POLICY RECOMMENDATIONS FOR EXPORT PROMOTION

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ABSTRACT

The paper examines policy recommendations for export promotion and accepts distortion-correction as the objective that fits well with received trade theory, policy experience and political economy considerations. Evaluating the new trade theory that has the objective of capturing a larger share of the global market, the paper notes its theoretical validity but limited value for policy recommendation. Support to specific export activities can be accommodated within a framework of distortion-correction. But that support has to be at the initiative of the private sector, it should be subject to evaluation as an investment in knowledge, and time bound.

EXTRACTO

Este documento examina las recomendaciones relativas a políticas para la promoción de exportaciones y acepta la corrección de distorsiones como el objetivo que mejor se ajusta con la teoría comercial en uso, con las experiencias en materia de políticas y con consideraciones de política económica. Al evaluar la nueva teoría comercial orientada a obtener una mayor participación en el mercado global, el documento pone de manifiesto su validez teórica, no obstante su valor limitado en cuanto a la formulación de políticas. Resulta posible adecuar el apoyo a las actividades específicas de exportación dentro de un marco de corrección de distorsiones. Pero ese apoyo debe depender de la iniciativa privada, estar sujeto a una evaluación como forma de inversión en conocimientos y tener un límite de tiempo.

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1. INTRODUCTION

Export promotion policies are those policies that are aimed at increasing the profitability of exports. Raising the value and the growth rate of exports is the essence of export promotion. This implies that the policy-makers of the country in question are not happy, for one reason or another, with the level of exports that takes place without export promotion policies. However, as we shall see below, these policies can well differ.

It is important here to refer to the overall policy environment since that determines to a large extent the need or the rationale for export promotion. The received theory for optimal trade policy, or the trade policy which maximizes the national product, is one of neutrality of incentives for export and for import-substitution. In the Bhagwati and Krueger sense, this means that the domestic resources utilized to earn a dollar of foreign exchange through exports is equal to the domestic resources used to save a dollar in foreign exchange by producing import-substitutes.[2] In other words, the effective exchange rates for exports is equal to that for import-substitutes. Unfortunately, many, including the authors of this concept, have called this policy an "export promotion policy" when they had really meant policy neutrality between export promotion and import-substitution.[3] Later writings refer to the concept of neutral policies as outward-oriented policies. The corresponding parallel to outward-oriented policies is inward-oriented policies which means that the effective exchange rate is higher for import-substitutes than for exports. This leads to another concept that was introduced by Bhagwati, namely "ultra export promotion", characterizing the case where the effective exchange rate for exports was higher than that for the production of import-substitutes.[4] We must note that all these concepts refer to overall incentive structures and are concerned with overall trade strategy.

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[1] I am indebted to Asad Alam for his comments on the paper and for his research for Section IV of the paper.

[2] See Krueger (1978) and Bhagwati (1978).

[3] Other studies such as Balassa (1975) also popularized the neutrality-based notion of export promotion.

[4] See Bhagwati (1988).

Policies that are aimed at increasing the value and the growth rate of exports can be applied under a system of neutral incentives, as when a particular export activity is promoted while keeping the overall incentives neutral, or under a system which is non-neutral and biased towards exports in the sense that export activities in general have higher effective exchange rates compared to production for the domestic market. Here, export promotion policies are defined as those that increase the profitability of individual exports in the context of neutrality. This means that only individual, and not all, export activities are promoted. Policy recommendations for promoting exports, therefore, have to deal with promoting the individual exports only.

In this paper, we tilt in favor of the opinion of mainstream economists that neutrality of the overall trade strategy is optimal and then raise the issues related to promoting individual exports. We also look at the East Asian experience with export promotion and contrast it with the Latin American experience. The plan of the paper is as follows. In section two, we outline the possible objectives of export promotion. Section three lays out the main features of the received theory and places export promotion in that context. Section four examines the new arguments for export promotion. Section five examines the instruments and the record of export promotion. The final section draws out lessons and recommends policy for export promotion.

2. OBJECTIVES OF EXPORT PROMOTION

There could be many objectives for export promotion in the sense we have defined above. We consider three principal objectives in turn:

(a) **Distortion-correcting export promotion:** This means attempts to reach neutrality. An important body of literature grew in the sixties rationalizing that governments could intervene in markets to correct distortions. These distortions could arise in trade from import protection, the protection of imported inputs for the production of exportables, over-valued exchange rates, or taxes on exports of one kind or another, and lead to a bias against exports. These belong to the genre of policy-induced distortions.

Another variant of the distortions-correcting export promotion is when the distortions are endogenous. Two lines of arguments for export promotion could arise here. One is related to externalities. The argument is that exporting activity creates benefits above and beyond the increase in export value for the individual exporter. Such benefits may arise from access to new markets, overall product quality reputation, learning to operate in foreign markets and access to the availability of particular types of goods and services in a foreign country, and may not be recovered fully by an individual exporter. So if there is promotion by the government, this will allow all exporters to gain the benefits that cannot be derived on their own. Note that the benefits cannot be internalized by any one exporting firm. Hence the rationale for government intervention in the form of export promotion. The other type of endogenous distortion that has often been cited is that of imperfect capital markets. The argument is that because of the under-developed nature of the capital market, there is little risk-pooling. Consequently, risky activities cannot be financed from the traditional sources of finance. Since export activities are inherently risky because the ultimate payment liability is with the foreign importer and there are currency risks as well as risks associated with entering a foreign market for the first time, export promotion should be used.

