Economic Development Institute of The World Bank

Increasing the International Competitiveness of Exports from Caribbean Countries

Edited by

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Increasing the International Competitiveness of Exports from Caribbean Countries

Collected papers from an EDI Policy Seminar held in Bridgetown, Barbados May 22-24, 1989

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The Editors

June 1991
The Senior Policy Seminar "Increasing the International Competitiveness of Exports of the Caribbean Countries" took place in Barbados on May 22–24, 1989. It was attended by thirty-three participants from fourteen countries, as well as representatives of regional and international organizations. The seminar was organized jointly by the Economic Development Institute (EDI) of the World Bank, the Caribbean Development Bank (CDB), and the Latin American Institute of Economic and Social Planning (ILPES). The participants included senior government officials, central bankers, and academics. The scope and content of their discussions are described in the rapporteurs' summary at the beginning of this volume.

The Caribbean region consists of about twenty small countries, mostly island economies that have a wide range of per capita incomes. Some are middle-income countries, but others are among the poorest in the world. All are former colonies of European powers. As colonies, they produced mainly sugar, cocoa, coffee, and tobacco and did very little manufacturing. Upon gaining independence, they found themselves faced with high population growth rates and therefore sought to industrialize quickly and to diversify away from the previous pattern of exporting primary products and commodities. Being very small countries, they have to import almost all the capital and raw material needed for manufacturing, as well as consumer goods and foods. The only minerals found in large quantities in the region are petroleum and bauxite. Like many developing countries, the Caribbean region has in recent years had to contend with sluggish markets abroad, high production costs, and inappropriate public policies. As a consequence, the countries have experienced slow export growth and serious balance of payments difficulties, made all the worse in some cases by a heavy external debt-service burden.

Owing to these circumstances, the industrial sector has not expanded fast enough to absorb the growing population, and unemployment has become a serious problem throughout the region. Even though the Caribbean countries have preferential access to the markets of the European Economic Community (EEC) under the Lomé Convention, their principal exports—notably sugar and bananas—have not been expanding as rapidly as those of their competitors. The region's manufactured exports, which have preferential access to U.S. markets if they have an American component, are up against similar problems because of low labor productivity, high wages, and shortages of skilled labor and entrepreneurs. However, the link to the U.S. dollar (because of trading relations) adversely affected the competitiveness of these economies during most of the 1980s. Even tourism, the primary source of foreign exchange earnings for many of these small countries, is battling high costs and inefficiency.

Being latecomers to industrialization, the Caribbean countries lack the infrastructure needed to support industrial expansion, in contrast to the East Asian newly industrializing economies (NIEs). They are also far behind the NIEs in technical education. In many of
them, the public sector is large and inefficient and an obstacle to the growth of private enterprise and foreign investment. High transport costs, inadequate port facilities, poor roads, and inadequate shipping services have also stood in the way of increasing export competitiveness.

The seminar was convened to discuss the need for the Caribbean region to improve its international competitiveness and was judged by most of the participants to be a timely activity. The seven background papers presented at the seminar and included in this volume examine the main policy instruments that can be used for this purpose: the exchange rate, fiscal and monetary policies, and incomes policies. These instruments are described in the Summary by Alan Roe and Jayshree Sengupta, rapporteurs for the seminar. Participants also discussed the experience of successful exporters such as Hong Kong, Singapore, Taiwan, Republic of Korea, and Mauritius and debated whether it could be replicated in the Caribbean. Another topic of discussion was whether the small countries should strengthen existing regional arrangements and enhance regional cooperation to increase their competitiveness.
SUMMARY REPORT

Alan Roe and Jayshree Sengupta

The Senior Policy Seminar on Increasing the International Competitiveness of Exports of the Caribbean Countries was held in Bridgetown, Barbados, from May 22-24, 1989. Participants from fourteen countries\(^1\) as well as representatives from two regional organizations\(^2\) attended the seminar. Two international organizations namely the United Nations Economic Commission for Latin America and the Caribbean (UN/ECLAC) and the International Monetary Fund (IMF) were also represented. The seminar was formally opened by Mr. Neville Nicholls, Mr. Juan Martin, and Mr. Yin-Kann Wen, representing the three co-sponsoring organizations namely the Caribbean Development Bank (CDB), the Latin American and Caribbean Institute for Economic and Social Planning (ILPES), and the Economic Development Institute (EDI) of the World Bank (National Economic Management Division) respectively. The seminar was moderated by Mr. Sidney Chernick of the EDI.

The seminar proceedings can essentially be divided into four main themes:

1. The definition of a conceptual framework for measuring and monitoring the degree of export competitiveness. Discussion centered mainly around a background paper presented by Professor Gerald K. Helleiner.

2. The main elements of an economic policy package necessary to achieve improved export competitiveness. This was informed by background papers presented by Mr. DeLisle Worrell (Fiscal Policy and Monetary, Credit and Interest Rate Policy); by Mr. Courtney N. Blackman (Wages and Incomes Policies); and by Mr. Alister McIntyre (Exchange-Rate Policies).

3. The experiences of successful exporters, drawing on two background papers; one on the experience of East Asia presented by Mr. Yung Whee Rhee and a second, on the export performance of Mauritius presented by Mrs. Jayshree Sengupta. In addition, the applicability of the East Asian experience drew on a background paper by Professor Winston H. Griffith.

4. Regional arrangements to stimulate improved export performance, especially the role of CARICOM.\(^3\) This discussion was supported by a background paper written by Mr. Havelock R. Brewster.

This summary report attempts to capture the main points of view presented both in the background papers and from the floor of the seminar. Its four main sections conform with the

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1. Anguilla, Antigua and Barbuda, Barbados, Belize, British Virgin Islands, Cayman Islands, Dominica, Grenada, Jamaica, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago, and Turks and Caicos Islands.


3. CARICOM (Caribbean Community) has thirteen member countries: Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent, and Trinidad and Tobago.
four themes of the seminar described above. A brief fifth section highlights some of the central issues and questions provoked by the seminar as a whole.

The Conceptual Framework for Defining and Measuring Competitiveness

The background paper by Helleiner drew an important distinction between the rather loose concept of competitiveness of a country, and competitiveness as applied to individual activities, industries or firms. He noted that in theoretical terms certain activities of any country will always be internationally competitive although what these might be will depend on the exchange rate, and the structure of the domestic factor prices, prevailing at any particular point in time. In that sense "competitiveness" is a concept akin to that of "comparative advantage" according to which every country, however poorly endowed or managed, will always enjoy comparative advantage and competitiveness in some activities. Pursuing this line of reasoning it is possible to conceive of a natural competitiveness, in which there is a ranking of activities in terms of their relative profitability, in the absence of government intervention. The policy challenge might then be regarded as one involving the changing of the ranking in order to raise the relative profitability of certain activities. The policies which might be invoked to achieve this would include numerous elements including training and specific investment incentive packages. Equally, ill-conceived policies such as a consistently overvalued exchange rate may affect the "cut-off point" in the ranking at which exporting is no longer profitable.

In the Caribbean and other developing economies, natural resources tended to provide a basis for a reasonable level of profitability in certain traditional activities, especially in the agricultural sector, and so discussions about improved competitiveness were often concerned mainly with non-traditional industries. Here, in addition to the natural resource base, there were three fundamental determinants of competitiveness: unit labor costs expressed in foreign currency (e.g., the U.S. dollar); the dollar costs of and reliability of other inputs such as power and materials; and transport costs. For most practical purposes it is the first and second of these that can be worked on by policymakers to achieve improved competitiveness. With regards to unit labor costs, these are directly affected by three main constituent elements, namely, labor productivity, local currency wage rates, and the nominal exchange rate—policies towards any of these three variables could therefore influence competitiveness.

In principle, any country can assess its competitiveness in relation to the overall competitiveness (or each of the components of competitiveness) of any particular activity by direct price and cost comparisons with relevant foreign competitors. In practice numerous factors such as differentiated products, variations in output mix, and the basic confidentiality of the relevant data could render such comparisons difficult. However, it is important to stress that the price competitiveness of developing countries' products were not necessarily the critical factor in overall export competitiveness. Established reputation, brandnames or the uniqueness of products could enable some exporters to consistently set prices above the world price and still achieve profitable sales. Caribbean tourism was probably a good example of this though not in all the islands. The small size of the countries did not necessarily imply that the demand curves they faced were all infinitely elastic.

When governments are concerned about the lack of competitiveness of particular activities, there are essentially three actions which they can take:
1. exchange rate devaluation, although this does not make sense if improvements are being sought only in relation to a limited range of products;
2. special subsidies for particular industries provided that these can be justified by infant industry or similar theoretical arguments for intervention; and
3. simply drop the idea that the activities in question can achieve any export success.

A fourth point mentioned in Helleiner's paper, namely, the non-price elements in competitiveness, was picked up for extensive further debate by commentators from the floor.
In particular, a serious question was raised as to whether price and non-price competitiveness can be sensibly distinguished. In the real world, export success depends on a complex mixture of price and non-price factors and new exporting industries or even countries have often lacked some of the critical ingredients of success. Worse still, in many cases there might be considerable ignorance as to precisely which factors were missing or were otherwise unsatisfactory. In other country contexts, such as in Singapore, foreign trading companies had enabled local industry to acquire the necessary marketing and related expertise to break into world markets. In the Caribbean, a more open approach to direct foreign investment may also be necessary to complete the package of ingredients needed to achieve real export breakthroughs. Other discussants supported this general line of argument by noting how important a degree of "street wisdom" was in turning a good export idea into a financially successful export business. The failure to promote sales of Jamaica winter vegetables in the U.S. was cited as an example of how the absence of specific types of knowledge about the requirements of destination markets can ruin export prospects. In this particular case, the competitiveness coming from a project that was sound in terms of technical and price factors was completely negated by serious marketing failures.

In general, participants accepted the predominant importance of non-price factors and emphasized the range of extension supports which might strengthen the region's capabilities to package their export ideas. There was considerable disagreement however about the mechanism for achieving improvement in this area and several contributors disputed the merits of dependence on foreign investment. There was suspicion in the comments of a few people about the efficacy of a technology transfer mechanism based on foreign investments. This reflected a corresponding conviction that the region needed to do things for itself. Others felt that the expertise available in the region to provide extension support to exporters was very limited and efforts ought to be made to target the use of such expertise. However, the practical implications of this suggestion were not explored in any detail. Overall, while considerable doubts were expressed about the efficacy of the exchange rate and other price intervention mechanisms in achieving price competitiveness, little interest was shown about any subsidy schemes to boost exports.

A second main line of discussion concerned Helleiner's proposition that it was important to discuss competitiveness at the level of specific industries and not at the national level. This was disputed by several participants who referred to various features—institutional, cultural and attitudinal—in the Caribbean which were inimical to increasing competitiveness in any activity. The poor quality of support services such as in telephones and facsimile transmission were mentioned in this context. There still existed suspicions about export-led growth because of the region's earlier preoccupation and experience with dependency and related theories of economic exploitation of poor countries. Most contributors seemed to feel that there were indeed national traits which compromised the region's export success but which were difficult to analyze in a tangible way and even more difficult to drastically change.

A final area of discussion emphasized the important point that competitiveness is a rapidly moving target. New products are continually emerging to challenge the old, and new process and product technologies are raising overall productivity in the best-practice plants by 6 percent per annum, even in traditional industries, such as textiles. Above all, new exporters are always emerging to establish the base-line of costs which would need to be matched by successful non-traditional exports from the Caribbean. In this climate for change, even standing still competitively involves an ongoing willingness to change and improve the region's products and lower production costs.

The policy implications of this for a successful export strategy are very clear. It needs to be supported by a high quality export information and monitoring service which can keep would-be exporters fully abreast both with new technical and product challenges, with new market possibilities and with the plans and achievements of actual and potential competitors. The provision of such an information service need not necessarily imply a high degree of government intervention in the actual business of exporting. But it would probably
need to be operated at least in part with support from the government. Participants agreed that there was need for the information provided, to be forward looking as far as possible. Ex post measures of competitiveness based on market shares, actually achieved in particular markets provided at best, a limited basis for assessing the region's export competitiveness. The idea is to help turn the potential advantage into actual advantage by providing appropriate and timely information.

**Economic Policies and Economic Management**

The discussion on policies to support exports was organized under four broad headings corresponding to the subject matter of the background papers, namely, fiscal policy, monetary, incomes policy, and exchange rate policy. There was also some discussion on special incentive arrangements. There was a degree of apparent disagreement amongst participants about the respective roles and relative importance of the various policy instruments. However, much of this was ultimately resolved by noting that there are at least three separate categories of countries in the Caribbean region which can be expected to have different perspectives on the policy mix. These are:

1. Countries which comprise the Organization of Eastern Caribbean States (OECS).  
   Here monetary instability is unlikely to occur because of the monetary arrangements which are followed, especially the inability of members to use the Eastern Caribbean Central Bank to finance fiscal deficits. This means that monetary policy is not seriously on the agenda of instruments which can influence export competitiveness. It also means that serious exchange rate misalignment necessitating major changes in nominal exchange rates is unlikely to be an issue. At the same time, the climate of broad economic stability, which many participants saw as an important precondition of export success, was reasonably well assured.

2. Countries such as Guyana and Jamaica where serious monetary and fiscal instability has occurred in the recent past and where stabilization programs are an absolutely unavoidable requirement of any strategy to improve export competitiveness. Here an active approach to exchange rate and monetary policy is essential.

3. Other Caribbean countries such as Barbados where macro policies have been reasonably sound, where the general economic climate is stable and where as a consequence it has proved possible to think of the nominal exchange rate as an instrument which can be held reasonably constant. In these countries, an explicit choice has been made to rely on strict fiscal and monetary policies for maintaining the balance of payments equilibrium.

**Exchange Rate Policy**

Participants agreed with the central proposition of McIntyre's presentation, namely, the importance for international competitiveness of maintaining a stable real effective exchange rate which took proper account of changes in technology, terms of trade, etc. However, there was substantial uncertainty about what this implied in practical terms. In his own paper, Worrell considered the practicalities of McIntyre's proposition in two polar cases. In the first of these, monetary and fiscal policies are operated consistently both with the maintenance of a long established nominal exchange rate (e.g., as in Barbados), and with the preservation of an adequate level of foreign exchange reserves. In such cases, any given nominal exchange rate can persist for very long periods of time. In the alternative case, policies and external circumstances are such as to cause an unsustainable drain of reserves which will eventually leave the authorities with no choice but to devalue the nominal
exchange rate. In both cases, Worrell suggested that the nominal exchange rate is effectively an endogenous variable over which the authorities maintain little real discretion as an instrument in raising competitiveness. However, both the semantics and the substance of this further proposition were rejected by several commentators. In particular, it was generally accepted that the authorities do have discretion in the sense that through their monetary and fiscal policies they have some choice about whether or not to put themselves into a position where nominal exchange rate changes become necessary. This is what has happened in, for example, Barbados. Equally, several comments were made which suggested that, contrary to Worrell's own position, long-term undervaluation might be regarded as a possible element in a strategy to boost economic competitiveness. However, no real conclusions were reached on this latter point which recurred in the discussion of the East Asian experiences.

Three of the practical implications of applying McIntyre's central proposition were actively discussed. The first of these concerned the difficulties for policymakers caused by large parallel foreign exchange markets, especially those fed from illegal trade in narcotics. Parallel markets were a problem in Jamaica and Guyana. The existence of such parallel markets made the management of foreign exchange on any sound basis extremely difficult. In particular, such markets are associated with the inefficiencies arising from multiple pricing of the same outputs in different uses, the loss of indirect tax revenues, a high incidence of illegal capital flight and numerous other ills. The only eventual solution was a unification of exchange rates but this was certainly not easy to achieve and was extremely problematic where narcotics was the basis of the parallel market.

The second problem was the appropriate choice of the basket of currencies. Although pegging to a basket ought in principle to be a means to achieve greater exchange rate stability, McIntyre noted that of the countries in the region, only Guyana pegged to a basket of currencies rather than to a single currency and most commonly the dollar. The Guyanese experiences were difficult to interpret because of the extreme economic instability that the country had suffered in recent years. In other countries, the task of defining an appropriate basket and assessing whether to move away from the dollar peg was extremely difficult especially if the geographical diversification of exports was a major objective of policy. Under present arrangements, the changes in competitiveness against, for example, the European Community associated with dollar devaluation or appreciation were largely arbitrary. This was a particular problem for the tourism sector in the region. A third problem was that in the face of large terms of trade and other external disturbances, it was extremely difficult to assess the "right" prices against which to calibrate a stable real exchange rate. This was particularly pertinent in Latin America and the Caribbean where the average terms of trade deterioration since 1982 had exceeded 22 percent.

A further line of discussion focused on the merits of using nominal devaluations and the likelihood that these could achieve desirable results. A useful taxonomy was proposed involving three separate reasons why the authorities might need to change the nominal exchange rate, namely:

1. passive reasons associated with an attempt to preserve a real effective exchange rate against the effects of an external disturbance;
2. compensatory reasons associated with the need to offset the consequences of bad fiscal and monetary policies; and
3. pro-active reasons associated with conscious efforts to achieve enhanced export competitiveness.

In all of these cases it was agreed that there was never a guarantee that a nominal devaluation would result in a change in the real effective exchange rate. McIntyre listed five major factors which can be considered as necessary conditions for this to happen. These include the need for wage costs to grow more slowly than the rate of devaluation; the existence of adequate spare capacity in the economy; the absence of substantial expectations on the part of speculators that one nominal devaluation would merely lead to others; and the ability of the government to avoid a serious deterioration in its own deficit in the face
of the devaluation. If one or more of these conditions failed to be met then the prospects might be that active nominal exchange rate policies would result in a continuous downward spiral of inflation—devaluation—and more inflation.

It was also noted that in the cases where the market for foreign exchange had effectively collapsed, as in the case of Guyana (point 2), the role of the nominal exchange rate becomes quite limited, if not irrelevant. A new nominal exchange rate could hardly be found to increase the supply of foreign currencies, or reduce their demand sufficiently to restore equilibrium on the foreign exchange market. In such cases, a parametric shift in foreign exchange, through foreign debt forgiveness, is required to bring supply and demand closer together. As the gap between demand and supply is closed, nominal devaluations would once again promote equilibrium. In the extreme case of market collapse, the equilibrium exchange rate is indeterminate in a world of practicality.

Finally, in relation to the possible pro-active role of the exchange rate to stimulate competitiveness, much of the discussion focused on the OECS. Although it was recognized that the monetary stability in that area had probably been an important ingredient for their superior economic performance, this did not necessarily imply that such a policy was correct in the long term. In particular, one proposition put forward was that under present arrangements in the OECS, a negative external shock will necessarily be absorbed via changes in the level of economic activity. Specifically in 1992, when the EEC has become an integrated market, difficulties may arise from a possible decline in the banana price and this might need to be addressed through a more active policy toward the exchange rate.

In summary, McIntyre's basic proposition about the maintenance of the real effective exchange rate was seen as a useful guideline for policy. Sound exchange rate policy was generally seen as an important part of the enabling policy for competitiveness. The practical consequences of this in different contexts was however a matter of some dispute and the seminar recognized the need for substantively different policy approaches in the different categories of countries identified earlier.

Fiscal and Public Expenditure Policy

The background paper by Worrell provided a broad ranging review of the impact of public expenditure and specific forms of taxation upon economic activity in general, and on export competitiveness in particular. The sub-set of those issues which were pertinent to the question of competitiveness were identified in the discussion and constitute the main focus of this summary. The paper itself can be consulted for the broader discussion.

Expenditures. On the expenditure side most Caribbean governments face major claims upon budgetary resources and are unlikely to be able to divert more than small amounts specifically to try to boost competitiveness. In particular, education budgets rightly pre-empt a large proportion of resources in most countries while there were also obvious and important claims upon health budgets. Equally, in those Caribbean countries which are unable to finance deficits through monetary expansion, expenditure has to be restrained to keep the total in line with total domestic revenues and foreign grants. Although basic public expenditure programs may not appear to be directly related to competitiveness, their indirect effects are extremely important. For example, adequate standards of health are necessary to support the development of tourism. Similarly in a world in which the knowledge-intensity of industry is rapidly increasing, a high quality education is a very important prerequisite for long-term competitiveness in non-traditional sectors. Additionally, the provision of appropriate infrastructure is clearly necessary for sound export performance and it seems unlikely that the improved export extension services, referred to earlier in this chapter as a key element of export competitiveness, can be achieved without increasing public expenditure. In other areas the role of the government is less clear. Worrell's own view about the direct involvement of the government in productive activity, including exporting, was pragmatic. He saw no necessary reason why the ownership of productive
resources by the state should be harmful to export performance. The extent of such involvement should however be conditioned by what he called the "stabilization needs of the economy."

There was little explicit discussion of the need for government subsidies to support exporting. However, it could be inferred that there was little real enthusiasm for this as a long-term approach to boosting export competitiveness. Worrell did point out that there were various approaches on the tax side of the government's activity which could equally well be used to achieve competitiveness. It is reasonable to summarize the discussion of public expenditures by noting that in developing countries there are many claims on public expenditures. Hence, for the government to support directly or indirectly, export competitiveness would mean additional pressure on limited budgetary resources. In all countries it would be appropriate to maintain organizations to champion the cause and spend more in these areas. But it should not be expected that such organizations would or should attract a large share of total budgetary resources.

**Taxation.** The seminar discussion covered a wide range of possible effects of the main categories of taxation on export competitiveness but with occasional digressions to consider the equity and distributional side effects of those taxes. In Worrell's paper, for example, it was argued that higher rates of personal income tax were unlikely to seriously reduce the supply of work effort. However, several participants disputed this, arguing that comparability with the U.S. labor markets was relevant to many Caribbean professionals and that the recent trend in the Caribbean to diminish the importance of the personal income tax was an important step in this context in protecting the region's competitive edge.

It was generally acknowledged that reduction of personal income tax could possibly harm the equity of the overall tax system, but wide disagreement arose as to whether it was possible to operate, for example, a value added tax (VAT) system in the Caribbean so as to maintain reasonable progressivity in taxation. One view was that differential higher rates applied to high income consumption goods, such as air tickets, could ensure reasonable progressivity, even in the complete absence of an income tax. Another view based on the experience in Grenada suggested that special pleading and tax avoidance by the rich and the powerful was just as likely under a VAT system as under a system dominated by personal income taxation. There was, however, evidence from some countries such as Grenada that the move to an expenditure-based system could achieve its theoretically expected result of boosting savings, and so indirectly supporting exports. Beneficial results were also visible in Antigua.

In relation to the corporate income tax, it was argued in Worrell's paper that its main effect from the viewpoint of competitiveness is that of providing the government with a lever (differential rates of tax) to boost investment. This proposition was generally accepted and broadened to note that an appropriate structure for corporation tax was part of the package of signals whereby governments could attract or deter enhanced foreign investment. Other important elements of that same package could include an acceptable investment code for foreign investment and membership of the Multilateral Investment Guarantee Agency (MIGA).

A final point of some importance and again dispute concerned the role and effect of import tariffs. Worrell's paper argued strongly against overprotection of import substitutes even though this might superficially be seen as having benefits for total government revenue. However, his argument related mainly to the hardship effect on consumers. It was agreed that where import substitutes do not compete for resources with exports, then an import duty merely plays the role of a consumption tax. But in most cases this absence of competition cannot be assumed. In the more general case it was argued from the floor that high import duties would certainly harm export performance by raising the profitability of industries supplying the home market relative to export industries. Thus moderate import taxation or alternatively an East Asian policy of ensuring essentially free trade conditions
Summary Report

for export activity via duty rebates or other means is an important element of strategy for export competitiveness.

Monetary Policy

The central conclusion of the background paper in this area was that "there are very few financial policy levers that actually work" in the context of small island economies. This broad judgement was applied to exchange controls, to interest rate policies as well as to credit controls and reserve requirements. However, once again the discussion brought out important differences between different types of economies in the Caribbean. In relation to interest rate policy, the Barbadian policy of keeping interest rates "at the minimum level consistent with the underlying trend in international interest rates" might indeed be consistent with the need for a passive approach to an interest rate policy in a reasonably stable environment. However, in less stable situations, a more active policy towards interest rates was argued to be a potentially important way of deterring capital flight and helping to achieve greater macroeconomic stability. It was not so much the impact of interest rates on saving which was relevant in this context as the impact of the interest rate on that part of saving which could be exported for investment elsewhere.

In relation to exchange controls, the comment made by one participant that their first and most important role is a psychological one and a device to raise the costs of transacting in foreign exchange received wide support. If you have to actually use the control, it was argued, then monetary policy has probably failed. Worrell's argument was that in such circumstances anyone who was denied access to foreign exchange would probably acquire it in parallel markets. Essentially if an economy becomes fundamentally unsound, exchange controls will not be able to prevent capital flight. Prior to that stage, the existence of exchange controls provides central banks with valuable information on how the economy is performing. If you actually abandon controls and legalize investment overseas, you immediately cease to know where that investment is.

Aside from this relatively specific set of propositions about particular financial instruments, two general points of direct relevance to export competitiveness were referred to several times. First, it is the primary objective of monetary policy to achieve a stable inflationary environment. Without this basic platform, any serious moves to boost investment, to raise productivity or diversify exports are likely to be compromised by the enormous uncertainties and numerous distortions in relative prices associated with high inflation. Thus sound monetary policy was another part of the enabling environment to support enhanced exports. Second, the need to ensure an equal footing with foreign competitors not only in relation to inputs at world market prices but also in relation to financial inputs required among other things, access to trade finance and foreign exchange for exports. This is an institutional requirement which had been well provided for in the case of the East Asian economies and was discussed in some detail in the paper by Rhee.

Wage and Price Policies

Blackman introduced his background paper on the subject by observing that "wage restraint is the centerpiece of incomes policy," and price control is its occasional companion. His central proposition was that the failure in Caribbean economists to treat wage rates as a controllable variable, and hence to recommend an incomes policy, has been a costly error on the part of these economies. In the environment of the late 1980s such a policy had several important roles to play. By helping to limit the price of tradables it could help to improve the international competitive position of the region. Incomes policy and wage restraint could also be of help in global markets where "production arbitraging" by multinationals gave rise to the most stringent degree of price competitiveness in export markets. It could be useful where the competitors were increasingly from the Pacific Basin rather than from the old imperialist centers. In this context, the various competitive weapons included political
stability, quality of infrastructure, and labor costs. As for labor costs, the Caribbean was not necessarily well-placed. He provided a number of specific examples of wage differentials with relative competitor countries but drew attention in particular to the "four tigers" of East Asia all of which had benefited from incomes policy restraint made possible by authoritarian governments and conciliatory trade unions.

In seeking to establish a more coherent control of incomes in the Caribbean, he recognized the inappropriateness of the authoritarian approaches of East Asia and argued instead for systems based on those applied in Western Europe. The systems there do not generally attempt to provide long-run subsidies to inefficient labor but they do regard the wage rate as a production variable which is domestically controllable. However, control in this and other fields of policy is flexible and accommodates the vagaries of economic change itself. This is in sharp contrast to the situation in some Caribbean states where the failure to recognize just how small they are has often resulted in large provocative and inflexible responses. These have included fierce exchange controls, import restrictions, nationalizations, and continued support of inefficient state industries.

He recommended a comprehensive program for incomes, of indefinite duration, involving the major participants in the wage determination process, conducting on-going review and negotiations about appropriate wage and salary levels. It would be institutionalized at the boundary of economic and political policymaking. The purpose of the policy would not be to set rates for every individual job but to establish guideline ceilings and floors between which most wages and salaries would be market-determined.

Much of the subsequent discussion was on the basic role which incomes policy in the Caribbean might play and there were some arguments against such a policy. One view was that some Caribbean countries, such as Barbados, may not need a long-term incomes policy but may need to achieve a once-and-for-all downgrading of the power of trade unions and establish a balance between wage and profit incomes more favorable to export expansion. This might involve the same sort of reform of labor legislation and confrontation with major unions which had been tried in Mrs. Thatcher's Britain. Several participants drew attention to the need to maintain flexibility in the policy and, above all, to allow it to provide adequate reflection of productivity change and emerging scarcities of particular skills. Others also noted the danger of an imbalance in policy application as between the public and private sectors with tight restraint in the public sector, giving rise to a progressive drain of skilled personnel and a general de-motivation of that sector. However, the discussion included little in the way of serious dissent from Blackman's main proposition. All agreed with the theoretical point that the availability of an incomes policy gave governments a greater prospect of achieving an acceptable level of employment consistent with their various other policy objectives.

Lessons From Mauritius And East Asia

MAURITIUS. The background paper by Sengupta emphasized the similarities between Mauritius and the Caribbean islands in terms of their smallness, dependence on external trade, strong links with the U.S. and the EEC, and substantial dependence on tourism. However, Mauritius by contrast with most Caribbean economies, had achieved a significant diversification of activity through a sustained export orientation of policies based predominantly on the export processing zone (EPZ) established in the early 1970s. This same emphasis had also enabled the economy to benefit from a major expansion of EPZ exports in the 1980s to help overcome the major financial imbalances which had afflicted the economy from 1979 to 1983.

Several main lessons were suggested for the Caribbean including the following:
1. The clear government support for export-led growth based centrally on foreign capital and a well-defined incentive package has enabled the economy to take effective advantage of its cheap and plentiful labor supply and easy market access to the EEC and the U.S.
2. By using surpluses from sugar in periods of high prices (e.g., 1970 to 1974), and generally, by attempting to raise agricultural productivity in parallel with industrial development, Mauritius has succeeded in releasing land for food production, thus reducing its dependence on imported food.

3. By keeping wages under control through a unique system of tripartite agreements between labor, private enterprise and government, the government of Mauritius has assisted EPZ exports to remain competitive. It has achieved a high rate of re-investment of surpluses back into EPZ firms. Regrettably, however, this has generated only limited diversification of exports away from textiles and knitwear.

4. This combination of policies has enabled Mauritius to move close to full employment in spite of the high rate of population growth which the Meade report on Mauritius in 1961 had expected to give the economy a serious unemployment problem.

The contrast with the Caribbean where unemployment rates are as high as 25 percent is also striking. Finally, the maintenance of a competitive real exchange rate through periodic devaluation was an important part of the explanation of rapidly rising EPZ exports and a sharp contrast with experience in most Caribbean countries. The outcome of the second surge of EPZ exports during the period 1983-1988 had brought the EPZ to the point where it now accounted for 60 percent of exports, 20 percent of the labor force, and 14 percent of GDP. However, trade was still heavily concentrated on knitwear products (88 percent of the total exports were knitwear, of which 80 percent of the sales was directed to the EEC).

Discussion focused on two main points, namely those aspects of Mauritius' performance that were unlikely to be replicated in the Caribbean, and the desirability of Caribbean countries learning the lesson in relation to the other and more easily replicable aspects. As regards the first point it was stressed that a significant part of the apparent success of Mauritius had been based on sanction-busting vis-a-vis South Africa. It was well documented, according to McIntyre, that a major part of the apparent investments from Hong Kong had in fact come from South Africa and that most tourism revenues had also come from this source. Specifically, the estimates from the Commonwealth Secretariat and elsewhere indicated that up to half the exports of manufactures might be explained in this way. This was not something which was feasible or desirable in the Caribbean, he said. The author pointed out that in the World Bank's documents, research papers and memoranda, no such figures have been attributed to South African trade and investment.

As regards the other issues, most reservations focused on various factors which seemed to throw doubts on the long-term sustainability of the Mauritius' export successes. The most important of these was the reliance on the single factor of low labor costs. While there was nothing wrong with the EPZ concept as such, its ultimate success would need to include a transition to more knowledge-intensive production involving a serious transfer of technology into the companies in the zones. It was far from clear what could be done to ensure that this transition actually did take place. A second and related point concerned the apparent inability of Mauritius to diversify its manufacturing away from knitwear products and into areas of production more clearly grounded in the domestic economy. Without such diversification its successes thus far had to be regarded as fragile. The question of whether, notwithstanding the reservations just described, the output and employment gains of a period of rapid EPZ growth were worth seeking in Caribbean countries was not discussed at any length.

EAST ASIA. The record of the successes of the four main East Asian exporters, namely, Hong Kong, Taiwan, Singapore and South Korea were recognized to be of greater relevance to Caribbean countries because of the absence of the special factors involved in the Mauritian case. The fact that these successes have now been sustained over a considerable period of time also made these countries' experiences interesting. Rhee opened the discussion by emphasizing three relatively common misconceptions about East Asian economic performance.
1. That the East Asian export success was largely attributable to the "magic of the market," whereas the active markets of the present day largely had to be fostered by government intervention.

2. That the fundamental reasons for success were related to the central role of the major policies. In reality, sound policies were important but would not have worked as well as they did without a great deal of work on constructing appropriate institutions. This institutional side has been frequently overlooked.

3. That the successes have depended in part on an appropriate sequencing of change, including policy reform. But a progressive upgrading of industry away from labor-intensive manufactures has also been important. The sequencing adopted in the four different countries was therefore an important facet of the lessons to be learned.

Rhee provided a detailed analysis of the factors that had contributed significantly to export success in East Asia. Some important lessons could be drawn from the analysis, four of which are as follows:

1. All four of the "tigers" established in different ways the capacity to package technical, marketing and managerial know-how so as to make their products saleable and profitable in overseas markets. He indicated that in all four cases, the initial gaps in these packages were filled by drawing in a variety of knowledge from abroad; in no case was the effort entirely an indigenous one. Thus, for example, both Hong Kong and Taiwan drew in large numbers of experienced Chinese businessmen who had earlier acquired specialized skills from the Japanese. Singapore by contrast, not having had the benefit of these human resources, relied extensively on multinational corporations to package the critical elements. These examples closely parallel the discussion reported above (The Conceptual Framework for Defining and Measuring Competitiveness) about the importance of a variety of non-price factors in export competitiveness. Rhee's analysis complemented this by suggesting that once a developing country acquires the capacity to package the critical elements, the creation of the physical capital is straightforward either because domestic savings are high or because foreign capital can readily provide the capital to make up for shortages of savings. Specifically, Hong Kong relied on local sources for marketing know-how because of its entrepot experience, but used skilled immigrants for its technical and managerial know-how. Korea made some use of foreign marketing expertise as well as foreign capital. Singapore relied heavily on foreign sources for most elements including a dependence on foreign direct investment.

2. Each of the countries established early on an "equal-footing" treatment for exporters in relation to all taxes and subsidies that might otherwise have raised the relative profitability of products for domestic markets over that for exports. This has meant above all that exporters have been guaranteed unrestricted access to imported raw materials and intermediate inputs at world prices (i.e., prices which are no worse than those faced by their international competitors). Such a policy does not subsidize exports, an approach which is in any case precluded by the GATT, but merely provides them with a neutral status vis-a-vis production for domestic use. The five main methods available to achieve this had included the Free Trade Zone (FTZ) approach used in Mauritius and four others, namely, full free trade; bonded manufacturing warehouses; automatic import licensing and duty exemptions on imports used by exporters; and finally, automatic import duty drawbacks. Table 3 in his paper provides a summary of the combination of these methods actually employed in each of the four countries at different time periods. In brief, Hong Kong and Singapore (after 1967) came closest to the model of full free trade. Taiwan and South Korea have both made extensive use of all the other four approaches.

