

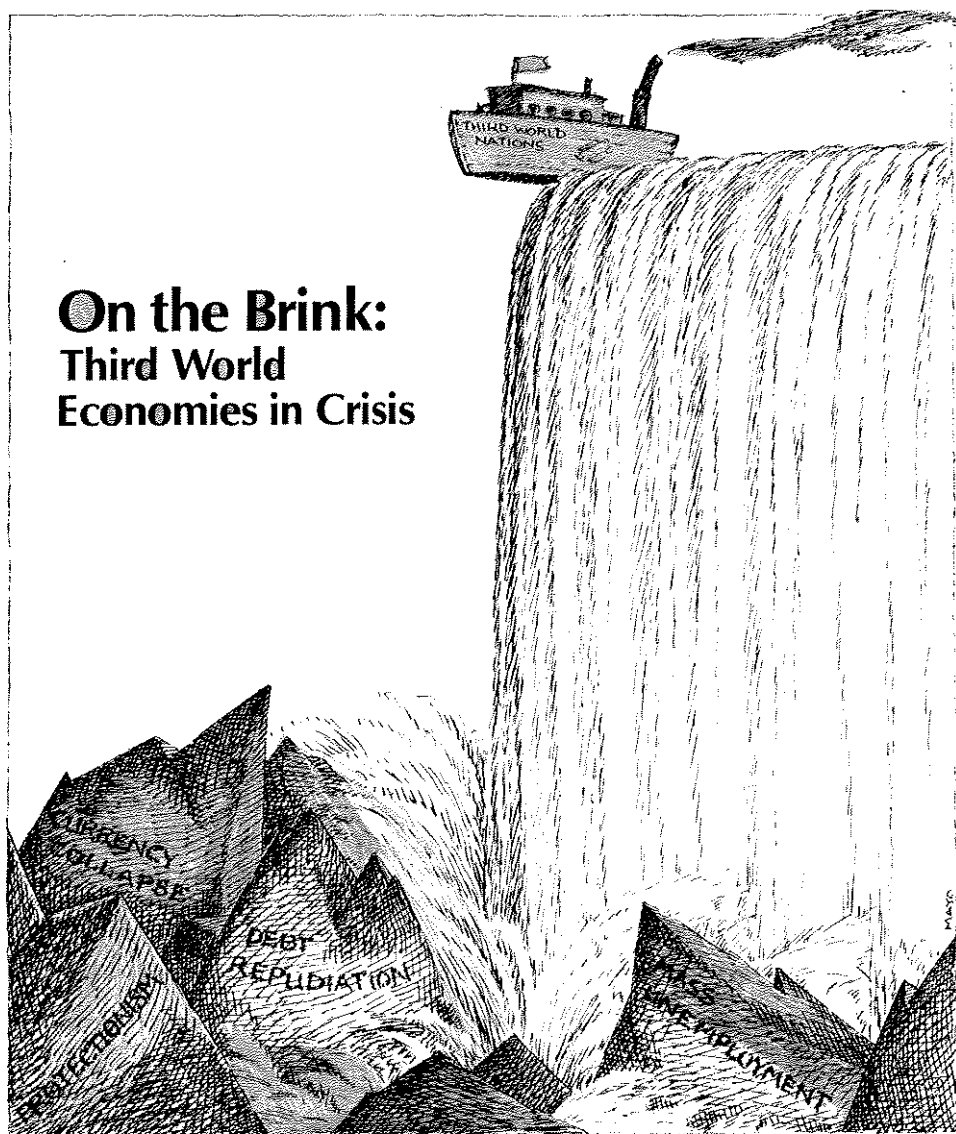
MANHATTAN REPORT

ON ECONOMIC POLICY

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On the Brink: Third World Economies in Crisis



Since 1960, Western industrial nations have extended over \$210 billion in official foreign aid to developing countries; yet, with few exceptions, Third World economic growth has been disappointing. Last year, for instance, per capita income in the developing world actually declined for the first time in almost a generation. And the inability of many of these nations to pay off their loans has made the world financial community very jittery—with good reason.

Blame for this state of affairs has been placed on the usual suspects: Western "imperialism," the world

recession, OPEC oil prices, etc. The typical solutions offered include demands for more aid or subsidies, or ambitious programs like the U.N. plan for worldwide commodity cartels, the so-called "New International Economic Order."

In his new book, *Development Without Aid*, Melvyn Krauss, Professor of Economics at New York University, and a senior fellow at the Hoover Institution, demonstrates that the real cause of economic stagnation in the developing world is bad domestic policies—in particular, inappropriate, state-subsidized investment, barriers to free trade, and high-tax, high-spending government budgets. Foreign aid, according to Professor Krauss, will not solve the problems of the Third World, and may even be an obstacle to the elimination of poverty.

Professor Krauss recently presented his controversial ideas before a New York audience which included representatives from over twenty African nations (on tour with Operation Crossroads Africa) and several U.N. Missions. Edited excerpts from his address, including the question-and-answer period, appear in this Manhattan Report. Professor Krauss also debated Professor John Eatwell (a Cambridge economist) on the relative merits of protectionism and free trade as a development strategy for Third World nations, particularly Mexico—the country to which Professor Eatwell served, until recently, as an adviser. We include their exchange of views as well.

Walter Williams—Poverty has been man's fate for most of history. Despite what we're told, however, there is no mystery about poverty. People are poor either because they can't produce very much, or because they can produce but are prevented from exchanging their products with others.

How did such a tiny minority of the world's population manage to escape its natural state of poverty? The richest countries in the world happen to have a large measure of economic freedom relative to their poor brethren around the globe. Their people have the right to acquire, keep, dispose, and exchange property more or less as they see fit. I see private property rights as a necessary, if not sufficient, ingredient for upward mobility in the West. Is it, as well, for the Third

World? Or is foreign aid, and government planning, a necessity? I hope that Professor Melvyn Krauss of New York University and the Hoover Institution can tell us.

Melvyn Krauss—Over a year ago I wrote an article for the *Wall Street Journal* in which I predicted, correctly alas, that Mexico was in for big trouble. The reason I argued Mexico would have a great deal of economic difficulty was that our neighbor to the South was depending on the government as the source for creating wealth. But the government was wasting oil money by investing it in industrial white elephants like steel mills and petrochemical plants that could never hope to be competitive on world markets. Moreover, Mexico was expanding its welfare state far beyond its financial means. In this respect, Mexico, I argued,

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"Governments absorb wealth; they do not create wealth."
—Melvyn Krauss

was becoming like Iran, where the Shah put oil money to similar uses. In fact, the name of the piece was "Will Mexico Make Iran's Mistakes?" Unfortunately, time has shown the answer to be affirmative.

