

Strategic Trade and Investment Policy for rapid industrialization: A possible approach to achieve Newly Industrialized Status

Present day fashionable thinking in development planning is get the prices right then market will look after the rest kind of approach. Nevertheless, in countries like Sri Lanka situation has been demanded from the state to play important role in guiding economic development and lead rather than follow the market while adhering to market orientated economic principles.

Most of Sri Lankan economists who advocate free market policy, thinks, once they introduce mechanisms that are coming under the free market theory, outcome instantaneous. Nevertheless, recent researches shows that advantage in international trade can be and is created by deliberate corporate and national policies. Comparative or competitive advantages result from deliberate corporate decisions and government policy choices rather than appearing as a gift from Mother Nature.

When it comes to industrial policy of a developing country like Sri Lanka importance of this kind of approach has become enhanced due its present inability on gaining advantages in free trading. Therefore it is difficult to discuss domestic industrial policy without discussing the trading policy of a given situation.

Therefore intention of this paper is discuss how to adopt a rational industrial and trade policy in Sri Lanka in order to achieve competitive advantage in international trade. It is interesting to embark this discussion from research outcome that made eye opener for most of the developing world. Micchel Porter, a professor at Harvard Business school, studied on the subject of the shift from comparative to competitive advantage. The central finding of the Porter's research was that internal characteristics of a national economy (including national system of political economy) affects the environment of domestic firms in

ways that either facilitate or obstruct development of competitive advantage in certain industries. According to Porter, several aspects of a national economy are particularly important: the national culture and its influence on the purpose of economic activities, status of capital and labor, the nature of effective demand, the condition of the supportive industries and the industrial structure of economy. These several factors determine domestic competitive conditions. In other words entrepreneurial culture and structure is needed to gain advantages (relative or absolute) from international trade. In other words Porters research shows us that the mechanisms based on traditional theory of free trade alone will not help to face the present day challenges of the international trade. To understand rational behind this approach it is important to understand the nature of the concept of free trade. When there is no theory to guide certain phenomenon there is a tendency to manipulate such a phenomenon. This will happen according to the objectives of actors who are dealing with such a phenomenon. This is exactly what happened with free trade concept. To understand this utterance it is important to explain briefly some of the theoretical backgrounds behind the concept of free trade.

Conventional Trade Theory: as an eclectic enumeration of factors:

Since its development in the early 1930s by Eli Hecksher and Bertil Ohlin (H-O model), the factor endowments or factor proportions model has been accepted as the standard explanation of international trade. This theory based assumption of consistent returns to scale, universal availability of production technologies, and determination of a country's comparative advantage and trade pattern by its factor endowments. This theory implies that:

1) A country will export those products that are intensive in its abundant factor: that is a capital-rich country will export capital intensive goods.

2) Trade will benefit the owners of the locally abundant factors and harm owners of the scarce factors. Thus, although all countries will benefit in absolute terms, there will be important distributive consequences that will favor either capital or labor in trading countries (Stopler-Samuelson theorem)

3) Trade in factors (capital or labor) and trade in goods will have the same effect and can fully substitute for one another (Mundell equivalence)

4) Under certain circumstances, trade in goods will over time equalize the return (wages to labor and profits to capital) for each factor of production (factor-price Equalization theorem)

The challenge now faced by this H-O model is that its inability to incorporate newly recognized factors such as human capital (skilled labor), learning by doing, technological innovation and economies of scale.

This made to believe the theory of international trade is not much more than an eclectic enumeration of the many factors that determine comparative advantage and trade flows¹. Therefore it is not a hard and fast rule to be obeyed sacredly. Following are the arguments in support of this assertion:

1. Concept of Human Capital:

Leontif Paradox² shown contrary to the stopler-Samuelson theory based on conventional trade theory: a country will export goods produced by its most abundant factor of production and import goods made by its least abundant factor.

Findings of Leontief Paradox which directly contradicted stopler-Samuelson theorem ultimately resolved by introducing concept of human capital and

¹ Gilpin (2000)pp88-113 or Gilpin (2001)pp.196-233

² Wassily W leontiff, domestic production and foreign trade: the American capital position reexamined" in pp208 Gilpin (201)

economies of scale into both trade theory and the neoclassical theory of economic growth.

