

# The Diminishing Returns to Export- Led Growth

A Paper from the Project on Development,  
Trade, and International Finance

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Robert A. Blecker

A Council on Foreign Relations Paper

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## FOREWORD

In the wake of the 1997–98 financial crises in emerging economies, many prominent thinkers focused their energies on what went wrong, how it could have been prevented, and what reform measures are required for the future. While some concentrated specifically on financial markets within the economies in question, others examined the larger system-wide implications. The Council on Foreign Relations Project on Development, Trade, and International Finance convened a Working Group in an attempt to look at the problem from both levels, to investigate the problems in the world economy that led to the crises, and to propose policy options calculated to prevent future large-scale disturbances.

Specifically, the goal of the Working Group, which began in 1999, was to promote discussion of different perspectives about the necessity for change in the world economic system, and to look at concrete forms that change might take. These included, but were not limited to, discussions about reforming the international financial architecture to facilitate a transition from export-led growth to internally or regionally demand-driven development strategies that offer the populations of the developing world an improved standard of living.

One of the Working Group's several undertakings was to commission papers from the participants on a broad range of subjects related to the international financial architecture. The authors come from a variety of backgrounds, and their papers reflect a diversity of perspectives. However, we believe that all of them provide useful insights into international financial architecture, and that they represent collectively factors that should be considered by both U.S. and international economic policy makers.

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## PROLOGUE: THE SUDDEN COLLAPSE OF THE EXPORT-LED ECONOMIES

In the 1970s and 1980s, there was a tremendous sea-change in development policy thinking, among both academic economists and policymakers. The inward-oriented, import-substitution strategy of the 1950s and 1960s became discredited and was replaced by an outward-oriented, export-promotion strategy. Although there was resistance, both intellectual and political, to this shift, by the early 1990s the battle was essentially over, and the export-promotion approach had won. This victory was aided in part by pressures from the U.S. government and the Bretton Woods institutions (the World Bank and the International Monetary Fund) in the aftermath of the 1980s debt crisis. However, it was also based on the apparently superior outcomes of the leading export-oriented economies in terms of both growth and equity objectives.

By the 1990s, the debate had shifted. Rather than focusing on whether an outward-oriented approach was superior, discussion now centered on why it was superior and what kinds of policies best promoted export-led growth. With regard to why export promotion was so vital, discussion focused on the relative importance of factors such as encouraging efficiency in resource allocation, stimulating learning effects and technological dynamism, and relaxing balance-of-payments constraints. With regard to policies, debate centered around whether export promotion was best achieved by laissez-faire policies that “let markets work” and “got

prices right,” or by government intervention that directed resources to strategic industries and altered price signals accordingly.<sup>1</sup>

In all of this discussion, the countries that were held up to the world (by every side in each debate) as the shining exemplars of successful, export-led, outward-oriented growth were the so-called “Four Tigers” (South Korea, Taiwan, Singapore, and Hong Kong), and the next wave of newly industrializing countries (NICs) in southeast Asia (such as Thailand, Malaysia, Indonesia, and China). Accordingly, it came as a major shock when many of these nations fell victim to a widespread financial crisis that sparked a sharp economic downturn in 1997–98. Although some non-Asian countries such as Russia and Brazil were caught in the shock waves after the Asian crisis, the core mystery is why a region whose development process had been widely viewed as highly successful, if not miraculous, was at the epicenter of such a gargantuan economic earthquake.<sup>2</sup> Was Asia merely the victim of some contingent (and potentially correctable) circumstances, such as mismanaged exchange-rate pegs or prematurely liberalized financial markets? Or did the financial crisis reveal some deeper, underlying flaws in the Asian development model—and if so, what are

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<sup>1</sup>See, for example, Alice Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (Oxford: Oxford University Press, 1989); Anne O. Krueger, *Liberalization Attempts and Consequences* (Cambridge, MA: Ballinger, 1978); Sanjaya Lall and Georg Kell, “Industrial Development in Developing Countries and the Role of Government Interventions,” *Banca Nazionale del Lavoro Quarterly Review* (September), excerpted in Gerald M. Meier, ed., *Leading Issues in Economic Development*, 6th ed. (New York: Oxford University Press, 1995); Demetris Papageorgiu et al., eds., *Liberalizing Foreign Trade* (Cambridge, MA: Blackwell, 1991); Stephen C. Smith, *Industrial Policy in Developing Countries: Reconsidering the Real Sources of Export-Led Growth* (Washington, D.C.: Economic Policy Institute, 1991); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990); World Bank; *Development Report 1987* and 1991 (New York: Oxford University Press), and World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (Oxford: Oxford University Press, 1993).

<sup>2</sup>Russia and Brazil both had large public-sector deficits and debts, which distinguished them from the Asian countries, most of which had small budget deficits (or surpluses) and mostly private debts. They also have a much greater reliance on primary commodity exports, compared with most of the Asian crisis countries.

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those deeper flaws, how can they be fixed, and what are the implications for development strategies in other regions?

There is no question that contingent factors played a dominant role in terms of the timing, location, and severity of the crisis.<sup>3</sup> The constellation of recently liberalized financial markets, overvalued exchange rates, speculative bubbles in asset markets, and large amounts of short-term, foreign-currency-denominated debt is a common factor in most of the crisis situations both in Asia and elsewhere in the 1990s—including Mexico in 1994, Russia in 1998, and Brazil in 1999, as well as Thailand, Korea, and other Asian coun-

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<sup>3</sup>Alternative analyses have focused either on macroeconomic policies that allowed exchange rates to become overvalued or the inherently destabilizing effects of liberalized capital markets and speculative financial flows. Those who blame pegged but adjustable exchange rates tend to advocate either rigidly fixed or perfectly flexible rates, though there is no consensus on which way to go. For a variety of views, see Steve H. Hanke, "How to Establish Monetary Stability in Asia," *Cato Journal* 17, no. 3 (Winter 1998), pp. 295–301; Steve H. Hanke, Lars Jonung, and Kurt Schuler, *Russian Currency and Finance: A Currency Board Approach to Reform* (London: Routledge, 1993); Jeffrey D. Sachs, "Brazil Fever: First, Do No Harm," *Milken Institute Review* (Second Quarter, 1999), pp. 16–25; Barry Eichengreen, *Toward a New International Financial Architecture: A Practical Post-Asia Agenda* (Washington, D.C.: Institute for International Economics, 1999); Ricardo Hausmann et al., "Financial Turmoil and the Choice of Exchange Rate Regime," photocopy, (Washington, D.C.: Inter-American Development Bank, March 1999); and Jeffrey A. Frankel, "The International Financial Architecture: Exchange Rate Regimes and Financial Integration," Brookings Policy Brief, no. 51 (June 1999). Those who blame destabilizing effects of capital market liberalization tend to call for reimposing capital controls and foreign exchange restrictions, or for creating a new global regulatory authority or an international lender of last resort. For example, see Robert A. Blecker, *Taming Global Finance: A Better Architecture for Growth and Equity* (Washington, D.C.: Economic Policy Institute, 1999); Jane D'Arista and Tom Schlesinger, "Reforming the Privatized International Monetary System" (Philomont, Va.: Financial Market Center, 1998); John Eatwell and Lance Taylor, *Global Finance at Risk: The Case for International Regulation* (New York: New Press, 2000); Henry Kaufman, "Preventing the Next Global Financial Crisis," *Washington Post*, January 28, 1998; Paul R. Krugman, "Saving Asia: It's Time to Get Radical," *Fortune*, September 7, 1998; Robert Wade, "The Asian Debt-and-Development Crisis of 1997? Causes and Consequences," *World Development* (August 1998), and "From 'Miracle' to 'Cronyism': Explaining the Great Asian Slump," *Cambridge Journal of Economics*, 22, no. 6 (November 1998), pp. 693–706; Robert Wade and Frank Veneroso, "The Asian Crisis: The High Debt Model vs. the Wall Street-Treasury-IMF Complex," *New Left Review* 228 (March/April 1998).

tries in 1997–98.<sup>4</sup> Moreover, it is now generally recognized that speculative attacks on pegged exchange rates helped to provoke the rash of currency collapses, and that self-fulfilling panics worsened the ensuing economic downturns and contagion effects. Finally, although this is more controversial, many observers blame the International Monetary Fund (IMF) and the U.S. Treasury for inept handling of the crisis, including misguided efforts to support indefensible exchange-rate pegs and inappropriate policy recommendations that worsened both financial panics and real recessions.<sup>5</sup>

Nevertheless, debate still rages over what were the most important underlying factors that created a vulnerability of these apparently successful economies to such a financial (and real) crash. The official view, promoted by the U.S. government, other G-7 governments, and the IMF, blames inadequate financial supervision

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<sup>4</sup>See, for example, Guillermo A. Calvo, Morris Goldstein, and Eduard Hochreiter, eds., *Private Capital Flows to Emerging Markets After the Mexican Crisis* (Washington, D.C.: Institute for International Economics, 1996); Jenny Corbett and David Vines, "The Asian Crisis: Competing Explanations," Center for Economic Policy Analysis, Working Paper Series III, no. 7 (New York: New School for Social Research, July 1998); Jason Furman and Joseph E. Stiglitz, "Economic Crises: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity* 1998, no. 2, pp. 1–135; Graciela L. Kaminsky, Saul Lizondo, and Carmen M. Reinhart, "Leading Indicators of Currency Crises," *IMF Working Paper* no. WP/97/79 (Washington, D.C.: International Monetary Fund, July 1997); Graciela L. Kaminsky and Carmen M. Reinhart, "The Twin Crises: The Causes of Banking and Balance-of-Payments Problems," *American Economic Review*, vol. 89, no. 3 (June 1999), pp. 473–500; Paul R. Krugman, *The Return of Depression Economics* (New York: Norton, 1999); Brian K. MacLean, Paul Bowles, and Osvaldo Croci, "Understanding the Asian Crisis and Its Implications for Regional Economic Integration," in Alan M. Rugman and Gavin Boyd, eds., *Deepening Integration in the Pacific Economies* (Northampton, Mass.: Edward Elgar, 1999); Steven Radelet and Jeffrey D. Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," *Brookings Papers on Economic Activity* 1998, no. 1, pp. 1–90; Jeffrey D. Sachs, Aaron Tornell, and Andrés Velasco, "Financial Crises in Emerging Markets: The Lessons from 1995," *Brookings Papers on Economic Activity* 1996, no. 1, pp. 147–215, and "The Mexican Peso Crisis: Sudden Death or Crisis Foretold?" *Journal of International Economics* 41, nos. 3/4 (November 1996), pp. 265–83; Ajit Singh, "'Asian Capitalism' and the Financial Crisis," Center for Economic Policy Analysis, Working Paper Series III, no. 10 (New York: New School for Social Research, August 1998); Joseph E. Stiglitz, "The Global Financial Crisis: Perspectives and Policies" (Rochester, N.Y.: McKenzie Lecture, April 1999); Lance Taylor, "Capital Market Crises: Liberalisation, Fixed Exchange Rates and Market-Driven Destabilisation," *Cambridge Journal of Economics*, 22, no. 6 (November 1998), pp. 663–76; Robert Wade, *ibid.*, 1998.