3. The establishment of a variety of infrastructure, including non-physical infrastructure, involving information systems about the nature and trends in world markets (see also The Conceptual Framework for Defining and Measuring Competitiveness above). As regards physical infrastructure, the beginnings of outward-oriented policies in the
late 1950s and 1960s had been helped by the existence of port and related facilities constructed in Hong Kong and Singapore to support entrepot trade and in the other countries by the Japanese colonialists for their own purposes. Subsequently, all four countries had devoted substantial resources to necessary infrastructure including the FTZs in Taiwan and Korea. As regards non-physical infrastructure, attention was drawn to export marketing institutions (see Table 5 in the paper), the development of trading companies; and above all to the institution of business-government collaboration which is a unique feature of East Asian experiences. The monthly export meetings held by President Park in Korea and the success of these in ensuring rapid identification and removal of impediments to exporting provides a key example.

4. The establishment of easy access to trade finance on reasonable terms. Rhee argued that exporters cannot respond to orders unless they have assured access to trade financing. Pre-shipment finance is needed to pay for imported inputs; domestic intermediate inputs; domestic wages, interest and rent; and inventories of finished products. Post-shipment finance is needed to pay for export sales on credit. The lesson from East Asia was that there was a need to concentrate on short-term pre-shipment trade finance and shorter-term post-shipment finance. Longer-term financing for heavier manufactures was less important in the early stages of industrialization.

The discussion about Rhee's suggestions were led off by Winston H. Griffith who provided a comprehensive critique of the view that the East Asian experiences were capable of being replicated in the Caribbean. His argument was centered on the fallacy of composition—the view that what had proved possible for a few countries in the 1960s and 1970s was unlikely to be possible for many additional countries in the 1990s because of the resistance which their manufactured exports would encounter in the main industrial markets. However, he also presented a variety of other arguments which together indicated that the East Asian experiences had depended on special factors. The first of these was the benefits obtained from the geo-politics of the Cold War at the time when their main burst of industrialization was occurring. Second, there was the favorable rate of growth of world trade, especially in manufactures, at that time. Third, the increasing sophistication of computer and other technology was making the comparative advantage associated with low wage rates increasingly less important. This was also causing the re-absorption of certain manufacturing processes back into the U.S. and Western Europe. The fourth point was the tacit approval which East Asian countries had received for side-stepping regulations designed to limit the sales of their products in certain industrial markets.

Clearly this skeptical view represented a polar extreme to that of Rhee, and inevitably provoked a lively discussion. Most contributors accepted one or more of the detailed points of Griffith's critique but not necessarily the whole package. It was noted that the intellectual attitudes of the 1960s and especially the consensus about dependency and exploitation continued to color the thinking of Caribbean policymakers, even though few of them would now openly admit to this. By contrast to the early view of W. Arthur Lewis that the region should and would learn from foreign investors, the Commonwealth Caribbean Regional Secretariat (1972) noted: "too much control of the (Caribbean) economies has been exercised from abroad particularly by international cooperation in the form of direct foreign investment. Too much reliance for economic expansion has been placed on foreign imports—the historical prime mover in the economies of the region." As a consequence, the regional policymakers had shown resistance to any domination by foreign investors, especially in commodity production. If any consensus at all emerged from the discussion it was that, notwithstanding the greatly enhanced difficulties of the 1990s compared with the 1960s, there were important lessons to be learned from the East Asian experiences. The region had little choice but to compete more actively in world markets even though such an approach is unlikely to lead it to the same high rates of growth as the East Asian economies had enjoyed. In short, comments of the type made by Griffith did not constitute the basis for a substantially different model of economic development. The advice to learn and adapt the lessons from East Asia was not tantamount to advising that these experiences could or should
be fully replicated in the Caribbean. Rhee in particular noted that if the Caribbean was not prepared to learn lessons from successful economies, from where would it draw lessons for its future strategy?

In summary, three strategic elements of East Asian experience were identified as comprising the sine qua non of a successful outward oriented policy. These are:

1. willingness to be forward looking and to continuously monitor and understand the markets and consumers to whom you are trying to sell your products;
2. an unambiguous political commitment to export trade established at the highest levels and backed by action and not just by rhetoric; and,
3. an equal-footing treatment of exports, which means that whatever the country decides to do in the area of trade protection, it must create an environment for exports which is equivalent to a free trade environment.

A wide variety of other and more detailed elements would also be necessary for export success including sound trade financing arrangements and good educational training facilities. However, most of these could be developed if the underpinning of political commitment and baseline policies, as indicated above, were in place.

Caribbean Regional Arrangements

The lead paper by Brewster (which in his absence, was presented by Chernick) addressed the matter of Caribbean Regional Arrangements in its second section. Brewster's paper emphasized four activity areas to be organized as Community facilities from which he felt individual member states could derive benefits in pursuing their efforts to enhance international competitiveness, namely: (a) regular intergovernmental consultations on macroeconomic management at the level of senior economic officials backed by appropriate statistical and analytical reviews (see, for example, OECD Economic Outlook) and research on current problems of macroeconomic management; (b) a systematic plan for upgrading the technology and productivity of primary export industries supported by a regionally based external technology aid program for exports; (c) a program for targeting and promoting new export industries and services, a feature of which should be normative guidelines embracing, for example, environmental, social, intellectual and aesthetic concerns; (d) a research program relevant to Caribbean economic, social and technological futures—aimed at questions arising from the "pre-competitive," emerging international environment, such as those concerned with the quality of life, post-adjustment/stabilization issues, and the future for existing and new industries.

The features of this set of regional proposals which could distinguish them from existing regional efforts are: first, that they would represent a coherent, concerted attack on a specific problem; and second, the locus of action and responsibility would rest with the enterprises, regional institutions and government departments directly involved in implementation, as distinct from remote control by the Community bureaucracy.

These proposals generated a good deal of consensus from the floor to the effect that structures and committees were already in place to help move the Caribbean to a higher plane of integration and cooperation. It was not particularly helpful at this stage to suggest a whole new range of committees and institutions before serious effort has been made to make the existing arrangements more effective. In any case, it was noted that many of the ideas put forward by Brewster were already in place. The Economic Commission for Latin America (ECLA), for example, already carried out an annual survey of Caribbean economic development and the CARICOM countries do have a plan for technological development. The fundamental question was whether a regional approach to competitiveness was more useful than individual national approaches and, if so, how could existing arrangements to foster regional competitiveness be made more effective.

Several familiar arguments were put forward to emphasize that a regional approach to enhance competitiveness was indeed preferable. Such an approach, for example, would help achieve substantial gains in both production and in support areas such as education and
research and development. It would provide greater muscle to individual companies and
countries fighting for improved access to the major markets and it would force a greater
convergence of macroeconomic and other policies. For example, it could help to avoid the
excesses of monetary expansion which have occurred in Jamaica and Guyana. Finally, on a
more defensive note it might give the Caribbean greater coherence to respond to the
accelerating trend for economic harmonization in the major trading blocs, and notably in the
integrated Europe of post-1992 and in the U.S./Canada free trade pact.

Why in the light of these clear benefits had Caribbean integration not moved forward
faster and why some fifteen years after the CARICOM treaty had arrangements about, for
example, a common external tariff, not proceeded on the agreed time schedule? Several
participants addressed this question by questioning whether the resolve to cooperate really
was well established in the region. It was noted, for example, that the individual
Caribbean countries simply did not understand just how small they were. Germany and
France had long ago recognized that they were too small to survive individually in the
modern world but this same message had yet to get across to most countries in the Caribbean.
Part of the reason for this was psychological. In the Caribbean, senior policymakers
sometimes preferred to be large fishes in very small ponds rather than smaller fishes in
somewhat larger ponds. There was a reluctance to surrender even small elements of control
even where this was clearly necessary for integration to proceed. A specific example related
to the efforts of an Antiguan company to encourage Trinidadians to buy property in Antigua.
This was eventually aborted because the Trinidadian officials wanted to directly monitor
the use of the money inside Antigua to ensure that it did not leak outside the region. This
was unacceptable to the Antiguan authorities. Other examples were cited in which
otherwise successful exercises in cooperation were aborted by petty restrictions imposed on
one small but vital part of the operation. Operations involving intra-regional capital flows
were especially problematic and this would undoubtedly complicate on-going efforts to
establish a regional stock exchange.

However, in spite of this relatively depressing history, the discussion ended on an
optimistic note. It was argued by several people that the EEC example and especially the
move toward the completion of the single market by 1992 offered both lessons and challenges
for the Caribbean. One lesson was that real harmonization takes a very long time: the
European Community in the twenty years prior to the Single European Act had made
precious little progress toward further integration because of the refusal of the French
administration to allow decisions to proceed on the basis of the majority voting of members.
Once this veto had been removed, progress toward full integration had been much
accelerated. Another lesson was that the dynamic effects of full integration in the form of
enhanced inward investment to take advantage of the enlarged market were proving to be
extremely important in the united Europe's case because Japanese, Scandinavian and U.S.
companies are all becoming far more active in this area. The Caribbean could possibly expect
a similar effect from full integration and not least from non-U.S. companies anxious to obtain
a toe-hold in the U.S. market. The challenge was that large integrated trading blocs were
becoming the norm rather than the exception in the modern world and that very small
countries had to design a response to this. There was a reasonable prospect that the
acceleration of these global trends would help to crystallize thinking in the Caribbean, and
give substance and structure to the outline undertakings and loose commitments about
cooperation which had been in place for many years. If this was indeed the case, then a
real enhancement of Caribbean trade and finance could undoubtedly provide a major boost to
the region's export competitiveness.

Overview of Main Issues

The discussion during the three days of the seminar covered a wide variety of factors
which directly or indirectly impinged on the competitiveness of Caribbean exports. No major
formula emerged to transform the present situation, but there was a good deal of consensus on
certain key issues. This final section of the paper merely highlights some of the more important aspects of this.

First, in relation to the definition and assessment of competitiveness, there was a broad consensus that while price competitiveness is relatively easy to define and assess, it represents only a small part of the overall situation of competitiveness in any particular country. The reality is that export success involves a complex interaction of price and non-price factors and that any overall strategy to enhance competitiveness must proceed on a broad front. While such a strategy was likely to be developed first and foremost in the light of the needs of particular industries, account had to be taken of the idea that national traits and attitudes were part of the explanation of poor export performance.

Second, the range of policy instruments which could be mobilized to enhance competitiveness was recognized to be very wide and, to a degree, country-specific. However, the linchpin of a sound strategy invariably involved the maintenance of a stable real effective exchange rate which took proper account of the external circumstances facing the country including changes in technology and the terms of trade. The practicalities of this for the nominal exchange rate vary considerably between different parts of the Caribbean. In particular, those countries which have systematically maintained reasonably sound monetary and fiscal policies have little need for the regular adjustment of their nominal exchange rates. In those cases, but not in general, the nominal exchange rate can be thought of as endogenously set by a variety of factors including the monetary and fiscal policies chosen by the country. In more unstable environments, the nominal exchange rate certainly needed to be actively manipulated as part of a strategy for export competitiveness, though this by itself is no guarantee for export success. In addition, in most cases, technical decisions about, for example, the basket of currencies against which to peg or crawl the exchange rate were also part of that strategy.

Third, fiscal, monetary and incomes policies all had roles to play in supporting an export competitiveness strategy and there were many different avenues through which such policies could exert an influence. Regarding public expenditure, the general view was that expenditure on basic services such as education and health may be as effective as expenditures specifically tailored to subsidize or otherwise pursue short-term gains in exports. However, this was not to deny the importance of public expenditures on export extension services, information services, and other export support arrangements. As regards monetary policy, it was agreed that its primary role in supporting exports is that of establishing a stable inflationary environment. The specific instruments of monetary policy, such as exchange controls and interest rates had particular roles to play in helping to achieve this. As regards incomes policy it was generally agreed that greater but flexible use of such a policy had the potential to enable governments both to achieve improved export competitiveness and to improve the employment situation consistently with its pursuit of other policies.

Fourth, the lessons from successful export economies could be divided into those which were unlikely to be replicable in the Caribbean context and those which have some potential to be replicated. There was a significant disagreement in the seminar about the exact dividing line, with some participants arguing that the potential for learning from East Asia was extremely limited. However, those who recognized that there were indeed lessons of some importance were also in broad agreement that the three key elements of a successful export strategy, as evidenced by the East Asian economies, were those referred to earlier, namely:

- a willingness to be forward-looking and to continuously monitor destination markets and consumers;
- an unambiguous commitment to export trade, established at the highest level; and
- an equal-footing treatment for exports for tax and other purposes to ensure that the profitability of exports is at least at par with the production of the same goods for domestic markets.
Finally, as regards Caribbean integration arrangements, the seminar manifested a mixture of disappointment and optimism. The disappointment was that most arrangements to support a regionally-based export push were already in place but were being used to only a limited degree. The optimism concerned the prospect that the accelerating global moves to establish and consolidate large trading blocs such as the EEC would crystallize thinking in the Caribbean and give substance and concreteness to undertakings and agreements for integration which had already been in place for many years.
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INCREASING INTERNATIONAL COMPETITIVENESS:
A CONCEPTUAL FRAMEWORK

Gerald K. Helleiner

A recent U.S. book on the subject of international competitiveness begins:

The problem of international competitiveness has been defined in highly diverse ways. These definitions (and the proposed solutions to the problem) are partially inconsistent, and thoroughly confusing to most academics, politicians, policymakers, and business managers. There is good reason for this confusion. The collection of problems alluded to as "competitiveness" is genuinely complex. Disagreements frequently occur not only at the level of empirical effects and of policies, but also in the very definition of the problem. Well-intentioned and reasonable people find themselves talking at cross purposes; sometimes it almost seems they are addressing different subjects (Spence and Hazard 1988:xvii).

It seems that in order to engage in useful exchanges concerning the possibility of increasing the competitiveness of exports we must first agree on what it is we are talking about.

Competitiveness and Comparative Advantage

International competitiveness cannot be a "problem" for long in all sectors and industries at the same time. Unless there are sustained capital inflows permitting the value of imports of goods and services to exceed the value of their exports—a less and less likely prospect for most developing countries today—current payments will fall to the level of current receipts. Even with capital inflows there still exists a sustainable imbalance at which current flows must settle. This implies a regime for the exchange rate and local factor (essentially labor) remuneration that will generate that balance or sustainable imbalance. This regime and the resulting prices and incomes will make some economic activities profitable and others unprofitable.

In the absence of governmental intervention, a comparative advantage that roughly determines the ranking of possible profitability in different activities, including those that do not at present exist in a given country, obviously lies behind these relative profitabilities. One cannot have a comparative disadvantage in everything! If an unfinanceable deficit persists, the value of the domestic currency or domestic incomes will eventually fall, and, in the case of currency devaluation, some tradable goods and services will thereby become profitable to sell for export or to replace imports.

In the smaller, poorer, and more structurally rigid economies, there is less prospect of "switching" existing production from domestic consumption to export, or of "switching" demand from imports to already existing domestic import-competing firms. In these economies what is at issue is the restructuring of production via new investments toward
profitable exporting and import-competing activities. And this may take some time (as well as financial investment).

Thus a country is always internationally competitive in some activities and internationally uncompetitive in others. That is, there are always some tradables that are profitable to produce domestically and others that are not. Given a country's underlying comparative advantage (which is the product of its resources, technology, income level, etc.), which activities are competitive and which are not at any one time depends, above all, on the exchange rate, the structure of domestic factor prices, especially wages, and the structure of other governmental forms of encouragement or disencouragement. This also depends on changes in domestic (as well as international) productivity that may be influenced by government policies, either directly or indirectly. Since the world is continually changing, some activities on the margin of "tradability" are moving into or out of international competitiveness all the time. As the pace of global technical change quickens, it becomes more important than ever for potential exporters—both firms and governments—to be able to monitor and adapt to continuing shifts in global industry and hence in their own competitiveness.

If a country attempts to maintain unsustainable official exchange rates or other such "temporary" policies, such actions may also generate "lags" in the adjustment of profitability to the positions at which they are likely to "settle" for more extended periods. For many activities, however, competitiveness, in the sense of the availability of profit from exporting, is fairly stable and predictable (although how much profit exporting generates may still be quite variable over time). To speak of strengthening a country's overall international competitiveness, then, is to speak nonsense. It makes sense to discuss international competitiveness only in terms of particular economic activities, industries, or firms—such as tourism, unskilled labor-intensive manufacturing, bananas production, and sugar production.

What industries, then, are we to be concerned with? Perhaps an obvious starting point is the distinction between those (traditional) industries and activities in the tradable sector (exporting and import-substituting) that have already been profitable and have existed for some time, and those (nontraditional) that are fairly new, or are being seriously contemplated, or those that have not even been thought of yet. Currently of prime interest in the Caribbean is the possibility of significantly expanding nontraditional exports. (The Caribbean is not alone in this regard; see Bond and Milne 1987.) One of the difficult questions for policymakers is how to identify the most promising new activities in which international competitiveness may be realized. In considering the desirability as well as the possibility of such new economic activities, they must also take into account broader issues of development strategy. Different activities generate different externalities, learning effects, and distribution of incomes. In some activities it may also be more difficult to remain competitive in the face of rapid global changes in technology and demand. These matters are beyond the scope of the discussion.

Competitiveness and Market Shares

Collectively, developing countries can expand their exports to the industrialized countries in ascending order of probable difficulty, (1) by sharing in the industrial countries' expanding domestic demand without expanding their present market share, (2) by displacing the market share of other industrialized country exporters without expanding total import share of the relevant market, or (3) by displacing the accustomed market shares of domestic producers. Individual developing countries can also, of course, compete with—and displace—one another. Indeed if, as many fear, aggregate developing country access to individual national markets, or to the EEC, or to the U.S.-Canadian free-trade area, or to the OECD as a whole faces some upper bound, there may be no option but to compete primarily with one another. Global price elasticity of demand for manufactures of the kind most likely to be exported by developing countries seems likely to be greater than for primary product exports.
(see Bond and Milne 1987: 105-6). But special measures in "sensitive" industries—such as the Multifibre Arrangement (MFA) for the textiles and clothing sector—can negate such presumptions. If access to such markets is limited in terms of imports in general, the developing countries can consider displacing some industrialized countries' exporters and not simply one another. Obviously there may be some potential for displacing of traditional suppliers in other developing country markets as well.

A country's overall international export competitiveness, as "revealed" in the export data, is sometimes summarized in a measure that combines (1) the behavior of market share in traditional products (and destinations) with (2) the degree of success in expanding exports of nontraditional goods and services.

Export growth can thus be decomposed into that which is attributable to growth in world markets for traditional exports, that which is attributable to altered share of traditional markets (traditional "competitiveness"), and that attributable to the development of new nontraditional exports ("diversification"):

\[
\Delta X = (x_1 W_2 - x_1 W_1) + (x_2 W_2 - x_1 W_2) + (NT_2 - NT_1)
\]

where \(W_t\) is the world market for this country's traditional exports in period \(t\), \(x_t\) is this country's share of these world markets in period \(t\), and \(NT_t\) is the value of nontraditional exports in period \(t\). (A further term may be useful to distinguish changes in world prices for exports from changes in the volume of world trade.) Adding the traditional "competitiveness" component to the "diversification" component of export performance in this expression (i.e., the last two terms), and expressing the sum as a percentage of total changed exports, yields a "revealed" measure of overall changing export competitiveness.

Such an after-the-fact (ex post) summary measure, indicating the export performance record, offers policymakers little guidance in formulating current policies or assessing future prospects. For that we must turn to micro-level measures of incentives and profitability.

Profitability and Price Competitiveness in Nontraditional Exporting

To identify new activities in which exporting is likely to be profitable over some agreed time horizon—that is, in which a country is internationally competitive—policymakers must look at the country's resource base; the unit labor costs in dollars (efficiency-adjusted local currency wage rates multiplied by the exchange rate); the dollar costs, and ease and reliability of gaining access to other inputs, such as power, water, and materials; and the location and hence dollar international transport costs.

To a substantial degree, the resource base and transport costs are invariant, at least in the short to medium term. That is not to say that full advantage has necessarily been taken of the opportunities to which they give rise, but only that they are basically exogenous and slow to change. Policies seeking to increase the international competitiveness of particular nontraditional activities are likely to bear on the unit labor costs and the reliability of the infrastructure.

The international price/cost competitiveness of particular industries at any point in time can be gauged by direct micro-level comparisons of price/cost levels and trends in domestic as against competing foreign industries. Product differentiation, the introduction of new products, variations in the output mix, rapid productivity changes, and confidentiality regarding cost data can all make such direct industry-level price/cost comparisons very difficult. One of the best-known systematic studies of international competitiveness (of a number of U.S. industries in the 1960s) provided evidence that nonprice factors—product quality, shipment delay, after-sales service, and the like—were of major, sometimes even dominant, importance (Kravis and Lipsey 1971: 151-65). Obviously the more homogeneous and standardized the product, the more important are price considerations relative to the
quality. Marketing, shipment, and related issues are nevertheless always important, as explained.

Despite the importance of non-price factors in exporting it is also true that international price competitiveness matters more in some sectors than in others. Profitability can be achieved in some activities by realizing an export price (in dollars) that is consistently higher than that of the international competition. If the demand for a particular country's export product is less than infinitely elastic (i.e., if its price is not essentially "given to it" by the world market) it can use its market power to enjoy a better price. The pricing rule for such cases is the familiar profit-maximization one—based upon the equating of marginal revenue with marginal cost. For policy purposes this translates into the equation of national marginal revenue (total earnings of nationals, direct and indirect) with marginal social cost (calculating all input costs, direct and indirect, as their social opportunity costs), and allowing, where possible, for both positive and negative externalities. Where capacity is not being fully utilized, in the short to medium term, the marginal cost may be low, and prices may also sensibly be set below that of the international competition.

In small countries these pricing considerations arise only in export sectors characterized by a degree of uniqueness or product differentiation. An established reputation, a brand name, or a unique resource may permit such pricing above international competition, as in the case of some kinds of tourism or some particular alcoholic beverages. The Caribbean as a whole appears to have unique tourist attractions, although individual countries in the region do not (Rosensweig, 1988). There are unlikely to be such possibilities in nontraditional activities where the object is to break into new export markets, and least of all in unskilled labor-intensive exporting. On the contrary, in these cases it may be necessary to price below the international competition at the outset, in order to attract buyers' attention.

Which countries should be used to compare international price/cost competitiveness? Assuming that the range of exportable industries being studied has already been narrowed to a "short list" of those in which the Caribbean has a broad comparative cost advantage (or potential advantage) relative to the countries to which it proposes to sell (notably the United States and EEC members), the most relevant price/cost comparison is with competing exporters, not with the United States or European countries themselves. All external suppliers of the U.S. or European markets can be assumed to overcome broadly the same entry barriers, allowing for the existence of preferential advantage from the Caribbean Basin Initiative (CBI), Generalized System of Preferences (GSP), and others (see World Bank 1988), which remain roughly unchanged.

**Measuring Price Competitiveness in Theory and Practice**

The most useful competitiveness indicator for any one country's industry would therefore be some kind of weighted average of the relative dollar price/cost levels or trends in the same industries in the major supplying (or potentially supplying) countries. The weights may vary from one industry to another, depending upon the intercountry sourcing pattern of the target market country's imports of the product in question. In the case of many nontraditional Caribbean export prospects, heavy weight will have to be assigned to Mexican competitors. Unfortunately for the Caribbean, Mexican hourly compensation costs in U.S. dollars are now less than half of what they were ten years ago; on the other hand, those of Taiwan and Korea have roughly quadrupled (U.S. Bureau of Labor Statistics and World Bank data). Notice that the weights that are most appropriate for these industry-specific competitiveness calculations are likely to be strikingly different from those employed by the International Monetary Fund (IMF) or by central banks in their calculations of trends in the real effective exchange rate (Edwards 1988). Moreover, even if these weights were the same, the exchange rate "required" to make one sector or activity internationally competitive may bear little relation to the rate that is appropriate for a sustained balance of payments equilibrium, once one takes into account the role of external capital inflows, the performance of other sectors (e.g., oil in Trinidad), or heavy debt-servicing obligations (e.g., in Guyana).
What can be used as a measure of product- or industry-specific prices or costs? Ideally, one would like to compare U.S. dollar costs, landed at the U.S. port, including freight and insurance, but excluding profits or taxes. This is impossible. In practice, it is extremely difficult even to compare total U.S. dollar costs at the factory level in different countries. In industries in which labor costs make up a large share of the value added, one could move a long way toward the objective if one could compare U.S. dollar unit labor costs, including benefits, employer-paid social insurance contributions, and so on (preferably adjusting for short-term variation attributable to the degree of capacity utilization). Unfortunately, even that measure can prove elusive. (Table 1.1 presents some recent data.) A measure of U.S. dollar wage rates is often the nearest one can approach to the preferred unit labor costs.

### Table 1.1 Hourly Compensation Costs for Semiskilled Production Workers In Export Manufacturing Industries, Selected Countries, 1987

<table>
<thead>
<tr>
<th>Country</th>
<th>U.S. dollars per hour</th>
<th>Index (U.S. = 100.0)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Industrialized Countries</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F.R. of Germany</td>
<td>15.93</td>
<td>116.6</td>
</tr>
<tr>
<td>United States</td>
<td>13.66</td>
<td>100.0</td>
</tr>
<tr>
<td>Canada</td>
<td>11.94</td>
<td>87.4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>8.67</td>
<td>63.5</td>
</tr>
<tr>
<td>Portugal</td>
<td>2.36</td>
<td>17.3</td>
</tr>
<tr>
<td><strong>Newly Industrialized Economies (NIEs)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>1.98</td>
<td>14.5</td>
</tr>
<tr>
<td>Taiwan</td>
<td>1.84</td>
<td>13.5</td>
</tr>
<tr>
<td>Korea, Republic of</td>
<td>1.54</td>
<td>11.2</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.35</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>Near NIEs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.29</td>
<td>2.1</td>
</tr>
<tr>
<td>Philippines</td>
<td>0.26</td>
<td>1.9</td>
</tr>
<tr>
<td>China</td>
<td>0.15</td>
<td>1.1</td>
</tr>
<tr>
<td><strong>Latin America</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Panama</td>
<td>1.77</td>
<td>13.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.14</td>
<td>8.4</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.84</td>
<td>6.2</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>0.95</td>
<td>7.0</td>
</tr>
<tr>
<td>Guatemala</td>
<td>0.88</td>
<td>6.4</td>
</tr>
<tr>
<td>Honduras</td>
<td>0.53</td>
<td>3.9</td>
</tr>
<tr>
<td><strong>Caribbean</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>0.79</td>
<td>5.8</td>
</tr>
<tr>
<td>Haiti</td>
<td>0.58</td>
<td>4.3</td>
</tr>
<tr>
<td>Jamaica</td>
<td>0.63</td>
<td>4.6</td>
</tr>
<tr>
<td>Barbados</td>
<td>1.72</td>
<td>12.6</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>1.66</td>
<td>12.2</td>
</tr>
<tr>
<td>Antigua</td>
<td>1.40</td>
<td>10.3</td>
</tr>
<tr>
<td>St. Vincent</td>
<td>1.15</td>
<td>8.4</td>
</tr>
<tr>
<td>Grenada</td>
<td>1.02</td>
<td>7.5</td>
</tr>
<tr>
<td>St. Kitts and Nevis</td>
<td>0.93</td>
<td>6.8</td>
</tr>
<tr>
<td>St. Lucia</td>
<td>0.92</td>
<td>6.7</td>
</tr>
<tr>
<td>Dominica</td>
<td>0.92</td>
<td>6.7</td>
</tr>
</tbody>
</table>

**Note:** Estimates contained in this table should be treated with caution. They are derived from a number of independent sources, including the industrial countries, Hong Kong, Taiwan, Korea and Brazil ILO reports. For Barbados, Costa Rica, Haiti, Honduras, Trinidad and Tobago, and Jamaica, the sources were various studies of free zones. Data for the remaining countries were developed from various informal and published sources. No importance should be attached to small differences.

* a. Including estimated payroll taxes, fringe benefits, and year-end or equivalent bonuses.

*Source:* World Bank 1988:35
Data on country-level U.S. dollar wage rates leave open the important questions of differential wage structures and incentive systems and of the representativeness of the average wage rate in different countries. Gary Fields (1984) has noted the importance of wage structure in assessing the prospects and consequences of manufacturing for export. If, as he says is typical in the Caribbean, manufacturing wages are much higher than agricultural wages—for example, because of union pressure, minimum wage laws, and foreign firms' or government wage-setting practices—an overall "average wage" would be quite misleading.

Even within the manufacturing sector there may be significant complications that limit the usefulness of average manufacturing wage data. Differences in the skill mix can be especially important, and countries' skilled-unskilled wage differentials can be expected to vary with such influences as the educational qualifications of the work force and ease of emigration. In the apparel sector, for example (see Table 1.2), not only is the wage rate's relationship with the average manufacturing wage highly variable across countries (compare Brazil's 55-62 percent with Hong Kong's 99-100 percent) but it also can change significantly within the same country over time.

Table 1.2 Hourly Compensation Costs in Apparel Manufacturing as Percentage of Comparable Costs in Manufacturing Production

<table>
<thead>
<tr>
<th>Country</th>
<th>1975</th>
<th>1986</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>62</td>
<td>55\textsuperscript{a}</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>99</td>
<td>100</td>
</tr>
<tr>
<td>India</td>
<td>84</td>
<td>75\textsuperscript{b}</td>
</tr>
<tr>
<td>Korea</td>
<td>62</td>
<td>65</td>
</tr>
<tr>
<td>Singapore</td>
<td>69</td>
<td>79</td>
</tr>
<tr>
<td>Taiwan</td>
<td>74</td>
<td>82</td>
</tr>
</tbody>
</table>

\textsuperscript{a} 1985.
\textsuperscript{b} 1982.


To calculate the U.S. dollar wage, then, one requires a representative wage rate for the industry in question, expressed in local currency, and the U.S. dollar price of the local currency. Where there is more than one exchange rate (or equivalent export earnings retention schemes), care must be taken to employ the rate that relates to exports in the industry in question.

There is no substitute for direct industry- or product-specific price/cost comparisons in ascertaining international price competitiveness in particular industries at a given point in time. It is also important, however, to be able to gauge changing competitiveness of the relevant industries or sectors over time. Indeed, increasing competitiveness is the theme of this seminar. And, to an important degree, any change in domestic productivity is the product of the level and composition of domestic investment.

In light of the difficulties in acquiring the desired "representative" wage data, it is small wonder that the analyst of changing competitiveness is so frequently driven to simpler and cruder measures—typically to measures of change in the overall level of prices and in
the nominal exchange rate, that is, to change in the real (inflation-adjusted) exchange rate, adjusted, where relevant, for industry- or sector-specific subsidies and taxes.

A usable, if rough, international price/cost competitiveness index for a particular industry, \( j \), in country \( h \), then, is

\[
C_{jh} = \sum_i E_i \frac{P_i}{P_h} W_{ij}
\]

where \( E_i \) is an index of change in the domestic currency cost of the currency of country \( i \); \( P_i \) is an index of overall price change in country \( i \); \( P_h \) is an index of overall price change in the home or domestic country; and \( W_{ij} \) is the share of country \( i \) in the competing imports of product \( j \) in the third country or countries (the market) for which competitiveness is being measured. This measure, \( C_{jh} \), records the change in the real effective exchange rate that is most relevant for assessing the competitiveness in a particular export market of industry \( j \) in country \( h \).

If possible, the expression \( P_i/P_h \) (the overall relative rate of price inflation) should be adjusted for particular taxes or subsidies relating to industry \( j \), so that it becomes \( P_{ij}/P_{hj} \) the relative industry \( j \)-specific rate of price inflation. Relative price change may also be substituted for, wherever possible, by overall or industry \( j \)-specific measures of change in labor costs.

Again, it is important to stress that, although this measure appears to bear some resemblance to the usual real effective exchange rate measures, the (industry-specific) weighting system suggested here will generate quite different results. Traditional trade-weighted measures of the real effective exchange rate remain, of course, important for assessing the overall appropriateness of official exchange rates, if the changing terms of trade, capital flows, debt-servicing obligations, and productivity change, are taken into account.

**Price Competitiveness: Some Policy Issues**

Avoiding gross misalignment (and undue instability) of the real exchange rate seems to be an obvious prerequisite for reasonable export success. The antiexport bias associated with overvalued currencies has certainly hurt many African and Latin American countries in recent years. Undervaluation of the domestic currency (and relative neutrality, as between exports and import substitutes within the tradable sector) seems to have been associated with successful export expansion in such cases as Korea and Taiwan. It is striking, however, that economic analysts have recently been unable to find any systematic cross-country relationship between the real effective exchange rate (as traditionally measured) and export performance. This is sufficiently surprising, and new, that it may be worth quoting:

We have experimented at length with various definitions of competitiveness, but found little support for the hypothesis that export growth can be associated with price competitiveness in the developing countries. Regression of exports on real exchange rates showed little correlation. An alternate possibility was to compare actual real exchange rates with the corresponding purchasing power parity. But, again, we were not able to provide an explanation for export growth with such a variable. (Adams, Behrman, and Boldin 1988: 14)

This perhaps serves to underline the need to focus on industry-specific incentives. There does exist fairly firm econometric evidence that nontraditional export growth is associated with the level and stability of the real exchange rate.

There is a presumption that investors in new kinds of (export-oriented) production respond better to stable and appropriate real exchange rates that are associated with low rates of price inflation than to those achieved through constant readjustment of nominal exchange rates in response to ongoing inflation. Cautious fiscal and monetary policies are therefore an important concomitant of getting and keeping the real exchange rate "right," as
long as this has not already been rendered too difficult (in the short run) as a consequence of prior inflationary experience.

If the overall real exchange rate does not provide a particular potential export industry with the international price/cost competitiveness it requires for successful exporting, there are essentially three possible short-term policy responses:

1. Devalue the domestic currency to the point where the industry becomes internationally competitive (allowing for possible inflationary offsets).
2. Create subsidies, special exchange rates, or other special arrangements for the industry, sufficient to make it internationally competitive, that is, profitable.
3. Abandon immediate efforts to export in that industry.

A decision to devalue may be the product of inability to compete in a range of specific potential export industries. An effort generally to encourage exports is likely to involve a real devaluation of the currency. It is unlikely, however, that one or two industry-specific competitiveness calculations will engender an across-the-board devaluation (unless, of course, the products in question are of overriding importance). Given the exchange rate, the choice is between options (2) and (3).

Industry-specific, targeted, export encouragements raise all of the theoretical issues and arguments long debated in the literature on protection. This is not the place to reiterate them. Suffice it to say that there are some reasons for believing that significant positive externalities come from some kinds of nontraditional export activities, notably in manufacturing, and that negative ones may well come from others; and there are some significant successful precedents for the targeting of infant exports in East Asia (Westphal 1982). However, countervailing and antidumping duties may be levied against differentially subsidized exports. They cannot be deployed against devaluation-assisted competitive products (but, of course, other protectionist measures can be).

**Nonprice Dimensions of Competitiveness**

Price/cost competitiveness is a necessary condition for export success. It is unfortunately not sufficient. Information about markets, product design and packaging, quality control, reliability of supplies, marketing and distribution skill are among the further critically important elements in successful exporting. The knowledge required can be obtained only through experience and learning by doing. Nor is this knowledge acquisition a "one shot" affair. Once acquired, it must be kept continually up-to-date. The fastest growing markets for manufactured exports from developing countries are not in standardized or local products but in made-to-order goods in which detailed (and changing) know-how is essential.

