Second, as a result, in those countries MS did not provide an environment sufficiently conducive to learning. Third, MS provided a lot of incentive to producers with little risks, as the domestic market was sheltered from import competition. Nevertheless, there was no pressure by the government on producers to attain efficiency and develop the capacity for export in exchange with the given high incentives. Fourth, as a result, the process became long due to the unchecked stakes of producers. Finally, the neglect of agricultural development – partly due to the bias in trade policies – put pressure on the balance-of-payments and/or often adversely affected the competitiveness of the manufacturing sector due to shortages of supply of foods as wage goods.

In the case of the majority group mentioned in the previous section, a variety of socio-economic, structural and external factors goes certainly some ways in explaining why trade liberalization and economic reform did not work in the last quarter of the 20<sup>th</sup> century. Nevertheless, the key reason is related to the misconception and design of the reform programmes, including trade policy reform, as perceived by IFIs and the “Washington Consensus”. Influenced by the orthodox approach, trade policy reform has been envisaged as synonymous with “uniform” import liberalization, applicable “universally” to all developing countries; the level of development, industrial base and special structural characteristics of individual countries were disregarded. Moreover, such an approach to trade policy is based mainly on “trade liberalization hypothesis”, a general theoretical abstraction which is, in turn, based on the theory of static comparative cost advantage.

One premise of this theory is that free trade will lead to an efficient reallocation of resources – markets function well and the free play of market forces will take care of industrialization and export expansion in any country – in accordance with the principle of comparative cost advantage. There is no need for government intervention, whether functional or selective. Since there is no market failure, and no sector or industry plays a particular role in providing positive externalities, it is maintained that there is no need for government intervention, whether functional or selective. The theory, however, involves unrealistic assumptions such as the existence of competitive internal and international market, the small size and “passivity” of firms, perfect functioning of markets in all countries, no market inadequacy, constant returns to scale, no externalities and no other causes of market failure. Moreover, according to this theory, all countries are at the same level of technological development, and technology is readily and freely available to their firms. Further, as all firms are small, they do not play an active role in pricing, technological development, capacity building and the learning process. Full employment, lack of uncertainty and risks, are other unrealistic assumptions of that theoretical abstraction.

In practice, firms of developing countries are faced with an oligopolistic international market dominated by a small number of large established firms which are strategically active. They benefit from increasing return to scale in production, R&D, marketing, distribution and financing. Further, they have the privilege of having long experience, controlling technology, know-how, and marketing and distribution network. Such attributes provide them with the power of “creative destruction” and

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<sup>4</sup> In fact Krugman (1984) regards import substitution as a prerequisite for export promotion. See also List (1856) and Shafaeddin (2005c)

capability to take strategic actions on prices as well as non-price attributes of products which place them in a superior “competitive advantages” vis-à-vis newcomer firms of developing countries. These create severe barriers against entry for the newcomers because unlike the established firms of developed countries only cheap labour and/or raw materials are their main sources of competitive advantage.

The afore-mentioned assumptions related to internal market structure are particularly unrealistic for low-income countries and those at the early stages of industrialization where the industrial production and export base is usually very small. In these countries the existing industrial capacity often reflects the production of scattered, light manufactured goods, produced at high cost owing to across-the-board import substitution and low capacity utilization; the latter being due to a shortage of foreign exchange and skilled manpower. Thus the pattern of industrial development that emerged in Africa and Latin America in recent years is not surprising. In fact, across-the-board, uniform and rapid trade liberalization, unmanaged capital flows and generally speaking reliance on market forces alone do lead to development in the pattern of output and exports in accordance with static, rather than dynamic, comparative advantage. Only industries which are near maturity have a better chance of surviving (Shafaeddin 2005b).

Generally speaking, the reform programmes did not pay attention to the importance of firm level issues; particularly to investment, learning and innovation. Their influence has not been particularly conducive to investment mainly because of their detrimental effects on investment decisions by the private sector i.e. changes in their perception of expected return and risks. It is true that the structure of incentives changed in favour of exportables as a result of trade liberalization. Nevertheless, in contrast to traditional MS, the outward orientation strategies reduced the incentive for investment in productive capacity and increased its risks.

