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## Export expansion and diversification in Central and Eastern Europe : what can be learnt from East and Southeast Asia?

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## Export Expansion and Diversification in Central and Eastern Europe: What Can Be Learnt from East and Southeast Asia?

by Jamuna P. Agarwal, Rolf J. Langhammer,  
Matthias Lücke and Peter Nunnenkamp

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- The outstanding world market success of East and Southeast Asian countries (ESAEs) provides lessons for Central and Eastern European countries (CEECs) striving to penetrate Western markets, even though starting conditions were strikingly different between these country groups. While ESAEs enjoyed the reputation of stable domestic policies, CEECs had to deal with institution building, macroeconomic stabilization and privatization at the same time.
- First of all, sound macroeconomic policies and an unrestricted access to domestic and imported inputs are absolutely vital for exporters. These factors cannot be substituted for by specific export incentives. Furthermore, Asian experience suggests that such incentives should be granted on a temporary basis in order to discourage rent-seeking and minimize the budgetary burden.
- Export processing zones are ineffective if they do not exert competitive pressure on the rest of the economy via input and output linkages. Stimulating exports through direct export subsidies has become less important in ESAEs over time because of inconsistency with the GATT and the retaliatory actions of trading partners. Using such subsidies is further constrained in the case of CEECs: Subsidies would conflict with the Europe Agreements, which require that state aid and competition rules harmonize with EU regulations.
- Foreign direct investment can play an important role in enhancing export growth and diversification, especially if such investment is attracted by favourable market prospects rather than tax holidays. Export promotion by governments should preferably concentrate on institutional support aimed at reducing the information costs faced by local suppliers and foreign importers.
- Asia's world market success was accompanied by increasing diversification and technological sophistication of exports. Intra-regional networking in terms of trade and investment helped this process considerably. For CEECs, it is thus essential to enhance local technological capabilities in order to enable exporters to apply new technologies. Furthermore, the prospects for a market-driven integration between CEECs can be improved to the extent that mobility of goods and factors of production is allowed for.
- Economic transformation in CEECs involves policy challenges which clearly go beyond export promotion as in Asia. Moreover, CEECs are facing an uphill struggle against established suppliers on Western markets. Under such conditions, CEECs are well advised not to follow the Asian way of maintaining national sovereignty in trade-related policies. Rather, they had to commit themselves to internationally binding trade liberalization in order to enhance the credibility of their transformation policies. Such commitments were made on a regional basis within the EU framework of Eastern enlargement as well as on a multilateral basis within the GATT/WTO. The contribution of this approach of tying one's own hands to stabilizing expectations should be enhanced by the EU by offering CEECs stable conditions for market access.

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## A. Introduction

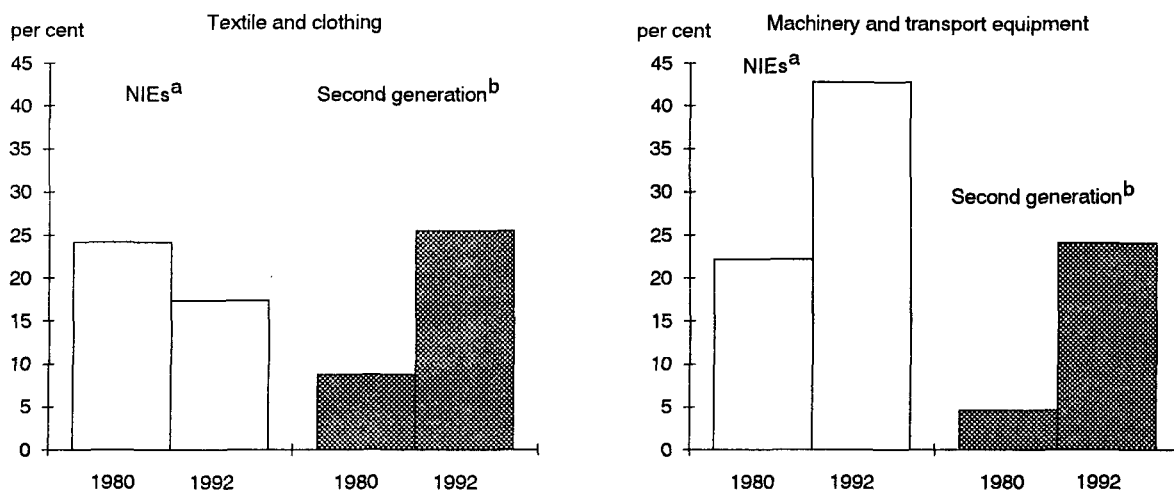
One of the most spectacular developments in post-war international economic relations has been the emergence of East and Southeast Asian economies (ESAEs) on world markets for manufactured goods. Starting from a narrow supply base of primary commodities and few semi-processed manufactures, the region has become the host of most competitive producers of a wide range of medium-tech goods within less than thirty years. While its share in total world trade (including primary commodities) almost tripled from 6.1 per cent in 1965 to 16 per cent in 1992 (including the far less dynamic South Asian countries), the true highlight was the unprecedented expansion of its share in the world market of manufacture from 3.6 per cent to 17.6 per cent. Rapid per capita income growth in the 1970s and 1980s (with about 6 per cent p.a. twice as high as the world average) would not have been sustainable if ESAEs had simply enlarged and defended traditional markets of well-established industries. Rather, permanent quality upgrading of old products, designing new products, penetrating new export markets, and exploiting opportunities for cost-effective sourcing of inputs have been required for living standards to improve.

Structural flexibility, both sectorally and regionally, seems to have been a major driving force behind sustainable export expansion in ESAEs. Sectoral changes in export supply have been indispensable for higher income economies whose export markets have been contested by lower income economies catching up from the same region. As a result, there has been a "cascading" effect of shifting production of standardized products from upper to lower income economies, parallel to the well-known "flying geese" pattern observed in Japanese investment flows within Asia. For example, the share of clothing and textiles in total exports of

the four NIEs (Hong Kong, Rep. of Korea, Singapore and Taiwan) declined from 24 per cent in 1980 to 17 per cent in 1992 while the share of machinery and transport equipment rose from 22 per cent to 43 per cent (Figure 1). At the same time, the second generation of successful exporters (China, Indonesia, Malaysia, and Thailand) increased the share of clothing and textiles in their total exports from 9 to 26 per cent; also the latter industry gained in importance — but its share remained lower than in the NIEs (5 and 24 per cent in 1980 and 1992, respectively). Putting the exports of the two country groups together, three quarters of textile and clothing exports originated from the NIEs in 1980 and only one quarter from the second-generation exporters. This distribution changed substantially until 1992 when the groups were almost at equal footing (51 to 49 per cent). For machinery and transport equipment, only 16 per cent of combined exports came from the second-generation exporters in 1980. In this industry, too, progress was made in catching up vis-à-vis the NIEs: second-generation exporters accounted for 27 per cent of total Asian machinery exports in 1992.

One of the major factors accelerating such changes during the last decade has been the emergence of China on world markets. EU trade with ESAEs bears witness to this point. For instance, Taiwan accounted for the largest individual country share in EU footwear imports from non-OECD sources in 1986 (18 per cent compared with China with only 4 per cent), but stepped down to 7 per cent in 1992 and lost its top rank to China (achieving 19 per cent in 1992). Yet, Taiwanese export growth did not lose momentum as the economy successfully concentrated on more income-elastic machinery exports.

Figure 1 – Shares of Two Product Groups in Total Exports of Two Asian Country Groups, 1980 and 1992



<sup>a</sup>The NIEs include Hong Kong, Rep. of Korea, Singapore, and Taiwan. — <sup>b</sup>The countries of the second generation include China, Indonesia, Malaysia, and Thailand.

Source: GATT *International Trade* (various issues).

Regional diversification has involved a shift from traditional markets, notably the US, to Europe and, subsequently, to neighbouring Asian countries. In fact, trade among ESAEs has received the largest impulse recently, and climbed to levels close to intra-NAFTA trade (about 40 per cent of total trade). By 1992, ESAEs bypassed the US as Japan's most important export market.

Asian trade dynamics have often been associated with export-oriented or export-driven growth. However, economic growth is triggered by allocating resources to investment rather than consumption in the first place. This does not necessarily imply that export demand is favoured over domestic demand. Export promotion measures would have discriminated against domestic demand only if they had overcompensated explicit export taxes, implicit taxes resulting from import protection, and a policy-induced overvaluation of real exchange rates. Analyzing the impact of such policy measures on Asian export success deserves special attention in this study.

Apart from explicit export promotion policies, the role of macroeconomic conditions and regional impulses received from neighbouring countries are discussed in Chapter B. Subsequently, the starting conditions of ESAEs are

contrasted with those of Central and East European countries (CEECs). In Chapter C, it is also assessed whether low transaction costs because of geographical proximity of CEECs to the EU help to overcome competitive disadvantages. Such disadvantages might arise if CEECs' exports to the EU have to compete with similar products exported by well-established suppliers from ESAEs. In this context, so-called trade overlap estimates are presented. Yet, even low overlaps and geographical proximity might be ineffective to spur CEECs' exports if supply-side constraints are still binding. This is why policy conditions in CEECs are given due attention in Chapter C. Finally, Chapter D provides conclusions on promising export strategies for transition economies considering both the Asian experience and the specific conditions prevailing in CEECs. The focus is on internal policy requirements, since the most generous conditions for access to export markets will be of little help if exports are effectively hampered by domestic policies in the CEECs themselves. Provided that domestic policies set appropriate incentives for exports, the EU and other export markets have to be absorptive and accessible. Hence, it is also discussed in which way the EU may enhance the export prospects of CEECs.

## B. Contributing Factors to Asian Export Success

### I. The Role of Export Promotion Policies in Asia

#### 1. Country Experiences

ESAEs have often been labelled as a homogeneous group of export-oriented economies. Yet, this label obscures considerable conceptual controversy on the true meaning of "openness" or "export-orientation" (Leamer 1988; Edwards 1989), as well as a large variance in starting conditions, policy sequences and timing of trade-related measures among ESAEs. Export promotion measures seem to have played an important role in offsetting export disincentives which result from import-substitution policies and their implicit taxation of exports. Beyond this offsetting function, it has remained controversial whether export promotion measures provided net incentives for exports and, thus, discriminated against production for domestic markets. Frequent changes in export promotion measures and varying levels of import protection on the one hand, and retaliatory measures of trading partners on the other hand render it rather unlikely that net export incentives have lasted for longer periods.

It is virtually impossible to convert various export promotion measures into a common numeraire (e.g., an exchange rate equivalent) in order to make them comparable across countries. Hence, it is more helpful to discuss export promotion measures taken by individual ESAEs and to analyze the relevance of specific measures across countries. Furthermore, it is necessary to discuss such measures in the context of the entire trade policy of ESAEs. In many cases, export promoting effects had arisen primarily from the dismantling of import protection, and direct export promotion had a supporting function only.

##### a. *Hong Kong*

Given its small size and lack of natural resources, Hong Kong adopted outward-oriented policies from the very beginning.<sup>1</sup> Now it is the

world's eighth largest trader with a share of 3.7 per cent in global exports.

Hong Kong is one of the most open economies in the world. Its trading regime is marked by the absence of any kind of import protection. It has no tariff or non-tariff restrictions on imports from any source. Whatever controls do exist, are maintained on technical, environmental, health or security grounds.

Exporters are not given subsidies, concessionary financing or tax exemptions. Hong Kong does not operate any state-trading enterprises. It has no foreign exchange controls. A minimal governmental assistance is available in the form of trade information and participation in trade fairs. Hong Kong presents an exemplary case of a successful open and market-driven economy.

##### b. *Indonesia*

Traditionally, the Indonesian economy has been heavily dependent on exploiting oil and gas resources.<sup>2</sup> During the 1960s and 1970s, Indonesia tried to diversify its economic structure through import-substitution policy, but achieved only limited success. In the 1980s, it shifted the policy emphasis to export promotion. The following were the major steps in this direction.

The Indonesian currency was devalued by 28 per cent in March 1983, followed by another devaluation by 31 per cent in September 1986. Since then shock devaluations have been avoided.<sup>3</sup> The currency has been allowed to depreciate under a managed floating system, based on a basket of currencies from major trading partners. The Indonesian exchange rate policy is targeted at stabilizing the real value of the currency to maintain competitiveness of exports and develop new export markets. Confidence in the currency has been enhanced by tight monetary policies and positive real interest rates. This policy has helped to stimulate investment into export production of manufactures and to reduce the current account deficit.

Liberalization of imports has been achieved through reducing the number of tariff lines sub-

ject to import licensing, replacing non-tariff barriers by price-related measures, and lowering tariffs. Reform packages introduced from time to time have reduced the protection level in Indonesia. Some of the industries which are viewed as strategic (e.g., shipbuilding, steel, aerospace, cement, fertilizers) and are dominated by state-trading companies, as well as a major part of agriculture continue to be shielded from import competition. On the whole, however, Indonesia's import liberalization has gradually exposed domestic producers to increased foreign competition and, thus, indirectly stimulated non-traditional exports.

Export policy has generally aimed at promoting non-fuel exports that had suffered from oil-price-induced real appreciation from time to time (dutch disease syndrome). Exporters have been granted excise duty and VAT exemptions as well as refunds on imported inputs. Provisions have been made to by-pass import licensing restrictions. Exports of natural resources such as logs and rattan are restricted in order to encourage domestic processing and exports of finished goods.

Direct assistance to exporters is extended through technical assistance in overseas marketing and promotion (participation in trade fairs, selling missions, trade promotion centres) as well as production management. Priority is given to goods with a local content of raw materials, high labour intensity and domestic multiplier effects. Cheap export financing was curtailed following Indonesia's signing of the GATT Code on Subsidies and Countervailing Duties in 1985. Export credits are now provided by commercial banks basically on commercial terms. Guarantee and insurance of export credits are provided by the government. In order to improve the reputation of Indonesian exports, the government specifies minimum standards for an increasing number of goods. Standards applied are not more stringent than internationally applicable.

The government has established special bonded zones, where imports of goods reexported after processing and warehousing are duty-free. Light manufacturing factories working for exports, e.g., in electronics, semi-con-

ductors, garments and food processing are allowed to locate in these zones.

Rules on foreign direct investment (FDI) have been liberalized especially in export-oriented manufacturing. Investment and local ownership requirements were virtually dropped in 1994 to encourage FDI which has been instrumental in boosting Indonesia's export capacity, especially in manufacturing. Only in the case of wholly foreign-owned companies a certain share of foreign ownership has to be sold within 15 years.