Marketing in the sense of finding or attracting customers and persuading them to place orders or buy output is almost inseparable in practice from building up the firm's supply capabilities. In getting orders, firms sell the whole package of their capabilities and knowledge together with their readiness to learn more and invest further in their exports. What is marketed is above all the firm's ability to meet all the buyer's requirements. Thus improving supply capabilities is central, and is virtually inseparable from developing skills in communicating to customers what the firm can do for them. (Keesing and Lall 1988: 14-15).

In small island economies, the key nonprice issue is frequently the adequacy of the relevant infrastructure. If transport and communications are sporadic and unreliable, it will be very difficult for suppliers to respond to buyers' needs in a competitive manner. In these cases, it may be necessary to concentrate on a subset of potential exports for which the reliability of delivery is relatively less important, until better infrastructure can be developed.

Once a developing country has the basic incentives right and has begun to acquire a record for reliability, business can multiply rapidly. Equally, "glaring failures and policy obstacles tend to cut off the learning and evoke lasting buyer mistrust of an economy as a source of supply" (Keesing and Lall 1988: 18).
What appears to be most needed in the early stages are specialized and informed service suppliers and consultants, with directly relevant business experience, to provide instruction, advice, and firm-specific extension services for the most promising potential exporters with production capacity. High-cost, generalized public sector export promotion agencies have not had a good track record.

The availability and cost of trade credit—preshipment (usually short-term working capital) or postshipment (often longer-term)—may also significantly affect the profitability and international competitiveness of particular exportables. Difficulties with export credit may merely be a by-product of problems in the overall domestic financial system, rather than being inherently export-related. Where this is the case, one first ought to pursue the requisite strengthening of overall financial management. It may nonetheless be necessary—pending more fundamental policy change and/or economic development—to consider credit measures specific to the particular desired export expansion. It is usually argued that such export-specific measures may be especially important for small and medium-size enterprises either producing directly for export or subcontracting for others who do. In the Caribbean area, the relative role of such smaller enterprises is likely to be fairly great. Scale economies in export marketing, distribution, and information management, as well as in credit management, require the consideration of potentially larger-scale institutions for the efficient performance of these essential functions.

Swift, easy, and duty-free access to key inputs, many of them imported, has also frequently proven to be vital. In the successful East Asian cases of rapid expansion of manufacturing for export, the liberalization of imported input requirements (direct and indirect, so as not to discriminate against local suppliers) for the expanding new export sectors was undertaken long before any thought was given to overall trade liberalization.

**Competitiveness and Foreign Investment**

There is another sense in which the term "international competitiveness" is frequently used—that is, in the sense of attractiveness to foreign investors. To some degree international competitiveness in this sense overlaps with the industry- or activity-specific concept of competitiveness discussed above. Certainly any discussion of the attraction of a country to foreign investors must be set in the context of a particular economic activity or industry. If the basic conditions for industry- or activity-specific profitability are not met, neither domestic nor foreign investors will be interested. Foreign investors, however, typically have further concerns, beyond those of domestic investors. Prime among them is their greater perception of risk, their inability to repatriate earnings or capital, currency devaluation, nationalistic policy measures directed discriminatorily against them, and the like; this makes them very sensitive to that amorphous factor of "business climate." They also frequently face different constraints; in particular, they have more limited knowledge of local conditions. Among the key relevant issues, of course, is the extent to which the government from the outset treats foreign investors differently from domestic investors. Differential treatment may mean either more favorable treatment for foreign investors or less favorable, fewer conditions or more numerous ones. In export-oriented activities, much more than in those catering to local or regional markets, foreign investors can be expected to respond to special tax and subsidy incentives. In these sectors there is therefore a particular danger of mutually destructive competition among countries that are in other respects quite similar to attract highly mobile international capital and skill. There are potential gains to host countries from some harmonization of policies toward export-oriented foreign investors to reduce that unpleasant prospect.
References


FISCAL AND MONETARY POLICIES IN SMALL ECONOMIES

DeLisle Worrell

In today's interdependent world, even large industrial countries like the United States must be concerned about their ability to export. Small countries cannot grow at all if they are not able to sell additional output in international markets at competitive prices. Small open economies must identify a combination of policies that accords with their comparative advantage—actual or targeted. Alternatively, they should maintain a stable policy regime over time to which comparative advantage may be adjusted via suitable investment. Such a policy regime will have numerous elements. It may be argued that the most important are the microeconomic aspects affecting the supply of skills, the choice of technology, and the efficiency of resource use. This discussion focuses on fiscal and monetary policies in relation to competitiveness, but there are specific associated policies, particularly microeconomic policies, without which the expected outcomes may not be attained. Fiscal policy, as part of a well-tailored package, may play an important role in promoting strong growth in internationally traded goods. Monetary policy only helps in the short run to adjust expenditure plans temporarily. It has few lasting effects.

Economic Characteristics of Caribbean Dualism

Output in the Caribbean countries may be divided into those goods that may be traded among countries, such as clothing, agricultural products, and tourism, and goods that by their nature must be provided locally, such as government services and public utilities. Small economies must accept the ruling selling price of traded goods. Anything they produce is too trifling in amount to make a difference to the international price. When their production costs change, firms in the traded sector have to change levels of output, and use new kinds of organization, marketing, and technology if they are to survive and prosper.

Firms in the nontraded sector may adopt similar strategies, but in addition they may change the price at which they offer to sell. The market will tolerate some change in price, depending on the strength of demand, and consumers have no option to appeal to cheaper foreign suppliers.

Fiscal and monetary policies will have different effects on the traded and nontraded sectors. For example, measures to reduce costs such as lower tariffs on inputs and reduced interest rates should lead to an increase in the output of tradables, but the effect on nontradables may be ambiguous. For items where the country only needs as much as it already consumes, prices may instead fall. Serious policy error will result if the effects on traded and nontraded production are not measured separately. The extent of the supply response may be overestimated. More important, the extent to which an increase in output arises in the traded sector may be miscalculated, and we may then expect too large an
improvement in the balance of payments. The fact that the expected foreign reserve gain may not materialize could threaten the entire policy package.

The Mobility of Capital

Because finance moves readily across borders in search of the most profitable locus of investment, domestic savings do not represent a constraint to growth. The limitation to investment is the failure to identify areas of comparative advantage where domestic firms could supply products of internationally acceptable quality. Once such opportunities are perceived, investment funds could come from international sources in unlimited quantity. There is clear evidence throughout the Caribbean in support of this contention.

Why then is there not a surge in investment in Guyana, the country with the greatest wealth of natural resources in the Caribbean? The answer lies in the existing social and political unease in the country and the decline of basic infrastructure. The prerequisites for investment are an orderly, stable society with obvious legitimate political authority, dependable public utilities and transport, and basically sound education, health, and social services. Once these are provided for, investment follows profitability.

Orthodox economists believe that domestic savings are the key to sustained economic growth. That is true of a closed economy that does not permit foreign investment. There are no Caribbean countries remaining in that category. It is also true if investment is directed to the nontradable sector where it does not generate the foreign exchange necessary to service the foreign debt. In fact there are only a few instances of major foreign investment in nontradables in the Caribbean, and they are concentrated by and large in public utilities.

Thus, where infrastructure is inadequate, fiscal resources must be allocated to bring it to the required minimum. Taxes and other incentives that enhance the rate of return on investment should feature prominently in a growth-oriented strategy. It is important to establish which incentives lead to greater profitability. The tax regime in the investor's country of origin must also be taken into account. Specifically, will his own tax authorities allow him to make deductions for local taxes forgiven, just as though he had paid that tax? Bilateral arrangements govern these matters. Such allowance is possible under some double taxation agreements.

Efforts to raise the domestic savings rate in the absence of demonstrated investment opportunities have no value. The real savings rate will not rise even if people try to increase their holdings of bank deposits and other financial "savings." Since there is no one to invest, banks lend out the additional funds for consumption. The increase in financial "savings" is matched with increased consumption, not more investment. If for any reason the demand for consumer credit is weak, banks will just accumulate reserves with the central bank, without making loans for fruitful investments.

Limits to Import Substitution

For small nonsubsistence economies, domestic production of importables is a small percentage of national output, usually less than 10 percent. (If we treat the Caribbean as a single market in defining importables, that percentage is no different, although for small countries the CARICOM market may be highly significant.) Nonsubsistence economies require a wide range of goods and services. If any small economy tried to produce more than a handful of these items, we would see a multitude of tiny producing plants, each one too small to attain the economies of scale required to sell at world market prices. The list of items for which the domestic market is sufficiently large or the economies of scale sufficiently small is soon exhausted.

Import substitution is not a realistic policy option for the Caribbean. Attempts to stimulate import substitution by fiat have all failed. They result in high prices, inconsistent quality, and a parallel market of international trade in competing products. A few import-substitution activities are able to compete domestically, but with the aid of a moderate
tariff. Such activities may be encouraged to help generate employment and economic growth. But the overall contribution of import substitution to national output will remain small as long as the economy does not revert to subsistence.

**Endogenous Exchange Rate Adjustment**

Small countries with large and rich neighbors do not have much say in their exchange rate. The value of Papua New Guinea’s currency in Australian dollars, the value of Botswana’s currency in South African rand, the value of the Netherlands guilder in deutsche mark, and the value of the Jamaican dollar in U.S. dollars are all determined by the smaller country’s foreign exchange reserves and balance of payments performance. If fiscal and monetary policies are so designed as to secure adequate foreign exchange reserves, the value of the currency may remain the same indefinitely.

Efforts to eliminate exchange rate uncertainty encourage trade and investment flows. Other circumstances such as relative factor use, technology, marketing, and choice of products adapt over time to this basic relationship, thereby preserving a country’s comparative advantage. The only really favorable circumstance for a currency change by a small country is a high level of foreign exchange reserves and strong underlying economic growth. But there is little incentive to change the exchange rate under such circumstances.

If foreign exchange reserves are low and the balance of payments weakens, then the local currency will be devalued. The authorities do not have much choice in the matter. Often they may wish to insist that the currency’s value remains unchanged, but they have no foreign exchange to sell at that rate. Increasingly over time the market ignores the central bank, and traders set their own rates for buying and selling among themselves. The longer the central bank delays devaluation, the smaller its share in the foreign exchange market. Ultimately, it will command foreign exchange only from primary exporters.

These views contrast with those of economists who believe that the exchange rate is an instrument to be used to improve balance of payments performance and stimulate growth. They believe that the exchange rate determines the balance of payments outcome. The truth is just the reverse. The naive version of the conventional view is that devaluation makes domestic goods cheaper and foreign goods more expensive. Both locals and foreigners buy more domestic goods and fewer foreign goods; hence the balance of payments improves and home output rises. This sounds too good to be true and it never happens that way in small economies. It is impossible to produce domestic goods to substitute for more than a fraction of imports, and the demand for a country’s main exports is determined by quotas and administrative arrangements. The increased cost of imported inputs raises the cost of domestic goods, and so, instead of cheaper domestic goods, there is inflation and little improvement in the balance of payments. Not many economists believe this naive version.

More sophisticated economists now view devaluation as a device to gain temporary advantage, to be exploited by an increase in the supply of export goods and a decline in living standards at least for some (hopefully more affluent) segments of society. Domestic costs do tend to catch up in time, but there is an interval in which costs are lower and exporters have an advantage that could boost production. Admittedly, if domestic substitutes are not available the country will have to incur higher import costs until there is renewed growth in income. The new rationale for exchange rate adjustment is no more convincing than the old.

**Endogenous Money**

Central banks in small open economies find themselves frustrated at every turn in attempting to regulate the amount of finance. In the end, the amount of finance depends on government borrowing and the central bank’s accumulation of foreign exchange reserves. Central banks try to influence economic performance by changing the amount of finance or its
allocation, but the means at their disposal are not effective, as will be explained below. The government budget is the most effective way of influencing economic activity. The budget outcome is reflected in the supply of finance. The comparative performance of the traded and nontraded sectors affects the balance of payments and this also helps to determine the quantity of money. Increases in the supply of money are fully determined by government borrowing from the central bank and the increase in foreign exchange reserves.

**Wage and Price Formation**

Domestic inflation has a large import element, and wages are sensitive to inflation. This circumscribes the extent of domestic cost adjustment where wages are a substantial proportion of total costs. The leeway for cost adjustment depends on how far wage increases lag behind price increases, on the technical change affecting labor productivity, and on the level of unemployment, which affects the bargaining strength of workers. Fiscal and monetary policies for increasing domestic competitiveness should work on the narrow wedge between domestic inflation and the price of imports, rather than by increased unemployment. Another means of increasing domestic competitiveness is to upgrade technology and enhance productivity.

**A Model of the Small Open Economy**

A simple model of the small open economy is presented in Table 2.1. It may be used to simulate a path of output expansion over time.

**National Output**

National output is the sum of quantities of tradables and nontradables. The quantity of tradables produced depends on wage costs and the costs of financing working capital compared with the selling price. When costs rise relative to selling prices, firms trim their output and vice versa. In time, profitable firms will improve their technology with new investment to compensate for cost increases.

The intended supply of nontradables responds to demand and to the relative prices of tradables and nontradables. Although few nontradable goods directly substitute for tradables, the contents of the consumption basket may be altered in response to changes in relative prices. The actual amount supplied is adjusted to demand, with a lag. Production is equal to last year's output plus a proportion of the discrepancy between that output and this year's demand. Nontradable goods are sold at a price that reflects the costs of producing a level of output. The costs include the price of imported inputs along with wage and finance costs.

**Balance of Payments**

A country's balance of payments is the value of its exports of goods and services less the value of its imports of goods and services plus capital inflows. Changes in import substitution make a negligible contribution to the balance of payments, and exports of goods and services are assumed to be approximately the same as sales of tradable goods. Imports of goods and services are determined by demand, that is, by absorption and the relative prices of tradables and nontradables. Imports are in unlimited supply at international prices.

If the foreign exchange loss is less than some level of reserves that is considered adequate by the private sector, there is no change in the exchange rate. But when the foreign exchange loss is greater than this, the exchange rate depreciates at a rate that is determined by the expected loss of foreign exchange reserves. Exchange rate depreciation raises the price of tradables, affecting the profitability of investment in the tradable sector,
the cost of nontradable goods, the demand for imports and for nontradables, domestic inflation, and wages.

Table 2.1 A Simple Model of the Small Open Economy

<table>
<thead>
<tr>
<th>National Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>( Q = Q_t + Q_n )</td>
</tr>
<tr>
<td>( Q_t = Q_t (P_t, w, r) )</td>
</tr>
<tr>
<td>( Q_n = Q_n (a, P_t/P_n, Q_n [t-1]) )</td>
</tr>
<tr>
<td>( P_n = P_n (Q_n, P_t, r) )</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance of Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>( m = m (a, P_t/P_n) )</td>
</tr>
<tr>
<td>( dR = P_t (Q_t - m) + K )</td>
</tr>
<tr>
<td>( de = \begin{cases} f(dR) &amp; dR &lt; R \ dR &gt; R &amp; f(dR) \end{cases} )</td>
</tr>
<tr>
<td>( P_t = e P_f )</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Wages, Prices, and Interest Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>( w = w (P, dQ/dN, (L-N)/L) )</td>
</tr>
<tr>
<td>( N = N (Q) )</td>
</tr>
<tr>
<td>( P = b_1 P_t + b_2 P_n )</td>
</tr>
<tr>
<td>( r = r_f + f(dMO/P) )</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Intended Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>( a = Q + dMO/P )</td>
</tr>
<tr>
<td>( dMO = Ag + dR )</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>( Q_{t+1}/Q_t = Q(I_t) )</td>
</tr>
<tr>
<td>( I_t = f(PI, tax[PI]) )</td>
</tr>
</tbody>
</table>

Note: \( Q_t \) = output of tradables; \( P_t \) = price of tradables; \( w \) = wages; \( r \) = interest rate; \( a \) = intended spending; \( P_n \) = output of non-tradables; \( Q_n \) = output of non-tradables; \( m \) = real imports; \( dR \) = change in foreign exchange reserves; \( I_t \) = investment in tradables; tax (PI) = corporate tax rate; \( K \) = net foreign capital; \( e \) = exchange rate; \( de \) = exchange rate change; \( R \) = adequate level of foreign exchange reserve; \( N \) = employment; \( L \) = labor force; \( r_f \) = foreign interest rate; \( dR \) = national output; \( P \) = price index; \( MO \) = money; \( Ag \) = central bank lending to government; \( P_f \) = foreign price index; \( PI \) = rate of return; \((-i)\) and \((+i)\) = periods of lags; \( b_1, b_2 \) = weighted average ratios; \( f() \) = function; \( f(dR) \) = function of \( dR \).

Wages, Prices, and Interest Rates

Prices are simply a weighted sum of the prices of tradables and of nontradables. Fiscal and monetary policies influence inflation via the price of nontradables. Wages adjust to
inflation with a lag. The extent of adjustment depends on labor productivity and the rate of unemployment. Employment varies with output and with the rate of technical change.

The interest rate is linked to interest rates in international markets, but not rigidly. There will be differentials, within limits, in response principally to the government's demand for domestic finance.

**Intended Spending**

The amount that the economy plans to spend during a given period is the sum of output plus expected real increases in the supply of money. The supply of money is the sum of government borrowing from the central bank and the accumulation of foreign exchange reserves.

**Growth**

Output will stagnate, whatever the demand at home and abroad, if there is insufficient investment in the modernization of systems and the implementation of competitive technologies. Furthermore, if the increase in output of traded goods is inadequate, the exchange rate depreciates and drives output down via reduced real demand for nontradable goods. Investment in tradables, to maintain the growth of output of tradables, is the effective way to raise the ceiling on the expansion of national output. Investment in tradables depends on the after-tax return on the production of tradables, assuming the necessary infrastructure has already been provided.

The rate of investment in tradables that is necessary to ensure that growth does not come to a halt because of capacity limitation may be derived in the tradable sector. The model may also be used to gain insight into the magnitude of responses to some global policy measures, such as increased government borrowing from the central bank or to changes in interest rates.

**Fiscal and Taxation Policies**

The effects of fiscal policies may be grouped under the categories of stabilization, growth, and income distribution. Stabilization refers to the short-term adjustment of national spending. Economic growth refers to the longer-term trend in output and requires incentives for investment, particularly investment in tradables. The purpose of income distribution is to ensure a minimum standard of household welfare. We assume that the target is the provision of basic needs to all households, especially the disadvantaged. Each aspect of fiscal policy can be examined in relation to these objectives. In the end we need a total package that offers the best compromise among them.

**Government Revenue**

The economic impact of the personal income tax depends on the average rate, the degree of progressivity, and the nature of allowances. A higher average personal income tax rate dampens spending and acts as a stabilizer against excessive foreign exchange spending. There is no reason to expect higher rates to reduce the supply of labor or work effort, popular myths notwithstanding. The labor market is not such that a worker may decide to work 36 hours per week if his tax rate is at a certain level and 40 hours per week if it is lower. The work week is 40 hours long. The worker decides whether to work or not. Where there is widespread unemployment, someone else is standing ready to replace the worker should he or she decide not to work. The few trivial examples of workers refusing overtime because of tax deductions do not affect the argument. A negligible amount of the national product is produced in overtime. Work effort depends on the organization of jobs
within the firm and the quality of management. Among the self-employed, some may choose to vary their activity in response to tax structure. Typically, however, they adjust activity between taxable and tax-exempt activity.

An efficiently administered progressive income tax is the most straightforward way to redistribute income. But a market economy will fail to achieve income redistribution via the progressive income tax if the rate of progression exceeds what is socially desirable. Those affected will resort to political lobbies and seek out tax shelters and legal loopholes in order to frustrate the excessive progression. If the government reacts in a hostile fashion to block these avenues, those affected will begin to leave the country. In a small country the proportion of skilled people who may be lost in this way is often quite significant. The progressive income tax is an important instrument for income distribution but progressivity must not be taken beyond what society accepts as reasonable (which may vary from time to time).

Many of the allowances, exemptions, and rebates provided for under the personal income tax regime are designed to redistribute income—for example, the personal allowance, allowances for mortgage interest payments, and health-related deductions. The level at which they ought to be set should be determined in the light of the degree of income distribution desired and the other means available for achieving it.

Investment by means of allowances may also be encouraged—for example, rebates on export profits, allowances against equity investment, and credits that dividend recipients may claim for taxes paid by firms before distribution. These allowances have an important role to play in encouraging investment that may lead to increased competitiveness. Most tax regimes in the Caribbean also include incentives for financial accumulation. In my view, they have no justification.

A well-designed personal income tax serves all three objectives of fiscal policy. The rate may be adjusted to the requirements of overall economic activity and spending. Progression may be adjusted to secure income distribution targets along with other ways of achieving welfare levels. Allowances may also contribute to income distribution but they have a potentially more important role as incentives for investment.

THE CORPORATE INCOME TAX. Like the personal income tax, the corporate tax may be used to dampen expenditure for short-run stabilization purposes. It may also serve to redistribute income. It adds to the progressivity of the personal income tax because it reduces the dividends accruing to owners of the firm, except where the full amount of corporate tax is allowed against personal income tax paid by dividend recipients. However, the most important role of the corporate income tax is as an investment incentive via the rules governing taxation. The incentives offered by a combination of the corporate tax rate, allowances, exemptions, and other incentives that the tax system offers to the firm can be formulated (see King and Fullerton 1984; Worrell 1989). These would include such things as accelerated depreciation allowances, special performance rebates for exports and new industries, write-offs against future profits, investment grants, and so forth. One may calculate the most effective incentive for various activities and adjust the structure of the corporation tax so as to ensure that investment in the tradables sector is encouraged most.

TAXES ON IMPORTS AND EXPORTS. Taxes on imports may be used to adjust expenditure and they may also provide for additional import substitution. It has been argued that high import tariffs give perverse incentives for investment in importables rather than in exportables, the so-called anti-export bias. If the argument is valid, it must mean that investment that is diverted to import substitution would otherwise have gone into the production of exports. But there is unlimited finance available for investment in exports, whether the profitability of exports is less than the profitability of import substitution. Even if a small country makes import substitutes too profitable and investors take up all available opportunities for import substitution, there are still investment funds available in New York and San Juan, if not in Port-of-Spain, to take up the additional profitable opportunities in the export sector. What
is more, the scale of investment in import substitution is trivial compared with the scale of investment in exports. No matter how profitable import substitution may be, investment will be quite small, a few million at most, and will be easily financed from local sources. In contrast, export investment is sizable, reaching US$10 million or more. An investor with the required finances may easily take up import substitution possibilities as an afterthought to his main export interest. There is a sound argument against overprotection of import substitutes. It is based on hardship and excessive expense to the consumer, not on the effect on exports. Moderate import tariffs may be used to adjust expenditure and to encourage reasonable investment in import substitutes.

It is possible to effect some income redistribution via differential tariffs on different classes of imports. The CARICOM Common External Tariff (CET) generally levies the highest tariffs on consumer durables and imposes lower tariffs on machinery, raw materials, and basic foods. But many have questioned the effectiveness of such income-distribution efforts. There is a great deal of market discretion between the tariff and the sale to the final consumer. For instance, it is possible to impose higher markups on low tax items to make up for lower markups on high tax items that one does not wish to sell at exorbitant prices.

In the Caribbean there are few taxes on exports because of the need to maintain competitiveness. It might be desirable to have negative taxes on exports where international regulations permit. Small economies have nothing to lose and much to gain from such taxes, in contrast to large countries for which negative export taxes are a form of "beggar-thy-neighbor" policy.

Consumption Taxes, Sales Taxes, and Excises. These taxes may have useful stabilizing effects provided the revenues they raise go to reduce the fiscal deficit. They reduce the volume of goods and services, including imported goods and services, which may be purchased with a given national income, although in the process they add to inflation. Taxes on spending are regressive in spite of the usual provisions for higher rates for consumer durables and luxuries.

There is a popular but specious argument that taxes on spending increase the propensity to save. Is it reasonable to presume that households will abandon plans to acquire commodities to which they aspire and accumulate funds instead because the goods have become more expensive? It is possible that households may be forced to postpone major purchases as a result of increased taxes resulting in a temporary slowdown in spending; but it is also likely that any additional funds accumulated in this period will go toward the down payment on the intended purchase as soon as financial savings have brought the household once more within reach of the purchase price.

Firms in the nontraded sector may pass on to consumers some price changes resulting from taxes on spending. There may be a reduction in output accompanying the price increases. Firms in the traded sector may not raise selling prices so their output may decline.

Government Expenditures

The Government Wage Bill. Government expenditure may be used as a stabilization tool, to reduce the deficit and contain national expenditure. To reduce the wage bill, which accounts for more than 50 percent of government expenditure in the Caribbean, the government will have to cut back on the services it provides. The average wage of government workers generally maintains some relationship to wage movements in the overall economy, although there may be differences in timing. So the only way to manage government wages is to manipulate national wages, which very few countries are able to do by government policy directive. The government must therefore accept the ruling wage and trim the civil service payrolls in order to attain its wages bill target.
Valiant attempts have been made in many countries—including Jamaica, Guyana, and Grenada in the Caribbean—to shed civil servants without drastically reducing the quantity and quality of public service. In the Caribbean cases, the majority of popular opinion does not find any improvement in public service, and in Jamaica and Guyana social indicators such as nutrition, mortality, and educational achievement show a decline.

Any government that decides to reduce the wages bill should determine in advance which services will be reduced or eliminated. If it fails to do so, health and education are most likely to deteriorate because they command the largest share of government expenditure. In any country that faces a large economic adjustment problem, the government should plan to contain the wage bill because wages and salary payments account for such a large proportion of government expenditure. If this is not achieved, a major reduction in government spending cannot take place.

A reduction in government services may have damaging consequences for economic growth and income distribution. The government provides the essential foundations for economic progress in the form of communications facilities, education, health services, law and order, the regulation of commercial transactions, the determination of national standards, and so forth. Unless these services are delivered with proficiency, economic stagnation is inevitable.

Many governments redistribute income in desirable ways and provide housing and health services for the old, for children of unstable households, and for persons with disability. They also provide education for the poor and the illiterate and healthy recreation for communities in depressed circumstances.

The choice of programs to be cut in an era of fiscal austerity is not simple or painless. To aid in the decision, governments should maintain ongoing, up-to-date surveys of the population to measure the consumption of essential goods and services at various income levels and sources from which this consumption is derived. To what extent do households purchase essential services out of their own income? To what extent do they rely on free provision by government, on government-subsidized provision, and on other sources? From this information, one may assess the effect on the consumption of basics when the government withdraws any of its provisions.

It is perhaps more difficult to determine where cuts in government expenditure begin to hinder eventual growth prospects. But some measures are available to help inform the decision, for example, educational achievement data, crime statistics, major health indicators, and reports on the maintenance of infrastructure. If such indicators are monitored carefully, it will be possible to anticipate any serious erosion of the country’s capacity to sustain investment.

Government Purchases. There is not much scope for manipulating government purchases to secure an overall expenditure target. The level of purchases is decided by the extent of government activity that is already fixed so as to adjust the wages bill in accordance with the considerations just discussed. Only temporary economies in the purchase of goods and services are possible.

Transfers to Households. The main function of transfers is to improve the distribution of income. Whether cuts can be made in these expenditures depends on the level of provision of services that are affected and on the other delivery systems that satisfy these targets. The tradeoffs may be evaluated along with other factors affecting income distribution using the social indicators recommended earlier. (Transfers to firms may be considered a negative corporate income tax in terms of their economic affects.)

Interest Payments. Governments will have no discretion in the level of current interest payments. But projected interest costs are an important factor determining the strategy for financing the government deficit. It should influence the extent of current borrowing, both local and foreign.
GOVERNMENT INVESTMENT. The level of government investment that provides for the strongest rate of growth will depend on the extent of state ownership of production. Much economic analysis has been devoted to determining what the government ought to own. The only convincing answer is that the government ought to own what citizens, expressing themselves through legitimate government representatives, decide it should own. Other positions have vigorous defenders. There are those who argue for only minimal government interference, primarily in the areas of law and order, health, education, roads, and ports. Some would even question whether all of these should be included in the minimum list. Others believe that the private sector should not be allowed to exploit citizens via natural monopolies such as public utilities. But in the end is it better to own public utilities or to regulate privately owned public utilities?

Beyond this, why should government not own productive enterprise? Governments are large entities and may need considerable resources to launch novel investment initiatives, for example, exports. It is futile to expect the typical small furniture manufacturer, who has difficulty maintaining delivery schedules to nearby outlets on home territory, to venture successfully into exports. The popular notion that privately owned enterprise is more efficient than government operations is too often based on biased comparisons between inefficient government and state corporations, on the one hand, and relatively more efficient private enterprises, on the other. Many examples might be cited to reach exactly the opposite conclusion.

I am therefore inclined to a strictly commonsense view of the scope of government investment. There is not much sentiment in the Caribbean to divest government of its basic functions of education, health, social security, and law and order. In addition, the ownership of public utilities should remain as is so long as service is efficient or ways may be found to make it efficient. "As is" may mean state owned, private owned, or state regulated, or a combination of these. The government should eschew 100 percent ownership of producing firms unless there is a need for fiscal expansion. The overall degree of government investment beyond basic government services may have to be varied in response to the stabilization needs of the economy. As long as no inroads are made on the investment required for basic government services, the adjustment of government investment should have little effect on long-term growth and the distribution of income.

Government Borrowing

Invariably, a government must manage its deficit and borrowings so that there is little need to borrow from the central bank. Often, overborrowing from the central bank in previous periods must be reversed.

If the foreign debt service is low (less than 10 percent of revenues from the export of goods and services) and the projected export growth is strong, foreign borrowing on reasonable terms might be sought as the first option. The terms should include maturities approaching ten years and the best available international market interest rates. Targets for foreign borrowing might be established on the basis of debt-service projections under various scenarios, taking into account possible future foreign borrowings as well. The targets would have to be adjusted to the extent that the available terms of credit fall short of what is desired. Lower targets must be set if the debt-service ratio is initially higher. Provided the deficit is not too large, an extra dollar of foreign borrowing is preferred to an extra dollar of domestic borrowing because the foreign borrowing provides foreign exchange to finance the import content of government expenditure. But if the fiscal deficit is too large, efforts must be made to attract domestic finance.

Domestic finance may be considered a substitute for direct taxes but such finance may not be forthcoming in sufficient quantity. The government is then forced to borrow from the central bank, creating new money to fund spending, hence driving up imports faster than foreign exchange receipts and weakening the balance of payments. Additional nonexpansionary domestic finance may be secured if the government's borrowing requirements
crowd out the private sector. To attract finance, the government may use increases in interest rates and increases in the requirements for holding government securities. If these measures crowd out private sector credit and expenditures, they will serve to assist the adjustment process. However, too often measures to attract finance to the government do not crowd out the private sector. Private demand for consumer credit remains high despite interest rate increases, and banks borrow from the central bank to satisfy the requirement to hold government securities without reducing the credit to the private sector. The results are the same as if government had borrowed directly from the central bank.

**Overview of Fiscal Policy**

Fiscal policy is complicated by the many tools available and their disparate effects. However, this offers rich scope for tailoring fiscal policy to a variety of ends. For a given deficit the extent of income distribution and the mix of incentives for investment may be varied in response to the country's needs. Fiscal policy must be assessed in a medium-term framework. Certain policies—for example, incentives for investment—need to be sustained for several years to achieve the intended effects. Also, the current year's fiscal policy should be varied in response to future economic performance and past economic performance, as well as the current year's outcome. For example, a one-year fiscal expansion to compensate for temporary loss in export demand is quite reasonable, whereas a long-term downward trend in export demand should not be compensated for in this way.

**Monetary and Financial Policies**

*Interest Rates*

As discussed earlier there is no reason to expect that higher interest rates stimulate savings. Even when interest rates encourage the accumulation of financial assets, they do not improve the return on investment; if there is no more investment, there is no more real saving. It is argued that the interest rate is an efficient credit-rationing device. More competitive firms bid credit away from the less competitive firms, by accepting higher loan rates. However, it is far more likely that consumers will bid credit away from all firms, both competitive and noncompetitive, if willingness to bid up the interest rate is the main criterion. Moreover, firms producing tradables are least able to accommodate rising finance costs because they cannot raise their selling prices; so high interest rates inhibit growth and destabilize the economy by encouraging consumption at the expense of production and nontradables at the expense of tradables.

In any case, central banks in small countries do not have much choice in the determination of interest rates. If Caribbean interest rates are more than a few points higher or lower than comparable rates in New York, Miami, and London, short-term capital moves into or out of the region. There are a variety of perfectly legal ways of moving funds even in countries with the most stringent exchange controls. For example, a firm may elect to borrow at home and to make cash payments for imports rather than negotiate suppliers' credit, if it is much cheaper to borrow locally. When enough firms do that, the balance of trade credits becomes negative and the country is financing all its transactions with foreigners rather than making use of a foreign exchange float, provided by foreigners. In addition, there are numerous illegal channels for financial flows that central banks and national governments have no effective means of detecting, even when balance of payments statistics reveal evidence of their existence.

The interest rate policy reflected in the publications of the Central Bank of Barbados stresses that interest rates should be kept at the minimum level consistent with the underlying trend in international interest rates. The thrust of the policy is to avoid erratic fluctuations to which international interest rates are subject and, at the same time, not to
allow wide gaps between local and foreign interest rates to be sustained long enough to encourage short-term capital flows. It is a policy that is highly recommended.

**Reserve Requirements**

Many economic adjustment programs in the Caribbean include reserve requirements because they are presumed to reduce credit to the private sector. How is this achieved? If banks do not hold excess reserves, an increase in the reserve requirement results in a switch from government securities in the first instance. The central bank has to replace the finance that the banks previously provided for the government, and there is no effect on credit for the private sector. To make the increase in reserves effective, credit to the government by the banks must be locked in as well. The financial system will then resort to discounts from the central bank and to foreign borrowing to satisfy an active demand for credit by the private sector. Both these avenues must be cut off by regulation.

We now appear to have a straightjacket on the supply of credit, but that is an illusion. The scarcity of credit drives up interest rates, widening the gap between local and foreign rates and attracting short-term foreign finance to augment the supply of loanable funds. In some instances the increase in reserve requirements may dampen the demand for credit temporarily, but that effect should not last.

**Lending to the Government**

Efforts to divert funds to the government, often desirable for adjustment purposes as mentioned earlier, are likely to have a similar outcome. Two measures can be used for this purpose: the central bank can require more financial institutions to hold government securities and it can increase interest rates on government securities. In either case, financial institutions must be denied access to other sources of funding for credit to the private sector when they are forced to divert funds to the government. As a scarcity of funds emerges, it is likely to provoke an increase in interest rates and an inflow of foreign short-term finance.

**Central Bank Sales and the Purchase of Government Securities**

Open market operations have essentially the same result. The central bank offers government securities for sale to financial institutions at attractive discounts. Funds are diverted from credit to the private sector, the private sector bids up the interest rate, and short-term funds flow into the economy.

**Credit Controls: Global and Selective**

Credit controls may put a temporary damper on credit and perhaps expenditure, either globally or in selected areas such as consumer credit. But if the controls remain in force for any length of time they are circumvented by informal financial arrangements of one kind or another. Devices that have sprung up in the Caribbean include a revival of partnerships and "sou-sous," direct lending that bypasses the financial system, lease and buy-back arrangements, and new institutions registered under nonfinancial legislation to carry out what are essentially financial operations.