No, I'm not predicting Mexico will get an Ayatollah. But one thing we know is that political stability does not follow economic instability. And so I think we have to worry about our neighbor to the South.

My new book, *Development Without Aid*, examines the respective roles of government and the private sector in the development process. Its major thesis—of which Mexico is a recent, tragic example—is that government is not and cannot be the source of growth. Governments absorb wealth; they do not create wealth.

The private sector, on the other hand, must be the source for creating wealth. Exports are critical for the economic prosperity of Third World countries. The private sector exports, not the government sector. Technological innovation is vital for growth. The private sector is the innovating sector. Guest workers who send money back to the home country are often very important in the development process. Guest workers are from the private, not the public sector.

Most important, government decisions are always based on political, not on economic logic. Governments build roads when their people cannot afford cars. Governments build telephone lines when the majority of people do not have telephones. Governments, in short, are very good at uneconomic prestige industries; in fact, that is probably where the state has a comparative advantage.

Many Third World governments think heavy, capital-intensive industries are the sign of industrial development and progress, simply because these industries exist in the North. This is what I call the "error of imitation," which destroys the economic base of Third World countries by neglecting to foster those industries more suitable for their own natural and human resources. That is exactly what Iran did. That is what Mexico is doing, and that is what many other Third World countries are doing as well.

Countries with an abundance of labor and a scarcity of capital should promote labor-intensive industries, not capital-intensive industries.

Governments, of course, do have a role to play in the economic life of Third World countries, for example, by providing such social services as housing, education, and health. But the provision of these social services do not spark growth, as many economists argue. They absorb, or use up wealth. Economists of the Left, I argue in my book, have for too long counseled less developed countries to follow what I call "cart-



Melvyn Krauss, *New York University*

before-the-horse" economics. These economists teach that the public sector is the horse which pulls society to prosperity. But the private sector is the horse, and the public sector is the cart.

Nowhere is this message clearer than in what I and many other people refer to as the "Gang of Four": Hong Kong, Singapore, Taiwan, and South Korea. I believe the study of those countries is extremely important for all of us who want to get insight into how to create prosperity for the Third World. And what we learn, above all, from the study of those countries is that, despite the differences between them, all have followed low tax and free trade policies. They allow capital as well as goods to come in freely. They are prosperous because they rely on the private sector. And because they are prosperous, their social spending has increased. The Gang of Four is proof that "trickle-down" economics works.

Now I don't know if all of my audience here is aware of the term trickle-down, and the controversy surrounding it, pitting supply-side theorists against the world. The idea is very simple. It is that private sector, profit-motivated economic activity will benefit poor people. Of course, the term trickle-down is a Democratic pejorative, because a trickle is not a heck of a lot. So it is used to disparage supply-side economics in general and President Reagan's policies in particular. Even if they do foster growth, some argue, the poor will benefit only marginally. But this is nonsense. In countries which have followed true supply-side policies, the poor have benefited enormously

Flow of Financial Resources to Developing Countries From Industrial Nations* (\$ Billions)

Official Development Assistance	1961-1970	1971-1980	20 YR. Total
Bilateral Grants	60.5	150.3	210.8
Bilateral Loans	36.6	72.1	108.7
Multilateral Contributions	17.8	32.3	50.1
	6.1	45.9	52.0

*Australia, Austria, Belgium, Canada, Denmark, Finland, France, Federal Republic of Germany, Italy, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States.

SOURCE:

OECD, Report by the Chairman of the Development Assistance Committee, 1980 and previously published reports.

from economic growth.

Experience in Asia demonstrates that when social spending is financed by high tax rates, the economy falters and social spending cannot be maintained. But when the economy is allowed to thrive on low tax rates, social services can be maintained and increased. Compare India with Singapore. In India, personal and corporate tax rates are much higher than in Singapore. But in the last two decades the rate of increase of public consumption in Singapore has been dramatically higher than in India. Look at Hong Kong. The rate of increase of public consumption in Hong Kong—which some uninformed demagogues think has no public sector—has been much higher than in most socialist countries, including Jamaica under Michael Manley, or Ghana under Nkrumah.

The reason is simple. The Gang of Four has higher rates of economic growth than India; and when a country is poor, it can't afford social services, or anything else.

The title of my book, *Development Without Aid*, which George Gilder and I came up with, is more than a catchy phrase. In my view, it identifies a principle—that the absence of foreign aid is almost a precondition for economic prosperity. I believe that foreign aid not only does not help less developed countries, but it hurts them. I would like to give you my reasons for this unorthodox conclusion.

The first reason why foreign aid hurts recipient countries is that it increases exchange rates. With an overvalued currency, the country exports less. Also, countries with a big tourist industry suffer.

More important, foreign aid sustains corrupt governments in power. Consider the case of Bangladesh, where a considerable amount of food aid was given for humanitarian reasons to help the starving in the country. We saw the terrible suffering on television, and we were moved

to help. What was the result? Did the starving people benefit? According to people who were there, the government used that aid to buy votes and sustain itself in power, not to feed poor people. And that's why many of us have become very cynical about foreign aid.

Foreign aid neutralizes the healthy role that crises play. Bad policy induces economic crises, which in turn generate pressures for reform. But foreign aid permits mistaken policies to continue by bailing out the government which implements them. Many in this country, for instance, want the International Monetary Fund (IMF) to increase its financial aid to Mexico because Mexico is in trouble. This would be a terrible mistake. It would only postpone the day of judgment.

The Mexican government has been investing in capital-intensive industries, and Mexican industry is not providing jobs for Mexicans. Because of this misallocation of capital, unemployed Mexicans are migrating to the United States in far greater numbers than would otherwise be the case. I'm in favor of free migration, of course, but I'm against propping up faulty regimes which needlessly induce their populations to leave. If we send aid to Mexico through the IMF, the Mexican government will have no incentive to change its policies, and we'll have a continuation of the crisis.