<sup>5</sup>See Blecker, *ibid.*; Martin Feldstein, "Refocusing the IMF," *Foreign Affairs* 77, no. 2 (1998), pp. 20–33; Steven Radelet and Sachs, *ibid.*; Taylor, *ibid.*; Wade and Veneroso, *ibid.*

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and a lack of transparency within the crisis countries. According to this view, the crisis revealed a fundamental flaw in the Asian financial system, namely the so-called “crony capitalist” relationships between corporations, banks, and governments, which allegedly created too much “moral hazard” through explicit or implicit loan guarantees. This view supports the official proposals for a “new financial architecture,” which emphasize improved transparency and surveillance—essentially, making over the financial systems of the Asian economies in the Western image (and, not coincidentally, opening them up to foreign ownership in the process).

It is true that close connections between private lenders, corporate borrowers, and government agencies (or officials) contributed to the buildup of bad loan portfolios in many of the Asian countries. However, it is not clear that most lenders really counted on being bailed out if their loans failed—rather, the possibility of borrowers being unable to service their debts was simply discounted. The problem of overlending appears to have been due more to investors’ myopia and willful ignorance of risk than to moral hazard.<sup>6</sup> Moreover, these same domestic financial systems worked well for the previous three decades, when the Asian economies achieved their record-breaking growth, during which time those financial systems successfully channeled national savings into productive investments in strategic sectors.<sup>7</sup>

In fact, it was the *removal* of government controls over capital inflows and investment finance in countries like Korea and Thailand in the 1990s—not the prior existence of such controls—that allowed lending to reach excessive proportions and permitted unsustainable levels of short-term, foreign currency borrowing to occur in the mid-1990s.<sup>8</sup> The removal of those controls was

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<sup>6</sup>On this point see Marcus Noland, Li-Gang Liu, Sherman Robinson, and Zhi Wang, *Global Economic Effects of the Asian Currency Devaluations* (Washington, D.C.: Institute for International Economics, 1998); Radelet and Sachs, *ibid.*; Taylor, *ibid.*

<sup>7</sup>See Amsden, *ibid.*; Robert Wade, *ibid.*, 1990; and Ajit Singh, “Savings, Investment, and the Corporation in the East Asian Miracle,” *Journal of Development Studies* 34, no. 6 (August 1998), pp. 112–37.

<sup>8</sup>This argument is made by Ha-Joon Chang, “Korea: The Misunderstood Crisis,” *World Development*, vol. 26, no. 8 (1998), pp. 1555–61; and Singh, “‘Asian Capitalism’ and the Financial Crisis.”

pushed and promoted by the U.S. government and the IMF in the early 1990s, without regard for the lack of adequate transparency and prudential regulation that were later blamed for causing the crisis. Also, the fact that several major Asian countries that never liberalized external capital flows (notably China, Taiwan, and India) escaped the financial meltdown of 1997–98 lends credence to the argument that financial market liberalization was a direct cause of the crisis—especially since these countries are not necessarily lacking in “crony” relationships between borrowers, lenders, and governments. At most, one could claim that the nature of the Asian financial systems created a vulnerability to overlending when those systems were opened up to liberalized capital inflows.

Nevertheless, it will be argued here that there is *another* fundamental flaw in the development strategy of the Asian countries and in the efforts of other developing countries to emulate the Asian model. This flaw is the “fallacy of composition” of so many countries simultaneously relying on export-led growth policies and the resulting overinvestment that has created an overhang of excess capacity in key export industries. While these policies did not directly cause the financial crisis, the competition of an increasing number of developing nations for a limited range of export markets in similar products was a source of underlying vulnerability to a crisis. In fact, the location and timing of some of the recent financial crises can be associated with situations of disappointing growth in countries that were counting on export booms to propel their development.

The increasing openness to imports and reliance on export growth in a large number of competing countries helps to account for the fact that countries with overvalued currencies were so vulnerable to speculative attacks and financial collapses. And the fact that all of the countries that are attempting to recover from financial crises are simultaneously trying to promote similar exports via depreciated currencies is an important reason why this recovery has been so slow and uncertain—and why even some countries that escaped the financial crisis of 1997–98 without suffering currency collapses of their own nevertheless saw their growth rates reduced.

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The rest of this paper is organized as follows. First is a more precise statement of the hypothesis about the constraints on export-led growth and discussion of some important qualifications to the argument. This is followed by a brief literature survey, including studies of exports and growth, models of balance-of-payments-constrained growth, analyses of the Asian development model and financial crisis, and previous studies of the “fallacy of composition” and of excess capacity in developing countries. Following the literature survey is a discussion of some preliminary empirical evidence that establishes the plausibility of diminishing returns to export-led growth becoming a problem in the 1990s. The final section offers a tentative discussion of the policy implications of the analysis, with emphasis on what it implies for the redesign of both domestic development policies and the international financial “architecture.”

### THE HYPOTHESIS: STATEMENT AND QUALIFICATIONS

The basic flaw in the export-led growth strategy is that, under a given set of global demand conditions, the market for developing country exports of manufactures is limited by the capacity (and willingness) of the industrialized nations to absorb the corresponding imports. The market for imports of labor-intensive manufactures and other NIC exports can only grow so fast, and as a result the export-led strategy can work only for a limited number of countries at a time. If this market is growing at, say, 7 percent per year, then not all of the NICs can have their exports increase at rates of 10 percent or 15 percent per year—although a few can, *provided that the market shares of other exporters or domestic producers are falling at the same time*. If all try to grow faster than is possible in the aggregate, the result can only be an overhang of excess industrial capacity and/or falling prices. And if some countries’ export performance is disappointing, they will suffer economic stagnation and become more prone to a currency collapse or financial crisis—especially if they attempt to paper over their growth slowdowns

with international borrowing that creates a fragile financial position and makes the currency overvalued.

Of course, total exports of manufactures from the developing countries can grow faster than domestic demand in the industrialized countries, provided that the former countries as a group increase their productive capacity and lower their average costs, thus permitting them to take away market share from domestic producers in the latter. In this respect, the ability of all developing country exporters to increase their total market share abroad is limited by two factors: first, by protectionist policies, either previously existing protection or responses to import surges; and second, by the eventual disappearance of domestic import-competing producers (or the survival of only a few “niche” producers), which then constrains total import growth to the growth rate of the domestic market in the industrialized countries.

To the extent that the total market share of developing country exporters cannot be increased further (e.g., because they are concentrated in product lines where there is no domestic production left in the industrialized countries, or remaining domestic producers in the latter countries have solid market niches or enduring protection), then each new entrant can achieve above-average rates of export growth only if it displaces some other exporting countries, whose export growth will inevitably falter as a result. A key variable in this process is the exchange rate: countries with low, competitive rates will succeed, while those with high, overvalued rates will lose out. But no amount of competitive devaluations can allow *all* of these countries to succeed in the same game of export-led growth at the same time with the same products.<sup>9</sup>

The current wave of export-led growth was initiated by Japan in the 1960s and 1970s, with its tremendous success in tradition-

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<sup>9</sup>One way out is to try to follow the Japanese and Korean model by upgrading the quality of exports, so as to avoid competition at the low end of the product scale with other low-wage exporters. But then, those markets too can become saturated and their prices can fall, and not all countries are prepared to go that route. See the discussion of Korkut Erturk, “Worldwide Intersectoral Balance, Overcapacity and the East Asian Crisis,” photocopy (New York: New School for Social Research, and Salt Lake City: University of Utah, 1999), below.



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al “smokestack” industries such as textiles, automobiles, and steel. By the late 1970s and early 1980s, when Japan was moving up the industrial ladder into more technologically advanced products, the Four Tigers stepped up their exports of labor-intensive products, thus initiating what became known as the “flying geese formation.” At that time, the Four Tigers were the only major developing country exporters of labor-intensive manufactures, and they grew rapidly by achieving rising shares of the U.S. consumer market in particular. Then, in the late 1980s and 1990s, one country after another tried to emulate the East Asian Tigers: Thailand, Mexico, China, Malaysia, Indonesia, and various other countries in Latin America and the Caribbean, South and Southeast Asia, Eastern Europe, and the Middle East.

As the market for developing country exports of manufactures became more crowded with new entrants, signs of intensified competition among these countries for export opportunities began to emerge in the 1990s. In particular, the success of the export-promoting nations became extremely sensitive to exchange-rate changes, both domestic and foreign. First Japan and then other East Asian nations (e.g., Korea) whose currencies had appreciated relative to others began to suffer slower export growth and reduced market share abroad, with negative repercussions for their own domestic growth. In this process, not only changes in the countries’ own exchange rates, but “cross-effects” of other countries’ exchange rate changes began to have significant effects. For example, the Chinese and Mexican devaluations of 1994 boosted those countries’ export growth, but put pressure on other countries some of which (notably Thailand and Korea) suffered currency collapses only a few years later.