**Specialized Financial Services**

Special discount facilities, exchange rate guarantees, and export guarantees are instruments that the central bank can use to support the expansion of the tradables sector. So far, however, their impact in the Caribbean countries has been quite small. The promotion of stock markets, another much heralded financial innovation, has also had limited impact. Perhaps little better could be expected given the small size of the Caribbean economies.
**Exchange Controls**

Exchange controls increase the cost of making foreign exchange transactions; they have no other effect. They fail completely in their intended purpose, which is to ration foreign exchange. Anyone who is denied foreign exchange under the official channel offers to buy from unofficial channels. If it is too difficult or dangerous to buy locally, foreign exchange is always available for local currency in North America, where such transactions are perfectly legal if one is prepared to pay the huge discount. Once foreign exchange earners recognize that they may profit substantially by selling unofficially, they may readily make arrangements to divert a large part of their earnings from official foreign exchange repositories.

**Overview of Monetary and Financial Policies**

There are few financial policy levers that actually work. Credit controls, reserve requirements, and exchange controls may have a short-term impact on credit and may cause a pause in the growth of national expenditure. Government’s need to put other expenditure adjustment measures in place during this breathing space. If they continue to rely on financial measures, the private sector will soon make necessary adjustments and expenditure will revive. Innovative financial services may help support exports and the growth of output, although they cannot be depended upon as the main stimulus.

**The Recommended Policy Regime**

In formulating their fiscal and monetary policies, governments must first establish a framework of analysis that will distinguish those policies that show promise from those policies that are not applicable. That is the intention of this simple model. It also allows authorities to identify the possible limits to economic growth. It requires a detailed assessment of the main fiscal adjustment measures with respect to revenue, expenditure, and financing and of their impact on the growth of income, the adjustment of the balance of payments, and the distribution of income. Governments require associated policy information on the consumption of essential services and the state of the infrastructure. They may then establish fiscal targets for a chosen multiyear horizon and simulate and deduce the associated exchange rate and monetary adjustments that might help them arrive at the targets.

The policy regime must be tailored to fit the country’s circumstances. Countries that are suffering from a prolonged debilitating economic crisis will need to drastically reduce the scope of government activities until they arrive at a core of public services, however few, that may be effectively delivered by the existing government. Countries facing a severe balance of payments disequilibrium will need to reduce the fiscal deficit, targeting expenditures on basic services and infrastructure. They may need to accompany the fiscal adjustment with devaluation and higher interest rates if the market deems the current levels are unsustainable. Countries with no balance of payments adjustment problem should seek to stimulate investment in the tradable sector directly or by suitable incentives and should try to improve the welfare of their least advantaged citizens.

**References**


WAGE PRICE POLICIES FOR INCREASING INTERNATIONAL COMPETITIVENESS IN THE CARIBBEAN

Courtney N. Blackman

The failure to treat wage rates as a controllable policy variable, and hence to recommend an incomes policy, has been a costly error on the part of Caribbean economists. In fact, wage rates in the Caribbean have for a generation been administered by trade unions, governments and, more recently, by the International Monetary Fund. Only a few Caribbean economists have assigned a role to wage restraint in macroeconomic management, and many still dismiss incomes policy as unworkable (see, for example, Worrell 1987: 217-18). Some Cave Hill economists, in mistaken application of the Keynesian closed-system model, have applauded inflated wage awards as a means of stimulating aggregate demand. The Trinidad and Tobago experience has demonstrated conclusively that the consequence of Keynesian-type remedies in open economies is a balance of payments deficit.

Sir Arthur Lewis recommended an incomes policy to Caribbean governments as early as 1964 and again in his brilliant presidential address at the annual general meeting of the Caribbean Development Bank in 1972. However, it was fashionable in those days to decry the future Nobel prize winner as "Afro-Saxon," "neoclassical," and "nonprogressive."

Even without the stamp of academic approval, Caribbean governments have resorted to wage restraint when nothing else seemed to work. Both the Barbados Labor party and the Democratic Labor party when they were in opposition, flayed the incumbent administration of Barbados for breaking off negotiations with trade unions and legislating wages, only to do the same when they came into power. The Guyanese government foreshadowed the Thatcher wage-restraint technique of trade union bashing; the Jamaican government has used frequent currency depreciations to cut real wages; the Chambers administration in Trinidad and Tobago imposed its famous "one-two-three" wage settlement for the civil service—a 1 percent increase in the first, 2 percent in the second, and 3 percent in the third year. The Robinson administration went beyond wage restraint to cut civil service salaries by 10 percent.

This chapter argues that an incomes policy is an essential tool for macroeconomic managers in the small open economies of the Caribbean. First, it supplements fiscal and monetary policy by restraining aggregate expenditure and, considering the high propensity to import in the Caribbean, it cuts imports; second, by restricting the price of nontradables, it curbs domestic inflation; and third, by limiting the price of tradables, it improves international competitiveness.

Competitive Environment of CARICOM

The economic environment of CARICOM has been marked in recent decades by increasing volatility, dynamism, and competitiveness. Emerging from the safety of Commonwealth commodity preferences and the security of marketing arrangements with metropolitan mother companies, Caribbean producers are now being exposed to competition from other
developing countries. At the same time, they are confronted by the protectionism of the industrial countries. The last vestiges of imperial concern—the Lome Convention, the Caribbean Basin Initiative, and the Caribbean-Canadian Initiative (CARIBCAN)—promise more than they deliver.

In the period immediately after World War II, Caribbean commodities, such as sugar and bananas, enjoyed preferential markets in the United Kingdom and, to a lesser extent, in Canada and the United States. Trinidad's oil, Guyana's sugar and bauxite, and later Jamaica's bauxite and alumina were produced by British, Canadian, or American multinationals and their access to world markets was ensured. At the same time, regional financial markets and, indeed, the Caribbean monetary system were integral parts of the sterling area and the region's balance of payments protected by the limitations imposed by the Currency Board System.

These protective arrangements began to disintegrate in the 1960s under the pressure of three main forces (1) political nationalism, (2) economic nationalism, and (3) the coming of the Information Age. Beginning in the early 1960s, Anglophone Caribbean islands moved in regular succession toward independence. Today only Anguilla, the Cayman Islands, the Turks and Caicos, Montserrat, and the British Virgin Islands remain British colonies. In the 1960s economists of the strident New World Group provided the ideological stimulus for delinking the Caribbean economies from "dependence" on the metropoles. (In fact, formal dependence has been replaced in some instances by the even more complete economic tutelage of international creditors.) Meanwhile, the New Information Age, brought into being by fantastic developments in transportation, computers, and telecommunications, has transformed the world into a global village. Countries are now increasingly sensitive to events in remote parts of the world.

With the global village has come the global marketplace and the global workplace. Multinationals now purchase raw materials and components from the cheapest sources, assemble them in the most efficient production centers, and sell them into the most lucrative markets. They indulge in what might be called "production arbitraging," to borrow a term from the world of finance. If they find that products can be produced more economically in the Philippines, they close their plant in Barbados (as Intel Corporation did). If shirts can be produced cheaper in Thailand, then orders are shifted from Jamaica. As the old colonial ties fade, countries move inexorably into a world of competitiveness.

Reflecting these revolutionary changes, the international economic and financial environments have spawned numerous problems. The terms of trade, for example, have turned sharply against commodity producers like CARICOM. At the same time, interest rates and exchange rates fluctuate violently as vast volumes of capital move daily from one financial center to another in search of the highest rates of return.

The new competitors that Caribbean countries face are other developing countries in the Pacific Basin and Latin America. They compete as suppliers of garments, electronic parts, and other manufactured components in the markets of Western Europe and North America. They also offer their sand, sun, and sea to European, North American, and, increasingly, to Japanese tourists.

The important considerations in this new environment are political stability, the quality of the infrastructure, and labor costs. It is in the area of labor costs that Caribbean countries' rivals have a competitive edge. Although up-to-date comparative statistics of wage rates are difficult to obtain, the most recent data available to the Investment Promotion Agencies of Barbados and the OECS indicate that wage rates and productivity in the OECS countries are comparable to those in other Latin American countries and are at about the same levels as those of Hong Kong and Korea (see Tables 3.1 to 3.4). But they are far above those of China, Thailand, and Sri Lanka. Wage rates in Jamaica are slightly higher than in the OECS; rates in Barbados and the Bahamas are about twice as high and are comparable to those of Taiwan and Singapore. Rates in Trinidad and Tobago, which were the highest in CARICOM during the oil boom, are now somewhere between those of Jamaica and Barbados.
A fierce Latin American rival of CARICOM is Mexico, which, in cooperation with the U.S. government, has developed a series of industrial estates ("maquiladora") on its northern border with the United States. A large number of American and Japanese firms have also established themselves on the U.S. side of the border to facilitate production-sharing with the Mexicans. There is a continuous flow of components and materials south of the border for further manufacture or assembly, and a return flow north of semifinished or finished products. This phenomenon deserves careful study by CARICOM governments and manufacturers. As a tourist destination, Mexico has the additional advantage of proximity to the United States.

Undoubtedly the most formidable opponents of CARICOM are the "four tigers" of East Asia. Their greatest advantage is their exceptional wage productivity, reflecting a culturally inspired work ethic. Singapore and Taiwan, although no longer low-wage producers, employ capital and technology far superior to that employed in CARICOM. Most important, the success of these "four dragons" derives in a large degree from their rigorous policies of wage restraint. All of these countries also have authoritarian governments of some sort and traditionally docile trade unions, a combination that adds up to a most effective incomes policy. This type of incomes policy is not generally available in the CARICOM because of the West European traditions of parliamentary democracy and trade unionism. That is why the experience of small West European states given below is so instructive for the Caribbean nations.

**Strategic Framework of Incomes Policy**

Almost every economic report on the Caribbean begins with a comment on the small size, limited resource base, and openness of the region's economies. European states such as the Netherlands, Belgium, Norway and Sweden also think of their economies as small, as having a limited resource base, and as being highly open. It is helpful to review their strategic response to situations comparable to those faced in the Caribbean.

The central theme of the economic strategies of small West European states is flexible adjustment in the face of international economic developments that are beyond their control. Being small, they cannot, as the Japanese have so adroitly done, transfer the cost of adjustment to other nations by adopting protectionist measures. Instead, they have combined liberal trading policies with compensatory domestic policies. Peter Katzenstein (1985: 44) describes this approach as follows:

For the small European states, with their open economies and fear of retaliation by other governments, exporting the costs of change through protectionist policies is not a viable political strategy. Protectionism would not only invite retaliation but also increase the costs of the intermediate inputs of products manufactured for export, thus undermining the international competitiveness of these small, open economies.

Indeed, Western Europeans have been far more supportive of free trade practices than larger countries such as the United Kingdom, France, Canada, and the United States, not to mention Japan. Sweden and Denmark regard import competition as a useful check on domestic inflation and on monopolistic tendencies in their small domestic markets. Alice Bourneuf commenting on the Norwegian position on this issue noted: "The solution is not to develop industries and protect them from more efficient foreign competition" (quoted in Katzenstein 1985: 40), although favoring liberal international economic regional trading arrangements—Benelux, its Nordic version, and (in the 1950s) the European Free Trade Area.

In monetary matters, the small European states have favored the free convertibility of their currencies and have generally striven for currency stability. For example, Switzerland has pursued conservative monetary policies promoting an extremely strong currency; Austria has pegged to the strong deutsche mark; the Benelux countries have huddled around the deutsche mark under the umbrella of the European monetary system, which will probably
unify West European currencies before the end of the century. Yet they have not been unwilling to devalue when needed, as Sweden did in the late 1970s.

The centerpiece of this compensatory policy is the restraint on wage increases imposed or agreed upon under a national "incomes policy." Occasionally price controls are coupled with wage restraint. Katzenstein (1985: 52) observes: "Economic openness has made the adoption of incomes policies an opportunity with which most of the small European states have experimented in the last two decades."

Three major considerations are at the base of the incomes policies of West European countries. First, they understand the futility, over the long run, of subsidizing inefficient labor. Subsidies to domestic enterprises are calculated to bring their operations to the level of international competitiveness. Restructuring, mergers, and assistance with research and development are encouraged. Second, they respect the imperative of the balance of payments: protected and inefficient labor does not promote balance of payments stability in the long term. Third, they recognize that the wage rate is a production variable that is domestically controllable. What is more, in small and cohesive societies with centrally organized trade unions, the negotiation of sensible wage rates is likely to involve politicians, businessmen, and trade unionists, who have the national interest at heart.

The absence of dogma and ideological grandstanding, an important feature of the West European approach, has promoted a climate of rationality and compromise:

- The strategy of the small European states is flexible, reactive, and incremental. It does not counter adverse change by shifting its costs to others abroad; it does not attempt to preempt change by ambitiously reordering the economy at home. Instead, the small European states continually improvise in living with change. (Katzenstein 1985: 79)

The typical Caribbean response to an uncertain and volatile environment has been almost the direct opposite of the West European reaction. Indeed, the Caribbean nations behave more like big countries than like small ones. They have invited conflict with larger nations and multinationals by nationalizing foreign assets or unilaterally abrogating agreements. Instead of trade liberalization, CARICOM imposed fierce exchange controls and import restrictions. Instead of minimizing intervention, the governments sought to "occupy the commanding heights of the economy," sometimes, virtually the entire economy. Instead of encouraging industrial efficiency, inefficient public sector and private sector enterprises were encouraged with quotas, import licenses, and other protectionist devices. All this promoted rigidity in the industrial policies of CARICOM.

The Caribbean nations paid inadequate attention to their balance of payments. In both Guyana and Jamaica, a balance of payments crisis was triggered in the mid-1970s by policy decisions that wiped out foreign exchange reserves in less than two years. In Trinidad and Tobago, the Bobb Report had warned as early as 1978 that government expenditure patterns were unsustainable. In Barbados, neither the steady decline in manufactured exports since 1984 nor the steady rise in external debt costs have deterred an inexorable increase in government expenditure.

Most notably, CARICOM neglected to institutionalize an incomes policy as a technique of internal adjustment to changes in the external environment. The members of CARICOM have preferred adjustments in real wages to be brought about by traumatic devaluations, which led their economies into a state of chronic crisis.

Incomes Policy in Macroeconomic Management

There are four established objectives of macroeconomic policy: (1) economic growth, (2) full employment, (3) price stability, and (4) balance of payments stability. The Dutch economist and Nobel Laureate, Jan Tinbergen, proved that the number of policy instruments must match the number of policy objectives being pursued. I would identify the minimum policy instruments required in the CARICOM situation as: fiscal policy, monetary policy, incomes policy, and exchange rate policy.
Fiscal policy is the most important instrument with which to achieve economic growth. Before economic growth can take place, investment must increase relative to consumption as a proportion of GDP. Through its budgetary measures, the government may regulate the allocation of income between investment and consumption. As the largest recipient of income, the government must also devote careful attention to its own allocation between capital expenditures and disbursements on wages, salaries, and social services.

Monetary policy is the instrument for achieving the objective of price stability. Ultimately, price stability depends on the liquidity of consumers relative to the availability of goods and services. By controlling the supply of money and credit in the economy, monetary authorities are able to influence the rate of inflation. Monetary policy, through the use of selective credit control and differential interest rates, may also be used to favor investment expenditure at the expense of consumption and thus promote economic growth.

Exchange rate policy is the specific tool that can be used for achieving balance of payments stability. If for some reason a disequilibrium develops between foreign payments and inflows, a change in the exchange rate may restore equilibrium. In the case of a deficit, a currency devaluation increases the cost of imports and reduces the price of exports; in the case of a balance of payments surplus, upward revaluation of the currency produces the opposite effect.

Note that the three policy objectives of growth, price stability, and balance of payments equilibrium are interrelated. Economic growth promotes price stability by increasing the availability of goods and services, thus easing the need for a strong monetary policy; it also increases the volume of exports, promoting equilibrium or surplus in the balance of payments. (Surpluses, in moderation, are easier to deal with than deficits.) Balance of payments stability promotes a favorable climate for investment and growth and thus reduces the need for strong fiscal and monetary policies.

In a regime of floating exchange rates, currency adjustments take place continuously and so a balance of payments equilibrium is automatically achieved. Increased expenditures on imports resulting from excessive wage increases quickly cause the value of currency in the foreign exchange markets to drop quickly, thereby bringing the balance of payments back into equilibrium.

For small developing countries with thin foreign exchange markets, the operation of floating exchange regime would be most hazardous. For this reason, most of them peg their currency to a strong international currency or currency basket and make discrete changes in their exchange rate should their currency move significantly out of equilibrium.

The CARICOM experience has also shown that frequent devaluations can be destabilizing and prejudicial to economic growth by creating a climate of uncertainty and expectations of future devaluations. For this reason, some CARICOM states—most notably the Bahamas, the OECS, and Barbados—have decided to hold the exchange rate steady and to rely on strict fiscal and monetary policies to maintain balance of payments equilibrium. The nature of their monetary arrangements makes it easier for the OECS to conduct this policy: The inability of member states to use the Eastern Caribbean Central Bank to finance fiscal deficits imposes a discipline on both monetary and fiscal policy in that subregion.

Until the 1960s, policies that promoted investment might also have been expected to stimulate employment. This became less true in the 1970s and 1980s. As Peter Drucker (1987: 21) explains, "In the industrial economy itself, production has become uncoupled from employment." An additional policy instrument is therefore required to promote employment. That is where the incomes policy comes in. The restraint of wages slows the rate at which capital is substituted for labor in the production process. Moreover, by restraining wage increases, an incomes policy may prolong the viability of firms and allow them to respond to economic change with some flexibility.

An incomes policy also complements the other three instruments. A lower rate of wage increase reduces the burden on fiscal and monetary policy by restraining disposable incomes.
The slower growth in disposable incomes curbs inflationary pressures in the economy and restricts imports, thus assisting exchange rate policy. Post-Keynesian economists believe that, even in the highly developed market economies, an incomes policy is necessary to achieve price stability.

In dismissing an incomes policy, Worrell throws the full burden of macroeconomic policymaking on fiscal and monetary policy, since he agrees with pegged exchange rates and also proposes exchange rate stability. In effect, he is using two and one-half policy instruments to address four policy objectives. He deplores the chronically high levels of unemployment that plague the Caribbean region but suggests no macroeconomic policy tool to deal with it.

According to the Tinbergen theorem, the additional policy tool of an incomes policy is essential for dealing with the policy objective of full employment, especially when the adjustment of real wages through currency devaluation is ruled out. Without an incomes policy, the economy will adjust to wage increases that are higher than productivity gains by unemployment, even if aggregate demand and aggregate supply remain in equilibrium and foreign payments remain in balance.

If the trend in excessive wage increases continues unchecked, domestic wage levels will eventually render exports uncompetitive and precipitate a balance of payments disequilibrium. This imbalance may be covered through foreign borrowing for some time. However, when foreign exchange reserves run out and a country's creditworthiness is eroded, attempts to correct the balance of payments through tight monetary and fiscal policies will exacerbate rather than alleviate the employment problem, as the examples of Jamaica, Guyana, and Trinidad and Tobago show. A traumatic currency devaluation, or a series of devaluations, will then be carried out to cut the real value of wages and so restore the competitiveness of tradables.

The moral of the story is that in small open economies that decide to maintain stable exchange rates the use of an incomes policy is unavoidable. An incomes policy is even more critical in promoting the international competitiveness of small open economies. Small size implies narrow domestic markets and, as we have so painfully learned in the Caribbean, viable manufacturing enterprises cannot be sustained by only the island markets and hardly by any regional market. Short of capital and heavily dependent on imported raw materials and intermediate goods as inputs for this production systems, the Caribbean countries find labor cost the only variable that they can control to increase competitiveness. All other factors of production are available to their competitors on the same terms. Thus increases in wages in excess of productivity gains must inevitably lead to losses and the ultimate collapse of enterprises, with subsequent unemployment. The process is painfully well-known in Trinidad and Tobago and Barbados, where the decline in wage cost competitiveness has led to significant job losses. Similarly, a wage level that is too high will deter new investors, as the sharp decline in new foreign business startups in Barbados also demonstrates. Existing firms are more prepared to trim labor costs and hold on as long as possible in defense of their original investment.

Excessive wage increases will slow new investment; hence they will slow job expansion and export earnings. An intelligent incomes policy would address this problem. That is why governments need to intervene in the wage-determination process.

Aspects of Incomes Policy

An incomes policy may be described as a continuing program, whether formal or informal, for the regulation of wages and salaries so as to reflect changes in productivity. It is a process of continuous dialogue and negotiations between the government, business, and labor unions, with the government acting as an intermediary when a consensus cannot be reached.
The incomes policy is a multifaceted instrument, hence its versatility and effectiveness. There are ten measures that might be used at some time or other in the application of an incomes policy.

1. **Wage Cut or Voluntary Give-Back.** Wage cuts are usually imposed by governments in extreme circumstances as a means of saving public sector jobs, as was the case recently in Trinidad and Tobago. Such a drastic measure is expected to have a demonstration effect on the private sector. Both the Netherlands Antilles and Aruba have used cuts in the civil service and public enterprise wages and salaries as a substitute for a currency devaluation, the effects of which they considered unpredictable and more damaging. American trade unions, especially in the steel, automotive, and airline industries, have frequently agreed to enormous "give-backs" in the form of reduced wages and benefits in order to ensure the survival of the enterprise.

2. **Wage Freeze and Price Control.** Wage freezes are frequently used as a shock treatment to halt spiraling inflation. They are usually imposed in tandem with price freezes. Price freezes are difficult to sustain over long periods except in times of national emergency. However, they can provide a welcome breathing space in which more comprehensive and sustainable policies can be initiated.

3. **Wage Restraint.** Wage restraint is based on the principle that wage and salary increases should be related to gains in productivity. Indeed, the traditional practice of linking wage and price increases has no basis in economic logic. Indeed, the only means of curbing inflation is to ensure that wage and salary increases fall short of the rate of increase in prices. In periods of declining sales, wage restraint reduces the incentive of management to lay off workers in the short run or to substitute capital for labor over the long term.

4. **Wage Inflation.** The establishment of a statutory minimum wage technically falls under the rubric of incomes policy. In a rare move in the 1970s, the government of Singapore deliberately stimulated a rise in wages for the declared purpose of squeezing low-wage industries out of business. It had concluded that the use of Singaporean labor in low-tech jobs was uneconomical. This policy created difficulties during the 1981-82 recession.

5. **Differential Wage Increases.** Under an incomes policy, governments may deliberately promote wage and salary differentials in order to stimulate the supply of strategic skills. In the Caribbean, especially in Barbados, the practice of granting progressively lower percentage increases to senior staff has so compressed wage scales as to provide little incentive for senior officers to take on increased responsibility.

6. **Tradeoffs.** Governments may trade cheap social services or income tax concessions that raise real incomes in return for reduced wage increases. This technique is quite common in Western Europe. The late Prime Minister Tom Adams tried this once in Barbados—without success.

7. **Employee Share Ownership Plans (ESOPs).** ESOPs, a form of payment in kind, have become popular in the United States. They reduce cash payments to employees and improve the cash flow of the enterprise. In effect, the employees trade off current earnings in return for job security, future earnings, and a share in the management of the enterprise.

8. **Flexible Wages.** It is the practice in many Japanese enterprises to pay a relatively low base wage, and to offer an annual bonus that varies with the profitability of the firm. This reduces the pressure on the enterprise to lay off workers in periods of declining profits.

9. **Retreading.** Retraining enables workers to earn higher wages from their improved skills. Retreaded workers may be moved out of "sunset" into "sunrise" industries, with the cost met entirely by the government or shared between government and private enterprise. Sweden is most famous for this practice.

10. **Corporate Strengthening.** Government subsidies are sometimes extended to failing enterprises to assist them in restructuring or forming merger programs as a means of restoring their viability. The purpose of this measure is to protect jobs and increase the future earnings of workers.
Conclusion and Recommendations

The ten measures just described are not likely to succeed if applied, as CARICOM has hitherto done, in a piecemeal and haphazard fashion. An incomes policy is a comprehensive program of indefinite duration in which the major participants in the wage determination process conduct an ongoing study and review of labor markets and engage in consultations and negotiations about appropriate wage and salary levels in the economy. In short, an incomes policy must be institutionalized.

The fact that both business and labor are already centrally organized in most CARICOM states would make it easier to introduce an incomes policy, which is essentially a political process. The failure of the British Labor party to institute an incomes policy in the 1970s was due to the extreme fragmentation of British trade union management.

The purpose of an incomes policy is not to set rates for every individual job, but to establish guidelines, ceilings, and floors. The majority of salaries and wages, especially in small and family businesses, would be market determined. Sometimes, and only if absolutely necessary, minimum wages would be established.

The institutionalization and successful operation of an incomes policy cannot take place unless the following conditions are present:

1. A consensus must emerge in society at large to the effect that the wage rate is an important factor in the achievement of economic growth, price stability, balance of payments equilibrium, and full employment; and that it is critical to international competitiveness. In this respect, it would help greatly if academic economists would accept that the wage rate is an administered price, which depends on the attitudes brought to the negotiating table by business, trade unions, and government officials. The wage rate does not emerge from the blind workings of the market. Moreover, labor is the only factor of production over which we may collectively exert considerable control.

2. Governments must take the lead in the institutionalization of incomes policies. They must be continuously involved in the wage determination process; they cannot regard themselves merely as rescuers, intervening only when negotiations are hopelessly deadlocked.

3. The trade union movement should liberate itself from obsolete images of commerce and industry in which management and labor are perceived as natural opponents. This would enable industrial relations to move forward from confrontational zero-sum conflicts into the arena of positive-sum games.

4. Similarly, business must develop greater openness in its dealings with staff and trade unions. Participative management should be gradually developed and staff encouraged to have a stake in the enterprise through ESOPs.

5. The government, in close cooperation with labor and business, should promote greater flexibility in the labor markets so that the improved operation of market forces may progressively reduce the burden on incomes policies. For example, experiments with flexible wages should be initiated. Pension rights should be made more portable. Severance payment schemes should be reformed so as to facilitate mergers and the restructuring of ailing businesses. Programs should be developed for retraining workers with obsolete skills, and opportunities provided for low-paid workers to improve their skills and marketability. Finally, the flexibility of labor markets would be greatly enhanced if the plethora of impediments to the free movement of skilled labor within CARICOM were eliminated.

References


### Table 3.1 Average Direct Labor Cost by Country

<table>
<thead>
<tr>
<th>Country</th>
<th>Wage (U.S. dollars per hour)</th>
<th>Fringes(^a) (percent)</th>
<th>Total(^b) (U.S. dollars per hour)</th>
<th>Effective(^c) (U.S. dollars per hour)</th>
<th>Percentage of Barbados Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barbados</td>
<td>1.61</td>
<td>35</td>
<td>2.17</td>
<td>2.53</td>
<td>100</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>0.86</td>
<td>50</td>
<td>1.29</td>
<td>1.40</td>
<td>59</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>0.60</td>
<td>45</td>
<td>0.87</td>
<td>0.99</td>
<td>40</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.75</td>
<td>37</td>
<td>1.03</td>
<td>1.44</td>
<td>47</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>5.76</td>
<td>41</td>
<td>7.66</td>
<td>8.79</td>
<td>353</td>
</tr>
</tbody>
</table>

\(a\). Fringe as percentage of direct labor cost.
\(b\). Total includes only required fringes plus base pay.
\(c\). Total paid per actual hour worked.

*Source: Mentor Interviews, Mentor International.*

### Table 3.2 Comparison of Indirect Monthly Salaries (U.S. dollars)

<table>
<thead>
<tr>
<th>Job</th>
<th>Barbados</th>
<th>Costa Rica</th>
<th>Dominican Republic</th>
<th>Mexico</th>
<th>Puerto Rico</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product manager</td>
<td>650</td>
<td>740</td>
<td>583</td>
<td>872</td>
<td>4,500</td>
</tr>
<tr>
<td>Quality control manager</td>
<td>n.a.</td>
<td>594</td>
<td>1,083</td>
<td>734</td>
<td>4,000</td>
</tr>
<tr>
<td>Plant engineer</td>
<td>1,200</td>
<td>440</td>
<td>975</td>
<td>1,190</td>
<td>2,916</td>
</tr>
<tr>
<td>Quality control Inspector</td>
<td>n.a.</td>
<td>158</td>
<td>100</td>
<td>311</td>
<td>1,720</td>
</tr>
<tr>
<td>General accountant</td>
<td>1,200</td>
<td>460</td>
<td>866</td>
<td>819</td>
<td>2,000</td>
</tr>
<tr>
<td>Analyst</td>
<td>n.a.</td>
<td>473</td>
<td>538</td>
<td>n.a.</td>
<td>2,167</td>
</tr>
<tr>
<td>Computer operator</td>
<td>550</td>
<td>250</td>
<td>n.a.</td>
<td>265</td>
<td>1,273</td>
</tr>
<tr>
<td>Secretary</td>
<td>550</td>
<td>300</td>
<td>866</td>
<td>265</td>
<td>1,600</td>
</tr>
<tr>
<td>Clerk</td>
<td>400</td>
<td>170</td>
<td>100</td>
<td>140</td>
<td>860</td>
</tr>
</tbody>
</table>

n.a. = Not applicable

*Source: Mentor Interviews, Mentor International.*
<table>
<thead>
<tr>
<th>Country</th>
<th>Wages (U.S. dollars per hour)</th>
<th>Fringes(^a)</th>
<th>Percentage of U.S. Productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Antigua</td>
<td>US$1.25</td>
<td>28</td>
<td>60 – 65</td>
</tr>
<tr>
<td>Bahamas</td>
<td>2.10</td>
<td>25</td>
<td>65 – 70</td>
</tr>
<tr>
<td>Barbados</td>
<td>2.30</td>
<td>26</td>
<td>70 – 75(^b)</td>
</tr>
<tr>
<td>Dominica</td>
<td>0.83</td>
<td>26</td>
<td>55 – 60</td>
</tr>
<tr>
<td>Grenada</td>
<td>0.75</td>
<td>22</td>
<td>60 – 65</td>
</tr>
<tr>
<td>Guyana</td>
<td>0.70</td>
<td>30</td>
<td>55 – 60</td>
</tr>
<tr>
<td>Jamaica</td>
<td>1.09</td>
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\(^a\) Fringe as percentage of direct labor cost.
\(^b\) In U.S. owned and managed companies in Barbados this ranges from 85 to 95 percent.

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*Source:* Eastern Caribbean Investment Promotion Service.
MAURITIUS: AN EXPORT-ORIENTED ISLAND ECONOMY

Jayshree Sengupta

As islands, Mauritius and the Caribbean countries have many features in common. They belong to the same group of African, Caribbean and Pacific (ACP) countries under the Lome Convention. The convention’s trade provisions granted the European Community (EC) duty-free access, on a nonreciprocal basis, to all ACP exports of manufactured goods and tropical agricultural produce. Mauritius cashed in heavily on its privileged entry into the EC market for its sugar exports. This chapter examines the common points and some of the major differences between the Caribbean countries and Mauritius. Of particular interest is the evolution of the Mauritius economy from import substitution to export promotion and the lessons that the Caribbean countries can draw from this experience. In the future, Mauritius will have to maintain its export growth and the Caribbean countries will have to increase exports so as to achieve a higher rate of GDP growth. Therefore, the Caribbean countries and Mauritius will have to take similar steps in many areas to achieve or maintain a faster rate of economic growth.

Similarities between Mauritius and the Caribbean Countries

As islands, Caribbean nations and Mauritius are all small countries and have to depend on trade for earning foreign exchange. Their small domestic markets and dependence in many cases on a single commodity for export have led to similar sets of problems. All have colonial pasts (Mauritius did not gain its independence until 1968), and until recently all have faced population growth, and unemployment is still a serious problem in many of them. Like Mauritius, the Caribbean countries lie near two large continents and are closely linked to the North American and EC markets. In addition, tourism is a vital ingredient of the economy, although it is more important in the Caribbean countries where it is the prime earner of foreign exchange.

At the same time, there are some differences. Mauritius is a multiracial democracy in which the political scene is dominated by a complex coalition of many parties representative of the racial groups. Private enterprise has shown a great deal of initiative and responded to various incentives. The labor force is educated and easily trainable and the government has been pursuing an export-led strategy for some years now. When shocks and disturbances destabilized the economy, the government was quick to recognize the problems. Mauritius has been successful in implementing economic reforms and in achieving a high rate of export growth and has avoided high international debt and inflation. The government has also managed to keep labor costs low, especially in the manufacturing sector.

Efforts to face up to the population challenge came even before independence when in 1962 a report to the government of Mauritius (the Meade Report) suggested that Mauritius should diversify its economy. The report pointed out that the country’s high population
growth and dependence on one crop (sugar) would only make the employment situation worse and then recognized the limitations of the sugar industry as a means of generating additional jobs.

Like Mauritius, the Caribbean countries have experienced external shocks and slow growth because of falling commodity prices. But, unlike Mauritius, the Caribbean countries have relied more on protection in developing their manufacturing industries, which resulted in various inefficiencies and biases. Manufacturing, in any case has not been the key economic activity in the Caribbean countries and has accounted for only a small percentage (12 percent) of the GDP. It is concentrated around a few activities, and the Caribbean countries depend on a few markets for their exports. All these factors have constrained the performance of exports with the result that low foreign exchange earnings have remained a problem for most of the Caribbean countries. Since the public sector has grown in many of these countries and their public expenditure has become excessive, they have had to rely more and more on external borrowing. The government faces financial problems and overstaffing, yet the movement of wages has outstripped the growth of production. As a consequence, the Caribbean countries are losing their competitiveness, and their balance of payments performance has remained unsatisfactory. Unlike Mauritius, the Caribbean countries lack a supply of trained and skilled labor and more important, a dynamic group of private entrepreneurs. Mauritius exploited its assets well and opted for rapid industrial growth and welcomed foreign investment.

On the agricultural side, most Caribbean countries need to diversify their agricultural activities. As will be discussed below, this has been an important aspect of Mauritian economic growth. Raising agricultural productivity and absorbing the younger generation of agricultural laborers, preventing them from migrating to towns in search of employment, has been a problem in the Caribbean countries. However, Mauritius is now facing the same problem after almost half a decade of rapid industrial growth.

Transition from Import Substitution to Export Promotion

Incentives for Industrial Growth

To encourage industrialization and diversification from agriculture, the government of Mauritius offered a number of incentives and concessions under the Development Certificate (D.C.) scheme introduced through the Development Certificate Act of 1964 to encourage import-substitution industries. The private sector responded, though not too vigorously, to concessions offered by the government. The D.C. scheme encouraged industries for the domestic market—from packaging materials to chemical fertilizers. A D.C. company was given five to eight years of corporate tax exemption and dividends to its shareholders were also exempted for the first five years, beginning in the year of the first dividend. A D.C. holder was provided protection from foreign competition by tariffs and nontariff barriers, and a D.C. company was allowed a rebate of duty on the import content of exports in some cases and outright duty exemptions on imports of equipment and raw materials. All manufacturing industries were owned by the private sector (except the now defunct sack factory and a livestock feed factory that was under public investment). The public sector was important, too, in the area of infrastructural development, health, and education.

1. As a result, the average effective rates of protection (EROP) rose. In 1983 the EROP in electrical machinery was 82%, in leather products 330, textile and apparel 189, metal products 113, paper products and printing 108, beverages and tobacco 79, and in food 24.