My thesis about foreign aid applies also to the Gang of Four countries. We sometimes forget that both Taiwan and South Korea floundered until the mid 1960s, when America cut them off from the massive amounts of aid we were giving them. Until the aid was terminated, both countries followed inward-looking protectionist policies, and did not prosper. When the aid was terminated, Taiwan and Korea turned to more open market policies. Their early industrial development concentrated on unpretentious, labor-intensive goods like toys, plastics, and clothing. And they flourished. Their industries weren't the

"Foreign aid neutralizes the healthy role that crises play."
—Melvyn Krauss



Ambassador Guojun Mi, Chinese Mission to the U.N.

sexy ones favored by the international aid bureaucrats. But they are profitable, and poor as well as rich people have thrived from them.

This leads me to compare and contrast two radically different approaches for alleviating poverty in the Third World: the social democratic, "international transfer of income" approach, and the free market, "international transfer of prosperity" approach. This first emphasizes foreign aid, and it's based on fundamentally pessimistic assumptions about the ability of the Third World countries to grow, as well as the ability of the world economy to promote prosperity. American liberals and European social democrats seem to believe that poor people lack the ability or the capacity to prosper alone. That's why they favor international income transfers. In their conception, aid is a kind of booby prize for losers.

The "international transfer of prosperity" approach, on the other hand, is based on optimistic assumptions: that poor people can escape poverty if the right policies are put in place, which permit capitalistic accumulation and international exchange. It assumes that North and South are linked by international trade, by capital and labor migration, and by technology transfers. Keep these lanes open, and growth will occur.

One of the primary agents responsible for the transfer of prosperity from North to South is the multinational corporation. It generates income for less developed countries' inhabitants, and transfers capital, technology, and other much-needed know-how to them. Multinationals also keep governments honest, and that is why the social

democrats, North and South, hate them so much. Multinationals have discovered how to avoid the high tax policies of individual governments by transferring their assets and operation to more hospitable climes. In so doing, multinationals have created what I call an antitrust policy for governments. They force governments to bid competitively for them—that is, to keep governments from exploiting them through their monopoly power. Intergovernmental competition keeps taxes low and regulations reasonable. And that, of course, is the real reason why multinationals are so disliked by the international income-transfer crowd. They see multinationals as a threat to their policies, and they are right. They are a threat. And we should be thankful for it!

Richard Grenier, *Commentary*—What effect has the United Nations had on trade and development between Western countries and the Third World?

Melvyn Krauss—Because the United Nations reflects the assumptions of the "international transfer of income" advocates, it has to that extent done a great deal of harm. Maybe it's unfair to single out the U.N., since so many other international organizations subscribe to the same point of view. The World Bank, for instance, was originally founded to create wealth, but it has become an agent for transferring income.

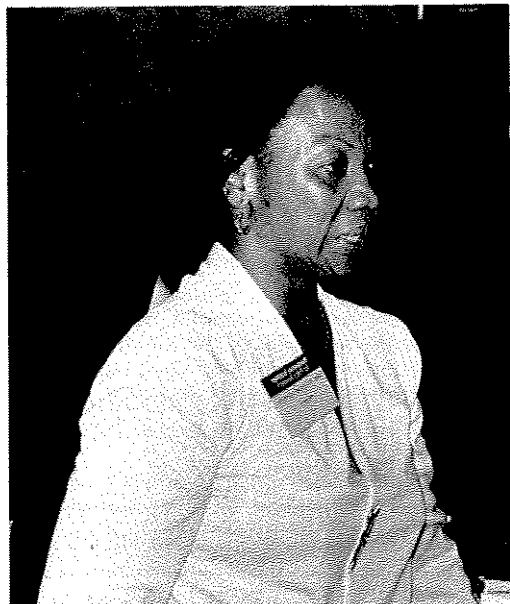
Peter Brimelow, *Barron's*—Has the Soviet planning model been influential among Third World leaders?

Melvyn Krauss—The Soviet model has had a tremendous amount of influence in the Third World. Quite frankly, countries like India have at one



African delegates, Operation Crossroads Africa

"The Gang of Four is proof that 'trickle-down' economics works."—Melvyn Krauss



Suzanne Razafindralandy Razafinirina,
Madagascar

time (and perhaps today, they still do) looked to the Soviet Union for economic inspiration. The U.S.S.R., for instance, emphasizes heavy, capital-intensive industries; and guided by their example, many Third World countries have inappropriately followed their lead. Needless to say, the Soviet model is also inappropriate for any economy, including their own.

Walter Williams—Many attribute Third World economic problems to the legacy of colonialism. Is there any truth in this?

Melvyn Krauss—Remembering their subservient economic position under colonialism, many Third World nations have acquired an unhealthy distaste for international trade and a bad appetite for autarchic, self-sufficiency policies. Then, too, several leaders of less developed countries have imported that most fallacious theory, Marxism, from the West.

To demonstrate their independence, many less developed countries try to copy industries that were dominant in the mother country during colonial times. That's very often a mistake. It would be a mistake if Wilt Chamberlain, the great American basketball player, tried to pursue a career as a jockey. It would be a mistake for a jockey to pursue a career in professional basketball. That would violate the law of comparative advantage, the theory developed in the last century by the economist David Ricardo to explain why nations, like individuals, should focus their productive efforts in areas where they are most comparatively well endowed.

Peter Duveen, *Newsweek*—Should the IMF actually stop aiding countries in trouble like Mexico? What would be the repercussions?

Melvyn Krauss—Joy would reign at New York University—at least in my office.

Peter Duveen—What about in the banking industry?

Melvyn Krauss—I think that if the IMF refused to help these countries certain banks would suffer. They ought to suffer the consequences for having made foolish loans, and perhaps they will cease to do so in the future. They're not doing the Third World any good with loans that facilitate inappropriate investment policies. People who worship the status quo believe we must continue to make bad loans and bail out the banks who make them. I don't think people interested in promoting world prosperity should worship the status quo.

Incidentally, I don't mean to cast aspersions on banks in general, or on any bank in particular. Nor do I favor toppling the world financial order. My point is simply that as long as governments implicitly or explicitly guarantee loans, the same mistakes will continue to occur.

Peter Duveen—Many argue that if we don't help Mexico, others will, possibly regimes unfriendly to us.

Melvyn Krauss—Let them. Let the Soviet Union do it. Another headache for them is fine. That kind of reasoning should not enter into our decision-making. Perhaps no one will bail them out and there will be a minor revolution. Maybe the country would get some good government for a change.

Claudia Rosett, *Writer*—It seems to me that most foreign aid is usually given not for altruistic reasons, but for some strategic military consideration. You want a friend, or a dependent, or whatever. Do you agree? And if so, does this contradict the argument of your book?