Trade reforms and liberalization programmes are reported (Pangestu 1992) to have been insufficient to completely remove the anti-export bias of government policies, including the negative consequences of the dutch-disease syndrome. Nevertheless, reforms have supported changes in the sectoral composition of exports towards manufactures. Furthermore, the growth of manufactured exports appears to be in accordance with changes in Indonesia's comparative advantages. FDI inflows have increased considerably and have become more export-oriented after the shift in the trade policy regime.

### c. *Malaysia*

Malaysia is a prime example of a country which has been able to evolve from a commodity-based to a diversified economy.<sup>4</sup> In a little more than three decades after its independence, the share of manufacturing in GDP increased by six times to nearly 30 per cent in the early 1990s. The manufacturing sector now accounts for 70 per cent of exports, whereas rubber and tin were the main foreign exchange earners in the 1960s (70 per cent of exports). A significant part of this success is due to Malaysia's shift from import-substitution policies in the 1960s and 1970s to export-oriented manufacturing in the 1980s.

The policy shift included the liberalization of international financial transactions. Financial transfers related to current transactions are free from restrictions. The exchange rate regime may be described as managed floating, with the central bank intervening in terms of a composite basket of currencies to maintain "orderly conditions". The real effective exchange rate of the Malaysian currency depreciated by about 22 per cent between 1980 and 1992. Empirical studies



reveal that exporters responded considerably to real exchange rate movements during the 1980s (Beng 1992: 203).

Malaysia has steadily lowered the effective rate of protection (ERP) to force local producers to become internationally competitive. The average ERP declined from 45 per cent in 1969 to 31 per cent in 1979 and to 17 per cent in 1987. Protection is given because of infant and strategic industry arguments to a small number of industries (e.g., motor vehicles, chassis with engines, tractors, basic steel products, etc.), but only on a temporary basis. In most of the cases where import licences are required, conditions are attached on health, moral or security grounds.

Free commercial zones for trading companies and free industrial zones for manufacturing companies have been established to promote imports and exports of goods and services. Businesses in these zones are exempted from customs duties, excise duties, sales tax and service tax in so far as their products are exported.

Other export promotion measures include the following: Exporters are eligible for a deduction from taxable income of twice the amount of relevant business expenditure and receive premiums on export credit insurance to encourage penetration of non-traditional markets. Exemptions from import and excise duties on raw materials and components used for export manufacturing are generally available in Malaysia. Export financing facilities cover almost all manufactures with a given minimum local content, and extend over four months for the pre-shipment period and six months for the post-shipment period.

In 1993, the Malaysia External Trade Development Corporation (MATRADE) was established to provide exporters with an expanded and intensified range of assistance including market research, product development and training in marketing. MATRADE is expected to promote the image of Malaysia as a high-quality exporting country having a good business ethic. There are other institutional facilities available for exporters wanting to establish representation and distribution centres abroad or taking part in trade fairs. These facilities are of

great help especially to smaller exporters and newcomers.

Malaysia has traditionally given several fiscal and financial incentives to foreign direct investors, especially in manufacturing industries devoted to exports. Some of them were scaled down in the early 1990s, but the government can grant more favourable support on a case-by-case basis. The present focus is on high technology, domestic value added, expanded domestic linkages, environmental protection and greater export capabilities. Malaysia has become an attractive location for FDI. Since 1987, 60 per cent of current manufacturing investment has been based on overseas capital, largely directed to export-oriented industries. The role of specific incentives, relative to the general policy framework, in explaining the inflow of FDI is open to debate, however.

#### *d. Republic of Korea*

In approximately three decades, Korea has been able to transform its agrarian structure into an industrialized economy.<sup>5</sup> This was, however, not a very smooth process. The country had to adjust its industrial and trade policies several times. During 1962–1971, Korea implemented an outward-oriented development strategy. It opted for promoting labour-intensive manufacturing exports in which it had comparative advantages. For this purpose, the exchange rate was devalued by nearly 100 per cent to eliminate the earlier bias against exports. Short-term export financing and tariff rebates on imported inputs for exports were made available. There was a general shift towards import liberalization and more competition on domestic factor and goods markets. Korean export growth turned out to be very high (33 per cent per annum in real terms) during this period. Then, however, the Korean government got concerned about the vulnerability of its labour-intensive manufactures on international markets due to arising protectionism in industrially advanced countries. The industrial strategy was shifted towards the development of heavy industries, which included iron and steel, non-ferrous metals, shipbuilding, automobiles, machinery, petrochemicals, and electronics.

In order to promote these industries, the government raised tariffs and quantitative restrictions on imports of competing goods in 1973 and 1976. Moreover, the exchange rate was fixed at a relatively low rate to avoid higher costs for imported equipment for these industries. Thus, the years between 1972 and 1978 can be regarded as a period of policy reversal towards import substitution. This policy drive was effective in the sense that the share of heavy industries (including chemicals) in all manufacturing fixed investment and total exports increased markedly. But it had some serious negative consequences and could not be sustained. Credit expansion in favour of heavy industries led to inflation. Relative prices were distorted by world-market standards. International competitiveness suffered badly, since the exchange rate was not allowed to adjust. Export growth became negative in real terms, and the growth of GNP decelerated. As a result, the Korean economic policy was overhauled in 1979.

The measures adopted since 1979 have aimed at stronger reliance on market mechanisms and private initiative, slower growth of money supply, realignment of credit priorities in favour of light industries, import liberalization and decontrol of many commodity prices. In January 1980, the Korean currency was devalued and a more flexible exchange rate regime was introduced. Furthermore, FDI was liberalized successively. Technology import was freed from prior government approval. Industry-specific incentives were replaced with general incentives available to all industries. By the mid-1980s, the success of these measures was noticeable in terms of export growth, FDI inflows and a more equitable income distribution. This seems to have contributed to a slowing down of the dynamism of reforms since then.

The main features of current trade policies in Korea are as follows:

- The country has operated a system of managed floating against the US dollar since 1990. Major realignments have not been made since the early 1980s.
- Several tariff reforms have reduced the average tariff on industrial goods to less than 10 per

cent. Virtually all tariffs are applied on an ad-valorem basis. There are no variable levies. However, Korea tries to influence the sourcing of its imports through officially guided diversification and so-called localization programmes. Import liberalization extends to almost all manufactured items (exceptions refer to some textiles and leather garments).

- Direct export subsidies are not given any more after retaliatory measures of trading partners through countervailing duties and anti-dumping procedures in the past. Some indirect subsidization of exports may still result from preferential access to export credits and export-related tax-free reserves.

- Drawbacks on tariffs and indirect internal taxes are allowed on all imported inputs used in export production.

- Insurance on all exports and overseas construction contracts are available from a publicly managed insurance agency. Its deficits, if any, are covered by the government budget.

- A rather comprehensive institutional set-up promotes exports through lowering costs of information. The major role is played by the Korea Trade Promotion Corporation (KOTRA), which has an international network encompassing nearly 70 countries. Its activities include collecting and distributing market information, finding customers for Korean products, assisting in product design and packaging, advertising Korean products abroad and participation in international trade fairs.

- There are two free-trade zones accounting for less than 3 per cent of Korea's exports and imports in 1990. Likewise, their share in total FDI inflows has been marginal.

- Several funds (Industrial Development Fund, National Investment Fund, Structural Adjustment Fund for Small and Medium Enterprises, Research and Development Fund) support enterprises in various ways, some of which are directed explicitly towards improving export competitiveness.

- FDI has been liberalized considerably. Almost all manufacturing industries are open for foreign direct investors. Tax and tariff privileges are given on investments coupled with advanced technologies.

Overall, the Korean experience illustrates an interesting aspect of timing. Direct export promotion was initiated *before* import liberalization had taken place, in order to relax balance-of-payments constraints in a period of declining foreign assistance. Arguably, immediate import liberalization would have faced the risk of further balance-of-payments deterioration. After export promotion had contributed to an improved balance-of-payments situation, import liberalization was considered sustainable. It then became the major impulse of sustained export growth. At the same time, direct export promotion measures substantially lost in importance.

#### e. *Singapore*

Before independence in 1959, the economy of the island city state of Singapore was dominated by entrepôt trade.<sup>6</sup> In the early 1960s, the focus was placed on industrial development involving labour-intensive industries producing mainly for export markets. This strategy was successful in yielding real GDP growth of about 10 per cent per annum in 1965–1980, and raising the share of manufactures in GDP from 15 to nearly 30 per cent. The emphasis shifted to skill- and technology-intensive sectors (including services) in the 1980s, again targeting at export markets. Export expansion was required to ensure the financing of the high import ratio that characterizes Singapore. It has, therefore, adopted an open trading regime from the very beginning. The total value of its exports and imports currently amounts to more than three times its GDP. The major features of Singapore's trade policy are summarized in the following.

Singapore has no foreign exchange controls since 1978. The external value of the currency is monitored against a trade-weighted basket of foreign currencies. The nominal effective exchange rate of the Singapore dollar was marked by a rising trend during the 1980s. Trade liberalization proceeded in two stages: (i) replacement of quotas with tariffs in the late 1960s, and (ii) total removal of quotas and tariff reduction in the early 1970s. Hence, Singapore liberalized its trading regime substantially within six years.

Protection of domestic industries through tariff or non-tariff barriers is largely absent today. Some non-tariff measures and import duties levied on alcohol, tobacco, fuel, vehicles, etc. are for health, social or environmental reasons. Textiles and clothing account for almost 80 per cent of the tariff lines bearing ad-valorem rates (most of which are at 5 per cent). Because of the high proportion of duty-free trade, the average tariff rate is below 1 per cent. It is thus not surprising that duty drawbacks for inputs used in export production are not frequently claimed.

In the context of the Uruguay Round (UR), Singapore raised the percentage of imports subject to bound rates from zero to 73 per cent. However, it did not guarantee duty-free treatment legally. Hence, duty-free treatment is still based on applied rather than bound rates.

Direct export subsidies are not provided in Singapore. As far as export financing is concerned, rediscounting of export bills is possible through the exporter's bank. Export credit guarantees and insurance are available through commercial banks and other non-governmental financial institutions at market rates.

Much of Singapore's transit trade takes place in six free-trade zones, which provide a range of facilities and services for storage and reexport of goods. Industries are not located in these zones, however.

Institutionally, exports are promoted by the Singapore Trade Development Board (TDB), which was set up in 1983. Its aims include the identification of new markets and attracting international trading activities to Singapore. Furthermore, TDB provides financial assistance to private companies for setting up overseas offices, improving product quality, marketing new products and services, and for participating in trade fairs and exhibitions. Financial assistance is given also for bidding for overseas contracts.

FDI is of central importance to the economy of Singapore. Its share in gross fixed capital formation is higher than in any other country of the world (except for Papua New Guinea in 1991 and 1992) (see UNCTAD 1994b: 421–426). Persistently high FDI inflows are to be attributed to the favourable macroeconomic and political investment climate, rather than to the

preferential treatment of foreign investors. No distinction is made between local and foreign companies with regard to investment incentives, which are given according to priorities of the general development strategy of the government. Since the 1980s, these priorities have been enjoyed mostly by industries requiring relatively few natural resources and using skilled labour. Local and foreign companies are eligible for double deduction from income of their expenses incurred on export promotion such as participation in trade fairs and maintenance of overseas trade offices.

Free trade and market-oriented policies have enabled Singapore to enjoy strong export and GDP growth since the 1960s. What distinguishes Singapore from other ESAEs, notably Korea, is that efforts at promoting exports took place simultaneously with import liberalization. Immediate import liberalization was feasible in Singapore because of the strong initial balance-of-payments position, the stability of the currency, the flexibility of domestic exporters in responding to the new competitive environment, and efficient factor markets.

#### *f. The Philippines*

The Philippine economy has been the "slow-goer" among the ESAEs considered here.<sup>7</sup> Average GDP and export growth rates have been lower than in other ASEAN countries in the last three decades. The country has suffered from chronic shortages of foreign exchange, and has often been faced with balance-of-payments crises. Most of these problems can be attributed to domestic economic policies. Import substitution was maintained during the 1950s and 1960s. It was only later in the 1970s that various export incentives were introduced, including the establishment of export processing zones. This resulted in a rapid growth of export items produced in these enclaves, particularly of textiles and electrical components. In 1981, a programme for the development of heavy industries was launched. Most of the 11 projects introduced under this programme proved to be a failure, and the priority of industrial strategy was shifted to agrobusiness and labour-intensive, small and medium-scale industries. Since 1987,

a greater emphasis has been laid on deregulation, privatization and liberalization of trade.

The real effective exchange rate of the Philippine peso has been subject to fluctuations. Major depreciations in 1983 (17 per cent) and 1986 (20 per cent) resulted in substantial increases in exports. The subsequent appreciation of the peso during 1986–1990 seems to have been responsible for the decline in export growth. While significant foreign exchange controls have been removed since 1992, the Central Bank has continued to intervene in the foreign exchange market to maintain "orderly conditions".

The nominal (unweighted) average tariff has been halved since 1980, and quantitative restrictions have been removed on about 95 per cent of import items. However, considerable tariff escalation in manufacturing has persisted. On an average, tariffs range between 10.7 per cent for raw materials and 26.5 per cent for processed goods. Escalation is lower in agriculture, but the corresponding tariff rates are much higher (38.1 per cent for raw materials and 43.6 per cent for processed goods). In addition to dismantling quantitative restrictions unilaterally, the Philippines have lowered implicit taxes on exports by further tariff cuts under the UR and by binding tariffs for more than 60 per cent of dutiable imports.

Similar to other developing countries, the Philippines have attempted to reduce the anti-export bias inherent in import restrictions through duty exemptions and drawbacks. However, their bureaucratic costs are high because only about 20 per cent of all exporters and half of non-traditional exporters have made use of the exemptions or drawbacks. The recent creation of the One-Stop Action and Information Centre may have reduced bureaucratic hurdles.

Four export processing zones and ten special industrial zones offer infrastructural facilities as well as tax and duty exemptions for imported raw materials and intermediate inputs used in processing, assembling and manufacturing of goods for export. The relative importance of exports originating from these zones increased during the 1980s, but remained below 10 per cent of total Philippine exports.

Export financing has been available through a variety of schemes (e.g., export packaging credits, export bill credits, foreign currency loans of the Central Bank, and loans from the Philippine International Trading Corporation). Financing has generally been at terms prevailing on international capital markets. Some subsidy element may be involved in credits given to small and medium-size exporters by the Philippine International Trading Corporation. The proportion of exports financed by all these schemes has been very low, however, at least partly because of collateral requirements. The scheme to provide a collateral substitute by the Philippine Export and Foreign Loan Guarantee Corporation has not worked well due to its own financial problems.