There are a number of important qualifications to this hypothesis, in regard to both the Asian development model in particular and export-led growth in general. Regarding the Asian model, an obvious caveat is that the Asian nations are diverse, and do not all exactly fit what Singh aptly calls the “ideal type” of the Asian model.<sup>10</sup> For example, three of the original Four Tigers (all except

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<sup>10</sup>Singh, “‘Asian Capitalism’ and the Financial Crisis.”

Hong Kong) had significant government direction of their industrial development strategies and restrictions on foreign direct investment, as does China today, while some other Southeast Asian economies have had less policy intervention of this type. Also, rapid export growth was a necessary, but not a sufficient, explanation for the “miraculous” growth of the East Asian economies in the 1980s and early 1990s. Other policies were also key to East Asia’s success, including the financial arrangements that have since been derided as forms of “crony capitalism.” Also important were various types of restrictions on imports and direct foreign investment, not to mention a variety of domestic policies usually touted as indicating “strong fundamentals” (including agricultural reforms, small budget deficits, low inflation rates, and high educational achievement).

The Asian model also included high private saving and investment rates, and has been referred to as a case of “investment-led growth” rather than export-led.<sup>11</sup> However, the high investment rates were linked to export promotion efforts and appear to have fostered excess capacity in key export sectors. More importantly, the high saving rates beg the question of what forces kept the Keynesian “paradox of thrift” from emerging. Our argument is that the combination of rapid export growth and high investment demand focused on export activities provided the aggregate demand stimulus that enabled these countries to sustain such high saving rates. As a result, when a country with such a high saving rate loses competitiveness in export markets (e.g., because its own currency appreciates or other countries’ currencies depreciate) and its export growth and investment demand fall off, the country is left with no source of demand stimulus as long as domestic consumer spending continues to be repressed.

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<sup>11</sup>See William H. Branson, “Trade and Structural Interdependence Between the United States and the Newly Industrializing Countries,” in Colin I. Bradford, Jr., and William H. Branson, eds., *Trade and Structural Change in Pacific Asia* (Chicago: University of Chicago Press, 1987). The importance of high investment rates in the East Asian experience has also been emphasized by Paul Krugman, “The Myth of Asia’s Miracle,” *Foreign Affairs*, 73 (1994), pp. 62–78.

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Another qualification is that not all of Asia's export growth has been targeted to the industrialized countries. East Asia especially has had significant growth of intraregional trade, which partly ameliorates the risks of relying on exports to the United States and Europe. Ironically, however, this did not help, and in fact contributed to regional contagion effects when the entire region became depressed in 1997–98. However, Japan has remained more closed to such intraregional trade in manufactures than most of its less-developed neighbors, implying that they have had to rely mainly on exports to each other and to the United States.<sup>12</sup> There have also been other efforts at “South-South” regional integration, notably Mercosur [Southern Cone Common Market] in South America. But again, an important lesson from the recent financial crisis is that such trade agreements do not work well, and can even spread regional contagion effects, when macroeconomic and financial weaknesses are not addressed.<sup>13</sup>

There are also important qualifications to the general idea of constraints on export-led growth. Most importantly, the constraints in terms of the growth of global markets for manufactured imports are not fixed and given. These constraints can be relaxed if the industrialized countries stimulate their domestic economies more and open up their import markets more to developing nations' exports. This point applies especially to Japan, which is notoriously closed to manufactured imports<sup>14</sup> and has been stuck in a chronic growth depression for most of the 1990s. However,

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<sup>12</sup>For supporting data and analysis, see Yilmaz Akyüz, Ha-Joon Chang, and Richard Kozul-Wright, “New Perspectives on East Asian Development,” *Journal of Development Studies* 34, no. 6 (August 1998), pp. 4–36.

<sup>13</sup>This problem was foreseen by Robert A. Blecker and William E. Spriggs, “Beyond NAFTA: Employment, Growth, and Income Distribution Effects of a Western Hemisphere Free Trade Area,” in *Trade Liberalization in the Western Hemisphere* (Washington, D.C.: Inter-American Development Bank and U.N. Economic Commission on Latin America and the Caribbean, 1995).

<sup>14</sup>See Robert Z. Lawrence, “Imports in Japan: Closed Markets or Minds?” *Brookings Papers on Economic Activity* 1987, no. 2, pp. 517–54; and “Efficient or Exclusionist? The Import Behavior of Japanese Corporate Groups,” *Brookings Papers on Economic Activity* 1991, no. 1, pp. 311–41.

the same point applies to Europe—which has thus far mainly opened itself up to more intraregional trade rather than more trade with outside regions,<sup>15</sup> and which has maintained slow growth and high unemployment in the 1990s for a combination of macroeconomic and structural reasons that are hotly debated. In this author's view, the restrictive macroeconomic policies adopted under the Maastricht plan for monetary union are the primary cause of high European unemployment, rather than the alleged structural problems in European labor markets (rigid real wages, lack of "flexibility"). However, whatever one's view on this issue, it is clear that European economies are unnaturally depressed and are not providing growing markets for developing country exports of manufactures.

Even the United States, while more open to developing country exports of manufactures than most other industrialized countries, maintains a number of limitations on imports of these goods such as the application of the "fair trade" or "contingent protection" laws (anti-dumping, countervailing duty, etc.) that effectively inhibit imports in certain sectors such as steel. Still, the United States is hardly alone in this respect. In spite of these restrictions, U.S. imports of manufactured products from developing countries have grown more rapidly than similar imports into any other major industrialized country, and they have contributed significantly to the growing U.S. trade deficit. As of 1998, 56 percent of the U.S. merchandise trade deficit was accounted for by Mexico plus the Asian developing nations, with 23 percent accounted for by China alone.<sup>16</sup> By 1999–2000, the United States was able to maintain large and growing trade deficits only as a result of the willingness of foreigners to lend this country more than \$300 billion annually, while Europe and Japan were running large trade sur-

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<sup>15</sup>See A. Kleinknecht and J. ter Wengel, "The Myth of Economic Globalisation," *Cambridge Journal of Economics*, vol. 22, no. 5 (September 1998), pp. 637–47.

<sup>16</sup>See Table 1 in Robert A. Blecker, "The Causes of the U.S. Trade Deficit," Statement to the U.S. Trade Deficit Review Commission (Washington, D.C., August 1999), based on data from the U.S. Department of Commerce, Bureau of Economic Analysis.

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pluses. However, the resulting increase in the U.S. net international debt position and vulnerability of the dollar to depreciation pressures suggests that this pattern of global imbalances is not sustainable in the long run.<sup>17</sup>

This comparison of Japan, Europe, and the United States suggests that the industrialized nations of the “North” cannot be treated as a uniform bloc with regard to either macroeconomic or commercial policies. As Table 1 shows, only the United States has a significantly higher ratio of trade to GDP today than it did in the pre-World War I epoch, while (by this measure) the major European countries’ openness to trade has barely returned to its pre-1914 level and Japan’s overall openness is still notably lower than it was at that time. Although the individual European countries appear more open to trade than either the United States or Japan, most of their trade is with each other, and the external trade of the

**Table 1. Exports and Imports of Goods as Percentages of GDP (in current prices), Selected Countries and Years**

	1913	1950	1973	1994
United States	11.2	6.9	10.8	17.8
Japan	30.1	16.4	18.2	14.6
United Kingdom	47.2	37.1	37.6	41.8
France	30.0	21.4	29.2	34.2
Germany	36.1	20.1	35.3	39.3
European Union (EU-12) <sup>a</sup>	NA	NA	14.8 <sup>b</sup>	17.2 <sup>c</sup>

Source: See A. Kleinknecht and J. ter Wengel, “The Myth of Economic Globalisation,” *Cambridge Journal of Economics*, vol. 22, no. 5 (1998), Tables 1 and 4, pp. 638, 641, and author’s calculations.

<sup>a</sup>Outside-EU exports and imports only.

<sup>b</sup>The figure shown is the sum of outside-EU exports and imports for 1970.

<sup>c</sup>The figure shown is the sum of outside-EU exports and imports for 1995.

<sup>17</sup>For analyses of the sustainability of the U.S. external deficit and foreign debt, see Robert A. Blecker, “International Capital Mobility, Macroeconomic Imbalances, and the Risk of Global Contraction,” Center for Economic Policy Analysis, Working Paper Series III, no. 5 (New York: New School for Social Research, 1998) and “The Ticking Debt Bomb: Why the U.S. International Financial Position Is Not Sustainable,” Briefing Paper (Washington, D.C.: Economic Policy Institute, June 1999); and Catherine L. Mann, *Is the U.S. Trade Deficit Sustainable?* (Washington, D.C.: Institute for International Economics, 1999).

European Union countries as a group is about the same order of magnitude as that of the United States (and higher than Japan's).

In recent years, and in spite of the occasional bouts of contingent protection referred to above, the United States has served as the "consumer of last resort" for exporters from all continents and regions due to a combination of relatively open markets, robust economic growth, and booming consumer demand (the latter of which is in turn attributable partly to the stock market boom and partly to growing consumer debt). Much of the tension in the international trading system today results from the disproportionate share of global manufactured exports that is absorbed in the U.S. market, which widens the U.S. trade deficit and causes political resentments in the United States, while also restricting export growth in the developing countries.

To be fair, Western Europe has been engaged in a process of continental integration, in which the Northern and Central European countries are increasingly absorbing manufactured imports from relatively low-wage countries in the European periphery (e.g., Ireland, Spain, Portugal, and Eastern Europe)—and suffering some of the same industrial dislocations and employment losses as the United States as a result. Still, Europe's absorption in its own internal integration and slow growth combined with Japan's general closure and malaise put the main burden of absorbing developing country exports of manufactures squarely on the United States. Greater macroeconomic stimulus policies together with increased market openness and structural reforms in Europe and Japan could help to relieve these pressures on the United States while increasing export opportunities for developing countries.