This emphasizes the importance of and effect of investment in training, education and know-how resulting skills and productivity.

2. Rise of Intraindustry Trade:

Most of the trade between US, EU and Japan take place contrary to the H-O theory, between countries with similar factor endowments.

3. Integration of International Trade and Foreign Investment:

Transnationalization of capital do not confirm to conventional trade theory based on concepts of comparative advantage. It has given an opportunity to the MNCs to do manage trade through its vastly expanding intrafirm transfers.

4. Competitive advantage:

This patter of trade based on especially in high tech sectors, arbitrary specialization on increasing returns rather than from efforts take advantage of fundamental national differences in resource or factor endowment.

5. New Trade Theory: or Strategic trade theory;

This incorporates a growing appreciation of imperfect competition, economies of scale, economies of scope, learning by doing, the importance of R&D and the role of the technological spillovers.

Because of the forgoing reasons most of the countries especially developed world and the newly industrialized countries have not shown serious attention to the free trade policy as their sole development model. Instead they combined free trade concept and developmental state theory model together .In the late 1980s and early 1990s this approach gained rapid recognition in the face of outstanding economic success of Japan and other East Asian counties.

Especially Newly Industrial Countries (NIC) s devised array of incentives that encouraged private investments in strategic industries. Also through a variety of techniques, these governments played a key role in creating an entrepreneur class, identified critical economic areas for development and first protected and thereafter exposed them these priority sectors to international competition that forced them to become efficient. These state policies encouraged development of an industrial and economic structure that would not have arisen merely in response to market signals. According to this approach governments deliberately got prices "wrong" in order to change behavior of firms: they also used nonprice means to alter firm behavior. At the core of this approach and the reason for its outstanding success were close ties among government, local banks and industry. These intimate relationships, which Wade calls " **alliance capitalism**". Facilitated channeling bank capital into promising industries and thus prompted rapid industrialization.

Strategic Trade and Investment Policy for rapid industrialization:

Because of the defects in traditional model, Strategic Trade and Industrial policy (STIP) have created a new agenda for the countries who are concerned about achieving absolute gains through international trade. This suggests that certain types of state intervention can shift gains from trade and specialization, in special circumstances, from foreign to domestic firms.

Brander and Spenser suggest that industries with imperfect competition and super normal profits, subsidies can shift global profits to domestic firms such that the increase in their profits exceeds the subsidies. Hence, on the aggregate, there is a net increase in national welfare.

See also the Krugman's (1994) hypothetical example.

Strategic trade theories, in conjunction with the technological trajectory theory of the industrial policies, provide the rationale for STIPs. The technological trajectory theory states that technological flows across national boundaries are imperfect even when capital is highly mobile, state intervention is needed to secure 'first mover advantages' for domestic firms in industries where learning curves are steep and supply infrastructures are difficult to reproduce.

The logic to these STIPs is provided by the success of Japan and newly industrialized countries (NIC) s rapid industrialization which is a result of these STIPs.

STIPs have been got the attention of the policy makers of most of the countries because,

1. Domestic architectures of supply in critical technologies, enabling domestic firms to compete in the international market.
2. Incentives for multinational corporations to invest in the country.

A practical approach:

Every country has developed their trade policy through activist industrial and agricultural policy. Every country that talking about free trade now have developed their economies applying activist industrial policy in combination with free market approach. Therefore it is essential to have a national industrial policy to a country based on these two strategies. This paper contends that free trade based de -regularization policy alone will not do any good to Sri Lankan economic development for an example according to the overall competitive ranks of the world nations Sri Lanka ranks sixty one. Most of the industrialized countries as well as resource rich countries lagging behind our country in economic liberalization. For an example Russia Venezuela and Indonesia's growth competitive ranking is in 2001 is far behind Sri Lanka. Nevertheless we have not attracted any substantial foreign Direct Investment (FDI) to our country. Although we tend to blame this for the ongoing civil strife of Sri Lanka real reason

is not that. If we study the world trend of attraction for FDI the attraction has been mostly towards developed countries but not towards developing countries. When Belgium-Luxemburg attracts FDIs worth of its 31.7% of its GDP India gets only 0.9% and Bangladesh gets 0.7% of its GDP.