Unlike MS, the producers faced a lot of competitive pressure by imports; particularly that liberalization was often sudden and significant. The profit margin of domestic investors declined and they suddenly became exposed to risks of competition at home as well as in less known foreign markets. But the theoretical foundation of trade liberalization in general does not take risks into consideration. Neither did the designers of structural reform programmes. Hence, instead of upgrading, it is not surprising that after liberalization many industrial firms closed down in Latin America and in Africa, although primary commodities and resource-based industries survived and did better. Some industries had been inefficient because of prolonged protection or the lack of maturity. Initial costs in new industries are high due to the lack of experience and/or the lack of required scale. As a result, liberalization would favour activities based on static comparative advantage.

Similarly, the reform programmes did not address the need for the “complementary factors” of investment such as institutions, infrastructure, etc., and paid little attention to the fact that supply, as well as demand cannot respond to price incentives without the support of such factors (Streeten 1993). Further, the design of SAPs and SPs was biased against domestic firms, in particular against the SMEs. Hence, in Latin America the reform programmes were associated with changes in the market structure in favour of large firms but against domestic firms, particularly the SMEs. It is therefore not unexpected that domestic investment was crowded out in half of the 50 countries in the sample studied by Shafaeddin (2005a, Chapter 3) and that while public investment was cut, private investment did not particularly crowd in. Further, in such a situation, the domestic investors proved right to discriminate against the more risky investment (Arrow 1962) – i.e. the manufacturing sector, and showing more interests in other activities.



It is neither surprising that foreign investors, while increasingly dominating the market, showed little interest in investment for upgrading and in spilling over their technical know-how to host countries (ibid, Chapter 3). In the case of tradeable goods, their main interest is to combine their home-based competitive advantages with that of the comparative cost advantage of the host country in areas that fit into their international network, namely in resource-based and assembly operations. Access to internal market is their main interest in non-tradeable goods, some consumer products and services. They preferred, for example, to purchase financial and telecommunication companies and some other existing plants rather than indulge in Greenfield investment (ibid.). Of course, TNCs did make an important contribution to the expansion of exports in some countries – e.g. Mexico but little to the learning factor of local manpower. Bruton (1998) is correct to say that outward oriented strategists fail to understand that learning is internal and that export is not a substitute for learning.

International production is becoming increasingly knowledge-based (Lundvall 2004), the products' life cycle is becoming shorter, and the process of learning is becoming longer. This makes international competition increasingly more dynamic. In such a world specialization, on the bases of factor cost advantage alone, is extremely vulnerable and fragile. There is continuous need to acquire dynamic comparative advantage and to upgrade the industrial structure. But acquiring dynamic comparative advantage would need a different trade and industrial policy than that proposed by the "Washington Consensus"; it requires, *inter alia*, government intervention and temporary infant industry protection.

The theory of infant industry protection is, however, also surrounded by fallacies (Shafaeddin 2000). Further, the present international trade rules limit the policy space of developing countries. Does this mean that developing countries cannot, or should not, industrialize because of such external constraints? Or does it imply that they should design an appropriate trade and industrial policy and opt for changes in international rules. We will go for the second alternative by arguing in the next section that some rethinking is required to develop a different approach to trade policy reform both at the national and international levels.

#### IV. AN ALTERNATIVE APPROACH

There is no blueprint for trade policy, industrialization, upgrading and economic development in general. Each country's particular situation has to be taken into account. Nevertheless, drawing on the experience of early- as well as late-industrializers, some elements of an alternative trade and industrial policy will be outlined below. To begin with, trade policy should be development-oriented. The objective is development, building up supply capacity and industrialization. Trade policy is a means to that end. So are, in fact, international trade, market, industrial policies, FDI, technology, etc. The "means" and "ends" or objectives should not be confused. As a tool of development, therefore, trade policy is not necessarily synonymous with trade liberalization and success in "liberalization" *per se* is not a guarantee of "success" in development. Trade policy should serve to achieve the long-run objectives of development; hence, it should be an integral part of industrial and development strategy.