Finally, it is important to recognize that, in principle, simultaneous export expansion can potentially provide increased reciprocal demand for all nations' exports. This is the vision of a prosperous, open international economy promoted by classical liberal economic thinkers since the time of Adam Smith. If this vision holds true, the constraints on export-led growth can become very elastic or even nonbinding. However, for such simultaneous export growth to be successful in expanding the global market for all countries' exports in reality, it is vital that the countries that are pro-

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moting their exports are also opening their own markets to imports and maintaining high domestic demand at the same time. In this way, simultaneous export expansion with roughly balanced trade can occur. What is not feasible is for all countries to attempt to achieve trade surpluses by promoting their exports while simultaneously restricting their imports in mercantilist fashion. Because all countries cannot have trade surpluses at the same time,<sup>18</sup> the widespread pursuit of this type of neomercantilist policy only tightens the global constraints on export-led growth—because not enough countries are willing to absorb the corresponding imports—and thus fosters intensified conflict over foreign market share.

In short, the classical liberal vision of a world in which export-led growth solves the demand problem through reciprocal and balanced market expansion is not flawed as a vision, but rather as a characterization of the real world in which we live. The challenge for policy today is whether and how that vision could be achieved in the future, and what nations should do in the present while that vision is not fulfilled in practice. We shall return to this policy dilemma in the concluding section, but first we take a detour through a review of studies of exports and growth followed by a discussion of some preliminary evidence on growing conflict over shares of the U.S. import market.

### LITERATURE SURVEY: STUDIES OF EXPORTS, GROWTH, AND THE FALLACY OF COMPOSITION

The notion of a fallacy of composition in the widespread promotion of the export-led growth strategy among developing countries is commonly discussed in popular accounts of globalization, such as William Greider's *One World, Ready or Not: The Manic Logic of Global Capitalism*, published in 1997. However, there has been remarkably little attention to this issue in the academic

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<sup>18</sup>This point was stressed by Joan Robinson, *Contributions to Modern Economics* (New York: Academic Press, 1978) and Amit Bhaduri, *Macroeconomics: The Dynamics of Commodity Production* (Armonk, N.Y.: M. E. Sharpe, 1986).

literature on trade and development. This section will briefly review some of the relevant literature, starting with studies of exports and growth that have largely ignored the issue and then move on to those exceptional studies that have taken the problem seriously.

### *Studies of Exports and Growth*

A useful place to start is with the large literature that has found positive effects of export growth or economic openness on overall economic growth and development.<sup>19</sup> These studies generally find a positive association of export growth (or export shares or some other measure of trade openness) with aggregate (or per capita) income growth, which is robust across a wide array of modeling specifications and measurement techniques. In addition, some studies have focused on testing for the direction of causality between export growth and output growth, generally finding that exports have significant causal effects on output.<sup>20</sup>

It is important to distinguish what these types of studies prove and what they don't prove, or don't even consider. Even if the results of these studies are accepted at face value, they simply show that the countries that actually had faster export growth (or were otherwise more open to trade) succeeded in growing faster than the other countries, subject to certain qualifications (e.g., other variables that are controlled for in the analyses). What these studies do *not* show, however, is that the countries with slower export growth could have increased their export growth without, to some extent,

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<sup>19</sup>See, for example, Bela Balassa, "Exports and Economic Growth: Further Evidence," *Journal of Development Economics* 5 (June 1978), pp. 181–89, and "Exports, Policy Choices, and Economic Growth in Developing Countries after the 1973 Oil Shock," *Journal of Development Economics*, vol. 18 (May–June 1985), pp. 23–35; Michael Michaely, "Exports and Growth: An Empirical Investigation," *Journal of Development Economics* 4 (March 1977), pp. 49–53; Demetris Papageorgiu et. al., *Liberalizing Foreign Trade*; and Jeffrey D. Sachs and Andrew Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity* 1995, no. 1, pp. 1–118.

<sup>20</sup>See, for example, Peter Chow, "Causality between Export Growth and Industrial Development: Empirical Evidence from the NICs," *Journal of Development Economics* 26 (June 1987), pp. 55–63; Ali Darrat, "Are Exports an Engine of Growth? Another Look at the Evidence," *Applied Economics* 19 (February 1987), pp. 277–83; and Jeffrey A. Frankel and David Romer, "Does Trade Cause Growth?" *American Economic Review*, vol. 89, no. 3 (June 1999), pp. 379–99.



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diminishing the export growth of the more successful exporting countries, during the same time periods. In other words, these studies assume that each country's export growth is independent of the others; they do not consider (or test for) whether there may be an "adding-up constraint" on total export growth by less-developed-country producers of manufactures.

Furthermore, the results of these studies should not be accepted uncritically. A number of careful studies have found decidedly more mixed results about the robustness of the export-growth or openness-growth relationship, and they undercut (or at least qualify) the general euphoria about export-led growth strategies in most of the economics profession. For example, McCarthy, Taylor, and Talati find that high-performing economies are *less* open to trade than low-performing economies,<sup>21</sup> for a sample of developing countries in the 1964–82 period. They also find that high-performing economies do not generally have higher shares of exports in GDP, although they are somewhat more specialized in manufactures than the low-performing countries.

Sprout and Weaver divide developing nations into groups based on country size and type of specialization.<sup>22</sup> They find that the positive export-growth relationship is strongest for small, nonprimary-product exporters, weaker for large less-developed countries, and weakest (and statistically insignificant) for small, primary-product exporters. This study also finds a positive effect of trading partners' growth (an exogenous variable) on export growth in the small, nonprimary-product exporters, although the effect was not statistically significant. These results suggest that it is not open-

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<sup>21</sup>See F. Desmond McCarthy, Lance Taylor, and Cyrus Talati, "Trade Patterns in Developing Countries, 1964–82," *Journal of Development Economics*, vol. 27 (1987), pp. 5–39. High and low performance were defined via the following method. The authors ran a regression of the average growth rate for each country for the whole sample period (1964–82) on the level of GNP per capita achieved in 1982; countries that lay above the (positively sloped) regression line were categorized as "high performers," while those lying below the line were designated as "low performers." All of the East Asian countries included in the study (Korea, Indonesia, Malaysia, Philippines) were counted as high performers by this criterion.

<sup>22</sup>Ronald V. A. Sprout and James H. Weaver, "Exports and Economic Growth in a Simultaneous Equations Model," *Journal of Developing Areas*, vol. 27 (April 1993), pp. 289–306.

ness or exports in general that promote growth, but rather a specialization in manufactures, and that the growth of the manufacturing exporting countries (at least the smaller ones) may have been constrained to some extent by the growth rates of their trading partners.

Sachs and Warner are distinguished by their focus on the trade policy regime, rather than on export growth rates or export shares of GDP.<sup>23</sup> They define countries as having a “closed” trading regime if they have *any one* of the following five characteristics: nontariff barriers covering 40 percent or more of trade; average tariff rates of 40 percent or more; a large black market exchange-rate premium (20 percent or more); a socialist economic system; or a state monopoly on major exports. Countries are defined as “open” if they have *none* of these five features. Based on this classification, Sachs and Warner find strong evidence that open countries tend to grow faster than closed countries and that “open [developing] economies display a strong tendency toward economic convergence” in per capita income with the industrialized countries while closed economies do not. However, this definition of openness falls far short of perfectly free trade, and does not exclude significant industrial policies, moderate import restrictions, or export-promoting interventions. Sachs and Warner also do not consider to what extent the successes of the relatively more “open” countries could be duplicated by other countries without running into global demand constraints.

A similar point applies to the literature on balance-of-payments-constrained (BPC) growth in the post-Keynesian tradition.<sup>24</sup> The simplest BPC growth model assumes that countries have to balance their trade in the long run and also assumes that relative price effects are weak (i.e., exchange-rate adjustments are not effective

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<sup>23</sup>Sachs and Warner, “Economic Reform and the Process of Global Integration,” p. 41.

<sup>24</sup>The BPC growth model was originally applied to the industrialized countries by A. P. Thirwall, “The Balance of Payments Constraint as an Explanation of International Growth Rate Differences,” *Banca Nazionale del Lavoro Quarterly Review*, no. 128 (March 1979), pp. 45–53, and later extended to developing countries by, among others, A. P. Thirwall and M. Nureldin Hussain, “The Balance of Payments Constraint, Capital Flows and Growth Rate Differences Between Developing Countries,” *Oxford Economic Papers*, vol. 34, no. 3 (1982), pp. 498–510.

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for balancing trade). Then a country's growth rate is constrained by the ratio of the growth rate of its exports to the income elasticity of its demand for imports.<sup>25</sup> The simple version of the model yields remarkably close predictions of actual, long-run average growth rates of GDP for the industrialized countries, while extensions of the model incorporating net capital inflows fit the data for the developing countries.<sup>26</sup>

The novelty of this approach—aside from its stark parsimony of explanation and neglect of “natural” supply-side factors (such as population growth) usually assumed to determine growth rates—lies in its emphasis on the *negative* effects of excessive openness to imports (as reflected in a high income elasticity of import demand) on output growth, as well as the positive effects of rapid export growth. This emphasis accords with the view that the East Asian countries' success can be attributed to a *limited* form of openness, in which exports were promoted but imports were selectively restricted.<sup>27</sup> Moreover, the BPC approach suggests a

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<sup>25</sup>This simple formulation can be modified to take account of various complexities, such as capital flows, mark-up pricing behavior, or labor-market dynamics. See Juan Carlos Moreno-Brid, “On Capital Flows and the Balance-of-Payments-Constrained Growth Model,” *Journal of Post Keynesian Economics*, vol. 21, no. 2 (Winter 1998–99), pp. 283–98; Robert A. Blecker, “International Competition, Relative Wages, and the Balance-of-Payments Constraint,” *Journal of Post Keynesian Economics*, vol. 20, no. 4 (Summer 1998), pp. 495–526; and Maurizio Pugno, “The Stability of Thirlwall's Model of Economic Growth and the Balance-of-Payments Constraint,” *Journal of Post Keynesian Economics*, vol. 20, no. 4 (Summer 1998), pp. 559–81.