Export promotion activities supported by the government include participation in international trade fairs, exhibitions, and selling missions, as well as training to improve management in the export sector. More efforts are being made to improve the institutional framework of export promotion.

As concerns FDI in the Philippines, the Foreign Investment Act of 1991 expanded the number of economic sectors open to 100 per cent foreign ownership, streamlined the approval process, and clearly defined the remaining limits and restrictions. With regard to tax and fiscal incentives, foreign firms have largely been treated at par with local firms. A distinguishing feature as compared to other ESAEs is that the Philippines have used debt-equity swaps to attract foreign enterprises. Reportedly, swaps have contributed significantly to the increase of FDI.

In summary, earlier attempts at direct export promotion in the Philippines were concentrated on free economic zones, bonded warehouses and other enclave activities. They left import substitution activities basically untouched. As a result, only few local inputs (including cheap labour) were tapped. Demand for inputs produced by the import-substituting sector and hence competition with this sector were minimal. Export promotion remained isolated and was not supported by significant import liberalization. Moreover, the effects of export promotion remained limited since the macroeconomic en-

vironment was flawed with volatility and lack of discipline. The Philippine economy is still lagging behind its competitors in the Asian region. However, trade promotion policies have made a definite headway more recently. The share of manufactured exports in total exports increased from 53 per cent in 1985 to 71 per cent in 1991. During 1986–1990, imports of liberalized goods increased by 20 per cent per annum without threatening seriously the existence of firms in most industries. Finally, monetary and fiscal discipline during recent years has provided a more supportive environment for trade reform than in the early 1980s.

#### *g. Thailand*

Like many other developing countries, Thailand started with an import-substitution strategy to transform its agriculture-dominated economic structure.<sup>8</sup> Realizing the limits of this strategy, it shifted the policy focus towards export-oriented industries in the mid-1970s. Thailand has witnessed significant trade liberalization since then, although several sectors such as agro-processing, textiles, leather products and motor vehicles still remain overproportionally protected. The country's exports and GDP have grown fast by worldwide standards. In order to maintain this momentum, more industries are likely to be opened to international competition.

The Thai currency has fluctuated in relation to a basket of currencies since 1984. The US dollar is used as the intervention currency. Foreign exchange regulations were substantially liberalized in May 1990. For the 1980s as a whole, the real effective exchange rate of the Thai currency depreciated by nearly one fifth, which contributed to the economy's competitiveness on world export markets. In spite of depreciation, the high demand for foreign inputs caused imports to increase more rapidly than exports. The resulting balance-of-payments deficit was more than compensated by foreign capital inflows in response to improved cost competitiveness of the Thai economy.

The Thai budget is more dependent on trade taxes than in other ESAEs. This has led to recurring changes in tariffs. Compared with the early 1960s, the average applied tariff declined

from about 24 to 17 per cent in the second half of the 1980s. As in many other developing countries, bound rates have remained higher. The trade weighted average of bound rates on industrial products was reduced from 37 per cent in the pre-UR period to 28 per cent thereafter.

The implicit tax on exports resulting from remaining import protection (notably tariff escalation, non-automatic licensing, local content schemes and government procurement policies) has been reduced through the remission of or exemption from tariffs, other import levies and income taxes. In addition, there are investment promotion zones, industrial estates, and export processing zones, where exporters are not subject to bureaucratic procedures in claiming tax rebates, etc., and benefit from favourable infrastructure. Export firms can bypass many customs procedures through bonded manufacturing warehouses, the geographical location of which is not restricted in Thailand.

Exporters have access to concessional export financing. Long-term export financing was started in 1985 with the help of the Japanese Overseas Economic Cooperation Fund; short-term financing is provided by the Bank of Thailand through commercial banks. Quantitative estimates of indirect export subsidization resulting from concessional export credits are not available, however.

A variety of incentives are available to foreign investors in addition to those given to domestic investors as well. They include guarantees against nationalization, competition from new state enterprises, and price controls. Some import protection is also given as tax-exempted imports of competing products are not allowed. The employment of skilled foreign personnel in foreign enterprises is not restricted. Favourable macroeconomic conditions supported a high growth of FDI, increasing its share in gross fixed capital formation from 3.2 per cent (1981–1985) to 5.6 per cent (1991) (see UNCTAD 1994b: 425). Japan has been the main source of FDI in Thailand. The structure of Japanese investment has shifted from import-substituting consumer goods industries to export-oriented sectors such as electrical and electronic products and textiles. Both the growth and sectoral allo-

cation of FDI imply favourable effects on Thailand's trade performance.

The legal framework of trade and FDI incentives in Thailand seems to manifest a higher degree of public management than in other ESAEs considered so far. Yet, a stable monetary environment has been sustained and flexible adjustment to changing world-market conditions has been encouraged rather than prevented by the government. Thailand's success in changing the export mix is documented by the rise of the share of manufactured goods in exports from less than one fifth to two thirds within two decades.

#### *h. Taiwan*

Taiwan, one of the fastest growing countries of the world, was highly concerned with the shortage of foreign exchange in the 1950s.<sup>9</sup> It launched a two-pronged strategy of import substitution and export promotion. The country raised its world export share from 0.1 per cent in the 1960s to 2.2 per cent in 1992, and has accumulated the highest amount of foreign exchange reserves in the world (UNCTAD 1994a: 334). Nine tenths of its exports in the 1950s consisted of agricultural goods. This position is now occupied by industrial products. All this has made Taiwan as the most often quoted example of successful export promotion.

The first stage of import substitution in the 1950s was targeted at labour-intensive consumer durables such as textiles, clothing, bicycles, wood and leather products. The government promoted the domestic production of these so-called light manufactures through low interest loans, tax reliefs, high tariffs and quantitative restrictions on imports, as well as overvalued multiple exchange rates. Import controls were the most important measure. In the 1970s, import substitution was shifted to intermediate products and capital goods. Nearly the same measures as in the 1950s were applied, but the emphasis was placed on tariffs rather than quantitative import restrictions in this second stage. Furthermore, the government established public enterprises in industries such as iron and steel, shipbuilding and petrochemicals. Subsequently, import controls have been removed

almost on all items except those related to agriculture, automobile production and military. In the wake of liberalization, import tariffs have also been reduced drastically. Average nominal tariffs declined from 56 per cent in 1972 to 5 per cent in 1992, which qualifies Taiwan to enter the WTO as an industrial economy rather than a developing economy seeking for special and differential treatment. Few industrial products such as automobiles still face relatively high tariffs.

Exports have been encouraged through duty and tax rebates since the early 1950s. However, the real push was given in 1957–58 when capacity utilization in many industries fell to very low levels, and the limits of absorptive capacity of domestic markets became quite conspicuous. A variety of export promotion measures were introduced. They were made available for all industries allowing entrepreneurs to develop their own export strategies. The multiple exchange rate system was replaced by a unified rate, which implied a heavy dose of currency devaluation. The effective devaluation amounted to 60 per cent for exporters. Further measures included the removal of quantitative restrictions on intermediate and capital goods imported by exporters; the simplification of procedures for the rebate of import duties, commodity and other taxes; and a broad package of fiscal incentives, subsidies, marketing support, cheap credits and export insurance. In 1965, foreign investors were granted a five-year corporate income tax holiday and a maximum tax of 25 per cent thereafter. Moreover, they enjoyed a duty and tax-free trade regime. Export production was further encouraged through export processing zones (EPZs), bonded factories and warehouses. During 1971–1980, EPZs accounted for three quarters of Taiwan's trade surplus. In the 1980s, this share declined sharply because of general trade liberalization and the introduction of bonded factories which could be established anywhere on the island.

Export policies in Taiwan, involving direct promotion and indirect support through import liberalization, have been highly successful. Exports as well as FDI have increased strongly. FDI grew from a negligible level in the 1950s to 11 per cent of gross capital formation in 1971;

by the mid-1970s, foreign enterprises accounted for 80 per cent of exports of electronics and electrical appliances.

Trade policy of Taiwan continued its liberalisation course during the 1980s. At the same time, high export growth, rising foreign exchange reserves and the resistance of trading partners motivated the government to slash the promotional export assistance. The subsidy element on export credits was reduced from 3–5 percentage points of interest rates in the 1970s to 1–2 percentage points in the 1980s. Tariff rebates and tax concessions declined substantially. In 1989, they amounted to only 7 per cent of total tariff and corporate tax collection as compared with 23 per cent in 1980. In April 1989, the international movement of money and capital was freed from foreign exchange controls. The exchange rate was allowed to be determined by market forces. Since then it has stabilized stopping the earlier tendency of appreciation.

Remarkable about the success of Taiwanese trade policies is that it has been achieved although manufactured exports have not received preferential treatment in important OECD markets. Unlike all other ESAEs, Taiwan has not been recognized as a G-77 member. Economically, preferential treatment is equivalent to an export subsidy financed by the government of the importing country, which foregoes tariff revenues, and by non-beneficiaries losing market shares. Taiwan belonging to the latter, it had to rely on its own policies. The financial burden of export promotion has been eased by high domestic savings and budgetary discipline.

With the emergence of the P.R. of China, competitive pressure on Taiwanese exports has intensified. Producers have been forced to upgrade the product mix, to lower costs and to out-locate production. The latter response to competitive pressure has made Taiwan a net exporter of FDI, with many firms locating production facilities particularly in mainland China in order to benefit from lower costs of production.

## 2. The Effectiveness of Export Promotion Instruments

The preceding review of different approaches to export promotion in ESAEs provides insights as to the effectiveness of policy instruments. The basic lesson from ESAEs is that macroeconomic stability and private sector confidence in future investment conditions are of great importance for the success of export promotion programmes. Export promotion is likely to remain futile, for example, if excessive volatility of real exchange rates prevails and the current account situation appears to be unsustainable. Likewise, chronic government deficits and monetary management running out of control will erode the effectiveness of export promotion. Under such conditions, domestic financing of capital formation in export industries will be deficient and FDI will be discouraged. Hence, specific export incentives should not be considered to be an alternative to sound macroeconomic policies.

Moreover, the evidence from ESAEs suggests that exporters should have unrestricted access to domestic and imported inputs. The success of export promotion further depends on the availability of essential infrastructure (transport, telecommunications, power supply, ports) and an efficient legal system to guarantee the enforcement of contracts (Rajapatirana 1993). There is another lesson to be drawn from the experience of ESAEs: In spite of an active participation of governments in the allocation of resources in most of these countries, they have left enough room for private initiative and the market mechanism (World Bank 1993). Investors have been forced to improve productivity and to produce under world market conditions. Structural change has been accelerated rather than impeded.

### a. Direct Subsidies

Subsidies are normally given as tax exemptions. Cash grants on exports are very rare. Tax exemptions can be based on profits, sales, value added, investments or expenses related to overseas marketing, etc. Profit-based income tax exemptions have been used, e.g., in Korea and Singapore, and are easy to implement. Sales-

based tax allowance has been applied in Malaysia. The Philippines have granted income tax credit on local value added. Some countries have used several forms of export subsidization (Rhee 1984). Since subsidies are usually granted together with other export promotion measures, it is difficult to ascertain their contribution to export expansion (Rajapatirana 1993: 14).

ESAEs have reduced direct subsidies gradually. Favourable export performance have made subsidies more and more redundant. Moreover, international pressure has induced the phasing out of direct subsidies. Still remaining subsidies have to be abolished within a period of five to eight years starting from January 1995, as the new WTO rules prohibit direct subsidies in the form of transfers of funds or foregone revenues. This applies to economies in transition as well if they are members of WTO. The phasing out period for them is seven years in the case of subsidies based on export performance, and eight years for those related to local value added. Thus, direct subsidies are no more relevant as an export promotion measure, except for "least developed" countries which are exempted from the prohibition of subsidies related to export performance. As concerns subsidies related to local content, even "least developed" countries are not allowed to grant them for more than eight years after the new agreement becomes effective (UNCTAD 1995).

### b. Credit Subsidies

Most ESAEs have established credit facilities for exporters. They range from short-term pre- and post-shipment credits (Malaysia) to long-term investment loans. Credits are given at market rates, e.g., in Singapore and the Philippines. In other cases, the subsidy element was reduced considerably during the 1980s (Indonesia and Taiwan). Asian governments considered the provision of export credits to be necessary in order to reduce the bias against exports, and to compensate for a loss of competitiveness vis-à-vis other countries granting low-cost export financing. In the early stages of development, especially of the domestic financial system, commercial banks tend to overestimate risks in export sectors and may, thus, impede access to



export credits. Government support is then conceded to offset capital market imperfections. Such imperfections are cured, however, once efficient financial institutions emerge and exporters get access to credit facilities at market rates. It follows that governments have only a temporary role to play in this area.

*c. Duty Drawbacks and Exemptions*

Duty drawbacks and exemptions are the most popular instruments of export promotion. They enable exporters to buy imported inputs at internationally competitive prices. All ESAEs considered in this study have established drawback or exemption schemes for imported inputs used in export production. The relevance and effectiveness of these schemes have differed significantly, however. In Singapore, for example, drawbacks have not been claimed frequently, since import duties have been very low. Taiwan granted its exporters a free trade status in the early 1950s. Moreover, the effectiveness of Taiwanese provisions has been enhanced by simplifying administrative procedures gradually. By contrast, the bureaucratic costs of claiming duty drawbacks have been high in the Philippines.

Asian experience suggests that duty exemptions are preferable over drawbacks. The latter involve financial costs for exporters since duty payments on imported inputs are reimbursed only after exports have taken place. However, exemptions require a greater administrative vigilance to avoid misuse of duty-free imports in non-exportables. The costs of operating duty exemption and drawback schemes can be reduced by eliminating redundant tariffs, i.e., tariffs which are higher than the difference between domestic prices and world market prices. Another important point is that duty drawbacks and exemptions should be given to producers of domestic inputs, too. In other words, the schemes should be neutral between foreign and domestic input suppliers in order to fully exploit comparative advantages in the production of intermediate goods. This requirement has been met in most of the ESAEs. Duty exemptions and drawbacks for imports of domestic firms supplying inputs for export production have con-

tributed to increase the local supply of intermediate goods.