If we define development as "the movement of the whole social system upward" (Myrdal 1971:356) it involves, *inter alia*, raising the standard of living of the masses of population and providing them with employment. Export expansion should not take place simply for exports' sake. The aim of export development and competitiveness is not to keep wages and other income of citizens low; otherwise,

ends are sacrificed for means (Paus 1989). Trade policy should help provide employment and improve the standard of living of citizens. To serve this purpose, one may use any useful tool, i.e. trade policy. Hence, trade policy may comprise the liberalization of trade in some goods, and it may at the same time strengthen, or loosen, the degree of protectionism accorded to others; it may include tariffs and/or quantitative restrictions, or payments of subsidies for particular goods, or any other measures suitable for achieving the objectives of development.

While drawing on the historical experience of other countries, the design of trade policy should be based on the realities of the international market at the time and the specific condition of the country rather than some theoretical abstraction. The history of industrialization in developed countries as well as NIEs indicate that with the exception of Hong Kong (China), no country has managed to industrialize without going through the stages of infant industry protection. History also teaches us that in all successful cases government intervention, both functional and selective, in the flow of trade and in the process of industrialization has been important. In other words, comparative advantage has been created over time. However, history also has taught us that prolonged protection and across-the-board import substitution has led to inefficiency and failure.

As discussed in the previous pages, in reality the international market is not competitive. International prices are distorted by the activities and interests of large oligopolistic firms, the maldistribution of income and assets among developed and developing countries and the tastes and technologies possessed by the former. In a globalizing world where large firms increasingly dominate production and international trade, coordination of certain economic activities takes place increasingly within large firms and through horizontal coordination among firms.<sup>5</sup> As a result, the relative role of market in international trade is decreasing in favour of global firms.

As changes in technology and organization of production have increased the role of knowledge and experience in industrialization, the period of learning has been prolonged and the need for infant industry support and technological development has increased. Some support is initially required for penetrating into international market. Whether the necessary support should be provided through protection or subsidization of output or factors of production is a secondary issue. The main point is that infant industry support is needed not only for import substitution but also for export promotion.

Economic policies, including reform programmes need to be country-specific and should depend on each country's needs, the degree of market development, initial industrial base, development objectives and socio-economic characteristics. In each point in time, for countries with little or no industrial capacity such as the low-income countries that are located mostly in Africa, the vital issue is to develop supply capacity and to lay the foundation for an expanding export market. For countries which have already undertaken some degree of import substitution such as most in Latin America and the Middle East, the main requirement is to make their industries efficient and competitive and to expand exports. The challenge now for those with some export capacity – the NIEs – is to upgrade their industrial structure in order to exploit other opportunities in the domestic and international markets. This upgrade would require, *inter alia*, technological development.

The market definitely has a role to play in the process of industrialization and development. The market mechanism can deal with gradual and marginal changes. Unfortunately, on its own it is “inadequate” to accelerate growth of supply capacity and promote dynamic comparative advantage.

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<sup>5</sup> For example, 70 per cent of world trade is undertaken by 500 large TNCs (Shafaeddin 2005a, Table 5.1)

The price mechanism is slow to create market and develop “non-price factors” necessary for the operation of the market. By non-price factors we mean institutions, infrastructure, information and back-up services necessary for the operation of the markets. The market also fails to make inefficient industries efficient and competitive, even through shock therapy, i.e. by sudden and drastic trade liberalization. Large and sudden changes in the price structure create uncertainty. The response to incentives will be limited especially when non-price factors are lacking.

Similarly, technological upgrading is not an automatic process. It involves a learning process which requires a deliberate effort to generate technical and managerial skills in the chain of production and distribution. It requires time and experience; it is costly and involves risks as well as externalities. Such efforts require a systemic approach for policies and actions at all levels: both national (including macro), sectoral, and micro (firm level) and international.

Therefore, it is a fallacy that government should not have a role, or have just a limited amount of it in the process of industrialization. Some government intervention is required to compensate for market inadequacies, to build up production capacity whether or not for export, to create markets, establish complementary “non-price factors” and to correct market failure. Furthermore, the market is a “servant” – the means – and not a “master”. As prices are to serve the long-term objectives of development, a wrong, i.e. distorted short-term price structure may be the right one if it serves to achieve the long-term objective of dynamic comparative advantage (Fontaine 1992, Amsden 1989 and Paus 1989).