Inward Foreign Direct Investment as a share of Gross Domestic Product, 1994

Source: Based on data in UNCTAD, World Investment Report:

Developed Country	Share of GDP (%)	Developing Countries	Share of GDP (%)
Belgium-Luxembourg	31.7	Singapore	72.8
Netherlands	27.7	Malaysia	46.2
Spain	25.0	Indonesia	26.5
Greece	23.5	Hong Kong	20.5
UK	20.9	Chile	19.2
Canada	19.2	China	17.9
Denmark	12.6	Mexico	14.4
France	10.7	Thailand	10.1
Ireland	10.3	Philippines	8.3
Sweden	9.7	Argentina	8.1
USA	7.5	Brazil	8.0
Germany	6.8	Taiwan	6.6
Portugal	6.6	Pakistan	6.0
Finland	5.9	South Korea	3.3
Italy	5.9	India	0.9
Japan	0.4	Bangladesh	0.7
Total/out of	8.6	Total/out of	12.5

Therefore it is high time to think about alternative industrial policy to underpin our estranged economy. This kind of situation can be explained in trade and economic angle also. Full-scale liberalization (de regularization) is considered good for the countries that have surplus in their payment balance. This also can be explained by using the three basics of macro economic management policies. The outcome of this tendency is the formation of a vicious circle of dependency on foreign debt. Low level of exports and high level of imports creates a deficit in

balance payment in foreign trade. Low level of export is an obvious factor in small market like Sri Lanka who have been open its flanks totally to the strategic trade competitors. This deficit in the balance of payment account is a common outcome in most of the developing world. The deficit in balance of payment creates a vicious circle based on depreciation of currency, and inflation. The popular theory that depreciation of currency helps to increase gains in exports will not do much in this kind of situation, because the exports of most of these countries represent a very small percentage of its GDP. For an example, the Les Developing Countries represent 20% of the world population, but they generate a mere 0.03% of the trade flows.

Also, a larger percentage of essential items of day-to-day life are also imported by these countries. Therefore, depreciation of currency will have the impact of increasing of the cost of living. Inflation, which is the immediate effect of the local currency depreciation, will suppress the level of savings and will have an adverse impact on investment. This creates a situation of continuous dependency on foreign debt. The cumulative outcome will be economic as well as social stagnation. Countries like ours, where the balance of payment is in deficit due to more imports than exports will have pressure on exchange rate. The result will be low exchange rate for local currency and therefore high prices for imported products and relative low income to the workers. The appreciation of earnings of existing export due to depreciation of currency will not compensate the appreciation of prices and depreciation of relative wages of the sector due to factor specificity of labor (mobility of labor from one sector to another is restrained) and low ratio of exports against the GNP. This kind of inflationary nature of economy is not possible to resurrect unless the state intervene through an activist industrial and trade policy. These kinds of interventions are not uncommon in the history of the industrial nations. Japan followed phased process of industrial development. In phase-I Japanese firms were disadvantaged in both development and production costs. To shelter these firms against international competition, the domestic market was partially closed with

combination of import barriers by establishing local subsidiaries and inward investment restrictions. In phase-II Japanese and other Asian firms borrowed technology from abroad to bridge the technology gap. The state therefore relaxed import restrictions while maintaining inward investment restrictions. The state also encouraged firms to export by linking state support, such as concessional credits, to export performance. Hence, the domestic firms, having established themselves in the home market, were gradually exposed to foreign competition. In phase-III Asian producers began to build the world market positions without fearing foreign competition. Even now they are employing these intervention methods. Ex. The Japanese VLSI (very large scale integrated circuits) development project.

Also USA and Europeans often adopted this kind of approaches to safeguard their national interests. After single European Act of 1987 as well as the Maastricht agreement were preceded by a series of programs to promote high-technology industries in the region to ensure the Europe does not fall behind Japan and US in key technologies and industries.