*d. Export Processing Zones and Bonded Warehouses*

Export processing zones and bonded manufacturing houses have been very popular among ESAEs to assure a free trade status for export producers (Spinanger 1984). Besides duty-free access to imported inputs, manufacturers in these zones are usually provided essential services such as water, energy, telecommunications, ports and containerized cargo facilities. The incidence of local taxes and excise duties is frequently lower for firms operating there.

However, the role that special zones have played in export promotion differs considerably across countries and over time. In Taiwan, they accounted for three quarters of the trade surplus during 1971–1980. Parallel to trade liberalization their importance declined substantially. The same is true for Korea, where free trade zones accounted for less than 3 per cent of exports and imports in 1990. This share has remained below 10 per cent in the Philippines, although free trade zones have been the most preferred export promotion scheme (GATT 1993a, Vol. I: 109). Especially the Philippine experience suggests that for special zones to be successful, they must not be delinked from resources available in other parts of the country. Thus, excessive import substitution policies rendering such resources non-competitive by world market standards undermine the effectiveness of special zones in promoting exports.

*e. Marketing and Institutional Support*

Marketing and institutional support is an essential element of export promotion because it is instrumental to lower costs of information. This should help domestic firms in creating proper trade channels for exports. Even Hong Kong, which does not promote exports actively through other measures, provides institutional assistance to exporters. Indonesia gives technical and financial assistance for participation in trade fairs, selling missions and trade promotion centres. Malaysia has a broadly based arrangement to

help exporters in market research, product development and training in marketing, etc. Reportedly (e.g. Rhee 1985), the Korean Trade Promotion Corporation and the Singapore Trade Development Board have been fairly effective in assisting exporters, e.g., in setting up overseas offices and marketing new products. Moreover, private trade associations have successfully cooperated with government agencies in many ESAEs. Overall, the experience of these countries shows that an outward oriented trade policy includes efficient institutions to take care of export interests in foreign markets and investments in creating market channels, rather than relying exclusively on the initiative of foreign buyers.

#### *f. Promotion of FDI*

FDI can be a useful vehicle to expand exports because multinational corporations (MNCs) usually possess an international network of marketing channels (see also Chapter B.III). Apart from MNC affiliates using this network, marketing know-how may spill over from MNC affiliates to domestic firms in the host country. FDI is also a means of filling up gaps in the field of technology and management skills. ESAEs offer a variety of incentives to foreign investors in addition to those available for exports. FDI incentives are sometimes linked to export performance.

Yet, the Asian experience suggests that exports of MNC affiliates depend essentially on international competitiveness of local factors of production, rather than on performance requirements: If exports are as profitable as domestic sales, obligatory export requirements are likely to be redundant. If exports are less profitable than domestic sales, foreign investors will comply with export obligations only if they are compensated (e.g., through tax privileges) or if possibilities for evasion exist (e.g., the burden of export obligations may be reduced through transfer pricing, notably overvoicing). Realizing this, ESAEs have relaxed performance requirements considerably in the course of liberalization. At the same time, the contribution of foreign firms to the exports of ESAEs has increased. This applies to Japanese MNCs in the first place, which established plants in ESAEs in

the 1960s and 1970s primarily to produce for third countries. As a consequence of the appreciation of the yen, Japanese affiliates in ESAEs are now increasingly exporting to their home market.

#### *g. Exchange Rate Adjustment*

Successful export promotion requires an effective real exchange rate at which the country's exports remain competitive. Many of the ESAEs have achieved this by using export promotion programmes as a means to raise the prices of tradables and to offset negative consequences of import protection. Consistent monetary and fiscal policies have helped to keep the exchange rate competitive. Commodity-rich ESAEs have been subject to considerable real exchange rate fluctuations, however, because they have imported price instability from international commodity markets. Under such conditions, dutch-disease problems may have arisen unless the effects of exchange rate fluctuations on domestic prices of non-tradables are sterilized. Hence, specific promotion measures for non-commodity exports had to be supplemented by efficient monetary management in order to contain dutch-disease effects.

#### *h. Conclusions*

Successful export promotion usually consists of a number of measures, ranging from sound macroeconomic policies to specific incentives for exporters and foreign investors. The selection of policy instruments and their relative importance depend on macroeconomic and structural conditions in a particular country. Nevertheless, some general lessons can be drawn from the review of export promotion in ESAEs and the effectiveness of different instruments.

The fundamental objective of export promotion should be to prevent a policy-induced bias against exportable products. The policy regime should aim at equalizing the domestic resource costs of earning one unit of foreign exchange through exports with the domestic resource costs of saving one unit of foreign exchange through import substitution. The ideal way to achieve a balanced incentive system would be to eliminate tariffs as well as quanti-

tative restrictions on all imports and exports, and to keep the exchange rate at the purchasing power parity of the currency. As long as this is not possible, any implicit taxation of exports resulting from import substitution policies must be compensated. Duty drawbacks and exemptions for inputs absorbed in exports have a central role to play in such a transitory second-best solution. Exporters should have free access to domestic as well as foreign inputs. Some of the problems related to the implementation of duty drawbacks and exemptions can be solved through export processing zones and bonded warehouses. The former tend to lose their importance with the liberalization of trade, but the latter may remain useful even at a higher level of integration of the economy into world markets. In order to sustain international competitiveness, overvaluation of the real exchange rate must be avoided. Monetary and fiscal discipline is crucially important in this respect.

Moreover, the Asian experience supports the following conclusions:

- Marketing and institutional support can be helpful especially for smaller and newcoming exporters.
- FDI may not only provide much needed capital, technology and human skills, but may also contribute directly to export growth. In attempting to attract FDI, it should be kept in mind that FDI inflows depend more on the host country's growth prospects and macro-economic stability than on specific promotion measures (Agarwal et al. 1991).
- Export subsidies in the ESAEs mainly granted in the form of tax rebates or exemptions and credit facilities at interest rates below market rates are said to account for greater assistance to exporters than duty drawbacks or exemptions (Lütkenhorst 1984: 60; Akrasanee and Wiboonchutikula 1994: 439). However, the evidence on the effectiveness of subsidies is mixed. Success stories from Asia contrast with failures in many Latin American economies. In any case, it is not advisable to assign a high ranking to direct subsidies for promoting exports. They have increasingly become subject to counter-

vailing duties and are allowed by the rules of WTO only for a transitional period.

In designing an appropriate package of export promotion, it should be kept in mind that: (i) specific export incentives should be complementary and cannot substitute for macro-economic stability; (ii) export promotion involves costs in terms of subsidies, foregone revenues and administrative expenses, and therefore must be considered as an investment which has to be subjected to cost benefit analysis as any other investment; (iii) export promotion should be given only for a limited period, and exit rules should be clear from the very beginning; (iv) interventions should be such that a competitive environment for private business is maintained, thereby providing incentives for an efficient allocation of resources and technological improvement.

## II. Mastering New Technologies

Growth and sectoral change in the exports from ESAEs since the 1960s have been accompanied by their increasing diversification and technological sophistication. This is illustrated by the increasing share of technology-intensive products in OECD imports from this region. The relative importance of resource-based and labour-intensive goods has declined accordingly (Lücke 1995: Table 12.1). The metaphor of 'flying geese' has been used to illustrate the resulting pattern of structural change. Each country continuously acquires competitive advantage in industries that require the mastery of hitherto unused, and increasingly demanding technologies. As per capita income rises, less sophisticated industries migrate to neighbouring countries with a lower level of economic development and, therefore, lower wages. While Japan has led the way, the first-generation NIEs have by now also experienced a substantial shift away from traditional, labour-intensive industries.

It is safe to state, therefore, that the continuous acquisition of technological and managerial know-how has been a precondition for the

fast growth of ESAEs' exports. While the private sector has accounted for most manufactured exports from this region and has been responsible for most investment in specific new technologies, government policy has played a two-fold role in facilitating technological change. First, government policies such as the trade and exchange rate regime affect many of the channels through which the transfer of foreign technologies may take place. Second, the successful application of new technologies depends on local technological capability, that is the ability to select, adapt, diffuse, and build upon imported technology. Local technological capability is influenced by government policy in several areas, most prominently in education. The following two subsections discuss the policy implications of the experience of ESAEs in each of these fields.

### 1. Technology Transfer

Channels of technology transfer may be classified by the demands they make on the user's technological capability (and, correspondingly, the intensity of the relationship between the supplier and the user of the transferred technology).<sup>10</sup> One extreme is represented by FDI in the form of turn-key plants where the new technology is not only supplied by, but also used under the direct control of the parent company. Initially at least, there may be little reliance on local inputs other than labour, and correspondingly limited scope for technological learning.

Technology licensing and the purchase of equipment embodying new technology involve more of an arms-length relationship between suppliers and users. As a result, the efficient use of these channels depends on the user's ability to obtain and process sufficient information to choose among available techniques, and to adapt the new technology to local conditions with only limited support from the supplier. This applies even more strongly to technological information obtained from customers, especially foreign importers, or from sources in the public domain (e.g., trade journals, fairs), or by studying and working abroad.

Like in other fields, there is no *one* East Asian model of technology transfer. The role played by the various channels in the individual ESAEs has varied widely in accordance with national industrial policies. This is especially true for FDI. Following the Japanese example, South Korea and Taiwan erected barriers against FDI in the earlier phases of their economic development, on the grounds that it would limit the scope for the build-up of technological capability by nationally owned firms. By contrast, Malaysia and Thailand actively encouraged FDI, for example in export processing zones. The experience of these countries shows that linkages with the host economies increased over time as especially the affiliates of Japanese multinational companies redirected their sourcing towards local markets. In a marked departure from the Latin American experience, most ESAEs granted no protection to FDI oriented mainly towards production for the local market with few export prospects. This is significant because such protection reduces incentives for cost minimization, and hence for the application of the most recent production technology.

Partly to compensate for the earlier absence of FDI, the South Korean government (among others) has encouraged the use of licensing agreements to obtain access to foreign technology. Although the impact of such agreements is difficult to assess, several considerations suggest that their scope must have been limited. Firms in industrialized countries will hardly transfer proprietary technology to potential competitors in the world market if this is likely to undermine their competitive position. As long as firms at the technological frontier are themselves involved in manufacturing, they will probably either insist on segmenting the export market, or they will only transfer less than up-to-date technology. Limitations on exports may be difficult to verify. Using slightly outmoded production techniques may be appropriate in the early stages of industrialization, as the discussion about the efficiency of second-hand machinery in developing countries demonstrates. This is true, however, only under the assumption that technical progress is mainly labour-saving, and that factor prices differ significantly.

Overall, therefore, the role of licensing in technology transfer to Asia has probably been limited.

Since neither FDI nor licensing appear to have been crucial in ESAEs such as Korea, this leaves the purchase of equipment embodying new technology, and information gathering in the course of exporting as the most important channels of technology transfer. Both channels offer a wide range of options with respect to the demands made on the technological capability of the user. Purchased equipment may be in the form of turn-key plants, for example, or may involve a combination of machinery from different foreign suppliers with significant local adaptation. Similarly, an exporting firm may concentrate on manufacturing operations while the importing firm is responsible for product design, quality control, and overseas marketing, or exporters may perform some or all of these functions themselves. A large number of case studies suggest that many Asian firms have transformed themselves along these lines. They typically started as mere manufacturers using standardized technologies, but successively built up their technological and management capabilities, and in the process increased locally retained value added.<sup>11</sup>

Two policy implications follow. *First*, access to lowest-cost sourcing is of paramount importance if emerging industries are to become internationally competitive. A vivid counter-example is provided by industrial policy for the machinery sector in Brazil and India. In both countries, the protection granted to this sector raised prices for many types of machinery above the world market level and placed a heavy burden on downstream industries. *Second*, the ability to export is not only a crucial test of the economic viability of an emerging industry. Exporting also conveys substantial amounts of commercial and technological information that would otherwise not reach many firms, or which firms would have no incentive to obtain if they produced only for a protected domestic market. This latter point applies especially to information in the public domain, such as the information which can be obtained from specialized journals, visiting trade fairs, studying

abroad etc. These considerations underscore the beneficial effects of avoiding any bias of incentives against exports and in favour of the domestic market, or against international sourcing and in favour of domestic suppliers. Arguably, most governments of ESAEs managed to abide by this role even when they actively promoted emerging industries.

## 2. Local Technological Capability

Ensuring that domestic firms have access to foreign technology through appropriate channels was only a necessary, but not a sufficient condition for successful technical change.<sup>12</sup> In addition, local firms needed to acquire technological capability, which may be defined as the ability to select, adapt, and apply hitherto unknown technologies. New technology may be understood widely to refer to innovations in both hardware, such as new machinery, and software, such as organization, business administration, marketing etc. The importance of building technological capability is emphasized, in general terms, by all students of East Asian development. What is less clear is the relative importance of formal education at the primary, secondary and tertiary levels vs. learning on the job.

The classification of formal education as investment in human capital reflects the fact that resources are spent on an activity (schooling, etc.) whose economic return is only realized in the future. Since a large proportion of the social cost of education is directly borne by the government, public policy plays a pivotal role in this field. It is clear that export and GDP growth, which involves structural change towards technologically sophisticated industries, cannot be sustained unless the educational level of the workforce is improved accordingly. Therefore growth of income and manufactured exports, in Asia and elsewhere, has been accompanied by rising levels of education.

The direction of the causality, however, is not very clear. Do improvements in formal education lead to structural change in industry and income growth, or does income growth create incentives (and resources) for higher investment

in formal education? Studies of growth episodes such as the British Industrial Revolution or the Green Revolution in Indian Agriculture suggest that frequently the impetus for economic growth did not come from increased human capital, but from exogenous factors such as technological innovations. Similarly, although the fast-growing ESAEs had high initial levels of formal education (compared with many poor countries), these were not higher than in other countries with a more modest growth performance. It is also important to notice that the educational level of a country's labour force can normally change only slowly to the extent to which new entrants have a higher educational level than those who leave the labour force. Accordingly, it is difficult to see how improvements in formal education can constitute an engine of economic growth, rather than a high educational standard being a necessary initial condition.

It has been suggested that learning on the job constitutes an important alternative form of human capital formation. The underlying rationale is that workers and managers with more experience, just like those with more education, earn higher wages and salaries. In contrast to formal education, learning on the job is not normally the result of any conscious investment of resources. Rather, it occurs as a result of gathering experience in the performance of a new activity, in the sense that the time required to perform a certain task declines with cumulative output. It is important to note that for learning on the job to become a constant source of productivity increases, new activities must be started continuously because otherwise the potential for productivity improvements through learning will soon be exhausted.