(b) **Export promotion for its own sake:** There is another genre of arguments that call for export promotion for its own sake and are grounded in the inherent merits of exporting. The view is that the promotion of export activities will lead to gains in terms of getting the economy on a dynamic path even though in a static sense this may not be the first-best policy. This dynamism can come from increased competition, greater potential for exploitation of economies of scale in the export of manufactures, and improved access to technology. The advocates of this type of export promotion see a variant of the infant-industry argument in operation, even though the original infant-industry argument had little or nothing to do with exports and applied to any type of activity in which there was learning and the opportunities to raise growth this way.[5]

(c) **Export promotion to capture a larger share of global profits:** These arguments are more modern and derive their theoretical support and validity from the application of industrial organization theory to trade policy. They start from the premise that the world market for some products, particularly manufactures, is oligopolistic. Since a key characteristic of oligopolistic competition is that the price charged for a good exceeds the marginal cost of production, countries importing such a good pay rents to the exporting firm. Thus, there is a role for strategic trade policy to capture a larger share of the market with first-strike or first-move advantage and thereby shift profits to domestic firms. These arguments are based on economies of scale. The abandonment of constant returns to scale leads to the abandonment of perfect competition, a characteristic of the standard trade models. It is

[5] See, e.g. Westphal (1982) and Pack (1984). They have argued that there are learning opportunities in export that are not found in other activities. As proof of this assertion, they argue that estimates of total factor productivity are consistently higher for exports than for any other activity.

really the possibility of increasing returns, or decreasing costs, that lead to arguments for promoting exports.[6]

To summarize, there are four main conclusions and implications to these arguments that give rise to export promotion objectives. First, the arguments for the promotion of specific activities for exports are consistent with the neutral incentives paradigm since neutral incentives refer to the overall incentive structure and not to an equality of incentives by activity. Thus, even after export promotion policies have been pursued to reach overall neutrality, there is still scope in the received theory to promote certain exports. Second, none of the mainstream economists who have advanced the new ideas of profit-shifting has asserted that overall incentives should be skewed in favor of exports. Rather, the contributions of Krugman et al have been to show that there are valid arguments to intervene in trade when there is imperfect competition in certain selected industries.[7] Third, not all of the different ways of promoting exports are compatible with the three rationales for export promotion. Finally, we have to examine the relevance of the new arguments particularly for the developing countries. The old arguments have been adequately dealt with over the last three decades.

3. THE RECEIVED THEORY AND PERMISSIBLE EXPORT PROMOTION

There are two well established cases for intervening in the trade regime in the static neo-classical paradigm. They are the infant-industry argument and the optimum tariff argument. The first can be seen as underlying the argument for export promotion if the infant is a potential exporter. The justification is derived from externalities and the imperfectness of the capital market. The other argument is the terms of trade argument for imposing an export tax when a country has monopoly power in trade in that activity. In the case of the received theory, the export promotion prescription is clear - apply the same rules and criteria for adopting export promotion as those for applying the infant-industry and the terms of trade arguments for intervention.

There are two caveats that are worth making about the received theory. First, it assumes that a country that is pursuing a neutral policy is at the production possibility frontier. So to increase exports by one unit, resources have to be shifted from either the non-tradeable sector or the import-substituting sector. But when a country is within the production possibility frontier and there is a large pool of unemployed resources, a country can have more exports without displacing import-substitutes. But even here the optimal policy is neutrality, in

[6] See Brander and Spencer (1985) and Krugman (1984).

[7] See Krugman (1987).

the sense that the resources are used at their opportunity costs. Thus, when we see countries having strong export growth while keeping domestic protection high, it is because they are utilizing the unemployed resources which are available at low costs. In this case, a reallocation of resources has the potential to raise national income. But once the aggregate cost curve begins to rise or to lose its elasticity, increase in exports will detract from allocative efficiency.

Second, the main criticism levelled against the neutrality principle is that it is a static concept. If there are dynamic gains from export promotion, they will not be captured by the equating of effective exchange rates. There are two possible answers to this criticism. One is that if the dynamic element is to be incorporated, it is possible to think of export promotion costs as a pure investment. They could be treated as investment in knowledge, or even in export infrastructure such as improving the ports, raising the standard of telephones or as some other communications investment. The same criteria should, therefore, be applied to these investments as to others. And if it has positive net value-added, it should be undertaken. While exports may or may not have inherent dynamic attributes as some claim, promoting exports is a less harmful activity than promoting import-substitutes. This is because, first, exports are always subject to competition. So there is an in-built market test for the viability of exports as against import-substitutes. Second, the effective exchange rates for exports and imports can be cast in terms of expected values so that a policy of maintaining neutrality can be based on expected exchange rates, expected future world market prices, and expected subsidies and tariffs. There exists of course the possibility that while the short-term expected effective exchange rates may be equal, the long-term may be unequal. The long-term effective exchange rate for exports may well be expected to fall and thereby create a bias against exports. In such a case, there would be a need to promote exports in the short-term and thereby create a bias in favor of exports sufficient to offset the future long-term expected bias against them.