Melvyn Krauss—First of all, let me say that I agree with you. I think when we buy friends that way we're really ensuring that these countries will remain poor for a long time to come. It is a kind of deal with the devil. But as long as these countries remain poor and economically unstable, they can't be fully relied upon as political allies.

Actually, you left out the consideration that economic aid is often a mechanism for promoting exports in the aid-giving country. France and Canada are two of the biggest promoters of increased foreign aid today. Why? Because much of their aid is actually tied to French and Canadian exports. It's a new form of protectionism.

On the larger question, I think we have a big problem in this country with the State Department. Its approach for many years has been to

Economic Performance of Selected Developing Nations

	Gross Domestic Product Average Annual Growth Rate %		Gross National Product Per Capita Average Annual Growth Rate %
	1960-1970	1970-1978	1960-1978
	Hong Kong	10.0	8.2
Singapore	8.8	8.5	7.4
South Korea	8.5	9.7	6.9
Taiwan	9.2	8.0	6.6
Brazil	5.3	9.2	4.9
Mexico	7.2	5.0	2.7
Argentina	4.2	2.3	2.6
Uruguay	1.2	1.9	0.7
Iran	11.3	7.4	7.9
India	3.6	3.7	1.4
Ivory Coast	8.0	6.8	2.5
Ghana	2.1	0.4	-0.5
Chad	0.5	1.7	-1.0
Zaire	3.6	1.3	1.1

	Public Consumption* Average Annual Growth Rate %		Exports Average Annual Growth Rate %	
	1960-1970	1970-1978	1960-1978	1970-1978
	Hong Kong	8.7	9.2	12.7
Singapore	12.6	6.4	4.2	9.8
South Korea	5.5	8.7	35.2	28.8
Taiwan	4.5	5.4	23.7	9.3
Brazil	3.5	8.6	5.0	6.0
Mexico	9.4	10.2	3.3	5.2
Argentina	1.0	-3.1	3.5	6.8
Uruguay	4.4	3.2	2.1	-5.0
Iran	16.0	20.4	12.7	-1.2
India	-1.7	4.2	3.1	6.0
Ivory Coast	11.8	7.5	8.8	8.5
Ghana	6.1	-0.3	0.1	-0.1
Chad	4.4	0.1	5.9	-3.0
Zaire	8.5	-0.2	-1.8	-4.1

*Includes all current expenditures for purchase of goods and services by all levels of government. In addition, capital expenditures on national defense and security is regarded as consumption expenditure.

SOURCE:

World Development Report, 1980, published by the World Bank.



Martin Lees, U.N. Project for Science and Technology Department

buy friends with foreign aid, but that policy conflicts with the goal of promoting prosperity. We need new thinking at the State Department.

Suzanne Razafinirina, Ministry of Foreign Affairs, Madagascar—I'm very interested in your remarks. I couldn't be more in agreement with much of what you said. I'm sure that many of my colleagues agree that competition must be promoted, but we in the Third World find ourselves confronted with this problem. We see all around us the fruits of technology and knowledge. We see that growth and prosperity is possible, but it is very hard to be satisfied with a step by step approach. It is psychologically very difficult for our people to be content with such a slow increase in their material living standards. How can we in the developing countries reconcile all that is potentially available to us with our limited means?

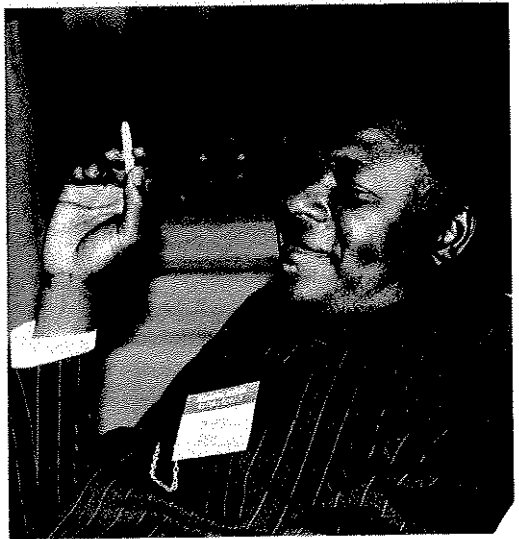
Melvyn Krauss—I'm going to respond to that thought-provoking question in the following way. First, I think the approach I recommend is not necessarily a slow one. Hong Kong, for instance, has been transformed from a poor, labor-abundant economy specializing in plastics and toys to a modern financial center producing very sophisticated goods in a period of maybe 25 to 30 years. Now to go that far in little more than a generation is hardly very slow. And Hong Kong, remember, has very little in the way of natural resources. Think of what resource-rich countries could do by fostering free trade.

But it is true that there are no shortcuts. If poor people in less developed countries are jealous of the riches in the West, that is not necessarily a bad thing. Not if they are motivated to open their

economy to competition and work hard. They will progress, or their children will. That's the proper time perspective. These things don't happen in five years. But in five years, nevertheless, a good foundation can be put in place.

Martin Lees, United Nations Project for Science and Technology—You keep on referring to the Gang of Four. But these nations are very small in terms of the Third World as a whole. I question if the private sector approach is all that relevant to a large, populous country, like India. I wonder if they do not need *more* aid, not less, in relation to their macroeconomic and social problems.

Melvyn Krauss—Whenever you talk about the Gang of Four, the common comeback is that, yes, they did well, but they're small. There is supposed to be some lesson here—that there is "small economy" economics and "big economy" economics. But for those of us who teach economics for a living, we know that's not the case. There are certain verities that apply in all cases, for example, the law of comparative advantage. Countries should specialize. It's common sense. It's like the jockey not entering professional basketball. That is as true for a small country as a large one. So the critical factors one may identify in the Gang of Four experience—low tax rates, limiting government expenditures to revenues—are generally applicable.



Simba Ndombe, Zaire

As far as foreign aid is concerned, I know that some argue that we don't give enough foreign aid. For example, I lived in Sweden for a year, and I participated in a national discussion of foreign aid. It became clear to me that a lot of sanctimonious breast-beating about the duties of the rich nations

(Continued on back cover)

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Economic Frustration Grips
Many Developing Countries

O.E.C.D.
Assesses
Debt Risks

By ALAN RIDING
Special to The New York Times

MEXICO CITY, Dec. 3 — The recession has slowed growth, to conquer hunger, sickness, ig-

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GATT Failure Sets New Battle Lines

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Brazil Seeks New Loans

Protectionism Imperils
East Asia's Exports

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William Brock,
large clamor for
more direct intervention by the
United States government in the
market". That seems to set out the
parameters for a new U.S.-European trade war.