Learning on the job is an attractive explanation of the growing technological capability of many Asian exporters. It allows the professional qualifications of many members of the labour force to improve simultaneously. This is in contrast to formal education which normally affects only new entrants. If one adds the extensive microeconomic evidence on learning effects, it is plausible to assume that learning by doing has played an important role in the acquisition of technological capability in fast-

growing ESAEs.<sup>13</sup> This raises a crucial question, however. By what mechanism was investment attracted to activities of growing technological sophistication that left ample room for learning by doing and subsequent productivity improvements, but were not so advanced as to overstrain complementary factors of production such as formal education levels? In the latter case, new branches of industry would have been economically unviable even in the medium to long run, as exemplified by the Brazilian electronics industry throughout much of the 1980s.

The answer to this question depends on the incentive structure for investment, and therefore varies with each country's policy environment. In some countries, for instance in South Korea, industrial targeting has probably been instrumental in this respect. Elsewhere, capital accumulation has responded to a larger degree to market mechanisms. Throughout the region, however, whatever government support an industry received was tied to its becoming a viable exporter within a reasonable timespan. This would have been impossible for an industry that was fundamentally ill-suited for a particular country given, in particular, the industry's technological sophistication and the country's technological capability.

In terms of policy implications, this observation leads back to the crucial role of openness to trade for East Asian development. Beyond this, the diversity of policy environments suggests that a fertile climate for productive investment may be created in different ways (with a few fundamentals, such as macroeconomic stability). Furthermore, a good education system is clearly important, preferably with an emphasis on technical and managerial skills. It is not, however, a sufficient condition for economic growth.

### **III. Globalization and Networking within Asia**

The preceding sections have shown that the factors contributing to ESAEs' favourable world-market performance went far beyond narrowly defined export promotion schemes. Rather, they

included macroeconomic stability, improved technological capabilities and human capital formation. Apart from their direct role in sustaining export growth, such factors also contributed indirectly to ESAEs' world-market success. First, they helped the region to become an attractive location for foreign investment which was export-oriented to a large extent. Second, economic linkages within Asia were strengthened in this way; both intra-regional trade and investment were supported. These less obvious, though important determinants of the region's export performance are discussed in the following.

### 1. FDI and World-Market Performance

As a matter of fact, ESAEs have become preferred destinations for FDI (Table 1). In 1993, FDI flows to all developing countries (DCs) in Asia amounted to more than five times the figure for 1987; the region's share in world-wide FDI flows soared to 26 per cent. Booming FDI in China contributed significantly to this development. Southeast Asian countries, too, attracted substantially higher FDI flows. Malaysia, for which inflows increased more than tenfold in the period 1987–1993, figures prominently within this group.

Table 1 – FDI Flows to Asian DCs, 1987 and 1993

	1987		1993	
	US\$ million	per cent of world total	US\$ million	per cent of world total
Asian DCs	8,258	6.51	44,935	25.93
NIEs	4,152	3.27	8,159 <sup>a</sup>	5.25 <sup>a</sup>
South Korea	601	0.47	516	0.30
Singapore	2,836	2.24	6,829	3.94
Taiwan	715	0.56	879 <sup>a</sup>	0.57 <sup>a</sup>
PR China	2,314	1.82	11,156 <sup>a</sup>	7.18 <sup>a</sup>
Southeast Asia	1,467	1.16	8,587 <sup>a</sup>	5.52 <sup>a</sup>
Indonesia	385	0.30	2,004	1.16
Malaysia	423	0.33	4,351	2.51
Philippines	307	0.24	763	0.44
Thailand	352	0.28	2,116 <sup>a</sup>	1.36 <sup>a</sup>
South Asia <sup>b</sup>	373	0.29	852 <sup>a</sup>	0.55 <sup>a</sup>

<sup>a</sup>1992. — <sup>b</sup>Bangladesh, India, Pakistan and Sri Lanka.

Source: ADB Asian Development Outlook 1994, IMF Balance of Payments Yearbook 1994.

All major investor countries have expanded their engagement in Asian DCs, albeit to varying

degree and from different starting levels (for details, see Agarwal et al. 1995):

- FDI outflows from the EU to Asian DCs more than doubled, when the periods 1990–1991 and 1986–1987 are compared. Nevertheless, the region remained a minor host for EU investors who preferred intra-EU engagements during the process of European integration.
- US FDI stocks in manufacturing industries of Asian DCs nearly quadrupled since 1985, and accounted for 7.2 per cent of world-wide US FDI stocks in manufacturing in 1993. The US engagement was concentrated on the most advanced economies among Asian DCs, particularly on Singapore and Hong Kong.
- For Japanese firms, the Asian region has traditionally been a preferred investment location. In the mid-1980s, roughly one fifth of total Japanese FDI outflows in manufacturing was directed to Asian DCs, the share of which amounted to one third in 1993. The focus of Japan's engagement in manufacturing within Asia has shifted over time, from NIEs to ASEAN countries such as Indonesia and Malaysia and, recently, to China.

The impact of Asia's attractiveness for FDI on its export performance is difficult to quantify. Nevertheless, the proposition is well founded that large and rising inflows of foreign risk capital have contributed considerably to sustainable export growth. Empirical analyses have shown that FDI and trade flows are positively correlated.<sup>14</sup> Higher outflows of FDI from Germany, Japan and the United States (representing three major suppliers of FDI) to industrialized and developing host countries went hand in hand with higher exports from the hosts to the home countries of foreign investors (and with higher bilateral trade in the opposite direction, too). Both bilateral FDI and trade flows appear to be driven by a common set of determinants. The steep increase of world-wide FDI over the last decade or so, and the close links between trade and FDI can be attributed to globalization strategies of multinational enterprises. Innovative production techniques, dramatically reduced transaction and communication costs, the

liberalization of capital markets and related developments have added new dimensions to the international division of labour. Production processes can increasingly be fragmented and relocated to countries offering the most favourable conditions for producing certain goods or parts thereof, which can then be supplied on world markets at competitive terms.

In the present context, this means that attractive investment locations in Asia have had better chances to penetrate world markets. ESAEs could derive particularly large benefits from the trend towards globalized production. Although exact data are not available, the share of world-market oriented FDI in total inflows appears to be higher in ESAEs than in other regions.<sup>15</sup> This type of FDI is directly linked with export expansion and export diversification, in contrast to FDI that is mainly oriented at the domestic markets of host countries.

The proposition that ESAEs have been among the first to gain from globalization is supported by various observations. Japanese firms which are among the leading investors in ESAEs are well known for their world-market orientation. In countries such as Malaysia, the Philippines and Thailand, foreign firms accounted for more than half of manufactured exports. Furthermore, much of ESAEs' recent export activity has been in sectors in which FDI and the associated transfer of technology and industrial know-how have been substantial. Both FDI in, and manufactured exports of ESAEs have shifted to more skill-intensive industries.

## 2. Complementarity in Supply

Arguably, it has mainly been the favourable world-market performance of the most advanced East Asian NIEs that has benefitted from the globalization strategies of multinational enterprises. However, Asia's success has spread well beyond this relatively small group of frontrunners. Close networking within the region provided the principal mechanism through which diffusion was achieved. An intra-regional division of labour was encouraged by strong complementarities in the supply structures of Asian

DCs.<sup>16</sup> The most relevant factors shaping complementarities include the following:<sup>17</sup>

- Per capita income ranged from about US\$200 in countries such as Bangladesh to US\$6,800 in South Korea and more than US\$15,000 in Hong Kong and Singapore. The per capita stock of physical and human capital typically being related to differences in income, the relative endowment with these production factors can be assumed to differ vastly within Asia.

- Measured by population size, small countries such as the two city states contrast with large countries with huge domestic markets, notably China and India. Related to this are dramatic differences in terms of trade shares in GDP; imports plus exports amounted to about 300 per cent of GDP in Singapore, 140 per cent in Malaysia, but only 20 per cent in India, for example.

- The degree of industrialization, measured by the share of manufacturing in GDP, was extremely low in countries such as Bangladesh (9 per cent), moderate in Indonesia (21 per cent), and relatively high in South Korea, Singapore and Thailand (26–28 per cent). Correspondingly, the primary sector remained dominant in some Asian DCs, whereas it played a marginal role elsewhere in the region. For example, the two relatively resource-rich ASEAN countries (Indonesia and Malaysia) and China are complementary to the resource-poor NIEs.

Strong complementarities imply that Asian DCs have various locational advantages to offer, ranging from favourable resource endowments and abundant low-paid labour to human skills and expertise, as well as booming domestic markets and investible surpluses. Significant differences in the structure of merchandise exports are the consequence (Table 2). Primary commodities (including fuels etc.) still figure prominently in the export basket of resource-rich economies, notably Indonesia, although their share is clearly declining relative to manufactured goods. Low-income countries in South Asia have moved rapidly into production and exports of relatively labour-intensive goods such as textiles and clothing. At the same time, the advanced East



Table 2 – The Structure of Merchandise Exports of Selected Asian DCs, 1992 (per cent)

	Fuels, minerals, metals	Other primary commodities	Machinery and transport equipment	Other manufactures <sup>a</sup>	Textiles, clothing
NIEs					
Hong Kong	2	3	24	71	40
Singapore	15	7	52	26	5
South Korea	3	4	40	53	20
Taiwan	2	5	40	53	14
PR China	7	14	15	64	30
Southeast Asia					
Indonesia	38	15	4	44	18
Malaysia	17	22	38	23	6
Philippines	8	19	17	56	10
Thailand	2	32	22	45	17
South Asia					
Bangladesh	0	18	0	81	72
India	8	21	7	64	25
Pakistan	1	20	0	79	69
Sri Lanka	1	27	2	71	52

<sup>a</sup>Includes textiles and clothing.

Source: World Bank *World Development Report 1994*.

Asian NIEs have shifted away from traditional exports.<sup>18</sup> Sophisticated and relatively skill-intensive export items, e.g. machinery and transport equipment, have reached a dominant position in the world-market supply of some of these economies. Second-generation exporters such as Malaysia are following suit.

### 3. Intra-Regional Trade

In addition to this general pattern of specialization, the above-mentioned complementarities have provided favourable conditions for a market-driven integration within the Asian region. Regional networking has proceeded with respect to both trade and FDI. As concerns trade, the share of intra-regional exports in total Asian exports has risen considerably, especially since the mid-1980s (Table 3).<sup>19</sup> In 1992, about 37 per cent of exports of Asian DCs went to other Asian DCs; for total exports (manufactured exports) this share increased by 13.5 (14.9) percentage points between 1980 and 1992. Including Japan, the intra-regional trade share surpassed 44 per cent of total exports in 1992.

The intra-Asian trade network has involved all major subgroups, though less so in the case of South Asia (Table 4). The exceptionally high share of Chinese exports accounted for by Asian NIEs is mainly due to entrepôt trade, in which

Table 3 – Development of Intra-Asian Trade, 1980–1992 (per cent of total Asian exports)

	Total exports		Manufactured exports	
	Asian DCs	Asian DCs plus Japan	Asian DCs	Asian DCs plus Japan
1980	24.0	37.0	21.7	27.0
1988	29.8	38.3	26.6	31.5
1990	33.2	41.1	32.2	35.7
1992	37.5	44.1	36.6	39.6

Source: UN (1994).

Table 4 – Matrix of Intra-Asian Exports, 1992 (per cent of total exports)

From	To	All Asian DCs	China	Asian NIEs	Southeast Asia	South Asia	Japan
All Asian DCs		34.4	7.5	19.0	6.2	1.6	12.3
China		53.4	–	49.0	2.8	1.5	13.7
Asian NIEs		33.5	12.0	12.1	7.8	1.4	9.1
Southeast Asia							
Asia		28.5	2.5	19.4	5.0	1.5	21.3
South Asia		16.7	1.1	8.2	3.9	3.5	7.9
Japan		28.1	3.5	15.2	8.3	1.0	–

Source: ADB *Asian Development Outlook 1994*.

the two city states played the leading role. Apart from that, Table 4 reveals two interesting features. *First*, the proposition of complementarities to have induced intra-regional trade is supported by significant trade relations between subgroups that are characterized by pronounced differences in terms of per capita income and income-related resource endowments. Evidence in favour of intensive trading because of geographical proximity and low transaction costs<sup>20</sup> is provided by (lower income) China and (higher income) Japan serving as outlets for the exports of Asian NIEs. The observation that about one fifth of Southeast Asian exports is absorbed by Asian NIEs, and another fifth by Japan represents another example that fits into this picture. *Second*, the trade matrix reveals that the inter-industry pattern of trade between Asian countries at different stages of economic development has been supplemented by trade relations between economies with similar per capita income: 12 per cent of the exports of Asian NIEs took place within this rather small subgroup.<sup>21</sup>

These observations suggest that the export dynamism within Asia has been driven by inter-industry trade *and* intra-industry trade. The op-

portunities for mutual exchanges of goods within the same product category have improved especially since the mid-1980s.<sup>22</sup> Intra-industry specialization is due to fast-growing per capita income, convergence in income levels, progressing industrialization, emerging similarities in demand and production structures, and declining transaction costs. At the country level, Hong Kong and Singapore reveal the highest degree of intra-industry trade, partly because of their status as entrepôts for China and ASEAN countries. Malaysia, South Korea and Taiwan rank next. For these three economies, the level of intra-industry trade was particularly high in technology-intensive goods, which is probably the result of successful integration into the globalization strategies of multinational enterprises. Apart from trade relations between Asian NIEs, intra-industry trade was most pronounced in trade between the NIEs on the one hand, and Japan and ASEAN on the other hand. By contrast, trade between Japan and ASEAN countries was dominated by inter-industry specialization. The same applies to China's trade with Japan and ASEAN. The proposition that intra-industry trade helped to sustain export expansion is supported by the observation that subregions with high shares of intra-industry trade in total trade benefitted overproportionally from export growth within the Asian region.

#### 4. Investment Linkages within Asia

The second dimension of Asian networking relates to intra-regional investment. Notwithstanding considerable data constraints, the "flying geese" pattern of specialization within this region is also evident from the development of intra-Asian FDI.<sup>23</sup> Initially, Japan's move towards more sophisticated lines of production stimulated Japanese FDI in neighbouring ESAEs. FDI was concentrated on sectors in which Japan had lost comparative advantage because of substantial real wage increases. Particularly Asian NIEs benefitted from the relocation of Japanese production and its favourable impact on economic growth, exports, employment generation and access to technology. In the 1980s, about half of total FDI in South Korea

originated from Japan, whose share was also significant in Taiwan and Thailand (Table 5).