2. In late 1971, the First Development Plan was launched (1971-75), followed by the Second Plan (1976-80). Total government expenditure was 25 percent of the total GDP in 1968 and did not increase in real terms during 1968-73.
But the small size of the market prevented economies of scale from being realized. The D.C. firms were unable to compete in the export markets because the high level of effective protection that was granted to them to encourage their growth in fact made them more inefficient. Value added was low because local raw materials were in short supply, and the impact on unemployment was also far less than expected. Thus the limitations of the import-substitution strategy were especially apparent in relation to the unemployment problem. To ease the unemployment situation the government provided a "relief work" program that was to absorb 30,000 workers (relief workers were temporary employees, employed on a four-day basis). But it proved to be a fiscal drain and only a stop-gap measure. In the case of the Caribbean countries, the failure of private sector to provide employment at a suitable pace encouraged the growth of public sector employment.

**Evolution of Export Growth Strategy in the 1970s**

After independence in 1968, the government's main concern was unemployment, which was growing substantially as the labor force was increasing at almost twice the rate of the population. The government sent a team to study industrial development in small export-successful nations, in which manufacturing was export-oriented and free trade zones were in operation. Responding to the recommendations in the team's July 1970 report, the government declared it intended to create an export-processing zone (EPZ). The idea behind the EPZ was to provide fiscal concessions and other benefits that would encourage overseas manufacturing firms with established markets to locate the labor-intensive part of their activities in Mauritius. The incentives included a long-term tax holiday; an option to repatriate profits; and duty exemptions on imports of machinery, equipment, and raw materials. The EPZ also offered the provision of a "literate, adaptable and non-unionized work force" and a guarantee against nationalization. The main purpose of an EPZ was to create jobs and absorb workers laid off as a result of the mechanization initiated by the government in the sugar industry after independence.

Mauritius' EPZ was to be different from the EPZs in other developing countries. This was not a geographically restricted free zone and the EPZ was defined in the most general terms as any area of land on which an eligible factory had been, was being, or was likely to be built. These so-called bonded factories employed mostly underpaid female labor, received certain privileges normally granted to geographically limited zones, and offered potential investors the chance of selecting the site of plants that suited their needs for providing labor, transport, and electricity. The legal framework provided a distinction between EPZ factories and those with Development Certificates and other enterprises, such as those involved in sugar production and processing.

Since the EPZ was created to attract foreign capital, the government provided institutional and administrative support and insurance to protect exporters against defaults by importers. Numerous measures were needed to support the export-led industrialization strategy. For example, the Ministry of Commerce and Industry was restructured. Export services were secured under bilateral and multilateral technical assistance programs with more advanced countries. This assistance compensated for skill shortages within the ministry and bolstered staff strength. New units for project evaluation, monitoring, investment promotion, and export marketing were created. Investment capital was already available from the Development Bank of Mauritius, while commercial banks were providing working capital within the limits authorized by the Bank of Mauritius to foreign-controlled companies registered in the country. Commercial banks also provided term loans either alone or jointly with the Development Bank of Mauritius when the size of the loan entailed consortium lending (Bheenick and Schapiro 1989: 103). From the beginning the export of manufactures was targeted to U.S. and EC markets. (The EPZ firms enjoyed preferential access to the European Community on a duty-free basis under the Yaounde and Lome conventions.)
An unexpected boost to export-led growth in Mauritius came from the sugar sector. During the first half of the 1970s, there was a record sugar crop and a tremendous surge in sugar prices between 1970 and 1974 (which rose twentyfold). The balance of payments improved and investible funds were amply available. They went into EPZ firms because these enterprises had the additional benefit of having a generous allocation of foreign exchange for the importation of raw materials, machinery, and equipment. But the government still felt that foreign investment was crucial for the growth of EPZ exports.

The government of Mauritius therefore launched a coordinated promotional campaign to disseminate information on the Mauritian EPZ, particularly the incentive packages available, through brochures and articles in newspapers, trade journals, and magazines. The government conducted promotional talks and set up displays of attractive features of the Mauritian economy at industrial and trade fairs. It also conducted seminars for businessmen, industrialists, and potential investors and directly approached foreign investors. In addition, it organized visits to Mauritius of a select group of potential entrepreneurs and representatives of private investment organizations.

Setback in Exports and the Beginning of a Crisis (1979-82)

Export growth began to pick up in 1975-76 but then slowed-down during 1979-82. The political situation had changed, and the repercussions from the two oil shocks of that time and a general world recession were being felt in the industrial countries of the world. There was also a sharp decline in sugar prices in 1976, which, along with the oil price increase, led to balance of payments difficulties. Although the sugar boom had cushioned the first oil shock to some extent, the euphoria over surging sugar prices led the government to enter some risky ventures. Substantial wage increases since 1976 as well as end-of-year bonuses ranging from one to twenty-two months' wages in certain sectors were granted. Both food subsidies and social expenditure were increased as the government pursued goals of a welfare state. Government expenditure as a percentage of GDP went from 22 percent in 1975 to 29 percent in 1976, and to 32 percent in 1978. This resulted in budgetary deficits and accelerating double-digit inflation. The real GDP growth rate declined by 1980. Investment in manufacturing also declined, and expansion of the manufacturing sector came to a halt. There was a sharp drop in foreign exchange reserves and the government had to borrow in Eurocurrency markets. Four-fifths of fixed investment in manufacturing in 1977-81 went to highly protected import-substitution industries (World Bank 1985).

The government also launched an ambitious investment program in infrastructure—building a bulk sugar terminal, harbor, roads and hydroelectric plants. Imports rose because of the increase in EPZ's input requirements from 50 percent of GDP in 1972 to 53 percent in 1973, manufactures' reaching the peak at 65 percent in 1977. As a result the balance of trade deficit widened, and unemployment increased as some of the EPZ firms began to shut down on account of higher wage costs and competition from other developing countries. The Mauritian export subsector grew at the rate of only 4 percent between 1980 and 1983, and production for the internal market also stagnated. All this led to a review of policies by the government, which decided that it needed to reorganize and reinforce existing institutions, create new ones, and modify the incentive structure.

A Change of Policies (1979-88)

The government embarked on a stabilization and structural adjustment program and obtained support from the IMF and the World Bank. The first standby agreement was signed with the IMF in 1979. The stabilization program focused on demand management. The overall budgetary deficit was narrowed from 14 to 7.3 percent of GDP in 1984, the external current account deficit was reduced from 16 percent of GDP to 2.6 percent in 1984, and inflation curbed from 29 percent in 1979 to 5.9 percent in 1983. Central to these stabilization policies was the exchange rate policy, which included a devaluation of the Mauritian rupee.
by 30 percent in 1979 and 20 percent in 1981, with respect to the Special Drawing Right (SDR). In 1983, the rupee was linked to a trade-weighted basket more representative of Mauritius' trading patterns, and a flexible exchange rate policy was adopted. Wage restraints were imposed that allowed wage increases in both public and private sectors to be considerably below the cost-of-living increase. This was achieved through a system of remunerative orders (ROs) that were trilateral agreements among private enterprises, trade unions, and the government on minimum wages, terms and conditions of employment, and job specifications. During 1979-80 and 1985-86, the consumer price index (CPI) increased by a cumulative 134.6 percent while the cost of living adjustment cumulatively allowed average wages to rise only by 48.6 percent. Consumer subsidies were also reduced, and credit and monetary policies became restrictive.

The structural adjustment lending (SAL) program supported by the World Bank focused on promotion and the diversification of exports in agriculture and industry and import substitution in food and energy. Several policy measures were undertaken and import substitution firms were made eligible for the drawback of duty on the import content of the exports in their manufacturing. The export incentives package was extended to firms engaged in export services or the reexport of merchandise. An export credit guarantee scheme was started under the management of the Development Bank of Mauritius, followed by an export credit insurance scheme. An export promotion unit was established in the Ministry of Commerce and Industry. The second structural adjustment program (SAL II) initiated in 1983 put more emphasis on export-led industrialization, and the government implemented a number of policy reforms.

Under the SAL II agreement of 1983, a number of recommendations were made and a program of action was adopted to improve the incentive system, which included the following measures:

1. Quantitative import restrictions were eliminated. By July 1984, quotas on all commodities with tariffs of 30 percent or more had been removed. The remaining quotas were removed by January 1985.
2. Price controls were eliminated. The number of imported products subject to price controls was reduced from thirty-four to eleven, locally produced goods from forty to seventeen; only basic necessities remained under price control.
3. The corporate tax rate system was changed—the effective corporate income tax was reduced from 65 percent to 35 percent and applied to all company profits before the distribution of dividends (June 1984). A system of corporate tax benefits was introduced for exporters operating outside the EEC scheme in which the tax rate would be reduced by 2 percentage points for each 10 percent of the output exported.
4. Wage rates for male workers in the EPZ were liberalized. Previously, the ROs for the EPZ provided for a substantially higher minimum wage for males than for female workers. This had an adverse effect on the employment of male workers. It also imposed a potential limitation on the expansion of EPZ firms in the face of declining supplies of female workers and was a likely source of tension, in the face of rising female employment and high levels of male unemployment. The government therefore decided to eliminate from the ROs the provision specifying minimum wage levels for male factory workers and unskilled laborers in EPZ firms. In response, the employment of males in the EPZ increased, and export production continued its rapid expansion.

Three institutions were created to encourage private, local, and foreign investment: the Mauritius Export Development and Investment Authority (MEDIA), the Industrial Coordination Unit (ICU), and the Mauritian Equity Finance Fund (MEFF). The ICU was created within the Ministry of Industry and Cooperatives to act as a one-stop shop, providing clearances and permits for potential investors. The MEFF was later replaced by the State Investment Corporation. Double taxation agreements were signed with France, United Kingdom, the Federal Republic of Germany, and India to protect EPZ firms.
The World Bank suggested a reduction in the average level and variability of import duties, but the government did not take this step. Further liberalization was feared because of its expected adverse impact on the balance of payments, external reserves, and public revenue. The government was also concerned about the effect lower import duties might have on the financial position of D.C. enterprises, which would become noncompetitive in a liberalized regime. In January 1986, however, some high import tariffs on transport equipment were lowered an average of 25 percent, but the government was not ready to agree to a schedule for phased rationalization of the overall tariff structure.

The government also phased out price controls on many manufactured products—starting with forty items in 1983 down to eight in 1985—the remaining controls were on essential items such as soap, kerosene, and toothpaste. It also reduced the number of items subject to maximum markup from forty in 1983 to eighteen in 1985. Ceilings on maximum markup remained on agricultural products, notably, potatoes, maize, rice, beans, garlic, turmeric, and groundnuts.

All these policy changes had a positive effect on the expansion of EPZ firms. The EPZ’s value added in constant prices expanded at 16 percent per annum during 1981-86, whereas D.C. firms expanded by only 3 percent per annum. The share of EPZ in total manufacturing investment increased from 27 percent in 1979 to 52 percent in 1985. These firms created 30,000 new jobs a year during the 1980s, and EPZ growth was a major instrument for reducing unemployment throughout the economy.

The Experience of Economic Reforms

The Process of Economic Reform

The reforms were by and large successful but the process was stressful. The weather created havoc in 1980 and again in 1983-84. Cyclone damages made adjustment difficult. The terms of trade also deteriorated in the early 1980s. But Mauritius was able to ride out huge financial imbalances in the 1980s because of a substantial expansion in EPZ exports. As a result of the performance of EPZ firms and the implementation of policy reforms, by 1986 the balance of payments was in surplus and the budget deficit had diminished. The local production of food items increased and less food was imported, all of which helped improve the balance of payments. Reduced public expenditure in real terms from 1979 to 1982 played an important part in stabilizing the economy.\(^3\)

Many dramatic changes took place in the political scene during the reform period (1979-86) but there was little basic change in the economic policy of the successive governments. The sequencing of the policy package adopted by Mauritius had been discussed in detail by government officials and the cabinet. Three different governments were involved in carrying out the reforms, but continuity and political stability were maintained.

The government undertook the economic reforms in two steps. The first, carried out over 1979-82, was mainly concerned with introducing stabilization policies and controlling aggregate demand. The second began in 1983 tackled sectoral problems. The stabilization policies were focused on rising unemployment, declining real wages, and the reduction in public expenditure. The second step was aimed at the sugar sector and the import protection regime for manufacturing D.C. enterprises, nonsugar agriculture, and tourism.

\(^3\) Total government expenditure was almost constant in real terms during 1981-84 and increased by only 3.4 percent during 1984-86. Current expenditure continued to rise on account of an increase in debt-service payment. In 1984-86 the current expenditure in real terms also stabilized because the ratio of most categories of government expenditure to GDP was significantly reduced over the reform period. No new projects were started and there were expenditure cuts in health, education, and housing. Investment in agriculture, tourism, and industry, constituted 20 percent of the total during the same period.
Sectoral Reforms

Mauritius, like the Caribbean countries dependent on sugar exports, wanted to diversify agriculture away from sugar production, but the dependence on sugar exports remained strong. During the 1960s, the government attempted to diversify by taxing sugar exports and protecting import-substituting industries. A tax on sugar was introduced at a uniform rate of 5 percent of the gross value of exports in 1961. The rationale was purely fiscal. In 1975 the sugar tax assumed a redistributive rationale in addition to the fiscal one. Small planters were exempted, and the principle of progression was introduced in the rate structure. The average tax rose from 6 percent in 1972 to 22 percent in 1979. In addition, estates were subject to a corporate tax at the rate of 55 percent on income after the payment of dividends.

In the late 1970s the sugar sector was besieged by financial problems owing to the collapse of world sugar prices and rising costs. The government decided to revamp the sugar sector and reduced the export duty on sugar in 1985 from an average rate of 23.5 percent to about 19 percent in the case of planters who were also millers. The tax relief was earmarked for investment in the sugar mills and other sugar-producing equipment. This increased the fixed assets of sugar estates from 1984 on. The government's objectives for the five-year period beginning in 1985 have been to rehabilitate and modernize sugar mills, strengthen the financial performance of the sugar mills, improve the productivity of the sugar sector, improve irrigation, promote the use of bagasse to generate power, improve small planters' productivity, and provide better research and extension support. To a large extent the government was successful in attaining these goals.

The government also aimed at reducing the dependence on imported food items. The nonsugar sector—comprising largely tea, tobacco, food crops, fishing, and animal husbandry—is dependent on the productivity of the sugar sector and the extent of land released from sugar without reducing capacity output. Diversification was needed to achieve self-sufficiency in a selected number of food crops and to reduce the dependence on imported meat, fish, and milk. The government also wanted to improve marketing and other institutional facilities to provide better support and security for producers. Because of the limited supply of arable land, nonsugar production has been expanded by crop rotation, multiple cropping, interplanting other crops with sugarcane, and converting the land meant for sugar cultivation to the production of other crops. The government's diversification has been successful in achieving self-sufficiency mainly in potatoes and in increasing production in a number of other staple food items.

The production of fish also improved as a result of government policies, which included the construction of a fishing port, decontrol of fish prices, and the lifting of export restrictions. Mauritius imported the bulk of its dairy products and meat (91 percent and 90 percent, respectively, in 1983). The aim of government policy has been to increase the market share of local produce to 40 percent. In many of the products, this goal was not achieved, although several policies have been implemented to this end—such as the control of cattle movements to prevent illegal slaughter, the restocking of breeding stations, fodder plantings, and an increase in cattle-feed subsidies.

The Government's Role in the Industrialization of Mauritius

The government played an important role in Mauritius's export growth. Unlike the Caribbean countries, which have been relatively passive in international negotiations, Mauritius fought for an increase in the sugar quota under the Lome Convention. The government also actively supported export-led growth, encouraged agricultural diversification, promoted the tourism sector, and undertook fiscal reform. Government's activities in various sectors of the economy are detailed below.

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4. The share of sugar export to total exports declined from 60 percent in 1981 to 41 percent in 1985.
INFRASTRUCTURE. Even though the government has left the development of the industrial sector to private initiative, it has helped provide the necessary infrastructure for export promotion. The government has invested in the construction of industrial estates, which are then leased to EPZ companies at concessionary rentals. The government's MEDIA has managed industrial estates, coordinated information, and given official clearance for new investors. The government has managed to convert Mauritius from a monocrop economy into an industrializing middle-income country in two decades.

PROMOTION OF EPZ DEVELOPMENT. Much of the spectacular change in the Mauritian economy was due to the contribution of EPZ firms that the government vigorously encouraged (see Table 4.1). As a share of total value added of nonsugar manufacturing, the EPZ's contribution rose from 33.4 percent in 1980 to 38.8 percent in 1983, 47 percent in 1984, and 55.4 percent in 1985. Total employment in the manufacturing sector benefited greatly over 1980-85 when the share of EPZ rose from 59.7 percent to 85.8 percent and new jobs were created in textiles and weaving apparel. The expansion of existing firms was responsible for 67 percent of the new jobs (IMF 1986: 15). EPZ firms, although subject to the general laws governing imports, have enjoyed exemptions from many regulations. For example, EPZ firms can fire workers without giving them any severance pay and can reduce the number of jobs without advance notification to the Board of Termination of Contracts. A by-product of the increased employment expansion of female labor in the EPZ was a reduction in fertility rates.

TAX INCENTIVES FOR INDUSTRIALIZATION. The government also tried to encourage domestic industries engaged in import substitution to shift to export production. Tax incentives were revised and standardized for all exporters in 1985-86. A graduated corporate tax reduction was introduced for companies that shifted output 100 percent. Such units were to pay a maximum corporate tax rate of 15 percent, the same rate as EPZ companies set up after July 1, 1985.

BOOST TO TOURISM. The government also tried its best to boost tourism. After sugar and EPZ, tourism is the third most important source of foreign exchange. Earnings from tourism, after peaking in 1979, declined in 1982. The slowdown was due to the rise in air fares related to the oil price increase and the subsequent recession in tourist-generating countries. There was also an increase in competition from rival tourist destinations. But the sector's earnings picked up in 1983 and 1984, when arrivals increased 4.6 percent and 12.8 percent, respectively. This recovery reflected the general recovery in international tourism.

The government promoted two schemes to provide incentives for private investors. Hotels and tourist-related facilities could be set up under the D.C. scheme or under the Hotel Management Certificate scheme. These schemes allow the investor a reduced corporate tax rate of 15 percent with dividends exempted from taxes over 10 years. The foreign investor is also allowed to repatriate invested capital, and all investors under the scheme are able to get local bank credit at preferential rates. Such incentives led to a 28 percent increase in the number of hotels between 1980 and 1985. Air access, which is very important, has been improved since Air Mauritius began providing access from Europe, Africa, and Asia.

ROLE IN WAGE POLICY. The government has played an important role in wage policy, intervening in labor markets frequently to maintain the competitiveness of Mauritian exports. The government could have crushed all militant trade unions but this was not considered a desirable option because of the country's strong trade union tradition and democratic political system. The Industrial Relations Act of 1973 instituted the system of Remunerative Orders (ROs), the tripartite agreement between the enterprises, trade unions, and the government on minimum wages, terms and conditions of employment, and job specifications.

In 1974, a system of cost of living adjustments (COLAs), was superimposed on ROs. All these labor policies applied to all economic sectors except EPZ firms. The impact of government intervention was that the compensation levels in the early 1970s were highest in
the government sector, sugar sector, and manufacturing firms catering to the home market and were lowest in EPZ firms. The high compensation for government workers was designed to attract people to the civil service, and the high compensation of sugar workers compared with those in manufacturing was due to the large nonwage benefits won by the stronger trade unions in sugar. The compensation in EPZ was low because it was excluded from labor laws.

**INTERNATIONAL NEGOTIATIONS.** The government was instrumental in negotiating various trade preferences that helped the sugar sector, and its foreign exchange earnings, which were later invested in the EPZ, facilitated the growth of manufactured exports. Before independence, Mauritius already had a quota of 386,000 tons of sugar in the United Kingdom under the Commonwealth Sugar Agreement. Under the Lome convention the government secured a quota of 505,000 tons in the combined EEC markets. The government also secured a quota of 29,000 tons in the U.S. market. The gains proved to be large since prices in the EEC and U.S. markets remained at a higher level than in the free market. During 1980-86 EEC sugar prices averaged 54 percent above the free market price and the EEC dividend equaled US$ 800 million. In the absence of these preferences, Mauritius would have faced foreign exchange problems that would have prevented the rapid expansion of EPZ.

**BUILDING HUMAN CAPITAL.** The government has also helped build up human capital and impart skills to the labor force. It has provided free education at the primary and secondary level since 1977, with the result that Mauritius now has a 90 percent literacy rate, and technical training has been available at the Industrial Trade Training Centre. In addition a new center and the Lycee Polytechnique have been in operation since the early 1980s to train people in industrial and other skills. The University of Mauritius also provides courses in various areas of agricultural administration and industrial technology.

**INCENTIVES FOR THE DIVERSIFICATION OF AGRICULTURE.** The government has introduced several incentives for the diversification of agriculture, made possible through the release of land from sugar production. The yield of small sugar producers rose. Self-sufficiency in food crops has been sought on political grounds and aided with subsidies, even when the cost of production was higher (as in the case of rice). Perhaps it would have been better to cultivate cash crops for export, such as tropical fruits, vegetables, flowers, and potted plants. The problem of mechanizing of agriculture remains largely unsolved (because of the rocky soil).

**STABILIZATION MEASURES AND MAINTENANCE OF A COMPETITIVE EXCHANGE RATE.** The government has maintained a competitive exchange rate, a very important factor for competitiveness, and has not resorted to exchange controls or import restrictions to the same degree as the Caribbean countries. The government undertook various stabilization measures and was also successful in controlling inflation. The short-lived surge in inflation during the early 1980s, caused by the substantial depreciation of the rupee and sharp increase in import prices, was subdued in 1985. Through appropriate fiscal and monetary policies, the government helped exports to grow. It also reduced public expenditure and the budget deficit. The government also tried to restructure parastatals by reducing the number of workers and by privatization. But progress in this area has been limited. Many of the large parastatals continue to be a substantial budgetary burden, and overstaffing remains the government’s most difficult problem.

**Lessons and Applicability to Caribbean Countries**

Even though Mauritius has emerged as an important exporter of manufactures, the range of its products is limited by and large to garments and knitwear. In addition, its

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5. Sugar production increased from 8.08 metric tons per hectare in the 1950s, to 8.88 metric tons in the 1970s and to 9.90 metric tons in 1980s. Between 1977 and 1987, the area under cane cultivation declined by 3.8 percent.
industrializing experience has been constrained by the narrowness of the market. About 90 percent of its EPZ exports go to the European Community and North America. In the past few years, Mauritius has had to negotiate bilateral voluntary export restraint agreements with Ireland, France, and the United Kingdom. In addition, Mauritius has export quotas in the U.S. and Canadian markets. Mauritius will have to move into the second stage of industrialization based on light engineering goods, high-tech products and also explore the possibilities of higher value added. Thus far the EPZ firms have not been able to develop many of the backward and forward linkages needed by the Mauritian economy to make the transition into a higher stage of industrial development and sustainable growth. This means that the EPZ failed to create processing firms and ancillary industries in the domestic sector and that all the intermediate inputs were imported because of the special concessions offered by the government.

The Caribbean countries can draw the following lessons from the Mauritian experience:

1. Unlike the Caribbean countries, Mauritius set out on a clear path of export-led growth once it recognized that an import-substitution strategy was not going to lead to rapid industrial growth. From the very outset, foreign capital was to play an important role. Foreigners were attracted by the availability of cheap trainable labor, and by the various incentives and access to the EEC and the U.S. markets from plants operated in Mauritius.

2. By developing agriculture at the same time and by giving price incentives, the government was able to regulate the flow of agricultural labor into urban areas, thus avoiding the problem of unemployment. Like the Caribbean countries, the Mauritius government decided to diversify agriculture and improve the productivity of sugar production. Mauritius successfully managed to release land for the production of other crops and, through increased productivity, was able to reduce the country's dependence on imported food.

3. Mauritius was successful in reducing its public expenditure. Although it also sought to increase the efficiency of parastatals, it was only moderately successful in this task. The government did succeed in narrowing the budget deficit but only through a reduction in public expenditure and by giving the high fiscal incentives that increased revenue. It thus avoided the problems of excessive external borrowing and indebtedness faced by some of the Caribbean countries (notably, Antigua and Barbuda, Guyana, and Jamaica). Of course, some Caribbean countries have improved the management of public sector savings as a percentage of GDP, just as in Mauritius has done.

4. By controlling wages through a unique system of tripartite agreements, Mauritius kept its exports competitive. The growth of the EPZ exports, generated an inflow of foreign exchange, which was reinvested in the sector. The high level of domestic investment in EPZ firms is noteworthy. Mauritian nationals control nearly 50 percent of the equity in export enterprises, a high percentage by international standards. However, the diversification of exports from textiles and knitwear has not been achieved, and the narrowness of the country's export products exposes it to protectionist barriers among the industrial countries. The same is the case in Caribbean countries whose exports of manufactures are concentrated (textile items) and go to a narrow range of external markets.

5. Unemployment continues to be a major problem in the Caribbean countries, and is now close to about 25 percent of the population. Mauritius, in contrast has almost full employment and faces a labor shortage in many of its industries. Population growth has been declining in Mauritius and is now less than 1 percent a year. In both Mauritius and the Caribbean countries, future agricultural and industrial development will depend on raising labor productivity.

6. There is some evidence of South African capital in the tourism sector of Mauritius. But the success of the EPZ is largely due to indigenous capital and the hard work of the people of Mauritius.
6. Mauritius, like the Caribbean countries, cannot pursue economic growth without advanced technology. The influx of "footloose" textile firms attracted to the Mauritian EPZ failed to stimulate the transfer of high technology. Without such technology, the prospect of producing sophisticated products will be slim in both the Caribbean countries and Mauritius.

7. Unlike Mauritius, where transportation costs have been relatively cheap, the Caribbean countries face high freight costs. (The CIF freight rates are twice as high for services to most of the island countries compared with the mainland countries.) The small and fluctuating volume of trade generated in the small Caribbean countries is outside the world trend, which favors containerization, mechanized terminals, and few ports of call.

8. Both Mauritius and the Caribbean countries would need to introduce financial reforms in order to finance the development of the real sector through the mobilization of domestic resources. Mauritius has been under a restrictive financial system for a long time, but the recent reforms, in the areas of interest deregulation, stock market reform, off-shore banking, and leasing would remove the barriers to true competition. For the Caribbean countries, too, the development of capital markets and elimination of interest rate controls and distortions are other important adjustments they need to consider. Financial reforms have become increasingly necessary to support other adjustment policies.

9. The government of Mauritius maintained the competitive value of the rupee by devaluations. In the case of the Caribbean countries, only the Dominican Republic and Jamaica have undertaken real devaluation and even then did not do so until their balance of payments became unsustainable. The result was a rapid growth of manufacture exports.

10. Tourism will be important in the future in both the Caribbean countries and Mauritius. It is the leading sector in the Caribbean but in Mauritius future growth will depend on whether it is able to attract the elite group of tourists it wants to attract (those who are affluent and come for an extended stay).

Policy Implications for Mauritius and Caribbean

Mauritius provides an important example for the Caribbean countries. In the 1970s and 1980s Mauritius implemented a program of stabilization and adjustment that succeeded in creating an economic environment in which most of the preconditions for sustained, export-led growth were satisfied. Thus, between 1983 and 1988, per capita income nearly doubled, the current account deficit turned into a surplus, the debt-service ratio fell from 18 percent to 7 percent, gross domestic savings rose from 17 percent to 26 percent of the GDP, the fiscal deficit declined from more than 8 percent to 3 percent of the GDP, and the rate of unemployment fell from 19 percent to 4 percent as EPZ industries grew at an average rate of 28 percent. The contributory factors were the liberalization of trade and exchange rate regimes, improved resource mobilization, restrained public expenditure, and infrastructural and institutional development.

But Mauritius will have to diversify its exports and markets if it is to sustain its impressive growth. It depends too much on trade preferences offered under the Sugar Protocol and the Lome Convention for entry into sheltered markets. Since Mauritius is facing near full employment, its future growth will also depend on how fast labor productivity rises. Agriculture needs to be diversified in both Mauritius and the Caribbean. So far, Mauritius has concentrated on self-sufficiency in food production but it also needs to cultivate other crops for export. Although the growth of the EPZ is important for Mauritius, market diversification is essential and the new provision calling for 10 percent of the country's output to be sold in the domestic markets is going to help the EPZ firms. Technology transfer will also be essential for both the Caribbean countries and Mauritius in the future.
### Table 4.1 Mauritius Main Economic Aggregates of EPZ Enterprises, 1982-87

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of establishments</td>
<td>Numbers</td>
<td>122</td>
<td>129</td>
<td>179</td>
<td>244</td>
<td>365</td>
<td>500</td>
</tr>
<tr>
<td>Employment (September)</td>
<td>Numbers</td>
<td>22,528</td>
<td>23,424</td>
<td>33,751</td>
<td>47,842</td>
<td>67,938</td>
<td>85,685</td>
</tr>
<tr>
<td>Compensation of employees</td>
<td>Rs million</td>
<td>211</td>
<td>283</td>
<td>408</td>
<td>661</td>
<td>955</td>
<td>——</td>
</tr>
<tr>
<td>Value added (current prices)</td>
<td>Rs million</td>
<td>449</td>
<td>548</td>
<td>865</td>
<td>1,333</td>
<td>1,900</td>
<td>2,425</td>
</tr>
<tr>
<td>Value added (constant 1979 Prices)</td>
<td>Rs million</td>
<td>449</td>
<td>489</td>
<td>650</td>
<td>845</td>
<td>1,140</td>
<td>1,390</td>
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<tr>
<td>Exports</td>
<td>Rs million</td>
<td>1,235</td>
<td>1,307</td>
<td>2,151</td>
<td>3,283</td>
<td>4,951</td>
<td>6,700</td>
</tr>
<tr>
<td>Imports</td>
<td>Rs million</td>
<td>734</td>
<td>847</td>
<td>1,651</td>
<td>1,530</td>
<td>3,863</td>
<td>4,801</td>
</tr>
<tr>
<td>Investment (current prices)</td>
<td>Rs million</td>
<td>38</td>
<td>74</td>
<td>210</td>
<td>340</td>
<td>560</td>
<td>——</td>
</tr>
<tr>
<td>Growth rate of value added</td>
<td>Percent</td>
<td>-2.8</td>
<td>8.9</td>
<td>32.9</td>
<td>30.0</td>
<td>34.9</td>
<td>21.9</td>
</tr>
<tr>
<td>Growth rate of Exports</td>
<td>Percent</td>
<td>-5.7</td>
<td>2.0</td>
<td>33.3</td>
<td>33.8</td>
<td>40.0</td>
<td>24.0</td>
</tr>
<tr>
<td>Share of EPZ in GDP</td>
<td>Percent</td>
<td>4.5</td>
<td>5.2</td>
<td>7.2</td>
<td>9.6</td>
<td>11.8</td>
<td>12.7</td>
</tr>
<tr>
<td>EPZ exports as percentage of total exports</td>
<td>Percent</td>
<td>31.0</td>
<td>30.1</td>
<td>41.4</td>
<td>49.5</td>
<td>54.7</td>
<td>57.8</td>
</tr>
<tr>
<td>EPZ imports as percentage of total imports</td>
<td>Percent</td>
<td>17.2</td>
<td>18.8</td>
<td>28.8</td>
<td>21.7</td>
<td>46.6</td>
<td>41.0</td>
</tr>
</tbody>
</table>

—- : Not available.

*Source: Mauritius: Central Statistics Office.*
References


MANAGING ENTRY INTO INTERNATIONAL MARKETS: LESSONS FROM THE EAST ASIAN EXPERIENCE

Yung Whee Rhee

Few would dispute that outward-oriented development strategies are the key to efficient industrial development, which in turn is vital for increasing income, reducing debt, and creating dynamics for growth in the developing countries of the world. However, how to initiate outward-oriented industrial development—particularly in developing countries with unfavorable start up conditions—is unclear. The success stories of the newly industrializing economies (NIEs) of East Asia are well-known, but practical and specific lessons from their success in world markets need to be articulated, particularly for the countries that lack initially favorable conditions for entry into those markets. This chapter provides an overview of such lessons.

The East Asian NIEs covered in this discussion are Hong Kong, Singapore, the Republic of Korea and Taiwan. References to Japan's experience at the early stage of its export development are included in relevant sections.

Initial Conditions in Developing Countries and Relevant Lessons in International Competitiveness

Many developing countries are at a significant competitive disadvantage because their firms lack the know-how and information to compete in these markets; their internal policy environments fail to ensure their firms will have equal footing with foreign competitors; and their institutions and infrastructure are inadequate to support export and related trade and production activities.

LACK OF CAPACITY TO EXPORT. Firms in developing countries do not have the capacity to enter world markets largely because exporters and their agents are still in their infancy. They do not have the technical, marketing, and managerial know-how critical to starting up the manufacture of exportable industrial goods or the ability to package the technical, marketing, and managerial know-how with domestic resources and external resources.¹ Nor do they have adequate access to information and links to the world markets for manufactured goods.

UNFAVORABLE POLICIES. Several policy factors are responsible for the failure to ensure exporters equal footing with foreign competitors: unrealistic real exchange rates; inadequate and difficult access to short-term trade financing at world market or domestic market interest rates; restricted access to raw materials and intermediate inputs (and capital goods) at

¹ For empirical evidence on the capacity to package the elements needed to enter the world markets in eleven non-East Asian NIEs see Rhee and Belot (1989).
world market prices; and difficult access to investment licensing for the creation of export production capacity, as well as to investment financing.

A fundamental objective of the export incentives of the East Asian NIEs has been to ensure equal footing with foreign competitors to resolve the first three of these problems.

**INSUFFICIENT INFRASTRUCTURE.** The insufficient institutional and physical infrastructure for supporting export and associated trade activities again reflects the infancy of export development. The lack of funds and human resources to deal with externalities and economies of scale are also hindrances. Developing countries need to sequence the necessary policy reforms and infrastructure buildup efficiently because their limited resources and other factors tend to constrain institutional and policy change.

**RELEVANT LESSONS.** A frequent question is whether the East Asian experience can be replicated (or emulated) in countries with markedly different initial conditions. Most observers of the East Asian NIEs during the 1950s noted their limited capacities and adverse conditions, which were not unlike the elements that affect the performance of developing countries today. Thus, some lessons for the current situation can be gleaned from the main factors that have contributed to the success of the East Asian NIE performance in initiating outward-oriented strategies. An assessment of policies, institutions, and economic agents critical for entry into the manufactured exports market can lead to an understanding of the basic practical mechanisms for facilitating that entry. Consequently, the emphasis in this discussion is on the East Asian experience in the 1960s and 1970s.

### Combining Foreign and Domestic Factors

In the 1960s, the four East Asian NIEs—Korea, Hong Kong, Singapore, and Taiwan—established outward-oriented development strategies based on manufactured exports. Each developed its capacity to enter the world markets in a different manner, particularly in combining foreign and domestic factors.

**Hong Kong and Singapore**

The outward orientation of Hong Kong and Singapore, two resource-poor city economies, evolved from their status as regional entrepots under British colonial rule (Hong Kong serving China, and Singapore the Southeast Asian region) in the nineteenth century. In the early 1950s, Hong Kong adopted an export strategy for light manufactured goods since its entrepôt trade with China had ended. Singapore developed an export strategy in the mid-1960s after becoming independent from Malaysia.