Espirit, Eureka, JESSI and Air Bus Consortium are examples of such programs.

The Sematech consortium for R&D in semiconductor technologies. National Flat Panel Display initiative has created an umbrella for R&D funding for commercialization of new flat panel display technologies by US firms. This was US answer for to large lead of electronics firms in the production of active matrix liquid crystal displays, mostly for laptop computers.

Food for thought:

One can argue country like Sri Lanka can not even think along these lines because of its present abilities and low strategic maneuvering capabilities. But all countries who have gained newly industrial country status started from same position as we are now twenty years ago. Therefore what we needed is strong political will to deal with international actors and factors and coherent ideological

path. In search of such a path following ideas will help to develop a strategic intervention that would help us to gain newly industrialized nation status at least within next two decades...

1. Innovative institutional arrangements like joint research ventures, technology exchange arrangements, and customer -supplier relationship

2. Strategic trade policies are not the same as governmental interventions in strategic sectors. Strategic sector may generate externalizes only for the domestic economy and does not necessarily have international linkages. What we need at the moment is to create the state support for high technology industry through a combination of trade and industrial policies, with an objective that the country retains thriving domestic architectures-of -supply in critical industries, thereby enabling domestic firms to be competitive in globalized markets characterized by super normal profits and creating foreign firms in those same industries to invest directly in the country. In this regard following trade manipulations are identified as appropriate interventions for the protection infant industries.

Policies towards Imports:

a. Non tariff Barriers;

Ex. Manipulation of existing trade agreements such as Sanitary and Phytosanitary Measures (SPS) and The Agreement on Technical Barriers to the Trade (TBT). Anti dumping measures (ADM) Create import licenses, import surcharges, custom procedures and documentation requirements, health and safety regulations. Etc.

b. Exchange rate manipulations

Policies towards exports:

a. Financial and fiscal incentives to export producers

b. Export credit and guarantees

- c. Setting of export targets and incentives
- d. Operation of overseas export promotion agencies
- e. Voluntary export restraints
- f. Embargo for strategic exports
- g. Exchange rate manipulations

3. Develop entrepreneurial national culture and structure: national culture and its influence on the purpose of economic activities, status of capital and labor, the nature of effective demand, the condition of the supportive industries and the industrial structure of economy are vital for this kind of approach...

4. Importance of and effect of investment in training, education and know-how resulting skills and productivity.

5. Since most of the international trade is shifted from comparative advantage to competitive advantage the importance of concentrating on high technology has become most crucial aspect of the whole intervention.

6. Identification of specific industries and corporations that are interested in investing in such sectors.

7. State patronage to selected sectors by sheltering these firms against international competition, by the import barriers by establishing local subsidiaries and inward investment restriction and concessional credits, to export performance.

8. Create super competitiveness of the domestic market (South Asian Region)
Ex. Japanese firms in automobiles and consumer electronics is explained by super competitiveness of the domestic market. This super competitiveness of the domestic market share rather than profit maximization. This had carried out

primarily through product innovation, application of technology to productive process, great attention to quality control rather than through price competition.

9. Regional approach

Regionalism should be the central strategy of the Sri Lankan strategic trade and industrial policy.

Regional institutional mechanisms can be used to avoid initial problems that would face in this kind of export boosting program. Being a country with small market, market failures small market shares, low level of economies of scale etc are common challenges. To face these challenges Sri Lanka should actively encourage Sri Lankan industrialist to go for joint ventures and mergers with Indian or South Asian enterprises in selected strategic trade areas while strengthening regional open trade and economic regimes. This kind of trade and economic regionalism will increase competition and economies of scale while simultaneously denying these advantages to outsiders unless they invest in the internal market and meet member country demands for local content, technological transfers and job creation. It also facilitates pooling of economic resources and formation of regional corporate regional alliances.

Therefore it is high time to open up our eyes in order to reevaluate current broad based uniform liberalization policy. Countries who have gained industrialist status as well as newly industrialist status had been followed this kind of pragmatic approaches in spite of their outward commitment for liberalized economic policies. What matters is the outcome that is development of our country not the blind following.