Table 5 – FDI Approvals in Selected Asian Countries, Cumulative Total 1980–1988

To	South Korea	Taiwan	Indonesia	Malaysia	Philippines	Thailand
World (US\$ million)	4,108	5,465	9,374	2,214	2,095	3,332
thereof (per cent):						
Asia	55.1	42.5	40.1	41.5	30.1	60.0
Japan	50.4	33.7	12.9	23.2	14.4	37.4
Hong Kong	3.8	7.3	10.0	5.6	3.9	10.8
South Korea	—	n.a.	2.3	0.9	0.2	0.4
Singapore	— <sup>a</sup>	1.2	4.4	11.3	0.7	5.1
Taiwan	n.a.	n.a.	1.3	3.4	5.8	1.5

<sup>a</sup>Negative. — n.a. = not available.

Source: Riedel (1991: 142).

Although Japan's engagement in some countries of the region (notably in Indonesia) declined in relative terms after 1985, intra-Asian FDI gathered further momentum. In the next phase, it was mainly Hong Kong, Singapore and Taiwan which became major investors in neighbouring countries. While South Korea was somewhat lagging behind, the Asian NIEs basically followed the Japanese route of exporting human and physical capital to less advanced economies in the region. For example, about 10 per cent of total FDI in Indonesia and Thailand came from Hong Kong in the period 1980–1988. In the late 1980s, Asian investors accounted for nearly two thirds of total FDI approved by a group of four Southeast Asian DCs (Indonesia, Malaysia, the Philippines, Thailand). Hong Kong was the second largest source of FDI in Indonesia, and among the top five sources for the Philippines and Thailand. Also similar to Japanese FDI, most of the Asian NIEs' engagement has been export-oriented, thereby further strengthening the export sectors of recipient countries.

Most recently, new patterns of intra-Asian FDI have emerged. Asian NIEs shifted their engagement from countries such as Indonesia, the Philippines and Thailand to China, where Hong Kong and Taiwan became top investors and surpassed Japan.<sup>24</sup> At the same time, companies from Indonesia, Malaysia and Thailand undertook significant investments, for example,

in China and Vietnam. China invested in Hong Kong in areas such as financial services. In other words, intra-Asian FDI flows have emerged from countries that were originally only recipients.

The changing pattern of intra-Asian FDI has been driven by the need for industrial restructuring going along with higher per capita income and rising wages. Fast-growing and relatively advanced ESAEs have lost their earlier comparative advantage in labour-intensive manufacturing. They increasingly attracted FDI in activities with a higher value added, while relocating part of their traditional production by investing in low-wage economies in the region. This explains why countries such as Thailand are seeking possibilities in Vietnam while, at the same time, actively courting foreign investors (ADB 1994: 16). In this way, FDI facilitates moving up the ladder of comparative advantage both in the source countries, which shift to more sophisticated activities, and in the host countries, whose industrial employment and non-traditional exports expand (Riedel 1991: 143).

## 5. The Role of Economic Policy

While the factors behind the rapid growth of intra-Asian trade and FDI are numerous,<sup>25</sup> successful industrial restructuring has been at the heart of both favourable world-market performance and regional networking. It should be noticed, however, that the division of labour at the regional level has been market-driven in the first place. In contrast to Europe, the decline in transaction costs (for example, comprising lower trade barriers, improved transportation facilities and reduced uncertainty) has been achieved without institutionalized regionalism (see also Panagariya 1993). Interestingly enough, economic transactions expanded particularly between countries with unsettled or even non-existent political relations. Taiwanese FDI in PR China provides an example. By contrast, economic relations remained comparatively weak between ESAEs that had established some institutionalized links. ASEAN is a case in point: little progress has been made in reducing trade barriers, and intra-ASEAN FDI accounts for

only a small share of ASEAN's total FDI inflows (Yue 1993).

If at all, regionalism has evolved along rather unconventional lines in Asia. Intra-regional co-operation has been attempted to some extent through more informal arrangements, such as so-called growth triangles, i.e., production sharing in border areas of countries with different factor endowments. The SIJORI growth triangle represents a well-known example: the co-operation among Singapore, the southern Malaysian state of Johor and the west Indonesian province of Riau resulted in growing subregional investment in 1987–1991 (Yue 1993: 89). Likewise, joint projects based on complementarities were launched in the China Economic Area encompassing southern China, Hong Kong and Taiwan.

The marginal role of institutionalized regionalism does not imply, however, that economic policy initiatives of Asian governments have been unimportant with regard to the countries' locational attractiveness and regional networking. Quite the contrary, policy reforms provided a major stimulus for industrial restructuring according to the countries' comparative advantage. Trade liberalization and the development of financial markets figure prominently in this respect. Although free-trade economies such as Hong Kong and Singapore are the exception in Asia, too, import restrictions have been liberalized considerably in most ESAEs during the 1980s and early 1990s.<sup>26</sup> Important common features of recent trade policy reforms comprise unilateral dismantling of tariffs and quantitative restrictions, substitution of tariffs for non-tariff barriers, and reduced tariff escalation by cutting peak tariff rates. In particular, the latter development has encouraged intra-Asian trade in the manufacturing sector in which peak tariffs had prevailed.

Financial market reforms have reduced uncertainty, enhanced the stability of the regulatory framework and provided better chances to draw on new sources of capital. During the 1980s, domestic capital markets were deregulated, access barriers were lowered, and administered interest rates were liberalized (notably in South-east Asian DCs). Moreover, international capital

mobility was supported by removing foreign exchange controls and other regulations governing foreign portfolio investment (For details, see Greenwood 1993). The move towards liberalization started from a fairly restrictive policy stance in countries such as South Korea and Taiwan, while financial transactions by non-residents had been virtually unrestricted in Hong Kong in the past already.

The attractiveness of the region for FDI in general, and intra-Asian FDI in particular, has benefitted from substantial revisions of foreign investment policies (Chen 1993; ADB 1990). FDI inflows have been liberalized by ASEAN countries, China, South Korea and Taiwan, notably since the mid-1980s. Sectors previously considered "sensitive" were opened to FDI, and restrictions on profit remittances were relaxed.

As a result, FDI policies of ESAEs have converged at a lower regulatory level. Another major impulse to the rapid growth of intra-Asian FDI was provided by the more liberal policy stance towards FDI outflows. This applies especially to South Korea and Taiwan since 1987, while Hong Kong has been the pioneer among Asian NIEs in terms of FDI outflows.

In summary, the 1980s and early 1990s have seen substantial efforts towards economic deregulation and liberalisation in ESAEs. The less restrictive attitude towards imports and FDI has encouraged industrial restructuring and, thereby, supported sustainable export growth in general and intra-Asian trade in particular. The expansion of both trade and investment has generally been the highest in countries where the process of liberalization has been the most advanced.

## C. Applicability of the ESAE's Strategy to CEECs

### I. Initial Conditions

By their very nature, cross-country comparisons of the effectiveness of economic policies are counterfactual exercises. In order to assess the relevance of experiences of one particular group of countries for another group, initial conditions and structural characteristics of the economies under consideration must be compared. Subsequently, we consider some important differences between CEECs and ESAEs, and the question is raised whether starting conditions have worked in favour of the latter.<sup>27</sup> Under rather unfavourable conditions, it may be difficult for CEECs to copy the Asian experience; then, similar export promotion policies will not automatically result in similarly strong export expansion and diversification.

Initial conditions may be divided into political, macroeconomic and structural factors. Political factors may influence the acceptability of policy measures. The responsiveness of producers and investors to policy changes and, thus, the adjustment flexibility of the economy is likely to be higher if the government's credibility

is beyond serious doubt. Macroeconomic instability may erode the effectiveness of export promotion policies unless they are closely linked to fiscal and monetary consolidation, which is a more demanding task than partial reforms in one specific policy area. Likewise, structural characteristics indicating significant domestic distortions and rigidities render it more difficult to foster export expansion and diversification.

ESAEs' favourable world-market performance has been helped by the reputation that governments had achieved in providing for a coherent and credible policy environment (Hiemenz, Nunnenkamp et al. 1991). The absence of considerable uncertainty has encouraged private economic agents to react promptly to economic policy initiatives such as export incentives. However, the role of the overall political regime in reducing uncertainty and strengthening the governments' credibility is open to debate. The evidence on successful and failed reform experiments, particularly in Latin America, reveals that an authoritarian policy regime is neither a sufficient nor a necessary condition for export and growth-enhancing economic policies. The Argentine government, for example, re-

gained credibility only after the move towards democracy.

This suggests that the success of ESAEs, which was achieved by authoritarian governments with few exceptions, may well be repeated under democratic conditions. For CEECs there has been no alternative from the very beginning but to achieve government credibility and confidence of economic agents together with democratization. Non-democratic governments were largely discredited at the end of the socialist era. Newly elected governments commanded considerable support in the early phases of economic and political transition. In some instances, however, their reputational bonus has melted away rather quickly. Reform-minded parties have lost their majority in re-elections, and political uncertainty has become a major problem in countries such as Poland. The effectiveness of economic reforms in general, and export promotion policies in particular can no longer be taken for granted, once the confidence of producers and investors has been eroded.

Typically, the credibility of governments in ESAEs went along with fairly stable macroeconomic conditions. Inflation, the level and volatility of which are clear indications of economic instability, was kept at bay (Table 6). This encouraged domestic savings. High and rising saving rates rendered it possible to finance world-market oriented investment on a sustainable basis. By contrast, some CEECs (notably Poland) started their economic transition in the

midst of macroeconomic turbulences. This may have reduced the effectiveness of trade policy reforms in the short run. Thus, the informative value of relative prices was still limited, and export-oriented investors faced problems in raising funds from capital markets. Furthermore, with fiscal consolidation ranking high on the policy agenda, governments were constrained in providing public financing of export promotion schemes.

Nevertheless, it would be wrong to conclude that macroeconomic starting conditions generally were much worse than in ESAEs. The former Czechoslovakia, for example, had maintained macroeconomic stability even before the regime change, and prudent fiscal policies helped the country to return to one-digit inflation rates shortly after price liberalization. Moreover, domestic savings rates in CEECs matched the East Asian standard, and were much higher than in South Asia. While shortages of consumption goods may have resulted in "forced savings" in CEECs, Table 6 does not support the proposition that the domestic financing of world-market oriented investment was seriously constrained because of insufficient savings. Arguably, the lack of efficient financial intermediation between savers and investors represented a much more critical bottleneck.<sup>28</sup> Under socialist conditions, banks had performed a passive role in allocating resources according to the directives of central planners. After the regime change, many of these banks remained state-owned entities for quite some time. They were burdened with inherited non-performing debt, and the institutional prerequisites for well functioning domestic capital markets were not yet in place. These legacies resulted in rather perverse incentive structures, which led bank managers to throw good money after the bad one. Traditional credit relations with overindebted customers, notably large enterprises that were still state-owned, were maintained, thereby discriminating against the emerging private sector and hampering a world-market oriented reallocation of investment funds.

CEECs faced a pressing need to reorient exports to OECD markets after the collapse of CMEA trade. While ESAEs had become competitive suppliers of manufactures during the

Table 6 – Inflation and Savings in CEECs and Asian DCs (per cent)

	Inflation <sup>a</sup>	Gross domestic savings rate	
	1980–1991	1970	1989
Bulgaria	7.8	n.a.	30
Czechoslovakia	3.5	n.a.	30
Hungary	10.3	31	30
Poland	63.1	n.a.	33
Romania	6.2	n.a.	27 <sup>b</sup>
East and Southeast Asia thereof	6.3	25	35
Malaysia	1.7	27	34
South Korea	5.6	15	37
Thailand	3.7	21	29
South Asia	8.3	14	18

<sup>a</sup>Yearly averages of GDP deflator. — <sup>b</sup>1990. — n.a. = not available.

Source: World Bank *World Development Report* (various issues).

1970s and 1980s, the starting conditions for CEECs to penetrate OECD markets were rather difficult in the late 1980s and early 1990s. Their supply of manufactured exports was rarely competitive by world-market standards. Notwithstanding the sometimes heavy subsidization of exports, the OECD accounted for only about 20 per cent of total exports of CEECs at the beginning of economic transition, i.e., less than half the corresponding share for Asian DCs (Table 7).

Table 7 – OECD Imports of Manufactures from CEECs and Asian DCs, 1989

	US\$ million	Share in exporting countries' total manufactured exports (per cent)
Bulgaria	374	n.a.
Czechoslovakia	2,642	18.3
Hungary	2,504	26.1
Poland	2,880	21.9
Romania	2,102	n.a.
East and Southeast Asia	96,190	49.3
<i>thereof</i>		
Malaysia	7,761	31.0
South Korea	42,601	68.4
Thailand	8,197	40.9
South Asia	12,497	53.4

Source: World Bank *World Development Report* (various issues).

The distorted regional trade pattern of CEECs, which was the result of the administered division of labour within the former socialist bloc in the first place, did not prove to be the most serious problem hindering economic catching-up processes such as in Asia, however. The reorientation of exports proceeded rather quickly after the regime change. This was partly due to the dismantling of former OECD trade restrictions against CMEA countries and, specifically, because of preferential access to EU markets. The more relevant differences between CEECs and ESAEs concern initial income levels, related structural characteristics, and rigidities inherited from the socialist era, which were largely unknown in Asia.

The most obvious difference between the two country groups is that economic catching-up in Asia started from a fairly low income level (Table 8). In the late 1970s, GNP per capita was

still below US\$ 1,000 in most economies of this region. Even considering that data on per capita income in CEECs for the year 1989 are not very reliable, it can safely be concluded that economic transformation was initiated at a significantly higher level of economic development. The potential for catching-up through learning from, and imitation of, more advanced economies becomes smaller with the rise of per capita income. More importantly, though, the short-run effectiveness of policy reforms may suffer if previous development efforts are stalled because of serious legacies in terms of resource misallocation and structural distortions.

Table 8 – Per Capita Income in CEECs and Asian DCs, 1978 and 1989 (US\$)

CEECs	1989	Asian DCs	1978	1989
Bulgaria	2,320	East and Southeast Asia		
Czechoslovakia	3,450	Asia	n.a.	540
Hungary	2,590	<i>thereof</i>		
Poland	1,790	Malaysia	1,090	2,160
Romania	1,640 <sup>a</sup>	South Korea	1,160	4,400
		Thailand	490	1,220
		South Asia	180	320 <sup>b</sup>

<sup>a</sup>1990. — <sup>b</sup>India (1989: 340). — n.a. = not available.