Two types of catalysts initiated the export of light manufactured goods from Hong Kong. One was the Chinese businessmen who in the late 1940s fled to Hong Kong from Shanghai, the industrial center on the China coast. These businessmen brought along skilled workers and textile machinery and initiated textile production with refugee workers who thus formed technical cadres. Generous bank loans (capital was abundant, with heavy inflows from abroad) allowed them to increase the number of spindles from 8,000 units in 1948 to 210,000 units in 1951 and to raise employment in manufacturing from 47,000 workers in 1947 to 177,000 in 1959.

The second catalytic group consisted of the British and Chinese merchant houses of Hong Kong, with their long-standing international commercial ties. They provided Hong Kong textile products with access to markets in the United Kingdom and later in the United States. Other multinational companies (MNCs) from the United States, Europe, and Japan rushed to form joint ventures or subcontracting arrangements with the numerous small Hong Kong firms. In turn, the many small Hong Kong trading companies, having learned the skills and networks of the British and Chinese merchant houses, developed a strong capacity to channel the manufactured products of their small producers into external markets.
In the mid-1960s Singapore switched its development strategy from import substitution to export orientation. The government acted on the belief that financial stringency and economic realities required that experienced foreign companies be induced to come to Singapore and develop manufactured exports. This would be more expeditious than waiting for the slow buildup of local capital and capabilities (Geiger and Geiger 1975). The government thus encouraged direct foreign investment (DFI) and joint ventures and used government funds to acquire minority equity interests in new enterprises and to provide loans. The Singapore Economic Development Board was the catalyst in attracting foreign firms into export activities by offering various incentives and an attractive industrial environment. Although MNCs have been the main agents for Singapore’s outward-oriented strategy, the government has continuously attempted to ensure that local firms play an effective complementary role.

Taiwan and Korea

Taiwan and Korea experienced similar major external and internal events in the twentieth century before initiating outward-oriented development strategies. Both were under Japanese colonial rule from the first half of the century until the end of World War II (Taiwan for 50 years, Korea for 35 years). Both were involved in military confrontations (Taiwan had Kuomintang confronting the mainland since 1949, and Korea the war from 1950 to 1953). In addition, both initiated outward-oriented development strategies in the late 1950s or early 1960s (the so-called 19 Point Reforms in Taiwan in 1959 and the policy reforms of the Park Chung Hee regime in Korea in early 1960).

In Taiwan, the entrepreneurs who initiated exports of manufactured goods were (1) merchants and industrialists who had fled the mainland; (2) expatriate Chinese who set up factories in Taiwan; and (3) native Taiwanese, who learned how to conduct business from the Japanese during the occupation or from the first Chinese entrepreneurs. Once Taiwan’s reputation for manufactured exports was established, MNCs from the United States, Europe, and Japan became extensively involved in exporting from Taiwan through subcontracts with small and medium-sized local firms on a original equipment manufacture (OEM) basis. Although the role of foreign trading companies was dominant in marketing the manufactured exports, the small Taiwanese trading companies also became important as they learned trading skills and how to use the network (Chang 1987).

At the end of the World War II, Korea was left with industrial facilities, entrepreneurs who had been exposed to Japanese technological organization and management, and a large, educated workforce familiar with manufacturing (Jones and Sakong 1980). After Korea’s independence in 1948, after three years of a U.S. military regime, and even after the Korean War, the country’s close ties with the United States were an important source of modern industrial skills (including organizational and managerial skills). When the government adopted an outward-oriented development strategy in the early 1960s, Korea’s chaebol (conglomerates) played a role in initiating the export industry by expanding their manufacturing facilities and upgrading localized production skills with the assistance of domestic bank and foreign loans. Export marketing by foreign trading companies and buyers supported the chaebols’ efforts.

Some of these conglomerates became general trading companies (GTCs). Having learned overseas marketing from the foreign trading companies, GTCs became actively involved in channeling the exports of small and medium producers. Even in the early 1960s, Korea’s outward-oriented strategy enabled large private firms to use their capacity to package the critical factors needed to enter world markets and to acquire the additional foreign know-how for upgrading and diversifying export products and markets. These large firms relied on

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2. Localized technology means technology that originally came from foreign sources but has been well absorbed by local firms with or without some modifications. See Rhee, Ross-Larson, Pursell (1984), p. 42.
foreign buyers, foreign trading companies, foreign machine suppliers, skilled Korean workers returning from overseas, and technical or marketing agreements with foreign firms to acquire the factors needed to enter the world markets at an early stage (Rhee and others, 1984).

Japan

Japan's leadership in outward-oriented development strategies in East Asia is rooted in its experience as the first Asian economy exposed to Western industrialization. The Meiji Restoration of 1868 paved the way for opening Japan to Western know-how and to foreign trade.

In the first decade of Meiji rule, Western companies built textile, cement, and other factories in Japan to Western specifications; Western personnel supervised their operation until the Japanese were able to replace them. Private Japanese enterprises later took over these factories (Woronoff 1986: 29). From this experience, Japan developed a capability for borrowing foreign technology (Peck 1976: 527).

Also beginning in the Meiji period, the government encouraged Japanese companies to replace the foreign trading companies. To do so, Japanese trading companies had to overcome local ignorance of foreign markets and languages, but the Japanese were spurred on by a desire to participate in the world economy. Some of the trading companies grew into zaibatsu (large family-controlled business groups), the origin of Japan's GTCs, which were catalysts in Japan's outward-oriented strategy (Krause and Sekiguchi 1976). The GTCs' role in providing an "invisible link" between large modern factories and smaller subcontractors has been as critical as their role as catalysts in penetrating overseas markets and transferring foreign know-how (Yoshino and Lifson 1986).

Lessons for Developing Countries

Beginning with the European Industrial Revolution, the East Asian economies depended on Western elements to initiate their industrial development and trade in manufactured goods. Table 5.1 summarizes the primary foreign and domestic elements that were critical in initiating outward-oriented development strategies. The East Asian experience provides some lessons for developing countries regarding the ideal combination of foreign and domestic elements needed to enter the world markets for manufactured goods.

Capacity to Package. The most important element in an outward-oriented strategy is the capacity to use both local and external resources to package the technical, marketing, and managerial know-how for entry into world markets. This capacity can be acquired only through a long association with foreign and local companies that already embody this capacity (i.e., through on-the-job training and learning by doing). Japan acquired its capacity from Western companies; Korea and, to some extent, Taiwan initially acquired theirs (in light manufacturing) from Japan during the colonial periods (Westphal, Rhee, and Pursell 1981). Hong Kong and, to an extent, Taiwan benefited from the inflow of Chinese businessmen who had acquired their capacities through association with foreign managers and skilled workers. Singapore, needing rapid capital and capacity accumulation, relied exclusively on MNCs to package the critical elements for its export-oriented strategy. Most developing countries with unfavorable initial conditions may be similar to Singapore in that direct foreign investment (DFI) would be an expeditious way to obtain foreign "packages" at the early stages of their export development.

Foreign Assistance with Missing Elements. This capacity to package critical factors is lacking in most developing countries at the early stages of export development. Thus, for them, the lesson from Singapore is important. Other East Asian economies, with built-in resources, used foreign and local know-how to package the elements they needed to enter world markets. Korea relied on local technical and managerial know-how to manufacture
light industrial items for export but used foreign sources for marketing know-how and access to the world markets. Korea also sought foreign loans to finance production and investments for exports. Hong Kong relied on local marketing know-how and access to world markets, which it had gained through its entrepot trade experience. At an early stage, it also used skilled immigrant personnel to gain the technical and managerial know-how for manufacturing exports. Taiwan, like Korea relied on foreign sources for initiating external marketing, and it followed both Korea and Hong Kong in employing local technical and managerial know-how.

Table 5.1 Foreign and Domestic Elements That Were Critical In Initiating Manufactured Exports In East Asian NIEs

<table>
<thead>
<tr>
<th>Key Elements</th>
<th>Hong Kong (Early 1950s)</th>
<th>Singapore (Mid-1960s)</th>
<th>Taiwan (Late 1950s)</th>
<th>Korea (Early 1960s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Technical know-how</td>
<td>F (L)</td>
<td>F</td>
<td>L, F (L)</td>
<td>L</td>
</tr>
<tr>
<td>B. Marketing know-how</td>
<td>L</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>C. Managerial know-how</td>
<td>F (L), L</td>
<td>F</td>
<td>L, F (L)</td>
<td>L</td>
</tr>
<tr>
<td>D. Capital</td>
<td>F, Local</td>
<td>F</td>
<td>Local</td>
<td>F</td>
</tr>
<tr>
<td>E. Access to overseas markets</td>
<td>L</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>F. Capacity to package (A), (B) and (C) with (D) and (E)</td>
<td>L, F(L)</td>
<td>F</td>
<td>F(L)</td>
<td>L</td>
</tr>
</tbody>
</table>

Note: F = foreign source; L = localized source; and F (L) = localized foreign source.

Ensuring Free-Trade Status for Export Activities

An important means of eliminating the disadvantages of exporters in developing countries is to guarantee unrestricted access to the imported inputs that generate export value added at world market prices. Imports would be free of import and foreign exchange restrictions as well as tariffs and indirect taxes. Indirect tax exemptions for exports achieve a neutral status with respect to indirect taxes for domestic sales under the destination principle as well as free-trade status. (Ensuring free-trade status for direct and indirect export activities is acceptable to the GATT and to importing economies). In addition, free-trade status for exports is a first step in completely liberalizing imports for the domestic market.

The five main methods of achieving free-trade status for export activities are: (1) free trade, (2) free trade zones (FTZs), (3) bonded manufacturing warehouses (BMWs), (4) automatic import license and duty exemptions, and (5) automatic import license and duty
drawbacks. Table 5.2 provides a comparative overview of the methods of achieving free-trade status in the East Asian NIEs.

Table 5.2 Overview of Methods of Achieving Free Trade Status of East Asian NIEs

<table>
<thead>
<tr>
<th>Schemes</th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Taiwan</th>
<th>Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warehouse (BMW)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automatic import license</td>
<td>Used before 1967</td>
<td>60 percent used duty exemption (in 1981)</td>
<td>Used before mid-1970</td>
<td></td>
</tr>
<tr>
<td>and duty exemption</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Automatic import license</td>
<td>Used before 1967</td>
<td>40 percent used duty drawback (in 1981)</td>
<td>Used after mid-1970</td>
<td></td>
</tr>
<tr>
<td>and duty drawback</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Free Trade**

Free trade status for exporters is ensured if a country adopts a free-trade policy for the entire economy. Given the small size of their domestic markets, extensive involvement in entrepot trade, and specialization in the final stages of production, Hong Kong and Singapore were ideally equipped for free trade in virtually all commodities, including imported inputs used for manufacturing exports. Until 1967, however, Singapore had a policy of temporary protection (i.e., tariff and import restrictions) of imports sold domestically. Given the prevalence of the tariff redundancy observed in 1967, it also appears that Singapore used an outward-orientation strategy to build up its internationally competitive industries before it had completely eliminated its domestic market protection (Tan and Hock 1982).

**Free-Trade Zone**

A free-trade zone (FTZ) is a special industrial area located physically or administratively outside a country's customs barrier and is devoted to the production of exports. Transactions in FTZs are not subject to import restrictions and tariffs and therefore escape the delays and administrative costs often associated with the duty exemptions or drawback systems applied to firms outside FTZs. FTZs usually offer fully serviced land and facilities, with easy access to ports and industrial plants. Good physical trade infrastructure (such as parts, transports, and communication) is a precondition for any export including FTZ
exports. FTZs are to attract foreign investment in their export industries. They usually offer additional incentives, such as income tax "holidays" and unrestricted transfer of profits.

**Hong Kong and Singapore.** Commercial FTZs have been in existence in Singapore since 1819 and in Hong Kong since 1842. When Hong Kong and Singapore adopted their export-oriented development policies in the 1950s and 1960s, they expanded their commercial FTZs into countrywide industrial FTZs.

**Taiwan.** The Kaohsiung FTZ, established in 1966 in southern Taiwan, was the world's first FTZ for manufacturing. The Nantze and Taichung FTZs were established in 1970 and 1971, respectively. In 1987, 254 enterprises were located in the FTZs, and employed approximately 94,500 people. In the mid-1980s, FTZ employment was 4.8 percent of the economy's total manufacturing employment. Total exports from the zone in 1987 were US$2.4 billion*, approximately 6.4 percent of Taiwan's total exports (ILO/UNCTAD 1988).

**Korea.** Korea established two FTZs in the early 1970s as a part of its outward-oriented industrial development strategy (Masan in 1971 and Iri in 1975). As of 1980, the zones had 94 enterprises, 72 of which were foreign-owned operations and 28 joint ventures. Employment in the zones in 1987 was close to 39,000. However, employment in the FTZs has never accounted for much more than 1.0 percent of Korea's total manufacturing employment. Exports from the zone in 1986 were US$460 million, or 2.8 percent of Korea's total exports.

Although the Korean FTZs have not accounted for a substantial part of employment and exports, it is believed that Korea benefited substantially from backward linkages with FTZ operations. For example, the exports from the Masan FTZ had more than 50 percent local content. Besides the two FTZs designed to attract foreign investments, by the mid-1980s more than 3,000 export manufacturing factories were located in the 24 export processing estates designed to provide infrastructure primarily for domestic firms (ILO/UNCTAD 1988).

**Bonded Manufacturing Warehouse System**

To allow companies outside the FTZs to bypass certain customs procedures when they import inputs needed for producing exports, the East Asian NIEs established bonded manufacturing warehouse (BMW) systems. The usual requirements for licensing BMWs are as follows:

1. The firm's factories must engage exclusively in manufacturing commodities for export.
2. The firm's factories must have separate warehouses approved by customs for the storage of imported inputs and finished commodities.
3. Customs officers must be stationed at the BMWs to inspect the imported inputs and finished outputs.

In 1981, Taiwan had 336 and Korea 218 BMWs, which accounted for about 14 percent and 12 percent of total exports and about 10 percent and 6 percent of total imports, respectively (Ministry of Finance, the Republic of Korea 1982).

**Automatic Import License and Duty/Indirect Tax Exemption**

To provide free-trade status for exporters outside the FTZs and the BMW system, automatic import licensing and automatic exemption from foreign exchange restrictions (i.e., automatic access to the foreign exchange needed to pay for imports for exports) need to precede the duty (and indirect tax) exemptions (sometimes called temporary import) or drawback (sometimes called refunds). A duty (and indirect tax) exemption system exempts exporters from paying duties (and indirect taxes) on imports used for export production.\(^3\)

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\(^*\) Billion = 1,000 million.

3. The duty exemption systems in the East Asian NIEs are mainly related to imports of raw materials and intermediate inputs. However, even those East Asian NIEs that later adopted the policies to promote domestic capital goods industries in the 1970s and 1980s had implemented the policies to
Korea. Korea used a duty and indirect tax-exemption system until the mid-1970s. It had two successful aspects. First, it ensured unrestricted choice between imported and domestically produced inputs, while treating indirect exporters the same as direct exporters in ensuring access to duty-free imports (and other export incentives). This policy extended free-trade status to indirect exporters and resulted in efficient backward linkages. Second, administrative efficiency was achieved through two major instruments: (1) pretabulated and published physical input-output coefficients; and (2) the use of trade-financing procedures and documents for duty-free imports.

Although Korea changed formally to the duty drawback system in the mid-1970s, it supplemented this in the 1980s with an innovative duty exemption system—the imported input stock accounting book method (see below)—mainly in the case of selected qualified exporters. This innovation was based on lessons learned from the experience of Taiwan (Ministry of Finance, the Republic of Korea 1982).

Taiwan. The duty exemption system of Taiwan uses import and export entry accounting to estimate outstanding duties associated with unfulfilled exports only at the end of certain periods. This system requires effective monitoring of the maximum ceiling on input stocks imported duty-free. As in Korea, successful implementation of the Taiwan system depended, in part, on the effective use of pretabulated input coefficients. About 80 percent of the duty-free imports in 1975 depended on the duty exemption system. Because of the parallel implementation of the duty drawback system, the share of duty exemptions declined to about 60 percent in 1981.

Duty Drawback System

In a duty drawback system, exporters located outside FTZs or BMWs obtain refunds of the duties (and indirect taxes) they have paid on imported inputs after they complete the exports. There are two ways of making the refunds. Under the individual drawback systems, duties (and indirect taxes) paid by firms are refunded on a case-by-case basis; this system operates much like a system of exemptions. Under a fixed drawback system, the estimated duties (and indirect taxes) that enter into the cost of producing export commodities are refunded according to a preset schedule. Just as in the case of duty exemptions, without the automatic import licensing and automatic allocation of foreign exchange needed to import inputs for export production, a duty drawback system would fail to provide free-trade status in an developing country with import and foreign exchange restrictions.

Korea. Korea switched from a duty exemption system to a duty drawback system in the middle of 1975 because of worsening balance of payments problems after the first oil crisis. The government intended to institute a fixed drawback system, which might have meant a less than free trade status for many exporters. When exporters were increasingly concerned about the possibility of losing equal footing with foreign competitors, the government instead introduced a duty-deferred payment system that was equivalent to an exemption system for many exporters. It then modified the fixed drawback system by combining it with an individual drawback system (only about 20 percent of Korean exports were subject to the fixed drawback system in 1980). While maintaining the duty-deferred payment system, the Korean government in 1981 implemented a new drawback schedule that combined the advantages of both fixed and individual drawbacks: Wherever major imported items were involved, the highest priority was to provide free trade status through individual drawbacks; in the case of miscellaneous imported items, the highest priority was administrative simplicity through fixed drawbacks. Subsequently, a two-step drawback payment system was implemented that provide free trade status for capital goods imports at the early stages of export development in the 1950s and 1960s.
provided immediate drawback payments after the exports were completed, based on rough estimates, followed by careful accounting within a three-month period. Korea has also made continuing efforts to streamline the administration of the input coefficients.

TAIWAN. Taiwan uses a drawback system mainly with exporters who are not qualified to use the duty exemption system. About 40 percent of the duty-free imports in 1981 involved the duty drawback system. Basically, Taiwan has a fixed drawback system. However, exporters who can document that they actually paid duties exceeding more than 10 percent of the drawback amount shown in the published schedule can use the individual drawback system. There are two types of fixed drawback schedules: One specifies the drawback amount (money value) per unit (i.e., physical quantity) of a designated export item; the other specifies the drawback amount as a certain percentage of the money value of a designated export item. The former (i.e., the quantity-based system) is generally used for export items that do not need a large number of diversified imported inputs; the latter (i.e., the money value-based system) is generally used for export items that need numerous imported inputs. These fixed drawback schedules are published periodically. The input-coefficient data are critical bases of the schedules.

Lessons for Developing Countries

Achieving free trade by eliminating the restrictions and duties (and indirect taxes) on all imports is a desirable and rational long-term objective for developing countries. However, often it cannot be achieved unless pursued gradually, since the initial conditions in these countries are unfavorable. If adopted quickly, free trade would allow imports to displace much domestic production, including infant industries that could otherwise become competitive.

If not fully "compensated for" by exchange rate and associated real sector adjustments, immediate across-the-board import liberalization also increases the balance of payments deficits, worsening the already heavy external debt burden. Often the political and social reaction to very rapid or ill-considered across-the-board import liberalization has resulted in a regression to import and foreign exchange controls.

Nevertheless, developing countries should immediately implement the measures designed to guarantee free trade status for all activities that generate export value added. Such measures are acceptable under the GATT rules, and they are one of the minimum conditions for providing exporters equal footing with foreign competitors. They also constitute a first step in gradually implementing complete import liberalization.

FTZs. FTZs can be very effective in the early stages of an export drive as a means of attracting foreign investors and demonstrating the country's export potential, especially in countries that lack the capacity to package the critical elements needed to initiate an outward-oriented development strategy. However, the development of infrastructure, formulation of appropriate incentives, and other elements of the work environment must be well-managed. It should be noted that where outward development strategies have been sustained and reinforced, as in the East Asian NIEs, the relative importance of FTZ exports has tended to decline as exports of other domestic industries have expanded under free-trade status.

BMWs. A bonded manufactured warehouse system is quite advantageous for well-established large firms that produce exports only. It is particularly desirable for such products as electronics, which require numerous imported inputs, because it reduces the administrative burden of estimating and monitoring input coefficients. These are the most critical data in determining the effectiveness of a duty exemption or drawback system. However, BMWs are impractical for small producers and indirect exporters, as well as for producers selling in both the export and domestic markets.
Duty Exemptions. For countries in the early stage of exporting, a duty exemption system is preferable to a duty drawback system for several reasons. First, although both systems impose a similar administrative burden in terms of the need for input coefficients and other data, the duty exemption system does not burden exporters with the working capital requirements and interest rates associated with the duty drawback system. Second, both systems require automatic import licensing and free access to foreign exchange for imported inputs if the government wants to guarantee free-trade status (i.e., the duty drawback system cannot succeed unless all the administrative arrangements needed for "temporary imports" are in place). The reason is that the potential costs for exporters stemming from a failure to resolve the restriction on imports and foreign exchange would be much higher than those stemming from the failure to resolve the duties and indirect tax burdens for exporters in countries with a highly distorted import regime. Third, the duty exemption system seems to carry less risk than the duty drawback system does in terms of potential export subsidy charges by importing economies.

The East Asian experiences provides a number of lessons concerning the effective implementation of a duty exemption system:

1. The success of a duty exemption system depends on speedy processing based on a transparent, nondiscretionary, and simple formula prepared in advance. The formula does not come from a magic equation, but from systematic and careful advance estimation of input coefficients by the government. The administrative costs of such estimates are, however, much smaller than those exporters and the government face under the ad hoc approaches many developing countries have been relying on, which fail to ensure speedy processing to provide free-trade status.
2. Administrative efficiency can be achieved with duty exemptions by using the trade-financing disbursement/liquidation mechanisms and instruments.
3. Indirect exporters and direct exporters should be treated equally in providing free-trade status.
4. Capital goods should be included in the duty exemption system at an early stage of export development, even if domestic capital good industries are competing with imports.
5. The imported input stock accounting book method should be allowed for well-established exporters.
6. The administrative burden of the duty exemption system can be reduced by eliminating all redundant import and foreign exchange restrictions and tariffs and gradually lowering import protections.

Duty Drawbacks. The parallel use of a duty drawback system is desirable in developing countries to allow firms that did not foresee exporting when they imported inputs to enjoy a free-trade status while they were exporting. Under a fixed drawback system, the option of an individual drawback is needed to safeguard exports from an excessive sacrifice of free-trade status that may stem from the fixed drawback.

Ensuring Easy Access to Trade Financing

To ensure easy access to trade financing, policymakers must first understand the role of trade financing in the economy (for a detailed discussion, see Rhee 1989).

The Role of Trade Financing

Exporters cannot respond to goods orders unless they have ensured access to trade financing. Access to trade financing based on export orders and bills of completed exports is

4. Cooper (1987) noted the important consensus reached at the IMF-World Bank Symposium on Growth-Oriented Adjustment Programs: In sequencing policy reforms aimed at resuming sustained growth, developing countries need to assign a high priority to measures that ensure rational regimes for
critical to realizing a supply response. Preshipment export finance is needed to pay for imports of foreign raw materials and intermediate inputs, domestic raw materials and intermediate inputs, domestic value-added components (wages, interest and rents) needed for export production, and inventories of finished commodities to be exported.

Normally granted on export orders and normally provided for less than 90 days, preshipment financing is particularly important in countries that have underdeveloped money markets and segmented bank-lending markets. Export orders cannot be filled—and existing export opportunities cannot be realized—unless exporters can meet their import, domestic purchase, production, and inventory financing needs before shipment.

Short-term postshipment export finance is needed to finance export sales on credit. Normally it is granted for up to 180 days on an accepted bill (an unconditional promise that a bank or importer will make payment for the export commodities received by a definite date). Medium- and long-term postshipment export financing, which finances export sales (mostly of heavy industry products) on credit exceeding 180 days, is not as important at the early stage of export development in most developing economies. To highlight the lessons on trade financing from the East Asian experience, the focus here is on short-term preshipment trade finance and short-term postshipment export finance.

Methods of Trade Financing

There are four methods of financing trade: company credit, bank credit, bank loans, and self-financing. In addressing the issues related to financing under the different methods, it is important to distinguish clearly between bank lending and bank credit and between bank credit and company credit. When a bank provides a "loan," it lends actual money. When it creates a banker's acceptance (BA)—its unconditional promise to pay a certain sum of money at a definite date to the bearer—it lends "credit." The bank creates a BA strictly on the basis of the expected revenue from a particular trade transaction: traders meet their trade-financing needs through the BA discount market, part of the money market. Company credits involve selling and buying between affiliated companies or between trading companies and suppliers "on credit." The most elementary method is self-financing from retained earnings.

Choosing among these methods and enacting appropriate measures to resolve access problems depend, among other factors, on the stage of development of the banking industry and the money market, the structure of trading companies and export manufacturers, and the percentage of trade financing to be met by retained earnings.

Intra-MNC Credit-Based Trade Financing

As shown in Table 5.3, Singapore has been the only East Asian NIEs to use intra-MNC credit-based trade financing extensively. At the same time, the Singapore government has not neglected the complementary role that bank loans can play. It introduced a preshipment and short-term postshipment financing system known as "the rediscounting scheme for pre-export and export bills of exchange" in 1975. Administered by the Monetary Authority of Singapore, it has complemented the intra-foreign MNC credit-based financing system, particularly in meeting the financing needs of local companies. Further, the Export Credit Insurance Corporation of Singapore Ltd. has supplemented the intra-MNC risk taking related to overseas buyer nonpayment. In 1985 it introduced a preshipment export finance
guarantee to ensure local companies access to preshipment financing. In 1986 the Economic Development Board introduced the Small Industries Finance and Guarantee Schemes.\(^5\)

Table 5.3 Comparative Overview of the Primary Trade Financing System of the East Asian Economies

<table>
<thead>
<tr>
<th>Primary Trade-Financing System</th>
<th>Preshipment Export Finance</th>
<th>Short-Term Postshipment Export Finance</th>
<th>Medium &amp; Long-Term Postshipment Export Finance</th>
<th>Exporter Nonperformance Risk Handling</th>
<th>Overseas Buyer Nonpayment Risk Handling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intra-MNC credit-based</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Singapore</td>
<td>Internalize by Firm or Bank</td>
<td>PEFG(^a)</td>
</tr>
<tr>
<td>Interfirm credit-based</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>Internalize by Firm or Bank</td>
<td>EC(I/G)^b</td>
</tr>
<tr>
<td>Bank credit-based</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td>Hong Kong</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank loan-system supported by the government</td>
<td>Korea</td>
<td>Singapore</td>
<td>Korea</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Self financing</td>
<td>Taiwan</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\(^a\) PEFG = preshipment export finance guarantee.  \(^b\) ECI\(G\) = export credit insurance and guarantee.

**Interfirm Credit-Based Trade Financing**

Japan's GTCs ensured access to trade financing for small producers, a role the commercial banks would not undertake because of their aversion to risk. Because they knew the small firms, the GTCs were able to internalize risk taking. Moreover, the GTCs themselves were able to tap into major financing resources because of their close banking ties and because most GTC credit to small, input- or output-supplying indirect exporters was tied to specific trade transactions. Often the credit to indirect exporters was in the form of imported raw materials on credit or advance payments for indirect export items, all provided before the GTCs received payment from overseas buyers. The GTCs also provided loan guarantees for small producers so that they could gain direct access to bank loans. In short, Japan's GTCs provided a typical form of interfirm credit-based trade financing.

Many developing economies have attempted to establish Japanese-type GTCs in the hope of providing a similar "invisible link" in expanding exports. Except for the Korean trading companies, most such attempts have not been successful as the companies have lacked the human and financial resources to carry out their diverse tasks. Moreover, in many cases domestic policy has not fully supported an outward-oriented strategy, and cultural factors have not been conducive to large GTCs (Ozawa, 1987). Even Korea's GTCs, which have been successful in providing marketing and technical services to small indirect

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5. This was in response to an assessment in the 1986 report of the Economic Committee, entitled *The Singapore Economy: New Directions*, which stated that "local companies, particularly the small ones, lack access to capital" (Ministry of Trade and Industry, Republic of Singapore 1986: 36).
exporters, have not been active in credit-based trade financing. The reason is that Korea's GTCs have been closely tied to the conglomerates, which have abundant human resources, but they and the conglomerates have had to rely on banks and foreign borrowing for their own capital.

Among the East Asian NIEs, Hong Kong and Taiwan have relied most on interfirm financing to meet the trade-financing needs of numerous small manufacturers of exports (Table 5.3). The small manufacturers have had to act as indirect exporters, relying on trading companies for direct exporting and company credit-based trade financing for imported inputs, even though the numerous Hong Kong and Taiwan trading companies also have been small.

**Trade Financing Based on Bank Credit**

The origin of the trade-financing market was the discount market for trade bills in England (a trade bill of exchange or draft is the seller's unconditional written demand for payment). Hong Kong is the only developing economy whose trade financing evolved as it did in England: from trade development to merchant banking to BA financing. In Hong Kong, in the early 1800s, bill discounting, tightly linked with the economy's entrepot trade, became the bread and butter of the large agency houses and the British and European merchant banks, known as "eastern exchange banks."

The main reason for establishing the Hong Kong and Shanghai Banking Corporation, a Shanghai bank with Hong Kong interests, was the comparative lack of enthusiasm among the exchange banks for intra-China coastal business. The corporation also became heavily involved in financing the entrepot trade, as was the case with its Anglo-Indian counterparts (Ghose 1987). The bills and BA outstanding domestic export ratio ranged from 8 percent to about 14 percent during 1980-85, the implication being that trade financing based on bank credit probably met about one- to two-thirds of the trade-financing needs, assuming four or five annual turnovers.

Although Hong Kong's BA-based trade financing may have evolved relative to other developing economies, after 150 years of experience it has not reached maturity. One reason is the absence of an active secondary market, a major obstacle to the development of money market instruments. This problem is largely the result of the fact that Hong Kong does not have a central bank that could provide direction and serve as "lender of last resort" through a rediscount window. The Hong Kong Shanghai Bank, which acts informally as a central bank, may not need a discount market or commercial paper for its own banking business. Since a secondary market would help its competitors, it has not worked to develop one (Skully 1976). In 1985, the Bank of China advocated establishing a government-sponsored discount window in Hong Kong to revitalize the secondary money market and to resolve the cash-flow problems of local banks (Ghose 1987).

**Trade Financing Based on Bank Loans**

Exporters in most developing economies cannot meet their trade financing needs through bank credit or company credit because they lack modern banks and trading companies that can internalize the risk taking. Therefore, the immediate objective of ensuring access to trade financing for all exporters with direct and indirect export orders must be met through bank loans.

**Basic Instruments.** The bank loan financing system is based on a trio of instruments and institutions: (1) transaction-based, self-liquidating mechanisms for trade financing (including rediscount mechanisms of the central bank); (2) institutions that can deal with exporters' needs; and (3) trade credit based on bank credit and market conditions.
nonperformance risk (i.e., preshipment export finance guarantees [PEFG]); and (3) institutions that can deal with overseas buyers' nonpayment risk (i.e., export credit insurance and guarantees [ECI/G]).

**Hong Kong and Singapore.** Hong Kong's primary trade-financing system is characterized by a mixture of bank and interfirm credit-based mechanisms. The only area in which the government has been directly involved has been to provide ECI/G to complement firms' and banks' internal handling of the risk of overseas buyers' nonpayment (Table 5.3). In contrast, Singapore's primary trade-financing system is intrafirm credit within large MNCs. However, given a parallel need to develop backward linkages with local enterprises, the trade-financing needs of these firms have been met by the bank loan system supported by the Singapore government. The system includes a PEFG and ECI/G that supplement the MNCs' internal handling of exporter nonperformance risk and overseas buyer nonpayment risk (Table 5.3).

**Taiwan.** Among the East Asian NIEs, Taiwan has relied on the most diverse sources of trade financing, excluding trade financing based on bank credit (Table 5.3). Bank loan-based trade financing supported by the central bank has supplemented local and foreign company credit-based trade financing, commercial loan-based trade financing of multinational banks, and self-financing. (Chiu 1981; Biggs 1988).

**Japan.** A pillar of the Japanese government's first postwar economic plan was its carefully created export policies and export institutions. The trade-financing system of the Bank of Japan was one of the critical components of these export policies. In the absence of a well-developed money market, the Bank of Japan implemented a preshipment export finance rediscount system, the Export Advance Bill System. Until the value of exports exceeded $1 billion, the system met more than half of the preshipment export financing needs. Even though the outstanding loan amounts declined after 1970, as exporters turned to other financing modes, certain exporters still use the system. The short-term postshipment financing schemes used until the early 1970s were the Export Usance Bill System, Loan Facilities for Export Time Bills, and the Foreign Exchange Bill Purchase System. The import financing schemes were the Import Settlement Bill System, the Import Financing Loan, and Import Usance Facilities.

**Korea.** Korea's trade-financing system is composed of (1) the Bank of Korea's trade transaction-based, self-liquidating trade-financing disbursement/liquidation mechanisms (together with its rediscount system); (2) the Korea Credit Guarantee Funds' PEFG; and (3) the Korea Export-Import Bank's ECI/G. The Bank of Korea's trade-financing mechanisms have been a particularly shining example of successful trade financing based on bank loans. They have made a more important contribution to the effective implementation of the outward-oriented development strategy than any other export policy instrument.

**Self-Financing**

Traders meet some part of their trade-financing needs with their own funds. In fact, the trade-financing system based on bank loans discussed above normally finances only 85 percent to 90 percent of the value of trade transactions. The remaining 10 to 15 percent is self-financed. For exporters who are denied access to trade loans because they fail to supply collateral, and in the absence of a modernized export financing system, the only way to fill export orders is to rely on self-financing. However, no developing economy has succeeded in expanding its trade when it is based mainly on self-financing. The only developing economy in which some exporters have relied significantly on self-financing appears to be Taiwan. Many small and medium-size export manufacturers were able to use their high retained earnings to supplement trade financing based on company credit and bank loans because of
the unusually high savings rate in Taiwan. This stemmed from the cultural heritage and favorable macroeconomic policies (Chiu 1981; Biggs 1988).

**Lessons for Developing Countries**

The export success of the East Asian economies has been facilitated by speedy and undisrupted access to trade financing for all (direct and indirect) exporters based on confirmed export orders or accepted bills of completed exports. Developing countries should attempt to develop all four methods of trade financing: company credit, bank credit, bank loans, self-financing—and combinations of these. Although the complementarity among these methods has to be maintained, most developing countries must—in the absence of modern domestic banks and trading companies that can internalize risk taking—start with foreign bank credit, foreign company credit or intra-MNC credit, and bank loan finance. The East Asian experience regarding bank loan trade financing yields a number of lessons for developing countries.

**Importance of Access to Trade Financing.** For success in exports, short-term preshipment and postshipment export financing is much more important than investment and general working capital financing and longer-term postshipment financing. Short-term trade financing based solely on confirmed export letters of credit (L/Cs) and other export orders, and associated import or domestic trade and production transactions must be available if the export potential of a developing country is to be exploited. In turn, the traditional analyses that assume the only role of trade financing is to provide an interest subsidy fail to capture the true objective of trade financing based on bank loans as demonstrated by the East Asian experience. For example, Korea and Taiwan could have achieved their export successes without export loan interest rate preferences (which were estimated to be 4.5 percent of Korea's export value in 1968 and 0.2 percent of Taiwan's export value in 1976) even when the interest rate preferences were the most extensive in these economies. However, Korea (and to some degree Taiwan) could not have achieved a similar success without the bank loan mechanisms that ensured easy access to trade financing based on export orders.