As learning and technological change play a vital role in industrialization,<sup>6</sup> an attempt should be made to promote learning at different levels of the economy – macro, industry and firm – and in its various types: learning by studying and training; learning-by-doing; learning-by-using, imitating and adapting; learning by experience; and most of all learning by trial and error. Nevertheless, specialized capabilities are developed at the firm and activity levels; it is efficient firms which are able to export, as knowledge and skills are firm-specific and activity-specific. Hence, not only functional intervention, through education, but also selective and targeted interventions are required by the government to promote specific skill and learning at the industry and activity levels.

Although there is also a risk of government failure, this is not an argument in favour of leaving everything to the mercy of market forces. After all, market is not and cannot be the only coordination mechanism. The coordination of economic activities at both domestic and international levels takes place through what we may call a coordination system (Shafaeddin 2004a); that is the combination of markets, state and firms, complemented and supported by “non-price factors”. Nevertheless, in contrast to the orthodox approach according to which firms are passive, the firm is the driving force in such a coordination system, around which the other coordination mechanisms operate. Further government action and policies should complement the market not replace it.

The relative role of each element of the coordination system and the degree of the interaction among various mechanisms vary from one country to another and in each country over time, depending on the level of development, structural, historical and socio-political conditions, and on the interrelation among various sectors of the economy. Similarly, the role of the private and public sectors may

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<sup>6</sup> See e.g. Nelson and Winter (1982), Noland and Pack (2003), Lundvall (2004), Westphal (2000), Lall (1996) and Lall (2004).

change over time, although close cooperation between the two is essential throughout the process of development.

In each country and in each period, the relative role of each mechanism depends on the existence of various markets and the degree of market failure which is, *inter alia*, influenced by the nature and the degree of development of “non-price factors”. At the early stages of their development, developing countries face a dilemma, because all coordination mechanisms run a high risk of failure. Market failure is pervasive because of the lack, or underdevelopment of markets; the risk of entrepreneurship failure is large because of the lack of experienced entrepreneurs and underdevelopment of the formal sector; the risk of government failure is significant because of the low capacity of the government. The lower the level of development, the higher is the risk of coordination failure. Moreover, there is a vicious circle. The country is underdeveloped because of the failure of the coordination mechanisms, the coordination mechanisms fail because of the low level of development. To break this circle, action should be taken on all fronts: to create or improve markets, to increase the organizational capacity of entrepreneurs, to develop the necessary infrastructure and institutional framework of the country and to increase the capacity of the State.

Nevertheless, to break the vicious circle, initially the key role is to be played by government. As had been mentioned earlier in this paper, market forces *per se* will develop neither the market nor the “non-price factors” rapidly. During the early stages of development, even the direct participation of the public sector in industrialization may become more necessary, particularly in areas where the private sector is not prepared to take significant risks or externalities. As the private sector and the market develop, public ownership and the role of the government may gradually be reduced. Experience, however, indicates that the development of infrastructure, institutions and back-up services and provision of information cannot be left to the private sector entirely due to the significant overhead investment and externalities involved.

The key to such development during the early stages of industrialization is to improve the learning capacity and efficiency of the government machinery in formulating, implementing and correcting its policies. It is not easy but feasible, as the experience of both early industrializers and NIEs indicate. Since design of a trade and industrial policy differs from one country to another, nobody knows what the “right policy” might be (as nobody knows what the “right prices” are) exactly in each specific case. It is a question of trial and error – of learning by doing.

The question therefore is not “market or government”: it is to what extent the government should intervene, in what form; and how the efficiency of the government intervention could be improved to minimize government and market failures. Nevertheless, unnecessary, rigid and prolonged government intervention in the economy should be avoided; the government should not replace the market when it operates well. It should leave things to the market when it works.

Trade and industrial policy should be *selective, mixed, dynamic, predictable and supplemented by development of “non-price factors” and agriculture*. The scarcity of resources, existence of different externalities, learning effects and linkages in different industries would imply that industrial development should start on a selective basis as has been the case in all successful early and late industrializers. Some consumer goods that are most commonly in demand in the internal market and which preferably also involve significant learning effects could be chosen as a first group of industries for capacity building. For a newcomer, the unit cost of production is high not only in industries subject to economies of scale, but also in all other industries due to the lack of experience and knowledge

(Fontaine 1992). Some infant industry support is therefore unavoidable. Whereas the final products of selected industries are protected, imported inputs for these industries should be free of duties.