The experiences of many countries over the last thirty years, particularly those of the East Asian countries, Hong Kong, Singapore, South Korea and Taiwan, yield important insights into which export promotion policies have worked and which have not. Tables 1 and 2 in the Appendix show a clear contrast of the trade policy and export promotion outcomes between two groups of East Asian and Latin American countries. By any standard, whether it be export growth, increase in the world market share, or the diversification and the contribution of exports to growth, the exports of these countries have been eminently successful. The term "East Asian miracle" is now a common reference in the trade and growth literature. In addition to the so-called tigers, there is also a new group of countries, Malaysia, Indonesia and Thailand, that have emerged as successful exporters. They have earned the term "tiger cubs" due to their export success following the original four tigers. The received theory can explain their success without great difficulty even though studies are now under way to re-interpret the export success of these countries in terms of a strategic policy-making paradigm that is more permissive of interventionist trade policy. None of the protagonists of the received theory - Bhagwati, Krueger, Corden or Little et al, have claimed that these successes were the result of free market policies.[8] In fact, all of the original tigers, except for Hong Kong, set policy to provide free trade status for exports and used accompanying policies to support the export effort. What then were the attributes of these policies that can inform us about the proper policy recommendations for export promotion?

Permissible Export Promotion

A few generalizations need to be established about the four tigers. First, their export promotion policies were of the distortion-correcting variety at the initial stages. The exception was Hong Kong which had neutrality from the start since it had hardly any import duties and maintained market determined exchange rates. The other three followed distortion-correcting export promotion in the face of numerous import restrictions and non-competitive exchange rates at the initial stages. In other words, they had to compensate for the bias against exports arising from the import regime and the exchange rate. Second, the overall policy environment supported export promotion policies in many ways by providing credibility of public policy both at the macroeconomic level and the microeconomic level. Third, some analysts have claimed that these countries had promoted exports, for their own sake at one time before they came to follow what appeared to be a neutral strategy. This may have been true for some time but not for the whole period, particularly not during the period of their greatest export success. Moreover, other countries that pursued export promotion for its own sake failed. Many countries in Latin America, from Argentina and Chile to Colombia and Uruguay and Mexico are cases in point. Finally, export promotion with the proper atmosphere has other benefits that are non-quantifiable such as the confidence that the exporters derive from the government's commitment to overall export promotion, the limits on the power of the public officials to direct activities since export promotion relies more on price incentives than import restrictions which are more quantity-based, and the reverse pressure to maintain good policy environments because policy failures are noticeable in the presence of export promotion measures.[9]

Under the received theory, the success of export promotion has a lot to do with appropriate macroeconomic environments. The stability of the real exchange rate is crucial as is the sustainability of the current account position. Interestingly enough, domestic price stability, while helpful for export promotion, is not

[8] See, e.g., Bhagwati (1988); Krueger (1978); Little, I.M.D., Scitovsky and Scott (1970); Corden (1971).
[9] See Krueger (1980).

crucial for its success. In the seventies, South Korea had high inflation rates and shared with its Latin American counterparts inflation rates exceeding 50 percent a year. What made export promotion a success was the stability of the real exchange rate, achieved through the adoption of a crawling peg. The continued export success alleviated foreign exchange scarcity and in turn permitted greater access to imported inputs. A similar situation was also present in the case of Brazil from the mid sixties to well into the seventies.

With stable real exchange rates and assured access to foreign exchange, microeconomic factors that support export promotion come into their own. There are many countries in South Asia including India, Pakistan, Sri Lanka and Bangladesh that satisfied the macroeconomic criterion of stable real exchange rates achieved through fixed exchange rates combined with low inflation but none of the microeconomic conditions which underlie the export success of the East Asian Tigers. Several microeconomic factors are important for the success of export promotion. First, there has to be unrestricted duty-free access to imported inputs so that exports can enjoy a free trade import regime. Second, the access should be automatic rather than discretionary. The latter would make the access operate only as a quantitative promotion device and deprive it of the flexibility and the certitude of automaticity. Third, there should be the same access to domestic inputs as there is to imported inputs. In other words, they should have equal status which would help domestic input-producing activities to benefit from the incentives for export.[10] In many Latin American and other countries that provided export incentives, this feature was absent. Colombia is a good example of this point. Fourth, duty drawbacks, duty waivers and rebates given at the point before the export is made are more effective than providing the rebates and the drawbacks afterwards. Post-adjustment reduces the effective exchange rate for exports and, therefore, the offset to the anti-export bias which the incentives for exports are supposed to provide. Thus there is a sequencing issue in providing export incentives. With respect to tax exemptions, many, such as Balassa, have pointed out that they are not equivalent to subsidies since they only offset the bias against exports. Furthermore, the exemption must equal at least the average import tariff rate to provide the offset.

Finally, an appropriate policy environment may not be enough. Export production will need support, such as well-designed and cost-reducing infrastructure including telecommunications, power facilities, ports, highways, airports and other paraphernalia, that the state can provide.[11] Exports would also need special services that are competitive. In addition, exporters require assistance with foreign marketing because of limited domestic knowledge, access

[10] This point is made very strongly by Bela Balassa who identified this as an important attribute of the Korean export success. See Balassa (1977).

[11] See Thomas, Nash, and Associates (1991).

to export credit and insurance, and the ability to obtain foreign technology through foreign investment.