Modern trade finance consists of various mechanisms: bank credit instruments such as L/Cs, domestic L/Cs, and BAs; export and associated import and domestic purchase transaction-based, self-liquidating trade loan disbursement/liquidation mechanisms; lender-of-last-resort facilities of central banks; institutions that deal with exporter nonperformance risk; and institutions that deal with overseas buyer nonpayment risk.

Developing countries should give high priority to the first three of these mechanisms. Properly developed, a modern trade-financing system composed of these mechanisms, that charges international or domestic market interest rates, and that covers all trade transactions is completely different from the so-called sectorally targeted credit-rationing mechanisms.

In fact, these three mechanisms are the first steps in developing the truly market-based (i.e., money market-based) trade-financing mechanisms. In turn, developing countries should implement a system of accepted export bill discounting (at world market rates) backed by central bank rediscounting for short-term postshipment financing, even in the absence of a money market. Further, trade transactions related to domestic sales should be treated the same as those related to exports, in having access to the lender-of-last resort facilities of central banks, as long as the domestic sales accompany the first two mechanisms as that would eliminate the risk of loan misuse and cover a significant part of the supplier nonperformance risk.

7. Developing these three mechanisms is not so different from the British government's efforts in the nineteenth century (in establishing the bill of exchange rediscounting of the Bank of England and enacting the Bill of Exchange Act of 1882) and the BA rediscounting of the U.S. Federal Reserve Board.
As for the establishment of institutions to deal with exporter nonperformance risk and
with overseas buyer nonpayment risk, developing countries need to wait until the social
gains associated with the additional exports stemming from a PEFG and/or an ECI/G
outweigh the social costs of operating these schemes. In addition, the operational
effectiveness of and effective learning-by-doing in such institutions are critical for their
success. Actual beneficiaries of those schemes must cover the full costs of operating them in a
multiyear framework.

**FOREIGN CURRENCY LOAN SCHEME.** When the domestic financial market is segmented and the
foreign exchange rate does not always reflect opportunity costs, and when external borrowing
plays a large role in financing development, the best way to ensure efficient management of
foreign exchange is to denominate all loans tied to the use of foreign exchange reserves in
foreign currency and to charge an international market interest rate plus some margin.
Foreign currency loans for imported inputs for export production must be included in this
category.

In the East Asian NIEs that have established correct priorities in foreign exchange
management, nothing has received higher priority than the allocation of foreign exchange
for importing the inputs needed for exports that earn additional foreign exchange. If foreign
exchange holdings are scarce, external financing to create a foreign exchange revolving fund
should receive priority. Between 1979 and 1983, Costa Rica, Mexico, Guyana, Jamaica,
Zimbabwe, and Yugoslavia, with the assistance of the World Bank, all established foreign
exchange revolving funds for foreign currency loans.

The "foreign exchange retention scheme" used in some developing economies as a means
of ensuring access to imported inputs is not a rational system, because current foreign
exchange needs usually do not match the past export performance of dynamic export
industries.

**EFFICIENT ADMINISTRATIVE TOOL FOR EXPORT INCENTIVES.** Modern trade loan disbursement/
liquidation mechanisms that extensively use L/Cs, domestic L/Cs, and BAs also serve as
efficient mechanisms for administering such export incentives as duty-free indirect tax-free,
and restriction-free imports and indirect tax exemptions for all exporters. In turn, such
instruments as domestic L/Cs are very effective in extending export incentives—including
trade financing, duty-free imports and indirect tax exemptions—to indirect exporters. Such
extensions of export incentives are critical in developing backward linkages and local trading
companies in developing countries.

**Maintaining a Realistic Exchange Rate**

As I have pointed out elsewhere (Rhee 1985), the exchange rate is the most important
variable affecting the returns exporters realize in local currency for the foreign exchange
they earn through export value added. The determination of the real exchange rate depends
on a country's foreign exchange management regime and its stabilization policies. In turn, its
approach to foreign exchange management cannot be separated from financial market
development and the payment and trade regimes. Table 5.4 provides an overview of foreign
exchange and payment systems in the East Asian NIEs in the 1970s. A developing country
pursuing an outward-oriented development strategy can and should maintain a realistic
exchange rate whatever its regime of foreign exchange management. One criterion
distinguishing the different types of foreign exchange regimes is whether the regime is
based on a free foreign exchange market.
Table 5.4 Overview of Foreign Exchange and Payment Systems of East Asian NIEs in the 1970s

<table>
<thead>
<tr>
<th></th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Korea</th>
<th>Taiwan</th>
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<tbody>
<tr>
<td>Currency convertibility</td>
<td></td>
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<tr>
<td>Article VIII status</td>
<td>X</td>
<td>X</td>
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<td>X</td>
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<tr>
<td>Article XIV status</td>
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<tr>
<td>Exchange rate flexibility</td>
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<tr>
<td>Par value</td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Pegged rate (U.S. dollars)</td>
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<tr>
<td>Composite currency rate</td>
<td></td>
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<td></td>
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<tr>
<td>Floating rate</td>
<td></td>
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<tr>
<td>Payment restriction</td>
<td></td>
<td></td>
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<tr>
<td>On current account</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>On capital account</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Surrender requirement for export proceeds</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>


A Foreign Exchange Regime Based on a Free Market

Currency Convertibility. An economy cannot have a free foreign exchange market unless the domestic currency is convertible (Article VIII of the IMF's Articles of Agreement defines current account convertibility). Japan did not formally achieve convertibility until 1964, while Hong Kong implemented Article VIII in 1961 and Singapore in 1968.

Financial Markets. The financial structure is the focus of analysis in choosing a foreign exchange regime (Branson 1983). A free foreign exchange market requires mature financial markets and institutions integrated with the international financial markets. Early British connections and exposure to international trade-related activities gave Hong Kong and Singapore ample opportunities to develop Western-style financial and trade-related institutions. Because they were entrepot trade centers, their financial institutions developed around international trade. As early as the 1850s, more than ten foreign banks representing British, Dutch, French, and American interests were operating in Singapore and Penang. Within a century the financial institutions and markets of Hong Kong and Singapore had developed into international financial centers (Geiger and Geiger 1975). In 1980, Hong Kong had 14 licensed banks with 1,123 branches operating within the territory, or about 1 branch for every 4,000 people, a ratio exceeding that of many developed countries. However, Korea and Taiwan's financial markets and institutions were not well-developed when they initiated their outward-oriented development strategies in the 1960s.
Hong Kong. Hong Kong’s foreign exchange market became active after Hong Kong was excluded from the sterling zone in 1972. The government ended the pegging of the Hong Kong dollar to the U.S. dollar in 1974. Since that time, the Hong Kong dollar has floated according to market conditions. However, the government has been active in the foreign exchange markets through its commercial bankers, to the extent that portfolio management of the Exchange Fund requires and to the extent that the timing of transactions can be varied with a view to their impact on the exchange rate of the Hong Kong dollar. In short, Hong Kong’s foreign exchange regime has helped it maintain its competitive position as a major exporter of manufactured goods.

Singapore. Even though Singapore conformed to the IMF’s convertibility requirements in November 1968, it maintained control over foreign exchange transactions, including restrictions on borrowing or depositing by Singapore residents in foreign currencies, particularly Asian currency units. Singapore’s foreign exchange market became much more active after the Singapore dollar began to float in 1973. Its foreign exchange regime is a successful example of an integrated strategy of monetary and exchange rate policies for a small open economy (McKinnon 1982).

The centerpiece of Singapore’s domestic monetary policy in the 1970s was the stabilization of its exchange rate with respect to the U.S. dollar. Singapore’s monetary base was largely endogenized to maintain an orderly foreign exchange market. Instead of setting firm internal rules for rates of monetary growth, Singapore allowed the monetary base to reflect foreign exchange intervention. This policy maintained the stability of the exchange rate even though the money supply fluctuated widely in the short run. Such short-run fluctuations did not, however, endanger price stability in Singapore’s open economy in which domestic prices were completely dominated by imports and exports.

Managed Foreign Exchange Regimes

As already indicated, underdeveloped financial markets and financial institutions were among the main reasons why Korea and Taiwan adopted managed foreign exchange regimes in the 1960s and 1970s instead of relying on a free foreign exchange market. Although they pursued financial maturity and rational trade regimes, the transitional status of foreign exchange management was inevitable in these economies. Financial immaturity and repression also are closely related to trade regimes. Capital constraints stemming from financial market fragmentation explain the persistent use of import and payment restrictions for infant industry support in developing countries (McKinnon 1971, 1979).

Unlike Hong Kong and Singapore, Korea and Taiwan did not have an early opportunity to develop financial institutions specializing in trade financing and foreign exchange transactions. Nor did they have the opportunity to develop modern financial markets and institutions during the Japanese colonial period. Even Japan’s financial markets were noncompetitive and segmented, unlike the Western industrial economies at a similar stage of development (Wallich and Wallich 1976). Consequently, managed foreign exchange regimes in the 1960s and 1970s were integral to their managed financial systems.

The influence of the commercial banks and nonbank customers in creating a unified market for foreign exchange, either spot or forward, is not as great under a managed foreign exchange regime as it is under a free-market regime. Instead, the central bank has the most influence. In other words, the role of the government in maintaining a realistic exchange rate is more critical under a managed foreign exchange regime than under a free foreign exchange market.

In contrast to other developing economies, Korea and Taiwan succeeded in maintaining realistic and unified real exchange rates in the 1960s and 1970s, through their managed foreign exchange regimes, while continuing to build financial maturity. Judging from the success of Korea’s outward-looking development strategy, which involved heavy external borrowing, the country’s managed foreign exchange system helped prevent capital flight,
allowed selectivity in capital inflows, used a foreign currency loan scheme for exchange reserves, and maintained stability in the real exchange rate or effective real exchange rate.

The successful macroeconomic stabilization policies in Korea and Taiwan as well as in Hong Kong and Singapore, also helped these NIEs maintain realistic and unified real exchange rates while initiating their outward-oriented strategies. The average annual inflation rate in Hong Kong and Singapore in the 1960s was a mere 1 to 2 percent, and Taiwan's rate during the same period was less than 5 percent. Korea's rate during that period was more than 10 percent, in part because of the large devaluations carried out in the early 1960s as part of the stabilization policy.

Lessons for Developing Countries

Achieving a free foreign exchange market is a desirable and rational long-term objective for developing countries. While they pursue policies for building conditions in the financial markets and the trade regimes needed to have a free foreign exchange market, they should also try to achieve a realistic and unified real exchange rate without delay. This is possible even under a managed foreign exchange regime. In achieving this objective, macroeconomic stabilization should precede any other measures.8

Building Institutional and Physical Infrastructure

Because of externalities and scale economies in infrastructure investments and the imperfect nature of information in the world markets, the physical infrastructure (ports, transport, and communication) and institutional infrastructure needed for trade-oriented development have to be built through a joint effort of the public and private sectors.

Physical Infrastructure

When the East Asian NIEs initiated their outward-oriented development strategies in the 1950s and 1960s, a basic physical infrastructure was in place—left over from the entrepot trade of Hong Kong and Singapore, and from Japanese colonial rule in Korea and Taiwan. Subsequently, the NIEs devoted considerable resources to infrastructure investments (e.g., the Hong Kong government constructed a major port for container shipping in the early 1970s).

Although all of Hong Kong and Singapore can be considered FTZs, the government-run Hong Kong Industrial Estates Corporation and Singapore's Jurong Town Corporation have developed industrial estates specifically to lease ready-built factory units at rents that would recover the full costs. These zones have been important in attracting foreign companies for export activities. Similarly, the three FTZs in Taiwan and two in Korea, established by the public sector, played an important role in attracting direct foreign investment to these economies in their early stages of export development. Industrial estates, export processing zones, and science parks have provided the additional infrastructure needed to upgrade, diversify, and expand industrial exports.

Institutional Infrastructure

It is equally important, however, to have an effective institutional infrastructure that is able to deal with imperfect information and imperfect competition in the world markets.

8. See Cooper (1987), Lin (1987), Ozawa (1989), and Sachs (1987) on the East Asian experience regarding the sequencing of liberalization in the various markets. The experience indicates that the precondition for liberalization was macroeconomic stabilization.
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Here, institutional infrastructure has a broad meaning, encompassing all the public and private organizations and agents that are development players.9

**Export Marketing Institutions.** As previously suggested in Table 5.1, in the 1950s and 1960s the East Asian NIEs generally relied on foreign trading companies for overseas marketing know-how and for providing access to world markets (except Hong Kong, which relied on local resources, namely, the British and Chinese merchant houses). As these economies pursued more aggressive strategies for penetrating and exploring external markets, they established public or semipublic marketing promotion institutions. Table 5.5 provides an overview of the export marketing institutions of the East Asian NIEs. However, their role has been coordination, information-gathering, and dissemination rather than direct marketing.

**Table 5.5 Comparative Overview of the Primary Export Marketing Institutions of East Asians NIEs**

<table>
<thead>
<tr>
<th>Institutional Role</th>
<th>Hong Kong</th>
<th>Singapore</th>
<th>Korea</th>
<th>Taiwan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutional support</td>
<td>Trade Development Council (established in 1966)</td>
<td>Singapore Trade Development Board (established in 1983)</td>
<td>Korea Trade Promotion Corporation (established in 1962)</td>
<td>China External Trade Development Council (established in 1970)</td>
</tr>
<tr>
<td>Export marketing channels</td>
<td>Merchant houses; small trading firms</td>
<td>MNCs; INTRACO</td>
<td>Korean general trading companies</td>
<td>Japanese general trading companies; small trading companies</td>
</tr>
</tbody>
</table>

**Trading Companies.** Korea appears to be the only developing economy that has succeeded in emulating large, Japanese-type private GTCs based on existing conglomerates. Singapore's GTC, INTRACO, is a public corporation. The trading companies in Hong Kong and Taiwan comprise many small businesses. In recent years, about 50,000 Hong Kong manufacturers have employed close to 1 million workers (fewer than 29 workers per firm). With more than 90 percent of Hong Kong's products being exported, more than 90 percent of its firms employ fewer than 10 workers. In Taiwan, 99 percent of the more than 120,000 manufacturing firms are small and medium-size operations (Medium and Small Business Administration 1987).

These small manufacturers are indirect exporters relying on trading companies for direct exports and imports of raw materials. The numerous Hong Kong and Taiwan trading companies supporting these small manufacturers are also small. More than 90 percent of the 28,000 trading enterprises in Hong Kong employ fewer than 20 people. The large trading companies in Hong Kong that employ more than 100 people account for only 1.3 percent of the total trading establishments (Chan 1987: 65). The more than 50,000 registered trading companies in Taiwan are all small and medium-size, except for several big trading companies being promoted by the authorities without much success (Chan 1987).

What have been the underlying factors enabling the small trading companies of Hong Kong and Taiwan to succeed in linking small producers to overseas markets? How have they

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9. Arrow (1974) and Stiglitz (1989) argue that the inequality in economic development stems largely from the differences in organizations and institutions that deal with imperfect and costly information.
been able to collect overseas information, provide the necessary financing, and take considerable risks? Why has the size of Hong Kong and Taiwan trading companies differed so markedly from that of Japan's and Korea's GTCs, which have exploited economies of scale in overseas market intelligence, sales, and distribution and have been able to tap the resources of the conglomerates?

The relationships between small traders and small manufacturers in Hong Kong and Taiwan have worked well because of the strong trust developed through close personal contacts, the flexibility and efficiency of small producers in meeting small orders and changing their product composition, the lower management and operating costs of smaller trading companies, and the smaller resource requirements for intra-firm credit-based trade financing. These advantages have outweighed scale and financing limitations. Trust and flexibility among family-related businessmen are also traditions in the Chinese culture. The vitality and prevalence of small and medium-size trading companies might also be related to a cultural preference for owning a business rather than being employed in a big corporation.

Business-Government Partnerships. The East Asian culture and other unique institutional underpinnings have forged effective partnerships between the business communities and governments (frequently characterized as Japan Inc., Singapore Inc., and the like), while basically private firms of the East Asian NIEs have carried out manufactured export production and overseas sales. This relationship has been markedly different from the more typical characterization of private versus public sector, or market versus intervention dichotomy, and has been vital to successful implementation of the outward-oriented development strategies in the East Asian NIEs.

Lessons for Developing Countries

Conditions in most developing countries offer neither the physical infrastructure found in the East Asian NIEs in the 1960s nor the investment resources to create it. Consequently, the concentrated development of infrastructure in a few FTZs is a key strategy these countries can use to attract direct foreign investment. The experience of Hong Kong and Singapore in developing industrial estates and factory units with proper cost-recovery leasing policies is valuable in light of the capital shortages of developing countries and the fact that subsidized rents alone would never induce such investment. Furthermore, the experience of some Latin American FTZs (e.g., in Costa Rica and the Dominican Republic) that have relied on private enterprises and capital (domestic or MNC) for establishing FTZs also is valuable.

Imperfect information about external markets and technology as well as economies of scale and external economies in overseas marketing justify institutional support for export marketing. However, the creation of a trade promotion agency in a developing country does not guarantee the level of success experienced by the East Asian NIEs. Efforts to improve the efficiency of such an organization are needed as well. For example, the Hong Kong Trade Development Council deliberately limited the share of expenses for personnel (to 30 percent) to prevent overstaffing; its investment was directed toward more trade services. The Singapore Trade Development Board was created (1983) by reforming the trade promotion function of previous agencies. The role of a trade promotion agency as central coordinator of the promotion activities of chambers of commerce, industry associations, trading companies,

10. President Park used Korea's "monthly trade promotion meetings" effectively to enhance public awareness of the outward-oriented development strategy at Korea's early stage of export development. This measure was a uniquely Korean adaptation of Japan's model, transposed to Korea's cultural background and temperament. The other East Asian NIEs also used their unique institutional mechanisms to induce collective efforts to implement their outward-oriented strategies.
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and export manufacturers is even more important than its information-gathering and disseminating functions.

A lesson for developing countries is that each culture has a unique institutional infrastructure that can become a foundation for effectively implementing an outward-oriented development strategy provided deliberate efforts are made to capitalize on the positive aspects. For example, Korea capitalized on the pragmatism of Korean shamanism. Research is needed to find, for example, the types of trading companies suitable for different cultures.

Conclusions

The emphasis in this chapter has been on the lessons from the East Asian NIEs that are relevant to developing countries today. These countries should pay particular attention to the NIEs' process of initiating outward-oriented development in the 1950s, 1960s, and 1970s. Of course, the task may be more difficult for developing countries, given their initial conditions and current world market environments. Such difficulties should not prevent them from pursuing an outward-oriented strategy, however. The strategy can initiate dynamic development in an outward-oriented direction, expand imports, and provide a more competitive domestic industrial base. The sequencing of the reforms related to policies and institutions and infrastructure building in the East Asian NIEs should be of special interest.

INITIATION OF DEVELOPMENT. A developing country with unfavorable initial conditions, as explained earlier, needs to bring in foreign parties and partners who can package the critical foreign and domestic elements needed to enter the world markets and establish the minimum policy and infrastructure environments that put domestic firms on an equal footing with their foreign competitors.

DIFFUSION OF DEVELOPMENT. Acquiring the capacity to enter the world markets by working with MNCs is a first step in gaining the industrial competence needed to sustain an outward-oriented development strategy. Development initiated through collaborative efforts with MNCs needs to be transmitted efficiently to other domestic firms and throughout the economy by taking advantage of the tremendous externalities that come from international contacts and competition.

SEQUENCING OF REFORMS. Given its significant policy distortions, the underdevelopment of its institutions (including markets), and its insufficient infrastructure, a developing country can seldom afford to wait until perfect, rational policy, institutional, and infrastructure environments exist before promoting outward-oriented development. It first must establish an "equal footing policy" and institutional and infrastructure arrangements. These not only are necessary conditions for encouraging foreign firms to participate and for initiating development in an outward-oriented direction, but they also can be the first steps in establishing perfectly rational policies, mature institutions, and rich infrastructure.

Upgrading the capabilities of institutions (such as banks, trading companies, and government agencies) that implement the policies that provide equal footing with foreign competitors will stimulate the government's willingness to extend export policy regimes to nonexport activities.

The East Asian experience suggests that developing countries would have a better chance of succeeding in their export policy reforms (i.e., free-trade status, easy access to trade financing, realistic and unitary real exchange rates and so on) and of extending them to the whole economy if these reforms were sequenced in parallel with the increasing industrial and institutional competence gained through world market competition.

References


90 Managing Entry into International Markets: Lessons from the East Asian Experience


The newly industrializing economies (NIEs) of Asia—Hong Kong, Singapore, Taiwan, and the Republic of Korea—which as late as the early 1950s were insignificant producers and exporters, have had a miraculous post-World War II economic experience. Between 1965 and 1980, the average annual growth of exports of Hong Kong, Singapore, Taiwan, and Korea was 9.5, 4.7, 27.3, and 19.0 percent, respectively; and for the period 1980 to 1986, it was 10.7, 6.1, 13.1, and 12.7 percent (World Bank 1988a). As the data indicate, between 1980 and 1986 the average annual growth of exports for Korea and Taiwan was much lower than during the period 1965 to 1980, but their performance was much better than that of any industrialized country. Compared with 1965, the value of their manufactured exports in 1986 is equally impressive. In 1965 it was US$995 million, US$338 million, US$104 million, and US$187 million respectively; for 1986 the corresponding figures were US$32 billion, US$14 billion, US$31 billion and US$35 billion. Some of their manufactured exports have risen so rapidly that they threaten established producers in many countries. Many of their exports no longer receive Generalized System of Preferences (GSP) treatment, and some Japanese producers are asking the Japanese government to restrict imports of some manufactures from these countries.

The Organisation for Economic Co-operation and Development (OECD) predicted that some time in 1989 the total exports of these countries would reach, other things constant, about 80 percent of Japan's. In Korea, the share of the manufacturing sector to gross domestic product (GDP), which was almost 5.3 percent in 1954, rose to approximately 30 percent in 1986. For Hong Kong, Singapore, and Korea, the share of machinery and transport equipment in 1970 was 16 percent, 28 percent, and 11 percent respectively; and for 1985 it was 21 percent, 49 percent, and 23 percent. During the period 1965 to 1986, the average annual growth rate of the gross national product (GNP) per capita was 6.2 percent for Hong Kong, 7.6 percent for Singapore, and 6.7 percent for Korea. These rates exceeded those of any of the industrial market economies.

In 1986 gross domestic investment as a percentage of GDP was 23, 40, and 29 percent for Hong Kong, Singapore, and Korea respectively; and the corresponding figures for gross domestic savings for the same countries were 27, 40, and 11 percent. Whereas almost all nonpetroleum exporting, developing countries have very limited foreign exchange assets, the four leading NIEs of Asia have been accumulating foreign exchange, particularly Taiwan, whose reserves in 1986 stood at US$50 billion. Taiwan has recently offered to make loans to some U.S. companies "to help encourage U.S. exports and reduce the huge U.S. trade deficit with the island" (Journal of Commerce, 1989). With the exception of Korea, the external debt of each of the other countries is less than US$2 billion. Their unemployment rates are

*Billion = 1,000 million.*
relatively low and other conventional economic indices of growth and development are also impressive.

A number of writers have attempted to identify the causes of the post-World War II economic success of the East Asian countries. Some of the causes they have pointed to are a penchant for hard work and high savings, the geopolitical significance of the region to the United States and most significant, their export-oriented production policies. Emphasizing the contribution of export-oriented production policies to the postwar economic success of the East Asian countries, proponents of the East Asian model state that an export-oriented strategy of development tends to be positively correlated with better growth performance (Balassa 1978: 54). They also say that export promotion is superior to import-substitution policies (Krueger 1981). They argue that minimal government intervention in economic performance is crucial to successful export-oriented strategies (Krueger 1985: 198).

It is doubtful that all less developing countries can successfully replicate the East Asian export performance because the industrialized countries will simply not allow huge imports of manufactures from the developing countries to disrupt their economies on a continuing basis. If all developing countries adopt the East Asian model of export-oriented development, they will capture about three-fifths of the share of manufactured imports by industrial market economies (Cline 1982: 394). If one adopts an import penetration of 15 percent as a threshold beyond which the industrial countries would institute protectionist barriers, then, according to Cline, "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 a flood of developing country exports, caused by a general adoption of the Asian export model." Even if one ignores the possibility of import restrictions, it seems unlikely that if all developing countries follow the East Asian model of export-oriented development, the industrialized countries will be able to absorb all of their manufactured exports.

This chapter hypothesizes that it may be difficult for the Caribbean Community and Common Market (CARICOM) countries to replicate the East Asian experience. But this does not mean that the Caribbean countries cannot gain any valuable lessons from the East Asian experience. To determine what these lessons are, I first examine the contention that minimal government intervention has been an important element contributing to the economic success of the East Asian countries. The arguments are as follows: (1) with the exception of Hong Kong, East Asian governments have played a very active role in their economies; (2) the international environment in which the East Asian countries began their export drive is very different from today's, in which CARICOM countries are being urged to pursue more export-oriented production policies; (3) the implications of the new technology for CARICOM countries is very different today; and (4) the infrastructure and certain social and institutional parameters may also prevent countries in the region from replicating the East Asian experience.

Laissez-Faire or Government Intervention?

Have East Asian countries been successful because their governments have played a minimal role in the economy? Some economists seem to suggest that the developing countries can realize high rates of growth and development by exposing their economies to free market forces. But the governments in at least three of the East Asian countries did not leave the development of the economy to the invisible hand. In 1973, for example, the government of Korea introduced the Heavy Industry and Chemical Plan to force the disproportionate growth of capital-intensive industries—shipbuilding, steel, machinery, and petrochemicals. It increased the production of ships by about 15,000 percent despite a global contraction. The Korean government also took over five leading commercial banks. In the 1960s and 1970s government spending was about 20 percent of the GNP and public investment was about 40 percent of total domestic investment. In the early 1980s the government was
still busy forcing mergers and monopolies to reduce competition and obliging companies to adopt a particular pattern of specialization.

In Taiwan, the government played an active role in economic affairs, although its involvement might have been less pervasive than that of the Korean government. For example, the Taiwanese government controlled most of the banks, and in the 1970s it directed most of the loans to the public heavy-industry programs (Cline 1982:49). Chen (1983: 8) notes that in Singapore the government owns or is a joint partner in "transportation, communications, finance, construction, shipbuilding and repairing, electronics, engineering, and other manufacturing activities."

**International Environment**

The late 1950s and early 1960s, when the East Asian countries began their export drive, witnessed an unprecedented global economic expansion. According to Reynolds, (1980: 94):

> From 1945 to 1973 the world economy grew as never before, confounding the prophets of stagnation who had flourished in the 1930s. In the OECD countries, GNP grew at an average annual rate of 5 percent per annum, and GNP per capita at close to 4 percent. These rates were well above those for any previous period of comparable length.

In the two decades following 1953, total trade increased by about 8 percent per annum and manufactures by about 11 percent per annum. According to Balassa (1981: 2), between 1973 and 1978 industrial countries' imports of manufactured goods from the developing countries increased by about 10.2 percent a year.

In addition to being part of a rapidly expanding global economy, the East Asian countries are situated in a region that assumed great geopolitical significance to the United States in its confrontation with the Soviet Union after World War II. The Communists had come to power in China and Western governments felt threatened by the growing nationalism in Asia. The East Asian countries benefited from the Cold War as the United States, the dominant hegemonic power at the time, extended them favorable trade concessions as part of its global strategy of containing communism.

Given the geopolitical significance of Asia to the United States in the postwar period, it should therefore come as no surprise that special privileges were granted to these countries, such as the waiving of textile quotas. Korea exported to the United States about 25 million pairs of shoes in excess of its quota (Balassa: 129), and U.S. customs showed leniency toward Hong Kong, Korea, and Taiwan when, in clear violation of established trade regulations, they used third countries to ship textiles, clothing, and footwear to the United States (Feijnzyler 1981).

Caribbean countries are being urged to pursue export-oriented policies in a global environment completely different from the one in which East Asian countries began their export drive. During the period 1980-86 the average annual growth rate of global trade was less than 1 percent (World Bank 1988b: 2). The United Nations (1987: 59) has reported that "during the period 1981-1985, exports of manufactures grew at 4.8 percent, compared with 7 percent during the 1970s and over 10 percent in the 1960s"; and that "trade remains a weaker engine of growth than in the past" (United Nations 1987: 51). Between 1980 and 1987, real per capita GDP in the industrial economies grew at about 1.9 percent a year (World Bank 1988a: 2).

Some believe that the Caribbean countries also have access to the world's richest markets (the United States and the European Community) which consist of 500 million consumers under Lome and Caribbean Basin Initiative (CBI) (Europe 1986: 27). But neither the primary commodities of the region nor the manufacturing-export industries such as textiles and apparel have unlimited access to the US-EC market. During the 1970s, for example, the United States granted Caribbean countries the GSP, which gave duty-free treatment to designated imports. Many CARICOM products enter the United States under GSP. But the GSP has limits on duty-free benefits and excludes some products. For instance,
the United States withdraws the preference "when the specific export product is either half of U.S. imports or exceeds about US$71.4 million in value" (World Bank 1988b: 8). Moreover, as former Secretary of State George Shultz testified before the U.S. Senate Finance Committee: "These (and other) limitations, and the whole complex structure of the GSP, limit the ability of small and relatively inexperienced traders—which is often the case in the Caribbean Basin—to take advantage of the GSP opportunities" (Shultz, 1982: 2).

Since a large number of regional commodities exported to the United States enjoy GSP treatment, one should not expect the list of products benefiting from the CBI to be very long. Indeed, the CBI excludes many products considered crucial to the long-run development of the region. Some of the excluded products are textiles and apparel, footwear, work gloves, handbags, luggage, petroleum, and sugar. The exclusion of the first two items has been particularly disappointing to countries in the region because of their perceived potential as employers of labor. The United States now allows some imports of textiles and apparel under the CBI, and in 1989 it increased the quota for these products for two Caribbean countries, Haiti and Jamaica (Caribbean Business 1988). But to be eligible for export textiles and apparel to the United States under CBI, designated beneficiary CBI countries must sign the Special Access Agreements that activate Guaranteed Access Levels; and only five CBI countries have signed the Special Access Agreements.

Although regional textile and apparel exports to the United States have risen as a result of the CBI (World Bank, 1988b: 13), Caribbean governments need not think that the United States will continually increase its imports of these products. About four years ago, a U.S. embassy official in Barbados, Gordon F. Dugan, warned CARICOM countries that whereas textiles had started the industrial revolution in England, Japan, and Korea, they would not be the catalyst for development in CARICOM countries. This is because the external market necessary for their large-scale development would not be open to them. Moreover, regional governments must remember that products now entering the United States duty-free under the CBI may be subject to tariffs tomorrow (as were rubber wet suits produced in St. Lucia by a U.S. firm).

**The New Technology**

The slow growth of world trade and manufactures as well as the protectionism in the more developed countries may be important elements adversely affecting the ability of Caribbean countries to replicate the East Asian experience. But a much more critical element is not only reducing the ability of Caribbean countries to export to the markets of the more developed countries but is also threatening development prospects and is rendering industrial development plans obsolete. The new technological revolution is making conventional theory and policy of limited value to the region, and unless Caribbean countries can devise new industrial strategies, they will "industrialize to obsolescence." The influence of the new technology will be global and the microelectronics revolution will be applied to virtually all sectors of the economy and society. Its products, by being more reliable, cheaper, and more durable, will penetrate all economies unless a country decides to maintain a full and permanently closed economy.

All Caribbean governments say that they must have foreign investment to achieve high levels of growth and development and that their countries must export to extraregional markets. To attract export-oriented foreign investment, they have been offering foreign investors various kinds of fiscal and other incentives. But the main export-oriented industries that the Caribbean nations have been able to attract to the region are labor-intensive and characterized by an assembly-type nature. Puerto Rico, which once led the region in such activity, has given way to the Dominican Republic, Haiti and Jamaica. Assembly-type activities have generated significant amounts of employment in some countries. In the Dominican Republic free trade zones, for example, employment reached about 70,000 compared with 20,000 in 1984. Similarly, in Jamaica, employment in the 807 garment assembly-type activity increased from about 2,000 in 1984 to almost 20,000 in early 1988.
Corresponding to such increases in employment have been increases in manufacturing exports. For example, the World Bank (1988b: 17) reported that "the 807 exports of the Dominican Republic, Haiti, and Jamaica have increased by more than 20 percent in the 1980s." Most of these exports are clothing, the largest 807 export category to the United States. Between 1980 and 1986, the annual growth rate of textiles and apparel export items to the United States by these three countries was 21.9, 10.9, and 38.8 percent, respectively (World Bank 1988b: 13). At least in these three Caribbean countries, export-oriented apparel production seems to have had some success. But will this kind of activity last a long time?

The vast majority of 807 Caribbean apparel exports, whether manufactured by foreign firms or through joint venture relationships, consist of fabric cut in the United States. The Caribbean conducts the assembly of the product. Although it gains in direct job creation, the region loses secondary and tertiary employment as a result of being relegated to the lowest level in the manufacturing hierarchy. Manufactures from industrial countries have been locating their sewing operations offshore because the process is very labor-intensive and labor in the industrialized countries is relatively expensive. In addition, sewing has proved difficult to mechanize. But Technology Corp. (TC\textsuperscript{2}), a combined effort of government, business, and labor located at the Massachusetts Institute of Technology, has now developed "a computerized production process with robots which will take cut fabric and fully automate the manufacture of subassemblies. The cut fabric will be automatically fed into a machine and, with a computer-aided vision system and robot, will sew, turn, and fold the fabric" (US Congress, Office of Technology Assessment 1987: 70).

TC\textsuperscript{2} is also applying the new technology to knitwear—permitting automatic sewing of knit parts. In addition to these developments, alternate technologies—gluing, fusing, and welding of fabrics—may be developed and can be automated more successfully than sewing. Japan is supporting such a high-tech venture. Caribbean governments must realize that the eventual development of these technologies and their general diffusion may reduce the attractiveness of the region as a garment-assembly production platform.

The new technology will also adversely affect the export of assembled electronic products and semiconductors from the region. The number of semiskilled operatives is declining relatively, if not absolutely. It may be useful to briefly examine this industry since many governments are trying to attract more direct foreign investment in data processing because of its perceived potential as an employer of labor. For example, AMR Caribbean Data Services (CDS), a subsidiary of American Airlines, has a plant in the Dominican Republic and in Barbados for processing its airline tickets. At its plant in the Dominican Republic, CDS employs more than 300 persons (BusinessWeek, April 4, 1988). The plant in Barbados employs a similar number of people. But Caribbean governments should not assume that data processing will always be a labor-intensive activity. The new technology like the "smart ticket" in which a machine reads and records data, will eventually reduce the attractiveness of the region as a place for offshore data processing.

**Infrastructure**

When the East Asian countries began their export-manufacturing drive, they had abundant supplies of unskilled labor that helped to keep their manufacturing costs of production internationally competitive. Today, an abundant supply of unskilled labor may be an insufficient condition for a successful industrialization export strategy because direct labor costs, as a percentage of the firm's total costs, are declining rapidly. Moreover, productivity arising from the new technology as well as the broader restructuring process in many firms is such that, despite relatively high wage rates, a firm onshore can still be competitive. If U.S. labor is competitive with its offshore counterpart, it therefore makes sense for the factory to be located in the market in which its products are consumed.