Source: World Bank *World Development Report* (various issues).

In accordance with the “normal” sectoral pattern of economic development, low-income DCs in Asia could draw on a large agricultural labour force in the early phases of catching-up. Increased productivity in agriculture provided the emerging industrial sector with an abundant supply of relatively cheap labour. In the late 1970s, agriculture still accounted for about one quarter of GDP in relatively advanced East Asian DCs (Table 9). By contrast, the transformation process of CEECs started from a remarkably high degree of industrialization. The sectoral contributions to GDP suggest that the priority of industrial development under central planning has resulted in excessive industrialization and significant discrimination against agriculture.

Economic transformation has implied a correction of distorted production structures in CEECs. Price liberalization revealed a new set of relative prices which was likely to deviate substantially from the administered relative

Table 9 – Share of Industry and Agriculture in GDP of CEECs and Asian DCs, 1978 and 1989 (per cent)

	Industry		Agriculture	
	1978	1989	1978	1989
Bulgaria	64	59	18	11
Czechoslovakia	72	57	9	6
Hungary	59	36	15	14
Poland	64	36 <sup>a</sup>	16	14 <sup>a</sup>
Romania	n.a.	48 <sup>a</sup>	n.a.	18 <sup>a</sup>
East and Southeast Asia	n.a.	44	n.a.	24
thereof				
Malaysia	32	n.a.	25	n.a.
South Korea	36	44	24	10
Thailand	27	38	27	15
South Asia	26 <sup>b</sup>	26	40	32 <sup>b</sup>

<sup>a</sup>1990. — <sup>b</sup>India (1989: 29 for industry, and 30 for agriculture).  
— n.a. = not available.

Source: World Bank *World Development Report* (various issues).

prices of the past. Resource misallocation and the “true” value of sector-specific capital stocks in previously subsidized and protected industries became evident. The required reallocation of resources could not take place over night. Rather, structural rigidities added to the transition crisis, the duration and depth of which depended on the degree of inherited distortions. Economic policy reforms designed along the lines suggested by the Asian success stories could, thus, not reasonably be expected to have immediate effects similar to what ESAEs had experienced at the beginning of their catching-up.

Within industry, too, structural differences between ESAEs and CEECs have rendered export expansion and diversification more difficult to achieve for the latter group of countries. *First*, the earlier promotion of industrialization in CEECs had been associated with a bias towards heavy and technology intensive industries, whereas the initial focus of ESAEs had been on relatively labour-intensive industries. Machinery and transport equipment, which represents a fairly sophisticated industry, accounted for about 10 per cent of manufacturing value added in Malaysia, South Korea and Thailand in the early 1970s; its share was twice to three times as high in Poland, Hungary and former Czechoslovakia.<sup>29</sup> Presumably, the industrial structure of ESAEs was more in line with comparative advantages than in CEECs, which has helped the

former countries’ favourable world-market performance.

*Second*, the adjustment flexibility of ESAEs has benefitted from a diversified economic structure, both in terms of ownership and scale of enterprises. The responsiveness of producers and investors to policy incentives in CEECs has been impaired by the dominance of huge state-owned industrial conglomerates, which frequently have resisted reforms in general and privatization in particular. The share of state-owned enterprises in overall industrial employment typically exceeded 90 per cent in socialist times. Even in the formerly centrally planned economies of Asia such as China and Vietnam, this share was considerably smaller (Raiser 1994; Diehl 1994). Moreover, small and medium-scale enterprises played a much greater role in the latter countries’ industrial production (China: 49 per cent in 1978). Because of competitive pressure, efficiency gains were easier to achieve in Asia than in CEECs where conglomerates, often employing the workforce of an entire region, had to be broken up in the first place. The ownership and scale characteristics prevailing in CEECs not only imposed political barriers on structural adjustment, but also had detrimental effects on factor mobility during the early phases of transformation, as substantial resources may have been blocked in one firm.

All in all, the impressive world-market performance of ESAEs has been supported considerably by fortuitous initial conditions, which have increased the effectiveness of policy incentives. A dynamic private sector existed from the very beginning of catching-up, and fundamental market-related institutions were in place as well. In this respect, the starting conditions of CEECs could not have been more different. The tradition of entrepreneurial initiative and adaptation to market signals had faded during decades of central planning, and the sudden regime shift resulted in an institutional void. The ensuing uncertainty of economic agents made economic policy formulation a rather daunting task for reformers in CEECs during the difficult transition period. Under such unfavourable conditions, it was not reasonable to expect that economic agents would react to specific policy incentives

as quickly and strongly as they had done in ESAEs in the 1970s and 1980s.

## II. EU and CEECs: Are They Natural Trading Partners?

Empirical studies suggest that policy measures intended to stimulate trade have less impact than proximity factors under conditions of so-called natural trading partnership. Natural trading partners enjoy advantages of low transaction costs due to geographical proximity, cultural similarity and complementarity in resource endowment.<sup>30</sup> So-called gravity models reveal, for instance, that for each doubling of distance, trade between two countries of similar size diminishes by two-thirds. A common border between two countries tends to increase trade by a factor of 2.5. Short distance, the same language and other bridging factors "explain" why, for instance, Austrian exports to Germany are more than thirty times larger (per dollar GNP of the recipient) than its exports to the United States (Pohl and Sorsa 1992: 89).

Yet, proximity cannot substitute for liberal trade policies as demonstrated by Albania, North Korea and Burma, for example, which do not trade intensively with neighbouring countries because of deliberate isolation. Nor can it substitute for sufficiently high per capita income as small (official) trade between neighbouring low-income African countries suggests. Natural trading partnerships to become effective requires liberal trade policies on both sides and absorptive capacity. If such prerequisites are given, it is argued that natural trading partnerships are not at the expense of third countries. Rather, marginal domestic suppliers will lose market shares when imports from the partner countries expand. Technically speaking, trade creation is expected to be much larger than trade diversion, so that world welfare will benefit.

Interestingly enough, the earlier experience of ESAEs does not offer much support for the natural trading partnership hypothesis. Cluster analyses show some subregional "cells" of intensive trading in the 1970s, for instance, between Malaysia and Singapore; Hong Kong and

China; and Indonesia and Japan. For most Asian countries, however, the United States represented the most important trading partner (Amelung 1992: Figures 1 and 2). Japanese absorption of finished goods exported by neighbouring Asian countries remained low for quite some time, and the economic isolation of China hindered natural trading partnerships from becoming effective. Moreover, intra-industry trade among neighbouring Asian countries emerged only with the rise of per capita income. It helped to diffuse protectionist threats that had hampered inter-industry trade. Intra-East Asian trade started to grow overproportionately in the early 1980s, after China had begun to open its market and ASEAN countries, Taiwan and Korea had dismantled non-tariff barriers. In other words, liberalization was a precondition for proximity factors to stimulate bilateral trade among Asian economies.

Likewise, natural trading partnership between CEECs and West European neighbours could be realized only after the former had embarked on liberalization. In the socialist era, CEECs were largely decoupled from world markets while trading intensively with each other. The degree to which the administered division of labour within the former CMEA had failed to exploit opportunities for trade with Western countries has been assessed in a number of studies.<sup>31</sup> Gravity models with "size" (GNP and population of trading partners) and "trade resistance" (distance, adjacency, trade policies) as the two principal sets of explanatory variables revealed that under „normal“ conditions CEECs would have exported several times as much to OECD countries as they actually did. Wang and Winters (1991), for instance, estimated that the exports of six CEECs to the EU could have been five times higher in 1985. A similarly large discrepancy between hypothetical and actual trade is revealed for CEECs' imports from the EU. Correspondingly, intra-CEEC trade would have been sharply redressed and would have amounted to only 27 per cent of total trade, instead of actually 67 per cent in 1985.

Which role the EU is expected to play in CEECs' trade in the future, relative to other OECD countries, depends on the importance of



distance as a trade resisting factor. Various models differ considerably in this respect. Havrylyshyn and Pritchett (1991) as well as Collins and Rodrik (1991) show larger negative effects of distance on trade than Wang and Winters (1991). As a result, remote trading partners (such as Japan and the US) account for a relatively low share in CEECs' exports in the former studies. According to Collins and Rodrik (1991: 129–134), the EU-12 share in bilateral trade flows with CEECs amounts to 50 per cent (except for Hungary). EU shares estimated by Wang and Winters (1991: 26) are in the range of 25–35 per cent (except for the former CSFR, the share of which exceeds 40 per cent). The largest concentration on EU markets is found by Havrylyshyn and Pritchett (1991): CEECs in total (excluding the former USSR and East Germany) would direct almost three quarters of their exports to Western Europe; the former CSFR would top the country ranking with 90 per cent, while Bulgaria would be at the lower end with 42 per cent.

German unification is not taken into account in the models, and they do not assume full EU membership of CEECs. The impact of unification is not difficult to predict. According to the logic of gravity analyses, both the size effect and the effects arising from distance and adjacency are strengthened. Hence, German unification further increases the EU weight in CEECs' trade. Likewise, further institutional deepening of bilateral trade relations might have an additional effect on EU trade shares. The impact of closer integration may remain rather small, however, since the empirical results suggest most of CEECs' trade to be conducted with the EU anyhow (Pohl and Sorsa 1992: 89).

It is somewhat difficult to assess the relevance of geographical proximity in EU–CEEC trade by confronting the model predictions with actual trade patterns as they have developed since 1989. Actual developments reflect both proximity factors and changes in EU trade policies vis-à-vis CEECs. It appears, however, that models in which distance effects alone account for very high EU shares tend to underrate the impact of trade policy changes. EU shares in total CEECs' exports have risen gradually, paral-

lel to EU trade liberalization under the Association Agreements. The EU share turns out to be highest for Polish exports, for which it reached 63 per cent in 1993. The Czech Republic exhibited a much lower EU share in its 1993 exports than the former CSFR, which is due to the separation of the Czech and Slovak Republics and the importance of bilateral relations now registered as external trade. The separation was not captured by the models, which show the former CSFR as the most strongly EU-oriented country among the CEECs. Including trade with those EFTA countries which became full EU member states in 1995, the enlarged EU share in CEECs' exports now exceeds 70 per cent for Poland, 60 per cent for Hungary and 50 per cent for the Czech Republic.<sup>32</sup> The rest of trade is largely accounted for by trade among CEECs and exports to developing countries.

Strategies towards full membership as concluded at the Essen Summit<sup>33</sup> may further add to the orientation of CEECs' exports towards the EU in an enlarged community of more than twenty member states. Yet, the more important impact of EU accession on CEECs' welfare may arise from more openness of CEECs in general. Accession will contribute to dismantling the remaining trade barriers of CEECs (see Section C.IV). This would not only intensify trade with the EU. At the same time, the trade between CEECs would be stimulated because rules of origin under the Visegrád co-operation, and the trade between the Visegrád countries and Bulgaria and Romania would become more multi-lateral than bilateral.

In sum, recent trade developments, notably the rapid reorientation of CEECs' exports towards the EU support the proposition that a natural trading partnership exists. Trade patterns that had prevailed in the inter-war period have been revitalized after the collapse of the socialist regime. Complementarity in resource endowment, low transaction costs and the absorptive capacity of EU markets are major forces driving EU–CEEC trade. The role of complementarities would be even larger if the CAP were substantially reformed and CEECs were allowed to fully realize cost advantages in agricultural production.

### III. Competition between CEECs and Asia in EU Markets

The extent to which CEECs may benefit from natural trading partnership with the EU depends not only on EU trade policy. Access to EU markets is also a function of the strength of actual or potential competitors in the market. In this context, particular attention needs to be paid to the position of producers from developing or newly industrializing countries in Asia. Their technological sophistication and unit labour costs are broadly similar to that in CEECs.<sup>34</sup> It is therefore conceivable that suppliers from the two country groups will compete with similar industries and products on EU markets. In this case, firms from CEECs might face an uphill struggle because they might still be handicapped due to their decade-long isolation from the world market. Asian firms, on the other hand, might already have well-established supply networks and might have realized productivity improvements through learning by doing.

The possible extent of such rivalry between firms from the two regions in the EU market may be gauged from so-called trade overlap ratios presented in Table 10. This indicator measures the similarity of the commodity com-

positions of EU imports from two countries or country groups.<sup>35</sup> In interpreting the trade overlap indicator it must be borne in mind that the figures are sensitive about the degree to which the commodity groups are aggregated (Kellman and Schroder 1983). It is therefore difficult to give meaning to the absolute value of the indicator. Comparisons are appropriate, however, over time as well as across CEECs.

Table 10 demonstrates that the export structure of CEECs have unequivocally become more similar to those of ESAEs since economic transformation started in the former countries in 1989. This finding applies to food as well as to non-food products, and also to every single transition economy.<sup>36</sup> It must be concluded, therefore, that as CEECs integrate into the world economy, they will increasingly have to face up to competition from Asian countries. Since the trade overlap ratios for the individual CEECs do not differ widely, this finding relates to all countries to a similar degree.

It is difficult to draw conclusions from this evidence as to how strongly competition from Asia will affect the prospects for market entry by Central or East European producers. Several considerations apply. *First*, the trade overlap indicator relates to ESAEs being on widely diverging levels of economic development, all of which are experiencing rapid economic growth and rising real wages. They are therefore under constant pressure to upgrade their exports, both in terms of product quality and in terms of moving towards more sophisticated products ('flying geese' pattern). Under these conditions, firms from CEECs probably have better prospects of entering markets than they would have in the presence of entrenched competitors experiencing little structural change.

*Second*, CEECs enjoy a competitive advantage over Asian countries in the West European market in terms of geographic and cultural proximity as well as preferential market access (see Section C.II). Preferential access is granted by the EU on the basis of the Europe Agreements. It involves successive and accelerated reductions in tariffs and quantitative restrictions

Table 10 – Trade Overlaps: Central and Eastern Europe vs. East and Southeast Asia, 1989–1993 (percentage points)<sup>a</sup>

	Food products		Non-food products	
	(HS 01–24)		(HS 25–99)	
	1989	1993	1989	1993
Poland	16.8	23.3	29.4	31.2
Hungary	17.1	19.5	30.6	36.0
Czechoslovakia	12.5	21.1 <sup>b</sup>	25.5	31.1 <sup>b</sup>
Czech Rep.	...	22.4	...	33.6
Slovakia	...	16.1	...	27.0
Bulgaria	16.9	20.8	25.0	32.3
Romania	11.9	17.3	23.0	29.9

<sup>a</sup>Definition of indicator: see text. Figures are based on 4-digit commodity groupings of the Harmonised System (HS). Asian countries include Thailand, Malaysia, Singapore, Indonesia, the Philippines, China, Taiwan, Hong Kong, and South Korea. Figures for intervening years are not reported because the trade overlaps increase gradually without significant fluctuations.—  
<sup>b</sup>1992.