4. EXPORT PROMOTION AND THE NEW TRADE THEORY ARGUMENTS

There is the interesting question of whether the new trade theory arguments invalidate the position taken by the received theory. But there is actually no contradiction of the received theory with the new arguments. They can be accommodated within the position that trade policy should be neutral between providing incentives for the foreign and the domestic market. One particular industry or activity can be supported in principle on grounds of profit-shifting in third markets and subsidies for activities such as R & D, which cannot be appropriated by a firm incurring such costs, can be provided. The questions at hand with respect to these arguments are: (a) What are the new arguments for export promotion? (b) How valid are the arguments on theoretical grounds? (c) How relevant are they for policy formulation taking into account the political economy aspects? and (d) How relevant are they for developing countries? We attempt to answer these questions in turn.

(a) What are the new arguments for export promotion? There are basically two versions of the new arguments for profit-shifting which provide the theoretical case for export promotion. The first version is based on the original modelling of profit-shifting provided by Brander and Spencer which argues for a subsidy to the domestic firm.[12] The domestic monopolist engages in a Cournot duopoly game with a foreign competitor in a third market. The assumption of a third market enables the discussion of national gain to be conducted in terms of producer surplus alone. It is in the nature of such a game that the equilibrium output level, determined by the two firms' reaction functions, is nationally suboptimal although jointly optimal. But a subsidy will lower the marginal cost to the domestic firm and commit it to a higher reaction function and capture a larger market-share, increasing domestic profit and reducing foreign profit. National welfare, net of the subsidy, increases as profit is higher and the subsidy itself is just a transfer payment. Crucial to this argument is the notion that the subsidy credibly commits the domestic firm to an aggressive strategy and thereby forces its foreign rival to adapt accordingly.

The second version of profit-shifting argues, paradoxically, for import protection as an export promotion mechanism.[13] The argument is that a protected

[12] See Brander and Spencer (1985).

[13] See Krugman (1984).

protected home market provides a firm characterized by economies of scale, internal to the firm, an advantage in scale over foreign producers, and enables it to raise market shares in domestic and foreign unprotected markets. This shifts profits from foreign to domestic firms and thereby increases domestic welfare at the expense of foreign welfare. Crucial to Krugman's modelling is the assumption that the domestic market is large enough to facilitate the realization of the presumed economies of scale.

(b) How valid are the arguments on theoretical grounds? There is no doubt that in the context of the specific models developed, the arguments are valid. Max Corden has convincingly argued that the new models provide another argument for departures from free trade, in the context of imperfect competition, that is theoretically sound for the purpose of extending the received theory.[14] But the condition under which the validity holds are highly circumscribed. Many other evaluations of these models also consistently point to the restrictiveness of models. Some show the crucial nature of the Cournot assumption where the strategic variable is output. When price is the strategic variable, as in the Bertrand strategy, then the policy conclusion is not for a subsidy but rather for an export tax much like the optimum tariff argument.[15] Others have questioned the assumption of excess profits or rents that an oligopolistic firm could earn and which becomes the basis of the profit-shifting argument. In fact, for each firm that has reaped profits from the R&D investments there are other firms that have made losses. So what appears as high ex-post rates of profit in oligopolistic industries are ex ante normal, risk-adjusted rates of return.[16] Furthermore, when there is more than one sector targeted for subsidization, free trade is the best policy because the informational requirements for assessing the cross effects of subsidies are forbidding. The general equilibrium effects cannot be easily measured under these circumstances. Raising taxes to finance the subsidy can reduce welfare rather than raise it.[17]

(c) How relevant are these arguments for export promotion when we take political economy factors into consideration? The political economy considerations detract severely from the validity of the strategic trade arguments even if the technical aspects of defining such a strategy are overcome in a multiple commodity and services world. Bhagwati has argued convincingly of the possibility of retaliation which could reduce welfare compared to free trade and could lead to trade wars reminiscent

[14] See Corden (1990).
[15] See Eaton and Grossman (1986).
[16] See Grossman (1986).
[17] See Dixit and Grossman (1986).

of the intervening period of the two world wars.[18] He argues that the potential for retaliation is greatest in the high technology industries where the proponents of the new trade theory believe the economies of scale are to be found. Moreover, once we abandon the assumption of benign government, the possibility exists that trade policy could be captured by sectarian interest leading to rent-seeking and directly unproductive activities that will make the economy worse off.

(d) How relevant are these arguments for developing countries? The possibilities for profit-shifting à la new trade theory are limited for developing countries. They are not the repositories of high technology industries which are really the focus of this argument. Moreover, the scope for exploiting economies of scale in their domestic markets is limited given their small economic size. In fact, the results of import protection have been highly adverse in these countries and export promotion has provided a way of offsetting the bias against exports arising from import protection. If a developing country has monopoly power in export, there is the traditional argument for an export tax. But this could also evoke retaliation. Indeed, developing countries are more prone to be retaliated against compared to the developed countries. For example, there was a tremendous increase in countervailing duties by developed countries in the seventies and the eighties. The trend is for increasing countervailing duties and unilateral trade opening action, such as the United States 301 actions, and a more increasing intolerance for developing country protection than in the past. When we consider the political economy arguments, there is an even greater scope for capture of strategic trade policy-making by sectarian interests given the fragile nature of political institutions and policy-making centers of government. Under the disguise of strategic export promotion, different interest could capture subsidies or demand and receive protection. In fact, the strong support to neutrality in trade policy is principally derived from political economy arguments. Once the possibility of departures from neutrality is admitted, there will be lobbying to capture the resulting rents.

To sum up, there is less scope for pursuing strategic trade policy in the case of developing countries given the nature of their trade, the limited scope for shifting profits to themselves and the prospects for the capture of trade policy-making by sectarian interests due to the fragile political and institutional make-up in these countries. In fact, there is no empirical testing of strategic trade theory that either supports or rejects the policy proposals implied by it.