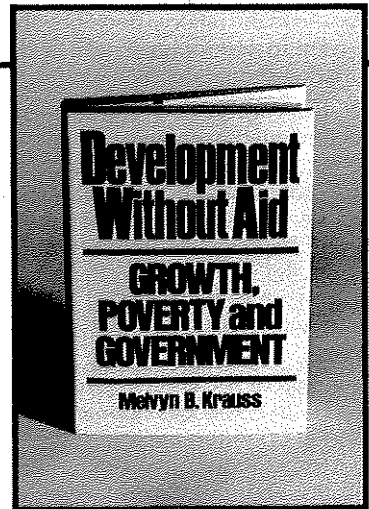
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DEVELOPMENT WITHOUT AID

Melvyn B. Krauss

"...knowledgeable,
competent, and fearless.
Anyone seriously interested in issues of
development and of international trade,
especially trade between the West and
the Third World, is certain to benefit
from this book."

—P. T. Bauer
The London School of Economics



"Krauss's contribution will shake up the international aid lobby and hopefully will enlighten the objective persons involved in policy decisions at both ends: the giver and the recipient."

—Manuel F. Ayau, President
Universidad Francisco Marroquin
Guatemala

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Free Trade or Tariffs: A Debate on Growth Strategy

Should developing nations open their borders to unrestricted trade, or should they use tariffs to foster domestic industries? We present below excerpts from an exchange of views between Professors Melvyn Krauss and John Eatwell on this question, particularly as it bears on Mexico in the late 1970s and early 1980s.

John Eatwell—My attitude toward economic policy is different from that which you'll find in Professor Krauss's book. I would describe it as a democratic view; I believe that human beings should have some control of their own affairs. I share Keynes's undying, if perhaps naive, belief in the power of reason to lead to some rational organization of the economy. I am, therefore, opposed to the idea that we hand over all economic affairs to an impersonal mechanism called the market and leave the organization of the economy to a system which Francois Quesnay (1694-1774), the founder of economics, described as operating independent of men's will and not according to men's needs. Instead, I think that human beings can look at the way the economy works and make rational decisions about the way they want to see it organized—as their servant. The market should not be a master.

In this context I want to address the role of protection in the organization of international trade and economic development. One can pursue protectionist policies that merely close up the economy, erect artificial monopolies for one's pals, and stagnate—as Professor Krauss states in his book. But that is hardly all.

Let's look at the facts. First, it is a fact that no major country has ever industrialized without protecting its industry, including Great Britain, usually seen as the great free trade nation of the 19th century. The development of Lancashire depended upon the political suppression of the Indian textile industry. The development of the British iron industry depended, in part, on prohibiting manufacture in the American colonies. The Americans weren't even allowed to make their own horseshoe nails. We didn't just fight over tea, you know.

Secondly, once a country has achieved industrial predominance, it will suddenly forget the virtues of protection and become a vociferous advocate of free trade. Free trade will give it access to others' markets; and its position will allow it to prevent its own markets from being penetrated by others. This was the pattern of the relation between Great Britain and the U.S. In 1906, the tariff on British manufactured goods was still generally around 73 percent. It was only after World War II, when Dean Acheson and Cordell Hull saw that the future development of the United States depended upon the expansion of American markets, that this country espoused a free trade policy. Similarly, Japanese industrialization since the Second World War was

based on a rather strict protectionism, which has only recently become relaxed.

Protectionist policy allows domestic markets to grow. It is a dynamic strategy that permits high economic growth for domestic industry without exposing a country to chronic balance of payments problems which would otherwise arise. In this context, let's look at Mexico. Unlike most commentators, I hold that it is the removal of protection, not its imposition, that has helped bring about Mexico's current liquidity crisis.

From about 1960 to 1976, Mexican industry sustained a reasonably high rate of output growth. Mexican manufacturing grew from employing about 18 percent of the labor force to employing 24 percent of the labor force. In the period of 1968-1975, its exports grew by an average of 16 to 17 percent a year, two or three points higher than Japan. In some major industrial sectors, like electronics, it was second only to Japan as an importer into the United States.

During this period, protectionism was high, achieved mostly by a licensing system which controlled about 80 percent of Mexican imports. And the deficit in Mexico's manufacturing trade balance, as a proportion of its Gross Domestic Product (GDP), steadily declined from the early 1960s to about 1974. Imports as a proportion of GDP diminished, and exports improved. Indeed, the import substitution strategy of Mexico was, by stimulating the development of manufacturing, actually an export promotion strategy, a consideration Professor Krauss, like other free traders, ignores.

The real crunch for Mexico came in the early 1970s with the virtual disappearance of the agricultural trade surplus, primarily due to high population growth absorbing agricultural goods at a rate faster than they could be produced. Then, in 1973-1974, Mexico became an importer of oil for the first time in living memory. As oil prices rose, there was a severe deterioration of Mexican balance of payments, causing a dramatic reduction in the levels of economic activity. The IMF was called in and a so-called extended term agreement was signed in 1976. One important component of this agreement was trade liberalization. The 80 percent or so of manufactured goods previously subject to import licensing was reduced to about 28 percent in three years. Licenses for the remainder were being given away like confetti, so there was on many goods a zero tariff. As a result, imports increased dramatically.

The Mexican Economy: Key Economic Indicators

	1977	1978	1979	1980	1981
Gross Domestic Product Growth Rate	3.2	6.6	9.2	8.3	8.1
Gross National Product Per Capita (Current \$ U.S.)	1,169	1,426	1,798	2,411	N.A.
Money Supply (M-1) (Billions of pesos)	195.7	260.3	346.5	461.2	612.4
Consumer Price Index (Percentage Change)	20.7	16.2	20.0	29.8	28.7
Public Sector Spending (Billions of pesos)	550	737	1068	1597	2579
Federal Government Deficits (Billions of pesos)	96	130	232	333	849
Trade Balance (Millions of \$ U.S.)	(-1,054.7)	(-1,854.4)	(3,187.4)	(-3,264.7)	(-4,814.0)
Balance of Payments, Current Account (Millions of \$ U.S.)	(-1,596.4)	(-2,693.0)	(-4,856.4)	(-6,596.6)	-11,704.0)

SOURCES:

The Bank of Mexico; Mexican Institute for Foreign Trade; State of the Union Address by Lopez Portillo, Annex, 1981; Ministry of Finance of Mexico; OECD, *Geographic Distribution of Financial Flows to Developing Countries, 1977-1980*.