The provision of protection to the selected industry should not, however, be given without conditions and without limit. The government should insist on performance in exchange for the incentives and sanction the industrialists in cases where their performance is not satisfactory. Any industrial strategy should embody elements of both rewards and pressure from the government, market or both. As firms develop their production capacity, the government should introduce or gradually increase the pressure of competition in the internal market by allowing new entrants to the field. In industries where economies of scale are important, however, the competitive pressure should not be at the cost of production at an inefficient scale. One criterion for performance should be cost reduction and quality improvement.

As domestic capacity is developed in an industry, all measures should be taken to allow the firms to enter rapidly into the foreign market. At this stage the relevant firms need to improve efficiency and quality if they are to compete in the internal and international markets. But the disadvantages of cost, external economies in market search and marketing, lack of experience in exporting and marketing and risks related to entry barriers require what is called an infant export protection/support through export subsidy, tax holiday and/or fiscal incentives. Government intervention should be more evident during the second stage of infancy, i.e. when the infant industry starts to cut into the international market. As mentioned earlier, infant industry support is not confined to the import substitution phase of production.

Once again incentives should be provided in exchange for performance – this time for export performance. One policy practised in Japan and other East Asian countries was to give preference in the allocation of foreign exchange for the import of inputs to those firms which export better. The enterprises must be made to know in advance that infant industry support during its first and second phases is temporary. They should also know the schedule of the phase out of this support. The pressure for improved efficiency should eventually take the form of the gradual liberalization of imports of final goods.

While the first group of industries go through the second infancy phase, an attempt should be made to use their exports proceeds for a parallel development of the second group of industries; again on a selective basis. These industries may include some other consumer goods and/or intermediate products that are needed by the first group of industries. A system of drawbacks should apply to the products of these industries when they are exported. As the second group of industries matures in the production process, some sophisticated and durable consumer goods, some inputs to the second group of industries and some machinery used in production of the first group could be added to the list of infant industries for support. Eventually, some of these industries become subject to infant export protection.

As one can see, for sometime a combination of import substitution, export promotion, infant industry support and import liberalization is at work for a mix of consumer goods, intermediate products and capital goods. Infant export protection/support also takes place on a selective basis for each group of industries which, over time, would themselves be subject to the same modalities as that of the first group. The choice of machinery may be influenced by the size of the country and the type of existing industries. The process of deepening industrialization could continue until an industrial base is established, export capabilities developed and capacities for efficient production of machinery are acquired. During such a process for each industry while the role of government intervention is

gradually reduced, the responsibilities of the firms and the role of the market are increased. Inter-firm relations, through trade and industrial associations, could be developed to help undertake these responsibilities. Clustering of industries would be useful to exploit externalities in institutions, infrastructure, marketing, skill development, etc. A close government-business relationship for drawing and implementing the related rules and guidelines would facilitate the process of industrialization and interchange of information.

For an example, if textiles were chosen as a first group of industries for industrial development, in the first phase textiles would be a subject of infant industry support and will be supplied with a free flow of imports of yarn and machineries. In the second phase the protection of production should be gradually reduced, but assistance and incentives will be provided to promote textiles exports. In this phase, exports can be accompanied with import substitution of yarns. Ultimately, assistance to exports of textiles should be reduced to zero as the industry matures and penetrates into the international market. In the meantime textile machines can be produced domestically and possibly be exported. When a number of industries are developed in this manner over time, the related process is said to resemble “flying geese”, an expression first used in the context of Japanese industrialization. Nonetheless, almost all successful industrializers followed more or less a similar process.<sup>7</sup>

Not all industries selected for import substitution could be necessarily candidates for exportation. Nonetheless, this should not imply that protection should continue for ever, the industries developed through import substitution should be made efficient so that they could compete at least in the domestic market.

As the industrial base widens the expansion of investment in production and export capacity takes on more importance. Further, to avoid terms of trade losses the industrial deepening should follow industrial widening. Industrial deepening requires an upgrading of products and the production process, quality improvement, and introduction of new products or a new variety of the same products. This process requires a technological innovation which is different from innovation at the first stage of industrialization. At this stage innovation could take the form of introducing and operating a new machine, imitation and adaptation. For upgrading innovation requires R&D and eventually development of new and frontier technology. The development of new technology in turn necessitates “infant” support because of the risks and dynamic internal and external economies of learning involved.