<sup>26</sup>See the evidence summarized by John S. L. McCombie and A. P. Thirlwall, *Economic Growth and the Balance-of-Payments Constraint* (New York: St. Martin's Press, 1994) and John S. L. McCombie, “Empirics of Balance-of-Payments-Constrained Growth,” *Journal of Post Keynesian Economics*, vol. 19, no. 3 (Spring 1997), pp. 345–75. However, José Alonso and Carlos Garcimartín, “A New Approach to the Balance-of-Payments Constraint: Some Empirical Evidence,” *Journal of Post Keynesian Economics*, vol. 21, no. 2 (Winter 1998–99), pp. 259–82, criticize the econometric methodology of earlier empirical tests of the BPC growth model that were based on correlating actual and predicted growth rates. They argue for an alternative approach that tests for whether balance-of-payments deficits tend to be eliminated by relative price adjustments (the neoclassical view) or income adjustments (the post-Keynesian view). Their results strongly support the latter view.

<sup>27</sup>For example, Sachs and Warner's data show that Taiwan had quotas on 38 percent of its imports, barely below the 40 percent threshold for being considered “closed” (Table 7, p. 32). Their definition does not even include other types of nontariff barriers or government interventions, such as subsidies.

*reason* why exports are so critical in the growth process: namely that they relieve the balance-of-payments constraint imposed by the high import requirements of rapid growth (e.g., to pay for imported capital goods and debt service).

But the BPC growth model suffers from the same problem as the development literature on exports and growth, discussed earlier: export growth rates of individual countries are taken as independent of each other, when in fact they are related insofar as total world exports must add up to equal total world imports, and the growth of the latter is not unlimited. Moreover, the standard BPC growth model considers only the relative prices of home goods compared with one composite foreign good, and ignores differences between prices of imported and exported goods as well as cross-price effects of competition with “third countries” in export markets.<sup>28</sup>

### *The Asian Model and the Financial Crisis*

Most studies of the Asian development model acknowledge the important role of international trade in facilitating the region's growth, but they differ in how they account for the region's stunning export success.<sup>29</sup> Generally, rapid growth of export markets is taken for granted in this literature, and the main issue is whether the policies that enabled these countries to take advantage of expanding export markets should be regarded as free-market or interventionist. Ajit Singh summarizes the East Asian approach to trade policy as follows:

the East Asian governments have sought not “close” but what might be called “strategic” integration with the world economy; i.e.,

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<sup>28</sup>Some ideas for correcting these deficiencies and using a modified BPC model to test for global demand constraints on export-led growth are discussed in Robert A. Blecker, “The Fallacy of Composition and the Limits of Export-led Growth,” paper presented at the Meeting on the World Financial Authority, July 1999, organized by the Center for Economic Analysis of the New School for Social Research, New York City.

<sup>29</sup>See Yilmaz Akyüz et. al., “New Perspectives on East Asian Development,” and Ajit Singh, “Asian Capitalism’ and the Financial Crisis,” for useful surveys of the main previous studies as well as new critical perspectives.

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they have integrated up to the point where it has been useful for them to do so. Thus during their high-growth, developmental phases, Japan (between 1950–1973) and Korea (1970s and 1980s) integrated with the world economy in relation to exports but not imports; with respect to science and technology but not finance and multinational investment.<sup>30</sup>

Most of the literature on export-led growth in Asia is curiously silent on the possibility of global demand constraints. When this issue is raised, it is usually quickly dismissed:

Regarding the danger of a ‘fallacy of composition’ in manufactured exports, while there is some evidence that this could become a constraint on industrial development in the South, particularly if slow growth persists in the advanced industrial countries, the potential scope for developing countries to enter Northern markets for textiles, clothing and other such goods is considerable .... Moreover, the very success of the East Asian economies means not only that they are facing pressures to vacate these markets and shift to higher value-added exports, but also that their own markets for low-skill manufactures are expanding, providing new export opportunities for the next generation of industrialising countries.<sup>31</sup>

In a 1994 article in *Foreign Affairs*, Paul Krugman claimed that the Asian economies were destined to slow down their phenomenal growth rates.<sup>32</sup> Specifically, he claimed that the Asian economies (including Japan) grew through almost Soviet-style “capital deepening”: investing in a large amount of capital per worker, and thus raising labor productivity substantially, but without much overall improvement in efficiency in the sense of “total factor productivity.” Krugman’s interpretation of the productivity numbers has been challenged,<sup>33</sup> but the biggest problem is his basic conceptual framework, which assumes that one can distin-

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<sup>30</sup>Singh, *ibid.*, p. 8.

<sup>31</sup>Akyüz *ibid.*, p. 30.

<sup>32</sup>Paul R. Krugman, “The Myth of Asia’s Miracle.”

<sup>33</sup>For example, by Steven Radelet and Jeffrey D. Sachs, “Asia’s Reemergence,” *Foreign Affairs*, vol. 76, no. 6 (1997), pp. 44–59, cited by Jenny Corbett and David Vines, “The Asian Crisis: Competing Explanations.”

guish the “quantity” of capital from the technology embedded in that capital. Krugman’s claim is simply that a large increase in the quantity of physical capital relative to other factors (including human capital, which was also accumulated rapidly in East Asia) would inevitably lead to diminishing marginal productivity and hence a reduction in the rate of return to capital. Problems of export markets—or the fact that so much of the capital was invested in similar export activities in competing countries—play no role in Krugman’s analysis.<sup>34</sup> The policies that were used to boost “rents” or oligopolistic profits in East Asia in order to finance investment are also ignored in the debate between Krugman and his critics, which is based on a methodology that assumes that economic profits are zero and that returns to capital are determined by marginal productivity.

Although the notion of limits to export-led growth has thus attracted little attention within the literature on the pre-1997 Asian miracle, there are greater hints about it in studies of the 1990s financial crises. One of the most robust findings in empirical studies of financial crises is the importance of real exchange rate overvaluation in explaining the outbreak of speculative attacks or contagion effects.<sup>35</sup> While any exchange-rate overvaluation may call for an eventual adjustment, the question is why overvaluation has proved to be so utterly disastrous in recent years. Part of the answer lies in the logic of speculative behavior in liberalized financial markets: once a currency is perceived as overvalued and is expected to have to depreciate in the future, the expectation of a depreciation becomes a self-fulfilling prophecy as soon as investors start to act on this expectation and begin to sell the cur-

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<sup>34</sup>Krugman has since backed away from claims that his diminishing marginal productivity of capital story explains the Asian crisis of 1997, because the latter occurred too rapidly to have been caused by a gradual falling tendency of the returns to capital.

<sup>35</sup>See Graciela L. Kaminsky and Carmen M. Reinhart, “The Twin Crises: The Causes of Banking and Balance-of-Payments Problems”; Steven Radelet and Jeffrey D. Sachs, “Asia’s Reemergence”; Jeffrey D. Sachs, Aaron Tornell, and Andrés Velasco, “Financial Crises in Emerging Markets: The Lessons from 1995”; and Aaron Tornell, “Common Fundamentals in the Tequila and Asian Crises,” photocopy (Cambridge, Mass.: Harvard University and National Bureau of Economic Research, 1998).

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rency short. This effect is then exacerbated if the country has large amounts of short-term, foreign-currency-denominated debt and creditors become worried about default risk. But there is another aspect to the problem, namely that in countries that have relied heavily on the stimulus of export growth, and especially in those that have also opened themselves significantly to imports (e.g., Mexico), the risks of currency overvaluation for the real economy are heightened. In such a policy environment, the negative consequences of currency overvaluation for the balance of payments are much more quickly realized, and the need for a corrective devaluation is much more rapidly perceived.<sup>36</sup>

The current debate over alternative exchange rate policies for developing nations also highlights, albeit implicitly, the importance of export markets in countries promoting exports of manufactures to the industrialized countries. There is a new “conventional wisdom” that claims countries must choose between rigidly fixed exchange rates and perfectly free-floating systems. Intermediate regimes such as crawling pegs have suddenly fallen out of vogue and are now regarded as untenable (a view that assumes, among other things, that reinstating capital controls is not an option). Leaving the merits of this new orthodoxy aside for the moment,<sup>37</sup> it is interesting to consider the political economy of which countries have opted for floating rates versus fixed rates.

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<sup>36</sup>Another finding in the crisis literature is that a currency crisis is often preceded by a prior slowdown in output growth (see Kaminsky and Reinhart, “The Twin Crises: The Causes of Banking and Balance-of-Payments Problems”). In export-oriented economies, such a slowdown in output growth can be a product of an overvalued currency, or—what authors in this literature have missed—of a currency devaluation by a competitor nation, which has taken export market share away from the country in question. For example, Corbett and Vines (“The Asian Crisis: Competing Explanations,” pp. 15–16) point out that, by conventional measures of real effective exchange rates, some Asian countries (such as Korea and Taiwan) did not have a substantial real appreciation prior to the 1997 crisis. However, Corbett and Vines do not consider whether real depreciations in *other* countries (such as China or Mexico) may have contributed to the slower export growth they identify in all the Asian crisis nations.

<sup>37</sup>For skeptical views of this new orthodoxy on exchange rates, see Jeffrey A. Frankel, “The International Financial Architecture: Exchange Rate Regimes and Financial Integration,” and John Williamson, “Filling the Void: Viable Intermediate Exchange Rate Regimes for East Asia,” photocopy (Washington, D.C.: Institute for International Economics, February 2000).