When, in 1979, the GDP grew 9 percent, imports grew by 50 percent. The new trade policies effectively confounded the good which would have resulted from the oil boom. So Mexico's recent problems, I suggest, are the result of the IMF trade liberalization policy and the weakening oil prices. This has caused loss of confidence in the peso and a dramatic outflow of currency, the result of speculation against the peso. The liberalization policy has been a disaster, and any continuation of that policy would significantly slow Mexican growth.

In short, I do not agree that protection for less developed countries is a bad thing. It worked quite well for Mexico in the 1950s, 1960s, and early 1970s. Moreover, I take exception to Professor Krauss's free trade models, the Gang of Four. In fact, Korea has tight quantitative restrictions on all capital goods. This has been an important part of their capital goods program, which was launched in 1973. Taiwan has also had close quantitative import restrictions on a whole range of manufactured goods, including consumer goods. They also use tariffs, some as high as 100 percent.

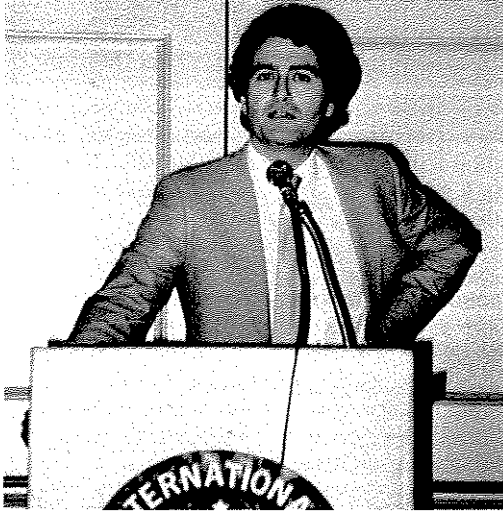
Professor Krauss derives much of his argu-

ment from the theory of comparative advantage. He believes that labor-intensive countries should export labor-intensive goods; capital-intensive countries should export capital-intensive goods. But how does a country become capital-intensive? Professor Krauss does not say, and this is the problem with the theory of comparative advantage. It is a totally static idea. It has nothing to do with growth, with the accumulation of capital, and with industrialism, which is the basis of economic prosperity.

The best refutation of the comparative advantage, free trade view was presented by Vice Minister Y. Ojimi of the Japanese MITI, in a speech before the Organization of Economic Cooperation and Development (OECD) in 1970. "After the Second World War," he said, "Japan exported toys, miscellaneous merchandise, and low quality textile goods. Should Japan have entrusted its future," according to the theory of comparative advantage, "to these industries, characterized by extensive use of labor, given its relative capital scarcity and relative labor abundance?" The Japanese didn't think so. "MITI decided to establish heavy, capital-intensive industries in Japan, such as steel, oil refining, petrochemicals, automobiles,

“... the import substitution strategy of Mexico was, by stimulating the development of manufacturing, actually an export promotion strategy...”

—John Eatwell



John Eatwell

aircraft, industrial machinery of all sorts, and electronics.* From a short-run static viewpoint, encouragement of these industries might have seemed to conflict with economic rationalism. But from a long-range viewpoint, these are precisely the industries where income elasticity of demand is high, technological progress is rapid, and labor productivity rises fast. Without these industries, it would be difficult to employ a population of 100 million and raise their standard of living to that of Europe and America.” So said Vice Minister Ojimi; and I agree.

Melvyn Krauss—I have always been a fan of “Beyond the Fringe,” a brilliant comedy show out of Cambridge twenty years ago. I see that the great Cambridge tradition is still alive, since the advice Professor Eatwell and his Cambridge colleagues is giving Mexico will take that country not only beyond the fringe, but over the edge.

Central to Professor Eatwell’s theory of protectionism as a dynamic strategy is the importance of allowing domestic markets to grow. But his analysis focuses entirely on domestic demand; that is, he discounts totally the impact of the world market and world demand. Why not follow the policy that permits your economy to integrate itself with the world market? That is the policy of those Third World countries which have done best in terms of economic growth during the past two decades.

On Taiwan and South Korea, which have had protectionism and import controls, I think that Professor Eatwell is missing the point. After World War II and until about 1960, both countries

followed protectionist policies, and both were unwilling to link themselves to the world economy. They discouraged foreign capital investment, and were dependent on U.S. aid. And both had very poor rates of economic growth compared to what came later—both in terms of GNP and in terms of exports.

Around the end of the 1950s and the beginning of the 1960s, the U.S. Congress became very worried about what was happening in Taiwan and South Korea. They felt that dependency on aid was leading to socialism in countries that were supposed to be models of capitalist development. Accordingly, they decided that aid would be gradually terminated. In anticipation of that outcome, both countries made strategic changes in their domestic policies. Both changed from protectionist, anti-foreign capital investment policies, to free trade, pro-foreign capital investment policies. And it was precisely at this point that both countries began their economic miracles.

Professor Eatwell has generally characterized the theory of comparative advantage as being static; but in fact, it has dynamic implications. He asks: How did Japan make the switch from labor-intensive industries to capital-intensive industries? Through savings; through the profits obtained by specializing first in labor-intensive industries. The profit was used to build up the capital stock and then, as the process proceeded, the country became relatively more capital-abundant—and thus able to switch into capital-intensive industries. Protectionism had very little to do with the change from labor- to capital-intensive industries in Japan.

The advice of the Cambridge school is typified by a remark of Nicholas Kaldor, its leader, recently published in the *New York Times*. Lord Kaldor is quoted as saying that “Mexico, a labor-abundant country, should not stick to products that use large amounts of inexpensive labor. As examples of successful nurturing of heavy industry in a developing country, there is Japan in the mid 1950s and the U.S. in the 19th century.” The message is that rapid economic development in labor-abundant economies is possible by using protectionism to specialize in heavy, capital-intensive industries.

This is bad advice. Most economists know that the economic success of a country is contingent upon its specializing on those types of industries that are compatible with its underlying economic resources. Labor-abundant countries should specialize in labor-intensive industries, and capital-abundant countries should specialize in capital-intensive industries. Moreover, Kaldor’s claims don’t fit the facts of Japan’s (or the United States’) economic experience. It has been tried by

*For a different interpretation of the postwar Japanese story, see “Industrial Policy, Part I: The Japanese Model,” *Manhattan Report*, Volume II, No. 8 (November 1982).