[18] See Bhagwati (1989).

5. INSTRUMENTS OF EXPORT PROMOTION

Whatever the objectives of export promotion, there is a need to select the instruments that are appropriate for the purpose (primarily to reduce the bias against exports) and do not lead to deleterious side effects. One thing that has been learned over the last twenty years through analytical advanced and empirical work is that there is no scope for promoting all exports. If all the exports are found to be inadequate compared to a target determined by, say, the level of imports, then this is not an export promotion issue. Rather, it is a macroeconomic issue that cannot be solved through export promotion instruments but rather through the exchange rate and through a cut in absorption. Indeed up to the mid eighties, many countries in Latin America used export promotion instruments as a surrogate for exchange rate adjustment with predictable disastrous results. This changed in the late eighties and early nineties when the inhibition against devaluations was overcome by many countries and they undertook strong stabilization measures along with trade liberalizations. Earlier, whenever a devaluation took place, the existing export promotion measures were reduced and whenever a devaluation was avoided, these measures were expanded.[19] Of course the use of export promotion instruments as a surrogate for a devaluation could not have worked. Devaluation raises the price of tradeables, helps to eliminate the excess demand for tradeables and increases their supply, while the associated reduction in the relative price of non-tradeables has the opposite effect on their domestic demand and supply. Since export promotion measures do little to change the domestic relative price of all tradeables, the excess demand is not eliminated. Such measures can thus exacerbate the excess demand situation and, therefore, worsen the macroeconomic situation.

Now that analytical work has revealed the issues underlying current account deficits, there is a general realization in the profession that export promotion will not help with the balance of payments. We can, therefore, consider genuine export promotion measures aimed at raising the value and the growth rate of exports based on the three objectives listed in Section II. Here, we shall explore the question of what the appropriate instruments of export promotion are which attempt to achieve a particular export objective that is consistent with maximizing the social welfare of the country.

Many different instruments of export promotion can be distinguished although with some overlap. These are direct subsidies, credit subsidies, duty drawbacks or exemptions, export processing zones and bonded manufactures warehouses, and marketing and institutional support. In one way or another, they attempt to raise some export receipts or reduce costs to the exporter. This must raise profits and ultimately lead to an increase in exports. In practice, this has not happened

[19] See Little, I.M.D. et.al. (1993).

often. It is not clear, even when exports have increased, whether the cost of increasing exports has been less than the benefit so that national income has also increased. We turn to each of these instruments and discuss their effectiveness and implied costs.

Direct Subsidies

These can take different forms and normally appear as income or profit tax exemptions. Cash subsidies are not generally given. These exemptions are given to favored export activities such as non-traditional exports. Even when they are not targeted to a particular export, in the sense that all non-traditional exports become eligible for a direct tax exemption, there is the issue of how the subsidy is financed: whether the subsidy increases the targeted exports and whether the costs of achieving the increase is commensurate with the increase in that category of exports (the latter can be thought of as the domestic resource costs of increasing one unit of export). Empirical evidence is negative on both these scores for direct subsidies.

Evaluating the Latin American experience with export subsidies, Julio Nogues gives a categorical answer particularly in relation to Argentina of the seventies and early eighties. As the size of these subsidies has increased, the value of the exports receiving the subsidies has declined.[20] Costa Rica, Mexico and Colombia had similar experiences to that of Argentina even though the financial costs were much less. Brazil is an exception as it did increase its exports significantly with large subsidies. Of course the East Asian Countries, Korea and Taiwan, achieved spectacular success with direct subsidies. Korea subsidized export enterprises. But no advance assurance of continuing support was given. As we see below, there were other factors at play, apart from the direct subsidies, that contributed to the success. It is, therefore, difficult to ascertain, the contribution of direct subsidies to export expansion. This is one of the problems of this instrument even though it is less distorting than other instruments that affect relative price.

Credit Subsidies

These have been used extensively in Latin America. The usual method of giving this subsidy is to provide increased access, charge lower interest rates for export financing compared to other credit, and extend maturity for loans to buy capital goods for export activities. Like other subsidies, the intention is to reduce the bias against exports, to provide access to export activity which is considered

[20] See Nogues (1990).

at early stages more risky than producing for the domestic market, and to offset a bias against export financing in an underdeveloped capital market. Credit subsidies have a mixed record in the countries that have used them. Success in East Asia, particularly Korea, is in marked contrast to their rank failure in other parts of the world such as in Latin America.

A number of characteristics are unique to credit subsidies that make them easy to abuse and more difficult to target and monitor. First, given the fungibility of the general purchasing power transferred through a credit subsidy, they are difficult to monitor. Second, the amount of the subsidy varies directly with inflation. The higher the inflation, the larger the subsidy is. Third, the longer the maturity of the loan, the larger the subsidy is. All three of these factors help to inhibit repayments in time. Since the delays raise the subsidy, they affect the portfolios of commercial banks adversely and retard financial market development. One other factor is important here. If the purpose of the subsidy is to offset an export bias, say from an overvaluation of the exchange rate by 25 percent, the credit subsidy needed to offset this bias where is, say, 60 percent debt to equity financing, must imply an interest rate subsidy of 41,3 percent an investment of one year maturity. The point being that if the market clearing interest rate is say 20 percent in nominal terms, no interest subsidy can compensate for the overvaluation of the exchange rate. The general conclusion emerging from empirical analysis is that credit subsidies are not the most appropriate instrument to promote exports. If there is inadequate credit for export, the problem is more a capital market-related one than an export incentive one. The most often cited problems with credit are the costs associated with perceived higher risks, limited information, fragmented and poorly developed capital markets, and government policies that exclude lending to new exporter-clients due to interest, reserve requirement and portfolio controls. Moreover, even under a liberalized trade regime, financial market controls inhibit the realization of efficiency gains from a liberalization.[21]