Argentina has opted for a strong form of a fixed exchange rate with a currency board, and is now seriously considering legal dollarization, in spite of the drag that this policy has placed on the country's balance of payments and growth. In contrast, Mexico has ended up keeping the flexible exchange rate regime that it originally adopted out of dire necessity at the end of 1994. This contrast might seem anomalous, because by conventional criteria Mexico is far more integrated with the United States than Argentina, and hence seems the more likely candidate for a dollar-based monetary union. Clearly, the desire to achieve "credibility" in financial markets and to avoid the reemergence of high inflation or large interest rate spreads is a key consideration for Argentina. However, Argentina does not have to worry as much about maintaining its bilateral competitiveness vis-à-vis the United States. Only 8.6 percent of its exports go to the United States, compared with 82.0 percent of Mexico's exports<sup>38</sup>—and Mexico's exports are much more concentrated in manufactured goods that compete with Asian exports.<sup>39</sup> Hence, the flexible exchange rate has become a crucial ingredient in Mexico's export-led recovery from the 1994–95 crisis, as well as in its relatively mild contagion effects from the Asian and Brazilian crises. The Mexican peso has depreciated further in nominal terms since 1995, thus keeping the real exchange rate from appreciating too much in spite of Mexico's higher inflation relative to the United States. (However, renewed capital inflows are once again threatening to push the Mexican peso too high in the early 2000s). At present, the Mexican authorities are content with how their (managed) floating exchange rate protects

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<sup>38</sup>These data are for 1997 and were calculated by the author from the World Trade Analyzer database produced by Statistics Canada and licensed to this author at the Economic Policy Institute.

<sup>39</sup>According to a report from the Inter-American Development Bank, 53.1 percent of Mexico's total exports fall into the category of "exports exposed to Asian competition in [the] OECD market; only 5.4 percent of Argentina's total exports fall into this category". See *Integration and Trade in the Americas, Special Report, The International Financial Crisis: Implications for Latin American and Caribbean Trade and Integration*, Periodic Note (Washington, D.C.: Inter-American Development Bank, February 1999), Table 13, p. 26.



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their external competitiveness, and they show no interest in dollarization or even less drastic forms of fixed exchange rates.<sup>40</sup>

Perhaps the most explicit consideration of the limits to export-led growth in the crisis literature has come in regard to the trade dimension of “contagion effects.” For example, Radelet and Sachs acknowledge that pressures from surging Chinese and Mexican exports after 1994 contributed to slowing the growth of exports from other Asian countries in subsequent years, although they argue the effect was quantitatively “moderate.”<sup>41</sup> Along the same lines, the Inter-American Development Bank highlights the “potential displacement of LAC [Latin American and Caribbean] exports in third markets such as those of the OECD [Organization for Economic Cooperation and Development], or the LAC regional market itself, where they compete with East Asian products which have become more price competitive.”<sup>42</sup>

A related point is the oft-stated importance of China’s decision *not* to devalue its currency following the financial crisis in the rest of East Asia. When China’s neighbors’ currencies were collapsing in 1997–98, it was widely feared that China would respond by devaluing its currency, thus possibly instigating a destabilizing cycle of competitive devaluations. Yet this did not happen. One

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<sup>40</sup>Guillermo Ortiz, governor of the Banco de México [Central Bank of Mexico], “Dollarization: Fad or Future for Latin America,” remarks at IMF Economic Forum (Washington, D.C.: International Monetary Fund, June 24, 1999).

<sup>41</sup>Steven Radelet and Jeffrey D. Sachs, “Asia’s Reemergence.”

<sup>42</sup>Inter-American Development Bank, *Integration and Trade in the Americas*, p. 19. The report points out that six key Asian currencies (those of Indonesia, Singapore, Korea, Malaysia, Philippines, and Thailand) fell by between 13 percent and 70 percent vis-à-vis the currencies of nine major Latin American exporters (Argentina, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Mexico, Peru, and Venezuela) between mid-1997 and mid-1998. Of course, the significance of this loss of price competitiveness for Latin American countries varies widely depending on the degree to which they export products that compete with Asian exports. In general, South American countries tend to export more primary products that do not compete with Asian exports, while Mexico and several Central American and Caribbean nations export more manufactures that compete with Asian exports. According to the IDB report (Table 13, p. 26), the following countries have at least 30 percent of their total exports in sectors exposed to competition from the Asian countries in OECD markets: Costa Rica (32.6%), Dominican Republic (58.9%), El Salvador (33.6%), Haiti (63.3%), Honduras (46.7%), Mexico (53.1%), and Panama (38.3%).

reason was that the rest of Asia's export growth was initially disappointing after the currencies depreciated (a result generally attributed to the tightening of financial constraints on Asian firms as a result of high interest rates and large debt burdens). Another reason was that the Chinese authorities made a conscious decision not to destabilize the region. Nevertheless, as of early 2000 China's efforts at preventing a growth slowdown without a devaluation appear to be faltering, and it is still feared that China will devalue in the next few years. How a future Chinese devaluation would actually affect other developing country exporters remains to be seen. However, the perceived threat of dire consequences of a Chinese devaluation for other newly industrializing countries implicitly recognizes that the significance of competition among these countries for market share in the industrialized countries constitutes a limiting factor on export-led growth.

*The Fallacy of Composition and Excess Capacity*

Previous studies that explicitly test for the existence of a fallacy of composition in the export-led growth strategy are remarkably scarce. One notable (and prescient) exception is William Cline's 1982 study of whether the East Asian growth model could be generalized.<sup>43</sup> While supporting an outward orientation of development efforts, Cline noted that "it may reasonably be asked whether the recent emphasis on export-oriented growth has sufficiently taken account of the constraints on international market demand."<sup>44</sup> In this regard, Cline focused on one dimension of those constraints: the potential threat of increased protectionism in the industrialized countries if imports of manufactured commodities exceeded a critical threshold as a share of total domestic consumption of those commodities. Cline's original conclusion is worth quoting at length:

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<sup>43</sup>William R. Cline, "Can the East Asian Import Model of Development be Generalized?" *World Development*, vol. 10, no. 2 (1982), pp. 81-90.

<sup>44</sup>Ibid., reprinted in William R. Cline, *Exports of Manufactures from Developing Countries* (Washington, D.C.: Brookings Institution, 1984), p. 198.

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...generalization of the East Asian model of export-led development across all developing countries would result in untenable market penetration into industrial countries. Generalization of the G-4 [Gang of Four, or Four Tigers] export strategy would require developing-country exports of manufactures to rise sevenfold, implying a surge in their share of industrial country manufactured imports from about one-sixth to about three-fifths. If a developing-country import-penetration ratio of 15 percent is used as a threshold beyond which protective responses would be expected, fully four-fifths of the industrial country markets for manufactured exports from developing countries would be vulnerable to probable protective action in the face of the flood of such exports caused by a general adoption of the East Asian export model.<sup>45</sup>

In his 1984 study, *Exports of Manufactures from Developing Countries*, Cline tempered his results by considering more moderate growth rates of other developing-country exports of manufactures to the industrialized countries than the rates that are implied by imitating the Four Tigers. He concluded that

there is a speed limit on the expansion of manufactured exports that developing countries would do well to observe if they wish to avoid a protectionist reaction. In the aggregate, developing countries can probably expand their manufactured exports at real rates of 10 to 15 percent annually without provoking a strong protectionist response ..., but expansion at rates of 30 percent or higher would be much more likely to provoke problems of market absorption and protection....<sup>46</sup>

Cline concludes that moderate manufactured export growth in the 10–15 percent per year range would suffice for achieving high growth rates in most developing countries. However, he does not consider whether (even in the absence of increased protection) the industrialized countries' total market for such exports would be likely to grow at that rate or what would happen if some

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<sup>45</sup>Cline, "Can the East Asian Export Model of Development be Generalized?", reprinted in Cline, *Exports of Manufactures from Developing Countries*, p. 213.

<sup>46</sup>Cline, *Exports of Manufactures from Developing Countries*, pp. 129–30.

developing countries tried to exceed the “speed limit” at the expense of others.<sup>47</sup>

A few other papers have considered the possibility of “immiserizing growth” resulting from the creation of excess capacity in export-oriented manufacturing industries in developing countries. Raphael Kaplinsky argues that this has occurred in the export-processing zones of countries like the Dominican Republic, which export labor-intensive commodity products such as apparel.<sup>48</sup> Kaplinsky argues that the countries exporting these goods have engaged in a process of competitive devaluation that has succeeded mainly in reducing their terms of trade and depressing the real wages of the workers who get jobs in these sectors. He defines this as “immiserizing employment growth, that is employment growth which is contingent upon wages falling in international purchasing power.”<sup>49</sup> Kaplinsky also applies a similar argument to the explanation of the Asian financial crisis:

...most of the East Asian economies locked themselves into a growth trajectory in which specialization in factor and product markets associated with low barriers to entry led to high rates of competition. This has led to falling terms of trade and persistent currency realignments, placing long-term pressures on real exchange rates.... the wider significance of the East Asian crisis is that competitive devaluations will be repeated there and elsewhere whenever out-

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<sup>47</sup>In future research on this topic, it will be useful to compare the actual growth of developing country exports of manufactures since the early 1980s with Cline’s alternative projections.

<sup>48</sup>Raphael Kaplinsky, “Export Processing Zones in the Dominican Republic: Transforming Manufactures into Commodities,” *World Development*, vol. 21, no. 11 (November 1993), pp. 1851–65. In a similar vein, Robert E. Scott argues that the slower growth of textile and apparel exports from Central America and the Caribbean in the late 1990s was caused by a surge in competitive exports from the East Asian countries following their currency depreciations in 1997–98, rather than by a lack of parity with Mexico’s access to the U.S. market under NAFTA. See Robert E. Scott, “Rebuilding the Caribbean: A Better Foundation for Sustainable Growth,” Briefing Paper (Washington, D.C.: Economic Policy Institute, 1999).

<sup>49</sup>Kaplinsky, *ibid.*, p. 1861.