With respect to FDI, the experience of developing countries indicates that it acts as an important channel for export. It may also have notable contribution to financing investment temporarily. Nonetheless its longer term contribution would be often limited in relation to total domestic investment and would involve little technological spillover. The recent experience of China indicates that FDI could play an important role in industrialization if it is guided and targeted toward specific areas where foreign technology is most needed and could contribute to the learning process of local manpower and expansion of domestic value added. In fact, China’s experience, unlike Mexico’s, would teach us that one could think of a process of export promotion through FDI that could lead to import substitution if it is managed. China started assembly operation in a number of industries, particularly electronics and telecommunication, based on imported input and gradually has been increasing domestic production and exports of components (Shafaeddin 2004b). For example, the share of components in exports of manufactured goods (excluding chemicals) of the country increased

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<sup>7</sup> See Akamatsu (1961), also Kasahara (2004) for a survey.

from about 6.4 per cent in 1992/1993 to 14.5 per cent in 1997/1998; and, 16.7 per cent in 2002/2003 after accession to WTO. More importantly, the corresponding share of imports of components, which had increased continuously between 1992/1993 until 1997/1998 from 17.7 per cent to 23.2 per cent, first increased more slowly (reaching nearly 24 per cent in 2000/2001) and then declined despite accession to WTO, to 22.3 per cent in 2002/2003.<sup>8</sup>

Trade and industrial policy alone cannot succeed unless they are accompanied by a host of other factors. The process of industrialization requires what I call “COU-P-INS” (Shafaeddin, 2006). COU stands for: Create capacity, Operate it efficiently and Upgrade the industrial structure. To do so incentives is necessary but not sufficient. There is a need for a number of INs and Ps. The INs include Investment, Input, Infrastructure, not only transport and communication but also other facilities such as marketing channels, distribution network etc., Institutions, Innovation and Information (Streeten 1987). We use information here in its wide sense of the term which includes knowledge, science as well as market information which requires investment in human resources through education, skill and training. In fact, investment is essential for all other INs as well as for the expansion of supply capacity and creation of organizational capabilities and learning. Most of INs outlined here are elements of “non-price factors” mentioned earlier.

The Ps stands for Political stability, Predictability of policies and Pressure for performance as previously explained. There are also two INs which are to be avoided. These are instability in exchange rates and inflation which are largely related to agricultural development, devaluation of the currency, capital flows and macroeconomic policies.

Development of agriculture is essential, particularly during the early stages of industrialization, to increase the supply of food, where feasible, in order to contribute to the availability of wage goods and to ease the pressure on the balance of payment and inflationary tendencies. For the same reason, an ample availability of other basic consumer goods is important, as availability of wage goods not only eases inflation, but also contributes to competitiveness of manufactured goods in the international market.

Devaluation of the local currency can temporarily provide some incentives for the production of tradeable goods, particularly exports.<sup>9</sup> It may also serve other purposes but, for a number of reasons, it is not necessarily the most desirable measure as a tool of industrial policy when it is repeatedly use. First, it results in uniform (nominal) price changes over the whole range of tradeable goods rather than for selected products.<sup>10</sup> Supply response to prices is much lower when all the outputs of a sector are equally affected; it is stronger when relative prices increase only for one good, or for a few goods (Streeten 1987). Even in industrialized countries there is some evidence that reallocation of resources

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<sup>8</sup> Based on the UN COMTRADE database.

<sup>9</sup> For example, Bautista (1982) examining a sample of developing countries for the period 1973–1979 has shown that currency depreciation, both small and large, did not lead to a permanent improvement in export competitiveness.

<sup>10</sup> Nevertheless, for a given rate of nominal devaluation, the implied real exchange rate depreciation will be different in different sectors, industries and firms as their import intensities are different. The higher the import intensity, the higher the increase in the cost of production for a given rate of nominal devaluation, thus the lower the real exchange rate depreciation achieved as a result of a given rate of nominal devaluation. Usually the import intensity for manufacturing sector is higher than that for other sectors, within the manufacturing sector, it varies from one industry to another and it is higher for modern industries and large firms and within these industries it is higher for export production than for the home market. Further, for each industry and firm the effective exchange rate could be yet different to the extent that the directions of trade of firms are different. Hence, devaluation, as it is claimed, cannot even work as a uniform price incentive. To achieve uniform effective exchange rate a complex nominal rate structure would be needed.

from non-tradeable to tradeable sectors, and within tradeables from importables to exportables (and in the latter from traditional to new products), might be more responsive to targeted incentives such as subsidies than to exchange rate adjustment (Schydrowsky 1982).