Again, the experiences of the Latin American and the East Asian countries are in sharp contrast. In Latin America, Colombia and Venezuela are two countries for which systematic evaluations have demonstrated that the export credit programs have been unqualified failures.[22] Despite the credit subsidies advanced by PROEXPO, Colombia's export promotion agency, its minor exports that were the target of these subsidies declined during 1980-1984 when the credit subsidy reached its maximum. In the case of Venezuela, the Central Bank's export promotion window, FINEXPO provided a subsidy of about 3-5 percent of export value-added at world prices. It may have hardly been a sufficient incentive but in the bargain, Venezuela incurred a large foreign debt, part of which was

[21] See Athukorale and Rajapatirana (1993).
[22] See Fitzgerald and Monson (1989).

directly related to the credit subsidies. So, it is not clear whether the costs of this promotion measure have been worth the result.

On the other hand, among the East Asian economies, Korea provided export credit incentives during the period 1962-1982. There were preferential discounts for capital goods purchases and pre-shipment export credits, among other instruments, accompanied by spectacular success in exporting. But the conclusion is not clear about the contribution of credit subsidies, per se, to this export expansion. Some argue that there was good monitoring and that the fungibility problem did not cause large problems. Others say that if Korea had attempted to eliminate the bias against exports by removing import protection, there would have been no need to offset the bias through credit subsidies. Furthermore, as a result of the interventions in the credit market, allocation of credit was not optimal and this may have delayed the development of the capital markets in Korea. In this sense, our conclusion is that it is not clear what role credit subsidies played and what the counterfactual is. However, one thing is clear: Korea has one of the highest savings rates in the world despite the lowering of the rate of return to savings through interest rate controls. Consequently, subsidized interest rates were not high compared to the implied social time preference.

Duty drawbacks and duty exemption

These are the most common of export promotion instruments. They are needed to offset bias against exports arising from the presence of import duties on imported inputs that raise the costs of export production. It is, therefore, logical to provide duty free or free trade status to imports used for export production. The time sequence when the exemption is given influences the incentives for export production. The drawback system has a presumed financial cost since the duty payment has to be financed. The duty exemption system does not have this cost. Some countries including Chile have provided duty exemption on raw materials used in the domestic purchases of inputs. This prevents the emergence of a bias against the purchase of domestic raw materials and intermediate goods that would have a higher price compared to the international price due to the payment of import duties by the original importer. An instrument used to make sure that free trade status is given to all inputs purchased is to issue domestic letters of credit back-to-back. These ensure that the domestic input producer also has access to the same facilities available to the exporter.

There are different variants of the duty drawback schemes. A rebate scheme on account in Taiwan, deferred drawback in Korea, temporary admissions in Mexico and duty exemption in Indonesia and Thailand.[23] A number of

[23] See Thomas and Nash and Associates (1991).

observations are warranted. The manner in which the duty exemption or drawback is administered is crucial. It requires strong administrative abilities, a system that is not easily thwarted by rent-seeking, and automaticity. Otherwise, export promotion through this instrument can have prohibitive costs. Balassa made a strong plea that these duty exemptions must be neutral between the domestic and foreign input suppliers. Without it, there will be little horizontal integration of manufacturing in the country and this will act against the emergence of comparative advantage in the production of intermediate inputs in an economy. The fact that there is growing inter-industry trade means that the bias against domestic procurement needs to be removed by giving the same opportunities to the domestic producer as to the foreign intermediate goods importer.

Export Processing Zones (EPZ) and Bonded Manufactures Warehouses (BMW)

These two instruments can be considered together since in principle they attempt to isolate the export activity from domestic market restrictions. An EPZ provides not only free trade status to the firms operating within the zone, it provides essential services such as the access to water, power telecommunications, ports containerized cargo facilities and basic infrastructure to exporters. There are many screening devices to determine the eligibility of the firms to get into an EPZ. These firms receive favored treatment with respect to both the import of intermediate goods and taxation in addition to relative cheap infrastructure. The output of these firms must be exported and any inputs not used for production must be re-exported. It is also no accident that most of the firms that locate inside the EPZ or BMW are foreign-owned. This could be called an enclave approach to export promotion.

By and large this enclave approach has been losing ground as countries extend facilities similar to those given to firms located in the EPZ to other producers. The governments that established these entities have found the rate of return to their investment low and the results of the first blush enthusiasm to use EPZs to increase exports and to create employment opportunities have been disappointing. They were seen as devices the countries used in order to avoid trade liberalization, either because of the fear of import competition from abroad or of across-the-board trade liberalization. Both Korea and Taiwan were the first to establish these in the early sixties. They lost enthusiasm for these entities when they realized that greater benefits could be had from extending similar facilities to those firms outside the EPZs.