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ward-oriented growth strategies cluster in competitive activities.<sup>50</sup>

Korkut Erturk argues that overinvestment occurred in East Asia's export sectors in the 1990s, as the former "flying geese formation" broke apart. In the flying geese model, the more advanced countries (i.e., first Japan, followed by Korea and Taiwan) move on to more capital-intensive and technologically sophisticated products as newer low-wage competitors enter the market for more labor-intensive, standardized types of manufactures. Erturk argues that too many countries began to enter the more advanced product categories at once in the 1990s, thus creating excess capacity and fostering falling prices.<sup>51</sup>

### EMPIRICAL PLAUSIBILITY: A PRELIMINARY LOOK AT EXPORT GROWTH TRENDS

This section discusses some simple, aggregated measures of developing country exports into the U.S. market, which are shown in Table 2. These data are for total exports, not just manufactures, and do not include other OECD export markets besides the United States. The point of presenting these admittedly limited data<sup>52</sup> is simply to illustrate the plausibility of the hypotheses proposed here in terms of competition over market shares in the United States. (As discussed earlier, the United States has been the largest and most open market for developing-country exports

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<sup>50</sup>Raphael Kaplinsky, "If you want to get somewhere else, you must run at least twice as fast as that!": The Roots of the East Asian Crisis," *Competition & Change*, vol. 4 (1999), pp. 1-30; this extract from pp. 2-3.

<sup>51</sup>Korkut Erturk, "Worldwide Intersectoral Balance, Overcapacity and the East Asian Crisis." Erturk also claims that the flying geese pattern was successfully maintained by greater "regional coordination" prior to the liberalization of capital inflows and domestic investment in the 1990s, but he does not specify how such coordination was achieved at that time.

<sup>52</sup>Future work by the present author on this topic will include more comprehensive and detailed data analysis. For a prospectus, see Robert A. Blecker, "The Fallacy of Composition and the Limits of Export-led Growth."

of manufactures). Also, the developing countries selected for this table are mostly countries with a high proportion of manufactured exports.

The data in Table 2 were collected for 1979 (1980 for some countries), 1989, 1994, and 1997. The first two years are intended to bracket the decade of the 1980s, while eliminating business-cycle effects in the U.S. economy by choosing starting and ending years that were both cyclical peaks (because recessions broke out in 1980 and 1990). The years 1994 and 1997 correspond to the outbreaks of the

**Table 2. U.S. Merchandise Imports, by Country of Origin, Selected Countries and Years, 1979–1997**

(Average annual growth rates of nominal values and shares of total U.S. imports)

	Average Annual Percentage Changes			Shares (percentages of total imports <sup>**</sup> )			
	1979–89	1989–94	1994–97	1979	1989	1994	1997
European Union	10.0	7.2	9.8	15.6	17.9	18.1	18.3
Japan	13.5	5.0	0.7	12.4	19.6	17.8	13.9
Canada	8.6	7.8	9.3	18.5	18.8	19.6	19.5
Mexico	11.9	13.0	20.1	4.2	5.7	7.5	9.9
Argentina*	5.9	7.7	6.1	0.3	0.3	0.3	0.3
Brazil*	9.8	1.6	1.6	1.5	1.9	1.4	1.1
Chile*	12.7	6.3	8.7	0.2	0.3	0.3	0.3
Korea	17.2	-0.2	5.7	1.9	4.1	2.9	2.6
Taiwan	15.7	0.9	6.9	2.8	5.3	4.0	3.7
Hong Kong	9.2	0.0	2.0	1.9	2.0	1.5	1.2
Singapore	19.8	11.4	9.3	0.7	1.9	2.3	2.3
China	35.0	26.4	17.3	0.3	2.5	5.8	7.1
Indonesia*	-2.8	9.3	8.0	2.2	0.9	1.0	0.9
Malaysia*	8.6	21.2	5.9	0.9	1.0	1.8	1.7
Philippines*	7.4	9.7	20.0	0.7	0.7	0.8	1.0
Thailand*	20.0	16.1	6.8	0.4	1.0	1.4	1.3
Total Imports <sup>**</sup>	8.5	7.0	9.5	8.3	8.8	9.6	10.8
Memo: Nominal GDP	7.8	5.0	5.3				

Notes: Based on underlying data in current U.S. dollars.

\*Data for these countries begin in 1980.

\*\*The shares shown for total imports are total imports as a share of GDP.

Sources: U.S. Department of Commerce, Bureau of Economic Analysis, U.S. International Transactions and National Income and Product Accounts, *Survey of Current Business* (various issues); Statistics Canada, *World Trade Analyzer Suite*; and author's calculations.

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Mexican and Thai currency crises, respectively. As may be seen, total U.S. imports (in current dollars) grew at average annual rates of 8.5 percent in 1979–89, at 7.0 percent in 1989–94, and 9.5 percent in 1994–97. Countries whose growth rates of exports exceeded these rates were gaining market share in the United States, while those whose growth rates were lower were losing market share.

The data for the 1980s show rapid growth of U.S. imports from all of the leading developing country exporters of manufactures at that time, including the Four Tigers (with average annual growth rates of 17.2 percent for Korea, 15.7 percent for Taiwan, 9.2 percent for Hong Kong, and 19.8 percent for Singapore). China and Thailand also have spectacular growth rates in the 1980s (35.0 percent and 20.0 percent, respectively), although China began from a very low base. Japanese exports to the United States continued to boom throughout the 1980s, growing at a 13.5 percent annual rate on top of previous rapid growth in the 1970s. Mexico's exports to the U.S. grew at a respectable 11.9 percent clip in the 1980s, during which (after the debt crisis and oil bust) Mexico reduced its import restrictions, opened up more to direct foreign investment, and devalued its currency. As a result of this above-average growth of their exports to the United States, all of these countries increased their shares of the overall U.S. import market between 1979 and 1989 at the expense of other countries.<sup>53</sup>

The 1990s were then marked by a series of notable shifts in relative growth rates and market shares. First, Japanese export growth fell off, to a 5.0 percent annual growth rate in 1989–94 and a mere 0.7 percent growth rate in 1994–97; as a result, Japan's share of the U.S. import market plummeted from 19.6 percent in 1989 to 13.9 percent in 1997. Not coincidentally, this sharp drop-off in Japanese export performance followed a major appreciation of the yen in the late 1980s. The drop-off also coincided with the slow-

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<sup>53</sup>The data for 1979–89 in Table 2 are affected by the fall in oil prices over that time period—a problem that can be solved in future research by using data for trade in manufactures or by correcting for price changes. Nevertheless, the fact that oil prices were falling makes Mexico's overall export growth in the 1980s all the more spectacular, because at the beginning of the decade Mexico was exporting large amounts of oil at high prices.

down in Japanese economic growth and the country's slide into chronically depressed conditions. Today, we hear many complaints of Japanese consumers' unwillingness to spend—but in the 1980s the same frugal consumer behavior was praised for the high saving rates it produced. In the 1980s, Japan didn't need consumer spending because its exports were growing so rapidly; today, with export growth stagnant, the lack of consumer spending is holding the entire Japanese economy down. Thus, the "liquidity trap" is not the only old Keynesian idea being vindicated in Japan, as the country also appears to be suffering from a notable "paradox of thrift."<sup>54,55</sup>

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<sup>54</sup>A liquidity trap occurs when a country's interest rates are driven to near-zero levels so that they cannot be reduced any further to stimulate the economy. For the application of this concept to recent economic problems in Japan, see Paul Krugman, "It's Back! Japan's Slump and the Return of the Liquidity Trap," *Brookings Papers on Economic Activity* 1998, no. 2, pp. 137–205." The paradox of thrift refers to the fact that a higher saving rate requires a reduction of consumer demand that can depress an economy's performance.

<sup>55</sup>For an alternative explanation of Japan's problems, see Ronald I. McKinnon, "Wading in the Yen Trap: The Origins of Japan's Deflation Lie Not in the Domestic Economy, But in the Movements of the Yen," *Economist* (July 24, 1999), based on an earlier book by McKinnon and Kenichi Ohno, *Dollar and Yen: Resolving Economic Conflict between the United States and Japan* (Cambridge, Mass.: MIT Press, 1997). McKinnon blames most of Japan's troubles on the perpetual expectation of future (long-term) yen appreciation, which he in turn attributes to pressures from the United States to resolve the Japanese-U.S. trade imbalance. According to McKinnon, the expected appreciation of the yen creates several problems. These include (1) the liquidity trap (because Japan's interest rates have to be lower than U.S. interest rates in order to maintain uncovered interest parity, but the former cannot be pushed below zero); (2) a deflationary psychology that inhibits investors' and consumers' spending; and (3) a rise in the "speculative demand for money." This argument makes some sense, although it does not explain why *short-term* interest rates are so low in Japan (surely short-term exchange rate expectations are not always in the direction of yen appreciation). But McKinnon's preferred solution—for the two governments to announce that the current yen/dollar exchange rate is acceptable in order to eliminate expectations of it to fall, and suspending U.S. protectionist responses to Japanese trade surpluses—would not solve the problems of the Japanese economy. The expectation that the currency of the country with the world's largest trade surplus needs to appreciate is not created by U.S. government policy, but by a rational view of international investors about the long-run unsustainability of the present pattern of international trade imbalances.

The only way for Japan to reduce its trade surplus without a substantial further appreciation of the yen is through a massive stimulus of *domestic* demand, along with whatever structural reforms are needed to spur Japanese households to consume more. By presuming that Japan will need to export its way out of its doldrums, McKinnon's solution would only perpetuate the export orientation of the Japanese economy that has been at the root of its recent problems.



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All of the Four Tigers' export growth rates slowed down in the 1990s compared with the 1980s, although less dramatically in the case of Singapore than for the other three countries. The exports of Korea, Taiwan, and Hong Kong to the United States were completely stagnant between 1989 and 1994. Exports from the first two of these countries recovered somewhat in 1994–97, but only to growth rates in the 5–7 percent range. This was far below their performance in the 1980s, and below the average annual 9.5 percent growth in total U.S. imports during the strong economic recovery of the 1994–97 period. On the whole, three of the Four Tigers lost market share in the United States during the 1990s.