Second, the direct impact of devaluation on production cost in manufacturing products, particularly exports, is greater than on the other sectors of the economy because of their higher import intensity which has, in fact, increased significantly due to import liberalization. Industrial production in low income countries, in particular, is dependent on imports for more than half its inputs. Therefore, in countries with a high ratio of imports to GDP, where manufactures are a small fraction of total exports and the manufacturing sector is highly import-intensive, incentives for exports of manufactures should be provided by other measures than devaluation. These may include e.g. subsidies, tax holidays and other fiscal and financial measures targeted to particular industries.

Further, the indirect contribution of devaluation on the cost of production in the manufacturing sector could be also higher than the other sectors if devaluation is accompanied by, or result in, a decline in productivity in this sector due to supply or demand factors or a combination of both. When devaluation involves contractionary effects,<sup>11</sup> or is accompanied by contractionary macroeconomic management, the demand for domestically produced goods will be reduced. Similarly, export may not increase in response to devaluation when the structure of supply is rigid, when export supply is constrained by import compression or low quality and inappropriate product for foreign markets, or when there is the lack of marketing channels. Similarly, export may not increase because of low price elasticity of demand or recession abroad. As a result, the combination of reduced effective domestic demand and little or no expansion in export may lead to lower capacity utilization and a decline in productivity. The neglect of the need for enhancing productivity and the overemphasis on devaluation have been important weaknesses of the reform programmes.

Third, devaluation could disrupt the economy through its inflationary impact, particularly in low-income countries. In fact, we have estimated that for every 10 per cent nominal devaluation during the period 1980–1987, in countries where per capita income is less than \$400 the real exchange rate declined only by 3 per cent within a year (Shafaeddin 1992; see also Edward and Wijnbergen 1989).<sup>12</sup>

Fourth, devaluation, as well as import liberalization, tends to turn the domestic terms of trade in favour of primary commodities and against the manufacturing sector because of differences in the nature of price determination in the two sectors (Shafaeddin 1991). While this may have a welcome positive effect on food production, it would seem that cash crops have benefited more than foods in many developing countries which have applied structural adjustment programmes (Stewart et al. 1992). Further, simultaneous currency devaluation by a large number of countries that produce the same commodity may result in terms-of-trade losses due to the “fallacy of composition” and decline in real wages.

Finally, the available empirical evidence indicates that other factors are more important in export competitiveness than exchange rate and costs and prices. For example, Fagerberg (1988) has shown that the contribution of cost competitiveness was far less than technological competitiveness and the

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<sup>11</sup> A study by Edward and Wijnbergen (1989:1526–1528) indicates that the contractionary impact of devaluation is important.

<sup>12</sup> Edward and Wijnbergen (1989) have shown, on the basis of a survey of the literature, that nominal devaluation leads to relatively high real depreciation temporarily, but the effect of nominal devaluation on real exchange rate erodes slowly taking between 8 to 16 quarters depending on the type of macroeconomic policies undertaken.



ability to compete on delivery (ibid.:371). An empirical study by Kaldor (1978) for the period 1963–1975 indicates that countries with the fastest rate of growth of exports, e.g. Japan were those which at the same time experienced faster rates of increase in their relative unit labour cost (RULC) than others. On the basis of this study he also concluded that in the long run relative changes in exchange rate can be the result of competitiveness, rather than its cause. Thus, he added, relying on changes in RULC alone as a policy tool for improving competitiveness would be a simplistic view.<sup>13</sup> Amendola et al. (1993) reached similar results for the period 1967–1987.<sup>14</sup>

As mentioned earlier, in the long run enhancing productivity rather than repeated nominal devaluation is a key to success in industrialization. Nonetheless, with the presence of strategically active international firms, the concept of productivity takes on a different meaning. It is not merely concerned with the volume of output produced. It involves creating value to the consumers through factors which contribute to the lowering of the price elasticity of demand. Such are, for example, a reputation for reliability, the supply of high quality products, timely and rapid deliveries, etc. Productivity enhancement requires continuous learning, skill development, innovation and upgrading.