The experiences with EPZs in other countries have been poor. A study of these entities has revealed the high costs of providing what are essentially subsidized infrastructure, generous tax breaks and subsidized credit. The experiences of Philippines, Indonesia and Malaysia are not reassuring with regard to this instrument.[24] The crucial issue here is also the lack of a counterfactual. Could the countries not have gotten higher returns from providing duty free access to all exporters compared to only those in the EPZ? Could not the administrative procedures have been simplified for all rather than a few? What were the rates of return on investment to the infrastructure provided within the zone compared to the whole economy? The answers to these questions are becoming increasingly clear. EPZs are not an efficient way of promoting exports. This is not to say that the infrastructure and other facilities should not be provided. Rather, it is to say that economy-wide concerns must be taken into account in providing facilities in one location and that the concessions granted in these zones have financial and economic costs to a country.

Marketing and Institutional Support

Many countries give marketing and institutional support to their exports by providing facilities through their commercial staff in their foreign offices. The participation in trade fairs and country representation in GATT and in other organizations related to exports are highly worthwhile activities. However, even more important than direct institutional support to exporters is the need to remove barriers to the acquisition of knowledge and information on foreign markets. In East Asia, private trade associations have provided strong support to exporters since there are externalities in conducting business and guarding reputations of products internationally. The work done by trade associations in Korea and Taiwan are significant. Singapore, on the other hand, has relied more on the foreign investment links to increase the knowledge of the country's exports abroad. It would be a good thing to guard a country's interest in third markets and work towards increasing market access on a regular basis as PROCHILE is credited with doing. In the past, as now, East Asian exporters were wooing the American market and investment that created an immediate link with the world's largest market. Latin American countries, on the other hand, erected barriers in the sixties and seventies in the vain hope of developing large dynamic markets among themselves.

To sum up, marketing and institutional support as export promotion instruments can be helpful when there are private interest in it. This may be a cost effective way of providing support. Also, as in East Asia, the associations can play an important role to ease administrative procedures for export, if any remain, and to remind the public institutions and officials to appreciate the challenges of competition in the international market. Trade mission travel,

[24] See Warr (1989).

inventorizing the barriers to a country's exports abroad and representing the interest of domestic exporters are important chores that public officials and institutions can undertake with benefit to the exporters.

6. LESSONS OF EXPERIENCE AND POLICY RECOMMENDATIONS

From the above review we can draw a number of policy lessons. These will provide the basis for the policy recommendations.

First, we have to note the crucial link between the overall policy environment and the success of the neutrality-creating export promotion, the type we favored in the main. The export promotion successes of the East Asian countries contrast vividly with the export promotion failures in many other countries including those in Latin America. Three ingredients can be identified in the success of the East Asian countries: (a) The stable macroeconomic environments including stable real exchange rates, predictable inflation, and sustainable current account deficits. The macroeconomic environments were entirely predictable in the sense that the governments adopted a style of macroeconomic management such that exporters were able to predict the course of macroeconomic variables and, therefore, write contracts, open letters of credit, and make reliable assumptions about costs. (b) Consistent accompanying policies. For example, the labor markets had remained flexible despite guaranteed employment and resources could be easily reallocated by a firm from one activity to another. (c) Continued success with export promotion policies. This raised the export growth rapidly and vitiated the need for import controls and further restrictions. Moreover, since export incentives were effectively price-oriented, this allowed sufficient flexibility to exporters to respond to changing demand conditions abroad. Thus the role of macroeconomic policies and the overall environment was crucial for export success. It must be noted, however, that these were necessary but not sufficient conditions for export success as the existence of stable macroeconomic and overall policy environments in other parts of Asia did not by themselves induce rapid export growth. In contrast, the Latin American countries were increasingly unstable with record high inflation rates in the late eighties and highly appreciated exchange rates. Whichever export measures these countries adopted, they did not bear fruit.

The second reason for export success. Here the microeconomic or allocation policies assume importance. There was a host of promotion schemes ranging from free trade status for imported inputs, neutrality between domestic and foreign inputs, credit subsidies, increased access to export credit, EPZs and BMWs, not to mention improvements in infrastructure. As we saw earlier, these measures certainly helped to reduce the bias against exports but once exports had truly taken off, as in the early to late seventies, the cost of these subsidies began to be felt. To alleviate the fiscal pressures, the Korean government, for example largely dismantled the subsidies, made adjustments to the exchange rate, and reduced import restrictions by transferring items from the positive list to the negative import list thereby reducing the bias against exports. But in the Latin American countries, there was neither a stable macroeconomic environment nor viable microeconomic policies to reduce the anti-export bias.

In addition to these two factors, one must add a human capital factor. Export success in East Asia was in no small measure due to the upgrading of human capital. The governments encouraged higher skill acquisition on the job and opened their doors to admit labor market entrants freely. Levels of both general and technical education rose. Foremen and junior engineers were trained in increasing numbers to help man position in foreign-owned businesses and factories. Moreover, the quality of administration in the East Asian countries was superior in the tradition of their committed public service. But these able and committed administrators followed the market and implemented promotion policies only after the private sector had identified the areas to be promoted.[25] Such traditions of public service and institutional support to private initiatives in export promotion were largely absent in many other parts of the world including Latin America. In fact, in the former British colonies, private sector initiatives were viewed with suspicion.