Countries with high export growth rates and rising U.S. market shares throughout the 1990s were led by China and Mexico.<sup>56</sup> However, there are also notable differences in some countries' export performance before and after the 1994 "Tequila Crisis" in Mexico. Mexico's exports to the United States grew at a 13.0 percent annual rate in 1989–94, as the country moved from unilateral trade liberalization toward membership in the North American Free Trade Agreement (NAFTA). Nevertheless, Mexico had a rising current account deficit throughout those years because, with liberalized trade and an overvalued peso, imports rose even faster than exports.<sup>57</sup> After NAFTA went into effect and the peso was devalued in 1994, Mexican export growth shot up to an astounding 20.1 percent annual rate in 1994–97 (and, unlike in China in the 1980s, this was from an already high base). Such a high rate of growth of Mexican exports could not have been achieved without the peso devaluation, which gave Mexico a far greater competitive boost than NAFTA alone. Meanwhile, China's exports

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<sup>56</sup>The apparent slowdown in China's export growth over the time periods shown is misleading, because the country's exports started from a very low base, and the absolute growth of Chinese exports continues to be spectacular (resulting in steadily rising market shares) despite falling percentage growth rates.

<sup>57</sup>Robert A. Blecker, "NAFTA, the Peso Crisis, and the Contradiction of the Mexican Economic Growth Strategy," Center for Economic Policy Analysis, Working Paper Series I, no. 3 (New York: New School for Social Research, July 1996), and J. A. Kregel, "East Asia is Not Mexico: The Difference between Balance of Payments Crises and Debt Deflations," Jerome Levy Economics Institute of Bard College, Working Paper no. 235 (Annandale-on-Hudson, N.Y.: Bard College, May 1998).

continued to grow at a very rapid 17.3 percent annual rate in 1994–97. Though down from the astronomical growth rates recorded earlier, it was still about double the average growth rate for U.S. imports, thus resulting in a further increase in China’s market share.

What is especially interesting about 1994–97 is whose exports were not growing as fast as before, namely Thailand’s. Thailand was expected to be one of the next “Tigers,”<sup>58</sup> but in fact its export growth slowed down from a healthy 16.1 percent annual rate in 1989–94 to a mere 6.8 percent annual rate in 1994–97. This was below the average growth rate of U.S. imports of 9.5 percent at that time. One reason usually cited for Thailand’s disappointing export performance and rising current account deficit in 1994–97 is the effective appreciation of the baht, which occurred because the baht was pegged to the U.S. dollar and the dollar was rising relative to the European and Japanese currencies. But this factor cannot explain why Thailand’s exports to *the United States* stagnated. To explain this, we need to look at the surging exports of *other* countries that exported similar products and whose market shares were rising as a result of devalued currencies, such as China and Mexico. Also, the baht appreciated at that time relative to other developing countries’ currencies that were not pegged to the dollar alone.

The only other Asian developing country that shows the same pattern as Thailand (i.e., with a major slowdown in exports to the United States between 1989–94 and 1994–97) is Malaysia, whose export growth fell from 21.2 percent per year to 5.9 percent per year between those two periods. The other Asian crisis countries—Korea, Indonesia, and the Philippines—all had steady or rising export growth rates to the United States during those times. But only in the case of the Philippines was the export growth truly rapid in 1994–97. In Korea it was still comparatively low at a mere 5.7 percent per

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<sup>58</sup>For example, see Stephen C. Smith, *Industrial Policy in Developing Countries*.

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year, while in Indonesia it was 8.0 percent per year, which was still lower than average U.S. import growth at the time.

The point here is not that slowing export growth caused all the financial crises, which it did not—although it seems to have been a major contributing factor in the case of Thailand, where it contributed to severe balance-of-payments problems that undermined confidence in the government's pegged exchange-rate policy. The point, rather, is to confirm that the "fallacy of composition" began to hit home in the 1990s, when a large number of countries had begun to compete with the original "Four Tigers," and surging exports and rising market shares for some countries meant sluggish exports and falling market shares for others. Exactly how those other countries were affected varied, depending on a host of contingent factors. As discussed earlier, those that maintained capital controls, had relatively small international debts (especially of the short-term, foreign-currency variety), and did not try to keep their currencies pegged at unsustainable levels did relatively better. Those who liberalized their capital markets, relied on short-term international borrowing, and kept their exchange rates pegged did the worst. But all of the countries whose export growth faltered also saw their domestic economic growth tumble, even those countries (such as Taiwan) that averted a purely financial crisis.<sup>59</sup>

### POLICY IMPLICATIONS: WHICH WAY OUT OF THE DILEMMA?

This paper has argued that the widespread adoption of a development strategy that relies primarily on high rates of growth of manufactured exports, especially exports targeted mainly on the U.S. consumer market, was bound to cause problems of growing excess capacity, intensified competitive pressures, and disappointing growth performance. At the same time, there is much that

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<sup>59</sup>See the data in the International Monetary Fund's *World Economic Outlook* (Washington, D.C.: International Monetary Fund, April 1999).

could be done to expand global export markets and allow all countries to provide more reciprocal demand for each other's products. Growth has been sluggish in Japan and much of Western Europe for many years, resulting in weak demand for developing-country exports and forcing the United States to serve as the "consumer of last resort." A significant economic recovery in Europe and Japan, which in turn would require macroeconomic stimulus policies as well as possible structural reforms, is vital for relieving the constraints imposed on the developing countries by present global market conditions, as well as for other reasons (e.g., to reduce global trading imbalances and to alleviate tensions in the global trading system). Moreover, to the extent that some industrialized countries have not opened their economies fully to developing country exports of manufactures (Japan especially comes to mind), there is much that could be done via trade agreements (both bilateral and multilateral) and structural reforms to increase market opportunities specifically for those exports. Regional trade arrangements such as Mercosur and APEC (Asia Pacific Economic Cooperation) could also be strengthened, although this will require resolving the financial and macroeconomic problems of those regions in order to make further South-South regional integration an attractive alternative.

Thus, it is possible to imagine an optimistic scenario of economic recovery and market opening in Europe and Japan, along with continued robust growth in the United States and expanding intra-regional trade among the developing countries. But the likelihood of such an optimistic scenario occurring in reality cannot be taken for granted. The problems of high European unemployment and sluggish Japanese growth are long-standing and, whatever their causes, are not likely to be resolved soon. The opposite scenario of global deflation and depression, while looking distinctly less likely at the time of this writing (early 2000) than it did at the peak of the Asian crisis two years earlier, still cannot be ruled out—especially if the bubbles in U.S. asset markets burst and the U.S. economy goes into a recession. The most likely scenario is probably that the global economy will continue to mud-

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dle along with very uneven growth, sputtering recoveries, more unbalanced trade, and recurring financial crises.

Moreover, the prospects for further global trade liberalization seem quite limited at present. In part, this is due to a political impasse over the direction that future trade negotiations should take, including the debate over whether they should incorporate labor rights, environmental standards, and other social concerns. But more fundamentally, the impasse results from the fact that the remaining trade barriers in the most closed countries in the world (e.g., Japan and China) are not mostly or exclusively formal trade barriers, such as tariffs and quotas, that can easily be negotiated downward. The closed character of these countries' markets results from intrinsic characteristics of their domestic political-economic systems, such as their unique corporate structures, financial arrangements, and close government-business relationships that inhibit entry of foreign firms or products except on terms favorable to local industrial development. The record of efforts to negotiate over these types of "structural impediments" is not very encouraging, to say the least. Even when agreements are reached on paper (and that is difficult in itself), they are often not enforced in practice. As the IMF is discovering in its efforts to promote financial transparency, long-standing domestic institutions and deeply ingrained practices are not easily changed. This point applies as much to industrial policies, corporate-financial linkages, and pro-saving biases as it does to banking regulation or fiscal policy.

From this more pessimistic point of view, the constraints on export-led growth are not likely to be relaxed in the near future. If this pessimism proves to be accurate, then continued efforts to rely on export-led growth will only result in more of the same problems: recurrent balance of payments problems, unstable currencies, competitive devaluations, and conflictive trade relations. In this situation, the only way forward for the Asian countries (and for developing countries in other regions as well) is to pursue more internally oriented development. This means less reliance on export markets especially in the United States, and more acceptance of the need for rising domestic wages in order to create a mass consumer market. In part, such a goal could be promoted by pro-

viding greater labor rights and upgrading labor standards (as contemplated in some approaches to trade negotiations), so that workers would be able to win wages more commensurate with their productivity and thus raise their living standards.<sup>66</sup> Furthermore, in East Asia, all the high-saving countries (including Japan) need to move away from the excessive saving rates they have achieved and start spending more on consumption. Countries with such high saving rates can avoid economic slowdowns only by relying on rapidly growing export markets and high rates of export-oriented investment; when these falter, the high saving rates turn from a blessing into a curse as the Keynesian paradox of thrift takes over and the lack of domestic consumer demand leads to depressed economic conditions.

While a shift toward a domestic orientation of development efforts will require significant internal changes and reforms, it does not necessarily require all developing countries to make themselves over in the Western image of liberalized markets and deregulated competition. Ironically, the prospects for recovery of the Asian crisis economies may be enhanced by their retaining, rather than eliminating, some of the government direction and financial linkages that have served them well in their export drives in the past, provided that these can be reoriented toward preparing them for a new direction in their economic development. Indeed, one of the advantages of a domestic reorientation of development efforts is that it permits the maintenance of many different economic development models, while preventing differences in national economic systems from fostering international tensions and imbalances as much as they do in an export-led development regime. The bottom line is that the current emphasis on export-led growth in developing countries is not a viable basis on which all countries can grow together under present structural conditions and macroeconomic policies.

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<sup>66</sup>For an argument along these lines, see Thomas I. Palley, "The Economic Case for International Labor Standards: Theory and Some Evidence," Economic Policy Paper no. Eo36, Public Policy Department (Washington, D.C.: AFL-CIO, 1999).

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