Finally, capital flows should be controlled and managed. Otherwise, erratic movement in capital flows will lead to erratic changes in the flow of imports, the exchange rate, interest rate, production cost, and the price structure. The ensuing chaos and confusion makes the price structure and the exchange rate lose their function as a guide to investment for the expansion of output and export, thus leading to instability in all significant economic variables – including MVA and GDP. In particular, the instability in the flow of imports would severely affect the growth of MVA and GDP.<sup>15</sup> In fact, in violently changing conditions and for large maladjustments exchange rate devaluation may be harmful and would not be desirable (Arndt 1985 and Henderson 1948).

The alternative approach we have proposed above looks idealistic as it is not in line with WTO rules, the “Washington Consensus”, the practices of IFIs and main bilateral donors when dealing with developing countries. Nevertheless, the existence of such rules, Consensus and practices are not an argument against what is needed. These rules are not God given; they can and need to be revised. Like Helleiner, “I am realistic enough to recognize that reconceptualization of WTO as a development institution may not happen quickly (although I am fully confident that it *eventually* [my emphasis] will).” It will take time (Helleiner 2000:19).

I am also well aware that such a reconceptualization will involve hard bargaining since experience has shown that developed countries will not give in purely on moral grounds (Shafaeddin 1984). Nevertheless, two points are worth emphasizing. First is the realization that there is a need for reconceptualization. Secondly, developing countries do have some bargaining power in international trade. After all they absorb about 23 per cent of exports of developed countries (when intra-trade of the EU is excluded, the figure reaches well over 30 per cent).<sup>16</sup> The question is how to mobilize these bargaining chips and strengthen their negotiation position (Shafaeddin 1984).

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<sup>13</sup> The simultaneous increase in RULC and market share is referred to as the Kaldor paradox in the literature.

<sup>14</sup> See Fetherston et al. (1977) and Kellman (1983) for similar views expressed in the late-1970s and early-1980s. See also Amable and Verspagen (1995).

<sup>15</sup> Helleiner (1986) has shown in the case of African countries that there was a strong negative relationship between instability in the volume of imports and GDP growth rates.

<sup>16</sup> Based on UNCTAD database.

A detailed redesign of WTO rules and other international trade and industrial policies relevant to developing countries<sup>17</sup> has to be a subject of a separate paper. Nevertheless, a few general points are worth mentioning with respect to a required framework for an international trade policy. First of all, the whole philosophy behind WTO rules needs change. It is not “policy space” as such within the existing framework of WTO rules that developing countries require. What is needed is a totally different framework which allows for a flexible trade policy with a broader dimension of space and time rather than one which is a one-size-for-all and for-all-time. This dimension of space would imply that trade policy should allow for different levels of development and industrialization of the various countries at each point in time – as a rule and not as exceptions to the rules – as sometimes requested for by developing countries within the context of the so-called “special and differential treatment”.<sup>18</sup> The dimension of time would imply that the rules should allow for dynamic trade policy of each developing country as the country develops.

Second, export performance requirements and domestic content clauses should be allowed in the relation between host countries and TNCs.

Third, while some protection of intellectual property is needed to encourage invention and innovation, the TRIPs agreement should be changed in order not to create severe barriers to the diffusion and application of new technology to the firms of developing countries because these barriers could render industrial deepening and upgrading difficult.

In short, the international community should aim at achieving more equitable international economic systems and policies in which the needs and different situation of countries at various stages of development are taken into greater consideration. After all, to achieve this equitableness is sought for not only in the interest of developing countries, but for the benefit of developed countries as well.

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<sup>17</sup> For a detailed list of restrictions imposed by international rules and bilateral trade relationships on trade and industrial policies of developing countries see, e.g. Rodrik (2004, Table 2).

<sup>18</sup> See, e.g. the Text of the G-20 Ministerial Declaration Adopted on 19 March 2005 at the conclusion of the Ministerial meeting of G-20 in New Delhi on 18 and 19 March 2005.

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