A fourth lesson from the export promotion experiences of countries is the need for clear exit rules for promotion. This is reminiscent of infant-industry support. There must be a clear timetable in which support is provided; otherwise the infant-industry support may well continue into adulthood and sometimes even into senility. Lack of clear exit rules has been the problem with many countries that have attempted to promote exports. Consequently, they have continued to provide huge subsidies to the export sector which, in some cases, has entailed a transfer of resources to the foreign importer. The domestic resource costs well exceeded the exchange rate. In the East Asian case, however, there were in-built pressures to cut-off assistance to export industries. When the cost of subsidies began to mount in Korea, the government moved to reduce the bias against exports by adopting competitive exchange rates and reducing import protection. Korea also found it easy to exit from the heavy and chemical industries. Many countries that failed to exhibit export success have not been able to withdraw their support to particular exports.

Finally, there is by now increasing realization that policy change, while necessary, may not be sufficient to promote exports. Investments in infrastructure including roads, power, telecommunications and port facilities are needed to

[25] Not everyone agrees with the position that the administrators followed the choices made by private firms to promote a particular activity. Robert Wade argues that the market was governed by these administrators and he places unwarranted trust on benevolent and incorruptible bureaucrats who eschew rent-seeking and directly unproductive activities. See Wade (1991).

develop a country's exports. In Latin America, during the eighties there was a regression in both the efficiency and the extent of the infrastructure which may have raised costs to potential exporters. Meanwhile, with the liberalization of many trade regimes in these countries, new patterns of trade are emerging. Therefore, there is a need to provide this infrastructure either through government intervention or through improvements in the regulatory environments so as to encourage the private sector to invest in these facilities. Incidentally, providing national status to foreign investment will be helpful in extending and improving the efficiency of the infrastructure.

Policy Recommendations

The maintenance of macroeconomic stability, the adoption of policies to offset the anti-export bias on a largely automatic basis such as providing free trade status for inputs used in export production, and institutional and infrastructural support on an economy-wide basis rather than for a specific activity or location is fundamental to the setting up of any such export promotion policy. It is only when these fundamental conditions are satisfied that more positive export promotion activities can be pursued if the government is convinced that there are sufficient grounds to support a particular activity.

Since countries differ from each other in a variety of ways, policy recommendations for any one country need not be the same as for another. While the policy itself can be adapted to different country settings, it should nonetheless adhere to a set of principle suggested by the above lessons. The exact form the policy takes is significant only to the extent that these principles are being met. Four essential criteria should be followed in adopting any measure of export promotion:

(a) The onus of justifying export promotion should lie on the parties seeking it. They should be able to demonstrate that they have export potential and that there are possibilities for reducing production costs over time, similar to the way in which infant-industry support is sought.

(b) The export promotion measure should be administered by a group of independent advisers who should evaluate the proposals for product development. Support should be provided only upon careful evaluation and promise of success. Export promotion measures should be seen as a form of investment subject to the same rates of return analysis as any private investment.

(c) Export promotion should be available only for a limited period of time, say, three years. There should be an automatic sundown provision attached to the fund. No one should be given an extension and the government should review the progress of export promotion measures annually.

(d) Access to export promotion should be nondiscriminatory and open to all sectors.

There are relatively safe and nondistortionary ways of adopting the above approach along the lines mentioned. For example, an export enterprise promotion fund can be set up to provide grants or low interest loans to defray particular expenditures such as product development. This would be particularly useful in providing limited public support to risky export activities which the capital market may not finance initially. It would also enable an exporting firm to build up a repayment record and track record and thereby become eligible for regular capital market funds. It is crucial that an export promotion is not provided on an open-ended basis or on a large-scale measure which does not have a positive rate or return.

APPENDIX

TABLE 1

TRADE TO OUTPUT RATIOS

(%)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Latin America												
Argentina	7	9	13	15	13	16	11	10	13	19	14	11
Brazil	9	9	8	11	14	12	9	9	11	8	7	–
Chile	23	16	19	24	24	29	31	34	37	38	37	36
Colombia	16	12	11	10	12	14	19	17	16	18	20	21
Costa Rica	26	43	45	36	34	31	31	32	34	35	34	39
Mexico	11	10	15	19	17	15	17	20	17	16	16	16
Uruguay	16	15	14	26	27	27	26	22	24	25	27	24
East Asia												
Hong Kong	88	91	85	96	107	108	111	122	133	134	135	141
Indonesia	33	28	24	26	26	22	19	24	24	25	26	27
Korea Rep.	34	37	34	36	36	35	39	42	40	34	31	29
Malaysia	58	52	51	51	54	55	56	64	67	74	78	81
Singapore	207	204	191	171	161	158	155	172	192	189	189	185
Taiwan	53	52	50	53	56	54	58	58	55	50	48	48
Thailand	24	24	24	20	22	24	26	30	34	37	36	38

Note : Trade to output ratio is defined as exports plus imports of goods and non-factor services as a percentage of GDP.

Source : ANDREX, World Bank.

TABLE 2

GROWTH OF MERCHANDISE TRADE

(% per annum)

Latin America	1965-1980	1980-1990	East Asia	1965-1980	1980-1990
Argentina	4.7	1.4	Hong Kong	9.1	6.2
Brazil	9.3	4.0	Indonesia	9.6	2.8
Chile	8.0	4.8	Korea, Rep.	27.2	12.8
Colombia	1.4	10.6	Malaysia	4.6	10.3
Costa Rica	7.0	3.1	Singapore	4.7	8.6
Mexico	7.7	3.4	Taiwan	18.9	12.1
Uruguay	4.6	3.2	Thailand	8.6	13.2

Source: World Development Report, 1992.

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