The East Asian countries have come to realize that economies of location based on inexpensive labor are temporary. They remember that companies from industrial countries moved plants to their countries to take advantage of their relative inexpensive labor; and
now that the cost of their labor is rising, they see that some of these companies are moving operations to neighboring Asian countries. They have responded by using the valuable expertise gained in the phase before the new technologies were acquired to produce products based on such technologies. Some may argue that many manufactured exports from East Asian countries are not national but are products of U.S. firms producing in these countries. This, however, overlooks the fact that the leading NIEs of Asia are accumulating a pool of national industrial entrepreneurs to help effect the transition to a high-tech society. Daewoo, which used to be a subcontractor to U.S. companies for computers, is now selling its own personal computers. A recent study by the OECD (1988) provides compelling evidence that East Asian countries are making the transition to high-tech societies. In addition to the four NIEs of Asia, the OECD included in its study Mexico and Brazil but, this does not weaken the argument.

To ensure that they have the personnel to compete in a high-tech world, East Asian countries have been spending large sums of money on technical education. Between 1976 and 1986 in Korea, for example, "the number of engineering graduates with advanced degrees increased sevenfold. R & D was only 0.39 percent of GNP in 1970; by 1986 it had reached 2 percent, even as GNP soared. According to government plans, R & D spending will rise to 2.8 percent of GNP by 1990 and 5 percent by the year 2000" (Amsden 1989: 53). The enrollment ratio at the tertiary level (i.e., the number of students enrolled at the tertiary level as a percentage of the age cohort 20-24) is about 12 percent for Hong Kong and Singapore and more than 30 percent for Korea (McIntyre 1988: 40). These figures compare favorably with those in the more industrialized countries. In the Caribbean, however, the enrollment ratio is about 5 percent or less (McIntyre 1988).

Caribbean countries do not have the national entrepreneurs who can help move the region to a stage of development where it can produce high-tech products locally. The dominant national entrepreneurial class is mercantile in outlook and seems reluctant to undertake productive activities. Some time ago, Lewis (1950: 40) warned that the mercantile class, instead of supporting, might even be hostile to manufacturing activity. Today many writers share Lewis's opinion of the Caribbean mercantile class. Manley (1974: 78) accuses the mercantile class of reinforcing the colonial tendency of the region toward export-import orientation. The former Minister of Foreign Affairs of Trinidad and Tobago, Errol Mahabir, said of local investors in that country, considered the most advanced in CARICOM:

[They] are very slow in arriving at decisions, and when they do decide, their decisions reflect a short-term view, preferring a quick return rather than long-term growth; in other words, the approach is largely that of traders rather than industrialists (Pryce, 1985: 247).

"Furthermore, in 1982, sixty percent of the gross profits turned over in Jamaica were concentrated in commerce and real estate" (Stone 1987: 31). Merchant capital still dominates national economic activity; but merchants trade in products as they find them and have little incentive to revolutionize the means of production since their profits are not significantly dependent on reducing the cost of production by raising levels of productivity.

The small national industrial class shows little willingness to promote the development any kind of technology; instead its members seem content to rely on imported technologies. In their study of vehicle assembly in Trinidad and Tobago, Farrell and Gajraj (1985: 199) have noted that the "assemblers show no enthusiasm for attempting to escape . . . (their technological) dependence." They added that such technological dependence might be in the interest of the local capitalists. Likewise, persons entering the food-processing sector might seek to manufacture a standard product for which a complete technological package is available, being reluctant to enter into uncharted waters without having a firm foundation in science and technology.

Even if one assumes that national entrepreneurs are willing to develop the new technology—a very unlikely situation given the nature of merchant capitalists—one must still ascertain whether they can. Developing the new technology is an expensive undertaking. In 1986 U.S. firms in the computer industry spent about US$7.9 billion on
research and development and U.S. chip makers about US$1.3 billion. In the same year, U.S. textiles and apparel industries spent about US$68 million on research and development (Business Week, June 22, 1987). In 1985 the informatics industry in Brazil—the word "informatics" covers the whole field of computing, including microelectronics, automation, software, and peripheral equipment—spent about US$130 million on research and development. Caribbean national entrepreneurs, individually or collectively, do not have the ability to spend such sums of money on R & D.

Not only is the region short of the financial resources necessary to develop the new technology, it is also short of the skills required to develop the new technology. The manager of Intel, which closed its plant in Barbados a few years ago, complained, for example, that it was unlikely to find a dozen electrical engineers in Barbados (Wall Street Journal, March 18, 1985). But, when persons with the essential skills are available, governments do not fully utilize their talents. Theoretically, CARICOM governments can overcome the shortage of skilled personnel in the region by importing such skills and devoting more expenditures to research at the university level. But they may be unable to compete with the industrialized countries, where the skills needed for research on the new technologies are scarce and are commanding relatively high salaries. Nor may regional governments be able, under their political system, to divert financial resources away from vital social services. Such action may result in political unrest and scare away foreign investment, which said to be crucial to the long-run development of the region.

Caribbean countries will thus have great difficulty attracting high-tech firms. In addition to other adverse elements, no foreign investor will locate in the region if the skills necessary to produce some given product are unavailable or, if they are available, but are not wage competitive. It is also pointless for Caribbean governments to talk about attracting high-technology firms when they are reluctant, for whatever reasons, to give the University of the West Indies the resources to restructure an educational system.

Institutionalization of Labor Relations

When they embarked on their industrial drive, the East Asian countries effectively suppressed any inconsistency that arose between the demands of the collective objective, as defined by the state, and the demands of political unionism that might have reduced the profitability of capital below its opportunity cost and slowed the industrialization process. East Asian states were able to establish an income distribution consistent with rapid economic growth.

Caribbean governments have not been able to enforce an income distribution consistent with the collective objective. This is due, among other things, to the close association between trade unions and political parties. Close political and financial ties exist between political parties and trade unions in virtually all Caribbean countries (Wallace 1977). But this "endearing oddity" of Caribbean political parties in conjunction with the Westminster model of government may often be a hindrance to long-run economic development. Demas (1965: 98) writes:

The consequences of these social and institutional parameters (trade unionism and Westminster-style political democracy) for the development process are not difficult to discern. First, the existence of political democracy and the possibility of alternative governments can bring to the forefront the quite justifiable demands of the population for immediate and badly needed improvements, especially in social services; and since resources are always limited, this can conflict with long-run objectives of promoting structural changes in the economy. Second, the trade unions can and often do pursue policies which secure short-term gains in real wages and working conditions for their membership at the expense of the expansion of employment opportunities, capital formation, and government budget.

In a flourishing political democracy it may be difficult for governments to survive for long should they adopt economic policies that do not have strong union support. However, because they are conducive to long-run development, governments ought to consider such
policies. The alienation of the trade unions by the ruling party in Barbados and in Jamaica contributed in some measure to the defeat of the governments in those countries in 1986 and 1989 respectively. The "Day of Resistance" in Trinidad and Tobago (Caribbean Contact April 1989) may portend trouble for the NAR regime in that country.

To identify the negative aspects of some institution is not to deny the positive contribution it has made to the development process. Anyone familiar with Caribbean development will not minimize the positive role that trade unions have played in improving the welfare and working conditions of Caribbean workers. There may be a conflict between the objectives of trade unions and the long-run objectives of governments in a political democracy where opposition parties are prepared to champion any cause that will help them capture the government. They may, however, abandon the cause after capturing the government, but in the mean time it may be difficult to resolve the conflict.

That Caribbean nations must have inflows of foreign investment to grow and develop is the opinion of the majority of politicians and trade unionists of all persuasions. Although they agree that foreign investment is indispensable to growth and development, some do not seem to understand fully the conditions that appeal to foreign investment. Foreign investment will gravitate toward those countries whose conditions facilitate the growth and expansion of capitalist development. In the 1960s, when the East Asian countries began to develop their export drive, foreign investors sought relatively inexpensive labor. Today, many still do—as evidenced by the fact that the new NIEs of Asia are attracting factories from the older NIEs whose industrial relations climate seems to be deteriorating. If Caribbean nations assert that they must have foreign capital to attain their objective of faster economic growth, they must create the regional conditions necessary to attract foreign capital. For example, the wage-productivity ratio in the Caribbean must be such that—given a favorable social and political climate—even with various disadvantages such as higher costs, countries in the region will still be competitive internationally.

Conclusion

To argue that Caribbean countries may have difficulty replicating the East Asian experience does not mean that Caribbean countries cannot gain any valuable lessons from the East Asian experience. Balassa (1988) has shown that developing countries can learn a great deal from the East Asian experience. But the Caribbean countries cannot however manipulate certain variables that contributed to the success of the East Asian countries. For example, they have no control over the slow growth of global trade; nor can they force the more developed countries to lower their protectionist barriers. Caribbean governments are being urged to become efficient and to turn over state-owned enterprises to the private sector as a condition for rescheduling their external debt and for obtaining loans in international financial markets. They must now compete in a world where high technology has become the basis for a nation's competitiveness, where the life cycles of many products are no more than three years, and where the new technologies are restructuring the international division of labor and reducing the demand for direct labor and raw materials. They have to compete in a world that is becoming more and more self-sufficient in everything except petroleum and is thus reducing the need to depend on the less developed countries for most products. Furthermore, it is difficult for the Caribbean countries to have the same high rates of growth as East Asia because the social infrastructure, the political system, and labor-management relations in East Asian countries are very different from those in the Caribbean.

References


INCREASING INTERNATIONAL COMPETITIVENESS: A CARIBBEAN COMMUNITY PROGRAM

Havelock R. Brewster

A normative element reflecting social and environmental preferences may be desirable in targeting export industries for the Caribbean. Comparative advantage can be and, in some countries, is being deliberately planned. Indicators of international competitiveness at the industry and macroeconomic level should preferably convey analytic signals, useful in the evaluation of alternative policy options. They should also be data manageable.

A distinction should be made between the gross and net value of exports, especially when different categories of export goods are being compared and conclusions drawn about the benefits of competitiveness and improved productivity. Competitiveness is most relevantly tested not against lower wage exporters but against manufacturers in the United States. Devaluation is not the proven cause of the increased exports of manufactured goods from some Caribbean countries. More detailed, innovative research is needed.

Community institutions can assist in the task of enhancing competitiveness by stimulating those directly responsible for implementation in government, business, and training and research institutions. This approach should also be cost-effective. Four measures would be helpful in this area: (1) regional consultations on macroeconomic management (CONMEC), (2) the upgrading of technology and productivity in primary industries (TECHPLAN), (3) targeting and promoting new export industries and services (NEXPRO), and (4) research on future economic, social, and technological issues (CARIBFUTURES).

Social Preferences and Comparative Advantage

In an age in which export activities can, to a good extent, be targeted, Caribbean societies should probably be cautious about leaving their social preferences to be indifferently determined by an intrinsic comparative advantage. The physical and economic characteristics of this incomparably beautiful region and the experience of so-called successful exporting countries over the past 30 years underscore the need for this caution. The very small, densely populated islands of the Caribbean can rapidly become environmentally unsustainable. A stunning example of this occurred on an island roughly the size of Hispaniola: "On April 1, Taiwan residents awoke to the news that air pollution across a wide swath of the island exceeded acceptable levels and the Environmental Protection Administration advised people to stay inside. With cases of cancer, birth defects and lung diseases on the rise, urban residents don surgical masks to protect themselves" (IHT, 1989). On a less spectacular scale, comparative advantage has decreed what, in retrospect, seems to be a repugnant or precarious dependence on sweatshops, massage parlors, and package tourism in some small countries.

A further caution is provided by the frightening relationship between space, density, and the pursuit of wealth, as, for example, in Hong Kong or Japan. With per capita income

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Increasing International Competitiveness: A Caribbean Community Program

some 15 times that of most Caribbean countries, it is doubtful that important aspects of the quality of life of the average Japanese are any better than those of the average Caribbean person. In fact, Japan's GNP capita is 21 times greater than that of Jamaica. But the Human Development Report (UNDP 1990, published subsequently to this seminar) gives Jamaica a human development score of 82 percent compared with 99 percent for Japan which occupies the first place.

Rates of unemployment are high in Caribbean countries but the absolute size of available labor is minute and could be quickly exhausted. With open investment and technology transfer regimes, the relative scarcity of capital and technology to labor becomes a questionable guide to attainable comparative advantage and potentially exportable goods and services (UNIDO 1986). Therefore it seems all the more advisable for Caribbean societies to look before they leap into exports.

The Measurement of International Export Competitiveness: Traditional Measures

A normative element may be desirable before determining the range of products in which international export competitiveness is sought. For example, there may be little interest in knowing that the Barbados holiday industry is not competitive with that of, say, Majorca or Miami Beach, if Barbadians feel more at ease with their particular kind of tourism and how they would like it to develop.

A measure of competitiveness should also convey information that is useful in selecting policy actions aimed at making a potential export activity competitive. Thus it may be pointless to know, for example, that China, as a result of very low wages, can export garments at a better unit price than Jamaica. Garments of a similar description and quality can be and are being sold at a wide range of prices, and countries can and have moved virtually overnight from being successful low-price exporters to successful high-price exporters. Moreover, no amount of devaluation or wage restraint can make Jamaica competitive with China—its retained value added in manufacturing is one-fifth that of China, while its wages are five times as high.

These perhaps extreme examples serve to illustrate why traditional measures of international export price competitiveness of the kind apparently first used by Kravis and Lipsey (1971) (K-L) and a variant of it suggested by Helleiner (1989) for the Caribbean may be of limited usefulness. The K-L index is essentially a comparison for a given product of the home country's price with the weighted average price of imports from other countries, using a common currency.

That is,

$$
\sum_{i} e_{i} \cdot \frac{w_{ij} \cdot P_{ij}}{P_{bj}}
$$

(1)

$e_{i}$ being the index of change in domestic currency cost of the currency of country $i$; $P_{ij}$ the index of price change in country $i$ for product $j$; $P_{bj}$ the index of price change in the home country for product $j$; and $w_{ij}$ the share of country $i$ in the competing imports of product $j$.

Kravis and Lipsey used their index to compare the price competitiveness of industrial products of the United States, in the mid-1950s to mid-1960s with that of several European countries and Japan. In a context where all the countries being compared already have the full range of industrial products and technological capacity, the index may be appropriate (in any case, the K-L study found that price competitiveness was not the decisive factor in explaining export success in industrial goods).

In more specific terms, the K-L index offers no guidance to countries like those of the Caribbean where the interest is in finding new exportable goods, preferably those, as suggested above, that are in tune with their social and environmental preferences. It is
likely to be, if not a mere abstraction, a misleading indicator for the reason that, given the relative importance of nonprice factors and their lack of correlation with prices, the weighted average price of competitors' products may be badly skewed from the standpoint of assessing the competitiveness of any particular exporting country. Such an index also says nothing beyond what may, in any event, already be self-evident to manufacturers, whereas the real need is for guidance on more specific actions to improve competitiveness. Finally, the K-L index is industry-based and thus may not be the most appropriate measure of international competitiveness for use by governments and the community for purposes of macroeconomic guidance and coordination.

Alternative Approaches at the Industry and Macroeconomic Level

It would probably not be possible to monitor with acceptable accuracy and regularly over time the prices of comparable manufactures of a range of competing exporting countries. As mentioned above, prices of similar, and even identical, manufactured goods in the same place vary greatly, while the performance of exporting countries seems to be affected predominantly by nonprice factors. Moreover, with experience, competing exporting countries are unlikely to supply at prices that are unnecessarily lower than the marginal cost of the importing country. There may be a reasonable presumption, therefore, that, given acceptable nonprice conditions, any manufactured product the supply price of which is comparable to or lower than that of manufacturers in a selected importing country could be salable. This makes possible and greatly simplifies the search for a usable index of international competitiveness at the industry level. This may be expressed in the form of two complementary indicators. First,

\[
c_{ji} = \frac{m_{ui} + v_{ji} \cdot e}{p_{ui}}
\]

(2)

where

\[
m_{ui} = (r_{ui} + t_{ui} + f_{ui} + \ldots)
\]

and

\[
v_{ji} \cdot e = (w_{ji} + s_{ji} + k_{ji} + u_{ji} + x_{ji} + \ldots) \cdot e
\]

where, for purposes of illustration, \(c_{ji}\) is the index of competitiveness of a targeted industrial exportable \((i)\) of Jamaica \((j)\) conforming to explicitly chosen normative criteria; \(m_{ui}\) is the share in price of material imports from the United States \((u)\) for the manufacture in Jamaica of exportable \(i\); \(v_{ji}\) is the retained Jamaican value added of exportable \(i\); \(e\) the rate of exchange of Jamaica for U.S. dollars; \(p_{ui}\) is the US supply price of product \(i\) manufactured in the United States; \(r_{ui}\), \(t_{ui}\), \(f_{ui}\) of U.S. raw and intermediate materials, transportation, etc., and tariffs in U.S. dollars; \(w_{ji}\), \(s_{ji}\), \(k_{ji}\), \(u_{ji}\), \(x_{ji}\) are respectively the share in the price of Jamaican wages, profits, working capital cost, utilities, and other goods and services and taxes in Jamaican dollars.

Index (2) brings out several policy useful features. For example,

- To the extent that \(c_{ji} > 1\) it indicates that there may be a need to make the chosen exportable competitive.
- It illustrates a possible feasible combination and range of policy actions that could, over time, contribute to improving competitiveness, ranging from devaluation of the rate of exchange and shifting to cheaper sources of materials, including domestic production, to reduced unit wages/increased productivity and decreased taxes.
- It highlights a tradeoff between retained value added and international competitiveness that suggests the need may be more to optimize \(c_{ji}\) than to minimize it in relation to competitors, especially those such as Asian countries that have a substantially higher retained value added. This point is particularly important in
cases where increased productivity would not result in a commensurate increase, if any at all, in retained value added—a situation that would be even more disadvantageous if the increase in productivity required an increase in capital, or if wage restraint would lower retained value added but would not itself be the cause of increased exports. Or where devaluation would lower the supply price beyond that which could suffice for a given expansion in export sales.

Second, it might also be useful to monitor changes in the competitiveness of an export product through the use of a data manageable indicator that also conveys specific policy signals.

\[ C_{ji} = e \left( \frac{w_{ji}}{n_{ji}} \right) \cdot \frac{1}{p_{ui}} \quad (3) \]

where \(C_{ji}\) is the change in the index of international competitiveness, e is the change in the index of the rate of exchange between Jamaican and U.S. dollars; \(w_{ji}\), \(n_{ji}\), \(p_{ui}\) are, respectively, changes in the index of Jamaican wages in export industry i, of Jamaican productivity in export industry i, and of the U.S. supply price of product i. This indicator is based on the experience that, at the level of a specific industry, especially one in which wages are a large proportion of retained value added, prices rise by at least the difference between the rate of increase of wages and the rate of increase of productivity. Again, for the reasons given above, competitiveness is expressed in relation to the supply price of the goods manufactured in the importing countries (not supply prices of so-called competing exporting countries). It also does not require information about productivity increases in the importing country’s industry.

If \(C_{ji} < 1\), Jamaica is likely to be improving its relative competitiveness, given the influence of nonprice factors. This indicator also suggests that it may be preferable to optimize rather than to minimize \(C_{ji}\). It illustrates, too, some of the main tradeoff possibilities, particularly in a situation that actually has been characteristic of the period since 1985, where \(p_{ui}\) is very small.

At the macroeconomic level OECD in its biannual review, OECD Economic Outlook, publishes a series of indices called “Competitive Positions” for its member states. These indices are: manufacturing unit labor costs in local currency, relative unit labor costs in manufacturing in a common currency, export prices of manufactures in local currency, and relative export prices of manufactures in a common currency.

Other indicators relevant to the assessment of international competitiveness at the macroeconomic level that are regularly monitored by the OECD include: year-to-year percentage change in wages (composition per employee), year-to-year percentage change in prices (GNP/GDP deflators), rates of exchange against the U.S. dollar, the effective exchange rate, profit shares (gross operating surplus relative to value added), real rates of return (gross operating surplus relative to the gross capital stock), pure profit rates (real rates of return minus real interest rates), rate of investment, and interest rates.

In addition, more recently, a series has been published on the rates of growth of private sector labor productivity, the rates of growth of private sector capital productivity, and the rates of growth of private sector total productivity.

This comprehensive series of macroeconomic international competitiveness indicators would probably set an overly ambitious standard for the Caribbean community and may not be altogether necessary or even particularly relevant, especially in view of the limitations of data and facilities. Although the concern in the Caribbean is not mainly (though it is to some extent) with competition within the area, as it is in the OECD, it would also not be possible to track the pertinent variables of countries that the Caribbean is supposedly competing with.
A minimum program of macroeconomic monitoring of competitiveness for the Caribbean might therefore be based on indices for the following key variables to be estimated for each Caribbean country, with the United States as the most relevant reference country: real output, the price of imports, wages, employment, the inflation rate, and the exchange rate.

The most relevant indicator of relative competitiveness for a Caribbean country, in view of the limited scope for discretionary policy action on import prices, at least in the medium term, would probably be

\[
mc_j = e \left( \frac{b_{cj} / y_j}{b_j / y_j} \right) / p_u = e \left( \frac{b_{cj}}{y_j} \right) \cdot \frac{1}{p_u}
\]

(4)

where \(mc_j\) is the index of change of macroeconomic competitiveness of Jamaica; \(e\) the index of change of the rate of exchange between the Jamaican and the U.S. dollar; \(b_{cj}\) is the index of change of labor compensation in Jamaica; \(b_j\) the index of change of labor employed in Jamaica; \(y_j\) is the index of change of real \(GDP\); and \(p_u\) the index of change of the GNP/GDP deflator of the United States.

A complementary algebraic elaboration of the issues raised by wage, price, and productivity relations in the macroeconomic management of structurally dependent economies is given in Brewster (1969).

Devaluation and Competitiveness

The extreme structural dichotomy of most Caribbean countries poses a virtually insoluble problem for exchange rate policies. On the one hand, the bulk of exports—traditional tropical agricultural and mineral products of high retained value added—faces a more or less fixed demand, with prices externally determined and quoted in foreign currency. On the other hand, the production of manufactured goods for export is as yet minute, highly dependent on imports, and thus composed of a very small retained value added. As for Caribbean tourism, given its particular characteristics, import content, and lack of conclusive evidence of sensitive relative price demand elasticities, devaluation cannot be viewed as necessarily producing net beneficial results. (A comparison of the experience of Jamaica, Barbados, Antigua, and the Bahamas in 1979-86 hardly supports the case for devaluation.)

On top of this, in these small societies of such patchy economic structure it would prove extremely difficult to limit the transmission of devaluation to domestic prices, to the full extent, if not more.

In Jamaica, Guyana, and Trinidad and Tobago, the devaluations that took place in the 1980s were more than offset, by a substantial margin, by the growth of inflation over a period of one to three years (when U.S. producer prices were increasing by an average of less than 1 percent a year).

There is a clear danger therefore of having the worst of all worlds—very high social costs with little positive impact on export earnings (Bourne and others 1988). It is recognized that devaluation entails transitional costs. However, the structural dichotomy referred to above is extreme in the Caribbean. For example, in Jamaica the most structurally developed of the community countries, exports of manufactured goods are about 5 percent of the total value of exports when expressed in net terms. This feature of the economy, together with the limited means available for mitigating social costs, suggests that the transitional period would be both very long and very painful, even if devaluation ultimately were beneficial.
However, external balance may well eventually be attained through the compression of imports and the adjustment of the standard of living to a lower level reflecting the region's economic realities. Whether one approaches the analysis as one of elasticities, absorption or money supply, the same conclusions are reached.

In this context, it may be worthwhile to review some of the conclusions of the World Bank (1988). Setting aside the fact that devaluation should be evaluated in terms of its economywide benefits and costs (and ideally in relation to other alternatives), the point is made that as a result of the depreciation over the period 1980 to 1986 of the export weighted real effective exchange rate (REER) of the currencies of Jamaica and the Dominican Republic (in contrast to other Caribbean countries), the exports of manufactures to the United States of those countries greatly increased (in Jamaica from $21 million to $141 million and in the Dominican Republic from $302 million to $655 million).

The bulk of the increase in manufactured goods consisted of garments. Returning to a point made earlier, it would be important in a deeper analysis to bear in mind, when comparing export values of different categories of goods, that the retained value added of garments is only about 20 to 25 percent of their gross export value. However, even without undertaking such an analysis, one finds that in the case of Jamaica the big increase in manufactured exports actually took place between 1984 and 1986 (from $40 million to $141 million). During this period there was no improvement in the (supposedly more sensitive indicator of relative competitiveness) REER of Jamaica. Ironically, during the period the nominal rate of exchange against the U.S. dollar depreciated by 40 percent but was exactly offset by the increase in domestic prices. In the Dominican Republic, the REER appreciated by 35 percent in the period 1980 to 1984, while its exports of manufactures to the United States increased by 68 percent (from US$302 million to US$507 million). These exports continued to increase by 29 percent (i.e. to US$655m) by 1986, by which time the REER had depreciated by as much as 270 percent.

What these apparent anomalies in the cases of both Jamaica and the Dominican Republic seem to suggest is the need for deeper research, greater care in analysis, and better interpretation of results. Any number of nonprice explanations for the growth of exports of manufactured goods could be put forward—ranging from the timing of the startup of factories and the stimulation of entrepreneurship to the buoyancy of the growth of demand and liberalization of access conditions.

For example, the impact of expansionary fiscal policies in the United States certainly merits greater attention. Throughout the period 1980 to mid-1985, when the effective exchange rate of the US dollar appreciated by 45 percent in relation to OECD currencies, and to a lesser extent against the currencies of Hong Kong, South Korea, Taiwan, and Singapore, the volume of U.S. imports of manufactures rose rapidly. And they continued to increase at a fast, though slower, pace in the years following (1985-88) when the effective exchange rate of the dollar declined as rapidly as it had risen in the earlier period.

The structural dilemma remains for the Caribbean. Resignation to unnecessarily heavy transitional costs of adjustment is neither a comforting nor secure answer to the problem posed by adherence to traditional economic policies. An important, innovative, indigenous research effort is clearly indicated here.

Role of the Community Institutions

The role that Caribbean Community institutions can play in enhancing the international competitiveness of the regional economies will depend to a good extent on the powers and jurisdiction vested in them, and, of course, on the resources made available for the exercise of their functions. The suggestions to be made below assume no significant upgrading of the commitment to regional unity. They are thus essentially conceived as means by which the individual member states could derive benefits from community facilities, in a regionally harmonious manner. And the arrangements for executing them are heedful of the need for economies and for making good use of those directly involved in the public or private sectors.
How these arrangements fit into the institutional organization of the community is a matter that has been left aside.

The institutions of the Caribbean Community can be of assistance in the task of enhancing international competitiveness. They can do so by stimulating (1) improved macroeconomic management and (2) technological and productivity upgrading of traditional primary export sectors; (3) the identification and promotion of new export industries and services; (4) research on the economic, social and technological challenges of the medium-term future.

Consultations on Macroeconomic Management (CONMEC)

It would appear from occurrences throughout the region that the improvement of macroeconomic management now deserves high priority. This may need to be based more on sound indigenous analysis and judgment rather than mere reaction to the advice of the World Bank and the IMF. The centerpiece of CONMEC would be an annual Caribbean Economic Survey and Outlook. The material could be thematically organized in a manner relevant to the main macroeconomic problems of the regions, and in this context, individual country experience and behavior could be analyzed. A special and recurrent theme of this publication and its accompanying statistics could be competitiveness (for example, costs, prices, and export performance). This publication could be the basis for an annual business-like consultation among senior economic officials (from ministries of finance, planning and development, and central banks). Such a Committee of Senior Economic Officials would not be expected to reach agreed conclusions and policies but their exchanges of views could be expected to be mutually beneficial and supportive. Gradually such a publication could venture to project its analysis (not necessarily in a formal econometric sense) and to introduce elements of policy orientation.

Even a modest macroeconomic monitoring program of the kind suggested in the previous section of this paper would strain the regional statistical capacities. Timely and reasonably accurate, comparable and comprehensive computerized statistical information are indispensable for carrying out this task. It is a matter that requires the urgent attention of a regional committee for statistics and data management. It would also require accelerated training programs to be organized in collaboration with the regional universities and the Economic Commission for Latin America and the Caribbean (ECLAC).

At the same time, there is also an immediate need for research on certain problems of macroeconomic management. Following from the discussion in the previous section, research would be useful on how to evaluate the prospective results of devaluation in a Caribbean context and in relation to other policies. How could the net benefits of devaluation be improved in the Caribbean context of structural bifurcation? Should the feasibility of dual exchange rates be reevaluated, perhaps in the context of efficiently administered free-trade zones for new export industries and services? Should more thought be given to the strategy of implementing devaluation and to the deployment of more judicious complements of policies and measures, accompanying and/or following devaluation? Would it, in any event, be inevitable for Caribbean societies to find and endure a lower internal equilibrium consistent with their external balance, and to begin rebuilding their economies on more structurally durable foundations? How could the deleterious effects of such a transition be mitigated and managed?

A related problem for research concerns intra-area exchange parities. The Caribbean countries adjust exchange rates as a function of their extraregional disequilibrium but also have as a principal objective the promotion of balanced intraregional trade. Could a general framework of objective principles be devised that, while recognizing the circumstances of individual countries, could allay apprehensions of unfair competitive advantage and overcome the need to resort to countervailing intraregional trade restrictive measures?

In the interest of cost saving, the regular publication proposed as well as the ad hoc macroeconomic policy research might be subcontracted to the regional institutes of economic
research. And the annual meetings of the Committee of Senior Economic Officials might be convened by individual member states on a rotation basis. Caribbean institutions could play a useful role as promoters and organizers.

Plan for Upgrading the Technology and Productivity of Primary Export Industries (TECHPLAN)

A thorough examination is now needed of the cost efficiency of each of the Caribbean's principal primary export industries and services. On the basis of this examination, a plan for technological and productivity upgrading could be drawn up where it is warranted. The priority industries might be those subject to special protocols under the EEC-ACP Lome Convention that could come under threat eventually, if not in 1992 when the EEC becomes a single market, as well as those rapidly losing their market shares—for example, bananas, sugar, cocoa, bauxite/alumina, tourism, fishery products, and timber.

Such an examination would need to pay attention to the cost-benefit expectations of technology and productivity upgrading. As mentioned earlier in the chapter, there are circumstances in which the benefits of productivity improvements do not accrue sufficiently to the producing countries and in which they could even be made worse off. Investment of upgraded technology in traditional industries could also in some circumstances be of dubious economic merit in relation to investment in alternative projects. This examination might well be the occasion, too, for studying the scope for and feasibility of gradually rationalizing the geographical pattern of export production, particularly as it concerns bananas, sugar, and cocoa.

TECHPLAN might be executed through a cooperative effort on the part of the industries concerned themselves, mainly, but sometimes with the assistance of, specialized national or associate regional institutions. Caribbean institutions could provide the political impulse and could act as animators and organizers. The community might also play an effective role in organizing and seeking on a regional basis external technology aid programs for exports and in serving as a conduit of such aid directly to the industries concerned, whether under public or private ownership.

Program for Targeting and Promoting New Export Industries and Services (NEXPRO)

One of the first tasks of this program might be to consider the normative guidelines for identifying new export industries and services. As mentioned earlier, intrinsic comparative advantage need not be taken as an immutable indicator of export possibilities. These guidelines would probably be concerned with the environmental, social, health, intellectual, and aesthetic characteristics of industries and services, apart from their economic features. Thus information on the apparent nonfeasibility of preferred activities is as important as information on the feasibility of nonpreferred and preferred activities. The task should therefore further include showing how, working backwards—by what combination of dynamic cost-reduction operations—apparently nonfeasible activities, especially those with high preference rankings, might be made exportable.

The execution of this program might be undertaken on a cooperative basis by the relevant national and regional associate institutions. The national industrial development corporations, development banks, manufacturers' associations, and chambers of commerce might be encouraged to participate substantially. The community institutions are again, viewed as providing the political impetus and organizational stimulation. In addition, since NEXPRO has targeted a set of activities and established the prefeasibility conditions, the Caribbean Development Bank, in collaboration with national and external financial institutions, might play a more purposeful role in linking entrepreneurship with sources of capital and technology.
It would also be useful to undertake, on a continuing basis, direct, first-hand examinations of the reasons behind the export performance of selected manufacturing industries and firms.

Research Program Relevant to Caribbean Economic, Social, and Technological Futures (CARIBFUTURES)

This task is aimed at preparing the Caribbean for the "precompetitive" emerging international environment. In the past, despite clear signals, the Caribbean invariably failed to anticipate the adjustments needed for future competitiveness. The dim future for its principal traditional primary commodities was visible twenty-five years ago. Equally, the Caribbean failed to take advantage of the bright prospects offered by expanding demand for vegetable oils, rubber, fishery products, garments, electronics, plastic goods, and various services.

It may therefore pay good dividends to monitor and coordinate research that may be relevant to the future options of Caribbean societies. If possible, some research of this kind may be undertaken, even if in many cases, original work may be beyond currently available means and skills. None of the national or community institutions or associate institutions would seem to be prepared for this task.

Issues deserving attention in a futuristic setting might be divided into three categories: the quality of life, macroeconomic issues, and microeconomic ones.

Quality of Life
• Caribbean conceptions of well-being, and the harmonization of economic activity with them.
• The physical environment, its protection and enhancement, and its integration into the socioeconomic policy framework.

Macroeconomic
• Beyond debt, structural adjustment, and stabilization programs, what might be the future for a "post equilibrium" that is capable of generating growth with equity and full employment.

Microeconomic
• Possible implications for Caribbean economies of "precompetitive" developments in the north, such as computer-integrated manufacturing (information technology and telecommunications generally), biotechnology-based agroindustry, metal and waste recycling and advanced materials, new energy systems and rational energy use, and climatic change.
• Scenarios for a future without sugar, bananas, petroleum, bauxite, exports, labor-intensive garments, electronics assembly, and services.
• Future of the tourism industry.

Caribbean institutions and national governments with their present and near-term preoccupations understandably may not be able to find the time to consider such precompetitive issues. Yet their neglect could mean a preempted future—and perhaps a misused present. For example, a contemporary question concerns training and education for international competitiveness. But in what? In the Caribbean, education, government, and business objectives would have to be made more compatible.

One idea might be to organize CARIBFUTURES as a community task force, directed ex officio by the head of an appropriate community institution or associate institute. The Caribbean Community itself might be in a good position to promote a regional program of external technical and financial assistance based on the needs identified by the task force.

Given the many elaborate developments in respect of future research in the European
Community—for example, Esprit, Eureka, Flair, and Eclair—at least some form of technical collaboration might be possible.

The suggestions given above for a Caribbean Community program intended to assist in upgrading the international export competitiveness of the regional economies have deliberately avoided the traditional approaches of intergovernmental organizations based on predetermined training and technical assistance. Although these ultimately remain important aspects of such an effort—and are indeed of the four programs outlined, CONMEC, TECHPLAN, NEXPRO and CARIBFUTURES—experience suggests that it would be more effective if specific needs are identified by, and derived from, the operations of those directly involved in the implementation.

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