"Protectionism will not make Mexico's heavy industry competitive on world markets, just as it did not help the Shah make Iran's heavy industry competitive."
—Melvyn Krauss

many LDCs, who have failed miserably.

If one is looking for a country to compare Mexico with, I suggest that Japan is not the right one. I think a comparison with Iran is more illuminating. Like Iran, the Mexican government is wasting its oil money by investing it in industrial white elephants that are not and can never hope to be competitive on the world market. Protectionism will not make Mexico's heavy industry competitive on world markets, just as it did not help the Shah make Iran's heavy industry competitive. If Mexico's new president, Miguel de la Madrid Hurtado, continues to take Cambridge advice—and there is good reason to believe he won't, since one of the first things he did as President was fire Kaldor's student, Carlos Tello, as head of the Mexican Central Bank—we may soon find ourselves with a Mexican Ayatollah.

As I explain in *Development Without Aid*, what we are seeing in Mexico is an example of a general phenomenon. The bright young men of the Third World pursue their higher education in Northern universities, where they come into contact with academically distinguished professors, so-called "development specialists" like Richard Musgrave of Harvard, Walter Heller of the University of Minnesota, and Nicholas Kaldor of Cambridge. Keynesian, social democratic ideas are implanted in these impressionable youths who, after they graduate, return to important, high-ranking positions in their home countries. And these false ideas are reinforced later on, when these same social democratic professors give advice to less developed countries as advisers, often under the patronage of the U.N., the Ford Foundation, and other such institutions. Thus, it came as no surprise to me that Carlos Tello, the ex-head of the Mexican Central Bank, was Professor Kaldor's student, as was Jose Andres de Ortezaya, Prime Minister of the Ministry of National Patrimony and Industrial Development, and others in Mexico as well.

John Eatwell—Sad to say, Cambridge economists did not have anything like the influence in Mexico Professor Krauss suggests. The people I worked with down there in the Industry Ministry were really the Cinderellas of the whole economic policy outfit. Economic policy was basically run by the Bank and Finance Ministry, most of whose leaders had Ph. D.s from Stanford and Chicago. We in the Industry Ministry were the loyal opposition. Our policies were not followed at all, insofar as liberalization and increased spending took place. We were the people who wanted to reduce the rate of growth of spending; we wanted the oil cap to reduce the petrification of the economy; and we were the people who were against excessive expenditure on government prestige projects.



Melvyn Krauss

What we were in favor of was industrialization. Not necessarily heavy or light industry, we were strong advocates of industries likely to grow, and likely to have a high income elasticity of demand. Industries, in other words, likely to be the basis both for providing a large number of goods required in Mexico itself, and for exporting overseas.

Professor Krauss paints a picture of Mexican industry as being enormously inefficient. How can we define efficiency? It wouldn't be fair to define it in terms of the Mexican market, since that is protected. We could define it in terms of Mexico's exports to the U.S., because they have no particular advantage there. And in that sense, Mexico's performance has been very good indeed. Its share of American markets has increased steadily over the period since 1960 up until the trade liberalization after 1976, when the large imports into Mexico really stunted the attempts of Mexican industrialists to invest, because they saw their domestic markets disappearing.

Melvyn Krauss—On the question of efficiency, all I claim is that Mexican heavy industry is inefficient. Labor-intensive industries are efficient in Mexico. Capital-intensive industries cannot and will not be efficient, and that's why they seek protection, which should be denied. Professor Eatwell asked how efficiency can be measured. Well, perhaps by the number of times Mexico has to go to the IMF window for loans. Mexico is doing very well in that regard.

John Eatwell—We wanted Mexico to grow at about 8 percent, because that is the rate needed to keep the growth of employment equal to the rate of growth of the labor force—and so not cause so many people to pour across the border into Texas and California. To accomplish that

Developing Countries Debt

	Total Disbursed Debt of Non-Opec Developing Countries, At Year End ¹	Total Annual Debt Service of Non-Opec Developing Countries ²	"Exposure" of Banks to Non-Opec Developing Countries ³
	(\$Billions)	(\$Billions)	(\$Billions)
1971	75	9.5	—
1977	227	32.2	32
1981	445 ^p	81.8 ^p	158
1982	520 ^e	98.3 ^e	208

¹ Includes bank loans, multilateral organization, loans, and government loans.

² Includes interest and amortization.

³ Exposure defined as total outstanding loans minus deposits.

p (preliminary)

e (estimate)

Source: OECD, *External Debt of Developing Countries, 1982 Survey*

growth, we had to reduce the propensity of Mexico to import, because otherwise there would have been a huge balance of payments deficit which would have aborted the whole process. What could we do, devalue the peso? The consequence would have been a dramatic inflation within Mexico. Mexico would simply have cut real wages 10 or 12 percent for a group of workers who had absorbed wage cuts of 4 to 5 percent every year from 1976-1979 anyhow. That was not politically sustainable in any shape or form. Anyhow, devaluation-induced inflation would have led to financial collapse in an economy with no exchange controls as Mexico then did not have.

The only alternative for inducing growth without upsetting the balance of payments or causing an explosive inflation was, we argued, protection. Yet Mexico actually, and unfortunately, did just the opposite. Hoping they could ride out the wave on oil money, they expanded rapidly and at the same time dismantled the protective apparatus. The consequent disaster is what we see today. Now, unfortunately, we've had the imposition of the IMF agreement. The consequences of the IMF agreement will be negative growth for the Mexican economy next year, and probably zero or very low growth for the next few years. The manufacturing base will deteriorate, as will the markets for American goods.

Melvyn Krauss—I, too, am distressed by the terms of the IMF loan to Mexico. Mexico's problems will not be solved by deflation of the type apparently requested by the IMF. I think that reducing public expenditures and budget deficits is a good idea, but not by increasing taxes. That will only cause the economy to stagnate.

Professor Eatwell obviously has doubts about the efficiency of exchange rate adjustments as an

instrument for equilibrating balance of payments problems. He favors fixed exchange rates which, given Mexico's balance of payment deficit, means that only protection or domestic deflation can bring about balance on international accounts. Professor Eatwell's alleged cure—protection—is worse than the disease. My own preference is for freely floating exchange rates, which can equilibrate the balance of payments without recourse to protectionism. Those who favor fixed exchange rates implicitly assume that the judgments of the public authority who fixes the rate is superior to the collective judgment of private individuals in the marketplace.

Bruce Bartlett, *Joint Economic Committee*—Is industrialization necessarily that desirable? What about the service sector, or agriculture? I raise this question because the answer may have implications for the United States as well.

John Eatwell—Manufacturing is the engine of economic growth, but that doesn't mean that other sectors, like agriculture, should be neglected. There's no doubt that the agricultural sector in Mexico is a problem sector, and that is why the introduction of the Agricultural Development Program (SAM) over the last few years has been important.

In agriculture, productivity growth tends to result in shedding of labor, without necessarily increasing output. Typically, in the Third World, there are huge reserves of underemployed labor on the land. Productivity grows as industry grows, pulling workers out of agriculture and giving them jobs. Moreover, there is not a very close relationship between productivity and output in services, either. The "throughput" of a store will often be the same, or can vary in a wide range, when you use the same amount of labor. And when there are major productivity improvements in services,

"The consequences of the IMF agreement will be negative growth for the Mexican economy next year, and probably zero or very low growth for the next few years."

—John Eatwell

such as in the development of supermarkets or data processing, the improvements are often traceable to the manufacturing sector.

The relationship between productivity and output in manufacturing is different. As output grows in manufacturing, there are dynamic increasing returns to scale. It is in industry where novel processes are developed, and where specialization leads to greater innovation and technological change. And as industry grows, the investment which leads to that productivity growth tends to grow also. Productivity growth leads to expansion of markets, which increases the demand for industrial goods; and this fosters or induces still further productivity gains. There is a dynamism in manufacturing which other sectors of the economy feed on. Agriculture benefits from the fertilizers, the machines, and the fact that surplus labor is drawn into manufacturing. Services benefit because services are becoming more and more industrialized. Take a simple service—a package holiday to Mexico. You need a ticket, an airplane, a hotel, knives and forks, etc. These are manufactured.

Melvyn Krauss—I agree that manufacturing is very important; but the key to economic growth is intelligent domestic public policy.

In agriculture, for instance, government policies have often ruined this sector. Export taxes are one instance, as is land reform—if only because landowners get wind of the change before it actually occurs and decapitalize their properties. What the peasants take over is not worth, in the final analysis, the taking—but of course, it is usually some state-run collective, and not the peasant, that inherits the farms anyway.

Incidentally, less developed countries do have a true grievance against Northern countries—namely the tariffs they place on Southern goods. This is an abominable policy, exploiting Northern consumers and keeping the Third World from growing.

Ben Crane, House Banking Committee—Following up on what Professor Krauss just said, I'd like to address a question to Professor Eatwell. If I were convinced by your case for protectionism, I don't see why it shouldn't be applied with a vengeance by the United States. After all, we are concerned with our manufacturing sector. Hence, on your logic, why shouldn't the developed countries ban imports from Mexico? For that matter, why shouldn't countries even poorer than Mexico do the same? Where would the dynamics of this activity leave the world?

John Eatwell—I can best answer your questions by taking the case of the United States. If the United States government now undertook an ex-

pansionary policy, it would suck in manufactured imports, creating an unsustainable balance of payments position and a dollar crisis. Suppose, instead, it was decided to impose restraints which prevented imports from rising as output rises, but *did not* cut imports. Then the U.S. could expand without fear of balance of payments problems, and no one would be worse off, since manufactured imports would be at the same level as before. Indeed, others might be better off. A U.S. expansion would require a large amount of raw materials from the Third World, and Third World countries would be sure to spend every dollar on industrial goods, benefiting Europe and Japan and the Third World industrial producers.

This would, however, be a crude policy. What we really need is a means of organizing world trade flows between all major economies so they can all expand without precipitating a financial crisis, given the delicate international situation we have now.

Melvyn Krauss—There is a weakness in this scenario. Attempts to promote growth by inflating domestic demand and cutting down on imports through protectionism will not guarantee that the supply of goods will increase, only that inflation will result. Professor Eatwell worries about the inflationary impact of devaluation; he should be more worried about the inflationary impact of overheated domestic demand. The incentives under protection are not to produce more, but to produce less, at a higher price. In many cases, protectionism leads to shrinking, not to growing, industries.

I do not have great faith in managing world trade flows, because this assumes that government knows more than the private sector. We learned from Friedrich Hayek years ago that the knowledge of individuals is limited. Who is going to plan the world economy? The people at Cambridge? The government bureaucrats at the U.N.? We all know how well they do things. I put my trust in the private sector, in the market—in individuals managing their own affairs, controlling their own destinies.

John Eatwell—Fundamentally the market is a good servant but a bad master. Handing over our destiny to unregulated markets is dangerous—as was demonstrated by the experience of the world fifty years ago.

Markets may encourage industrial efficiency and innovation. But they certainly cannot ensure full employment or international equilibrium.

Melvyn Krauss—I believe that prosperity results from free trade, through free capital movements, and through labor migrations. When we put obstacles in the way of the free movement of capital, labor, and goods, we get ourselves in trouble. □

Third World in Crisis

(Continued from page 8)

had nothing to do with a sincere desire to help Third World countries. It was due to a desire to help Swedish exports.

In any event, since I believe that foreign aid hurts rather than helps, I feel that the optimal level is pretty close to zero.

Abdi Awaleh Jama, Somalia—While I agree with many of your comments and observations, I wonder if you don't condemn too quickly governments with serious social problems, like India, which adopt command structures and intervention. After all, don't these countries have a responsibility to foster social justice and control their own destiny according to their own cultural traditions?

Melvyn Krauss—I certainly believe in social justice. The difference between myself and the traditional type of thinking you get in development economics is the way to promote it. I define social

justice as increasing the standard of living of poor people. I don't believe you increase people's living standards by redistribution and restrictionist policies that destroy a country's economic base. You foster social justice by permitting growth, and you permit growth through economic freedom. Increased social services follow. Incidentally, there is a substantial amount of evidence that high growth rates result in a more equitable distribution of income also. Brazil during the 1960s is a case in point, which I develop at length in my book.

I sympathize with the aspirations of a country's inhabitants to control their own destinies, but this cannot be achieved by policies which sabotage their economic prospects, and make them dependent on foreign governments for survival. Autarchy is often as not a road to poverty, not autonomy. □

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