Source: Eurostat (various issues), own calculations.

for most industrial goods, leading to the eventual abolition of trade barriers by the end of the current decade. Such preferences matter particularly in quota-restricted items. Restrictions on EU imports of agricultural products from CEECs are also scheduled to be reduced, albeit at lower speed and over a longer time horizon. With respect to cultural and geographic proximity, it may be noted that CEECs' exports of many intermediate industrial goods as well as exports after processing benefit from frequent head-to-head contacts with customers, which are facilitated by proximity to the West European market. It is likely that CEECs will tend to specialize in such products, often involving intra-industry trade.<sup>37</sup>

*Third*, it has been suspected that demand constraints could limit the growth of exports from developing to industrialized countries, especially if a large number of developing countries embarked simultaneously on a strategy of export-oriented development (the so-called "fallacy of composition" argument). If true, this would call into question the applicability of the "East Asian model" of world-market orientation to other regions, including Central and Eastern Europe.<sup>38</sup> Demand constraints may take the form of protectionism by industrialized countries when imports from lower-wage economies exceed some politically acceptable level. From the point of view of CEECs, this fear would seem to have been contained by the strong commitment made by the EU in the Europe Agreements and the post-Essen "pre-accession strategy" (PAS) towards the reduction of tariffs and contingent protection affecting imports from CEECs.

More importantly perhaps, if a large number of countries simultaneously increase their export supply of a similar range of products, the world market prices of these goods will tend to fall. Unless the import prices of the countries concerned are equally reduced, their net barter terms of trade are bound to deteriorate. Several considerations suggest, however, that the net welfare effects of the opening of their economies will still tend to be positive.<sup>39</sup> Economic liberalization and the build-up of technological capability start from different levels and proceed gradually, because the policy regime and stage

of economic development vary considerably among the developing and transition economies in question. Even if various countries implement far-reaching policy reforms simultaneously, they may specialize in different product groups. Each country's terms of trade will therefore deteriorate by less than would be suggested by a mechanistic application of the export patterns of the four Asian 'tigers' to the rest of the developing world or to the transition economies. For example, manufactured exports will continue to play a smaller role in many resource-rich Asian countries than in the resource-poor NIEs.

In the medium term, the more advanced developing and transition economies will increasingly become efficient exporters of relatively sophisticated products, including capital goods, which constitute a large share of the imports of less advanced developing and transition economies. A growing share of their total exports will hence be directed towards newly emerging markets, rather than to traditional markets in industrialized countries. This trend will be intensified to the extent to which exporters from developing or transition economies are able to supply product varieties which are particularly appropriate for local conditions, especially local relative factor prices. The resulting decline of the world market prices of relatively sophisticated goods will benefit the net importers of such products among the developing and transition countries.

In sum, there is no reason to downplay the competitive pressure faced by CEECs as they increase their exports to West European markets where ESAEs have already settled as important suppliers. However, neither competitive pressure nor unfavourable demand conditions are likely to constitute an insurmountable obstacle to their integration into Western European or other OECD markets. This conclusion is supported by their rapid success in raising their shares in EU imports in spite of fierce competition from China and other fast-growing Asian exporters of manufactures.

#### IV. Policy-Specific Conditions in CEECs

Previous sections in this study have shown that East Asia's export success has been facilitated by various factors:

- Catching-up processes started from low income levels. ESAEs did not face the painful experience of CEECs, which had to cope with an obsolete capital stock and suffered from declining production in the initial phase of economic transformation.
- Export growth was achieved in a relatively open trading environment. Unlike CEECs, ESAEs had not to deal with the legacy of having been cut off from natural trading partners by almost half a century.
- ESAEs were export forerunners in a large number of manufacturing industries at times of high world economic growth. Late-coming CEECs had to enter OECD markets when demand was more sluggish than in the 1960s and 1970s and when EU markets were already penetrated by Asian exporters. Trade overlap estimates suggest that CEECs have to face the competition of established suppliers from ESAEs, since the specialization profiles of the two country groups have tended to converge slowly.

In addition to differences related to more or less exogenous factors, the applicability of the Asian path to world market integration to CEECs may be debated on economic policy grounds as well. As concerns the external policies of ESAEs, national sovereignty in policy-making remained untouched. Regional commitments were not taken, and multilateral trade liberalization was applied but not accepted as binding. Until the Uruguay Round (UR), many Asian countries shied away from bound tariff rates, membership in various GATT codes and other international rules designed for strengthening discipline. They preferred unilateral over multilateral liberalization in order to maintain scope for policy manoeuvring.

CEECs have been in a different position and, consequently, have chosen the opposite option.

They had to deal with institution building, monetary stabilization and real adjustment at the same time. Given this demanding policy agenda and the lack of experience in implementing market-related reforms, the risk of policy reversal and volatility was fairly high at the beginning of economic transformation. Governments in CEECs attempted to minimize such risks by tying their own hands as far as external policies were concerned. In other words, they accepted international commitments by way of acceding to supranational bodies and multilateral treaties.

The approach of CEECs consists of three major elements, which will be analyzed in the subsequent sections. *First*, CEECs liberalize multilaterally in the GATT/WTO framework. While Bulgaria was still negotiating with the WTO on accession by early 1995, four CEECs have already been WTO member states and Poland has been in the stage of domestic ratification of WTO membership. GATT/WTO membership implies full implementation of liberalization measures concluded in the UR. Hence, it can be regarded as the most far-reaching step of opening goods markets. *Second*, regional integration will be pursued between the Visegrád countries, as well as between the Visegrád countries and Bulgaria/Romania. *Third*, the CEECs are in a process of acceding to the EU, with the Europe Agreements and the PAS as the two institutional pillars. Accelerating trade liberalization by both sides, with the EU proceeding first, aims at achieving a bilateral free trade area ten years after the first liberalization steps were launched in spring 1992. Full EU membership has implications far beyond trade-related policies, however. Notably the "acquis communautaire" has to be met by CEECs. This involves the adjustment of their entire institutional framework to the EU legal system concerning, for instance, subsidies, competition rules, indirect taxation, commercial laws and banking regulations.

##### 1. CEECs' Policy Measures within the GATT/WTO Framework

Except for Bulgaria, all CEECs have actively participated in the UR. Contributions comprised

the following quantitative commitments, inter alia:

(i) Visegrád countries will reduce tariffs on industrial products by 30 per cent from 8.6 to 6.0 per cent (Table 11). Poland tops the ranking in terms of percentage reduction (38 per cent), but still has the highest tariff level after the UR. The Czech and Slovak Republics display the lowest tariff level (both before and after the UR), coming close to that of the EU. Hungary has somewhat decoupled from the EU tariff because its tariff cuts are lower than those of the EU (28 per cent against 37 per cent). Hence, tariff differentials between Hungary and the EU has become larger. Romania sharply deviates from the Visegrád pattern because it has preferred tariff binding over tariff reductions. As a result, Romanian post-UR bound rates are on average higher than the applied rates before. Notwithstanding the significance of tariff binding for more transparency and credibility, tariff protection continues to play a much larger role in Romania than in the Visegrád countries. Furthermore, in contrast to Visegrád countries, Romania is still treated as a developing country so that it may invoke the GATT/WTO clause on "special and differential treatment". Bulgaria's status is the most uncertain one among the CEECs but its tariff structure resembles more the Romanian than the Visegrád one.

Table 11 – Tariff Reductions on Industrial Products by CEECs

	Trade-weighted tariff averages <sup>a</sup>		
	Pre-Uruguay Round	Post-Uruguay Round	Percentage reduction
Czech Rep.	4.9	3.8	22
Hungary	9.6	6.9	28
Poland	16.9	9.9	38
Slovak Rep.	4.9	3.8	22
Visegrád Group	8.6	6.0	30
Romania	11.7	33.9 <sup>b</sup>	-
Memo: EU	5.7	3.6	37

<sup>a</sup>Pre- and post-Uruguay round tariff averages are computed as the weighted average of tariff rates on bound lines and applied tariff rates on unbound lines. — <sup>b</sup>Binding of ceilings more than offsets tariff reductions.

Source: GATT (1994a: Appendix Tables 5 and 7).

For the accession strategy, the following conclusions can be drawn from the GATT/WTO tariff commitments of the CEECs. *First*, preferential effects of the six bilateral EU–CEEC Free Trade Agreements will be reduced once the multilateral commitments are implemented. It follows that trade diversion feared by third countries will become less likely. *Second*, remaining tariff differentials between CEECs and the EU, and between the individual CEECs suggest difficulties to arise if a customs union with the EU is aimed at for all CEECs simultaneously. By descending order, Romania, Bulgaria and Hungary might require longer transition periods on the way to a customs union than the other three countries. *Third*, integration between the individual Visegrád countries and between this region and Bulgaria/Romania is impeded if tariffs are dismantled more slowly in CEECs with the highest initial tariff protection. From the EU perspective, trade integration seems to be easiest with the Czech Republic and most difficult with Romania and Bulgaria.

(ii) Like all major OECD countries, Visegrád countries and Romania agreed to cut export subsidies for agricultural products. The normal target rate is in the range of 24 per cent (Romania) and 36 per cent (Visegrád countries) for the total of subsidized agricultural products. However, rates of reduction vary widely by products (GATT 1994a: Appendix Table 12).

(iii) Parallel to other Contracting Parties (including the EU), the Visegrád countries offered to reduce domestic support to agricultural producers (by 20 per cent) (see GATT 1994: Appendix Table 13). They have thus accompanied EU reforms of the CAP by own measures.

(iv) Finally, CEECs have committed themselves to inscribe in those service activities which become subject to market access and national treatment under the GATS (positive list for sectoral coverage), and to notify restrictions to be maintained for these activities (negative or exclusion list). This signals that CEECs are prepared to dismantle trade barriers in services at a much earlier stage of economic development

than many other Contracting Parties. The CEECs' commitments facilitate the accession to the internal market, considering that the 1992 programme focuses strongly on services. The number of service activities for which commitments are made is smaller for Romania (45) than for the Visegrád countries (Czech and Slovak Republics: 81 and 82, respectively; Hungary: 89; Poland: 54).

In sum, Visegrád countries seem visibly advanced relative to the two other CEECs, both in terms of coverage and depth of multilaterally concluded liberalization measures. Compared with the ESAEs, the Visegrád countries have relied more on binding measures. The share of industrial imports subject to bound rates was already fairly high before the UR in Visegrád countries (74 per cent compared with only 10 per cent on average for the ESAEs). This share will increase to 96 per cent after the UR (ESAEs: 70 per cent). Romania will approach the Visegrád level, since it has increased the share of imports subject to bound rates from 10 per cent in the pre-UR period to 100 per cent. In short, ESAEs have applied relatively low tariff rates but refused to guarantee them in a legally binding way until recently. By contrast, CEECs have guaranteed the level of liberalization achieved by the end of the UR to almost 100 per cent.

## 2. Integration and Co-operation among CEECs

Policy-specific conditions in CEECs differ from those in ESAEs with respect to regional integration and co-operation as well. This is not to say that co-operation does not exist among ESAEs. However, it is very much driven by the private sector with few public interventions only (for instance, so-called growth triangles to facilitate border trade and capital flows; see also Section II.C). Again, CEECs are in a different position. For accession to the EU, it is useful to remove barriers to trade and capital flows between each other. Such liberalization would be indispensable if the countries wanted to accede simultaneously. By contrast, a "convoy" ap-

proach with the most "mature" economy entering first and the other countries following step by step would allow to postpone the removal of trade barriers between CEECs until latecomers join the EU. However, the more liberalization schedules differ between EU-CEEC trade on the one hand and intra-CEEC trade on the other hand, the more likely is trade diversion to the detriment of CEEC suppliers. The liberalization of CEECs' imports from the EU may render such imports cheaper than still restricted imports from other CEECs, even though production costs are lower in CEECs than in the EU. Hence, CEEC suppliers may lose neighbouring markets to EU competitors.

Since the collapse of CMEA, economic interdependence among CEECs has been much lower than between CEECs and the EU. Table 12 reveals that intra-regional trade shares did not exceed 8 per cent in 1993, except for trade within the former CSFR. Gravity models predict that intra-CEEC trade — exemplified by intra-Visegrád trade — would actually expand due to mutual free trade arrangements (ECE 1993). The estimates suggest that Poland's exports to Hungary could grow to more than three times the 1991 level. Hungary would triple its exports to Poland and double its exports to the former CSFR. Such increases would bring intra-CEEC trade close to former CMEA trade shares in 1985.

Table 12 – Intra-CEEC Trade as a Share of Total Trade, 1993 (per cent)

	Exports	Imports
Czech Republic	20.6	17.8
Slovak Republic <sup>a</sup>	53.7	52.1
Poland	3.7	3.1
Hungary	7.8	6.8
Bulgaria	6.4	4.3
Romania	5.4	6.3

<sup>a</sup>Only with Czech Republic.

Source: IMF *Direction of Trade 1994 Yearbook*.

Yet, the role of mutual free trade arrangements should not be overrated. Full membership in the EU is clearly the dominating concern of CEECs. Moreover, the experience of ESAEs

suggests that intra-regional trade may expand without preferences if high income growth gives rise to intra-industry trade. The bulk of external trade of ESAEs has always been accounted for by OECD countries, however. The same is likely to hold for CEECs.

This may explain why initiatives to deepen integration between the individual Visegrád countries and between this group and Bulgaria/Romania are not strongly rooted in the countries themselves. Rather, they originate from the EU side. CEECs regard themselves as competing units rather than as congenial partners which would enjoy better collective bargaining power vis-à-vis the EU. EU initiatives for subregional integration are interpreted as "diversion tactics" (Richter 1994: 22). Politically, the drive for early accession may be slowed down in this way. Economically, the EU may be interested in having a larger part of CEECs' exports absorbed by other markets than the EU in order to reduce its own adjustment needs. For a number of reasons, however, it may be favourable for both the EU and CEECs to link the accession to the EU with improvements in dismantling trade barriers among all CEECs. *First*, rules of origin have to be maintained and strictly controlled as long as partner countries in a free trade arrangement apply different levels of external protection against third countries. Rules of origin are essential in order to ensure the effectiveness of tariff discrimination between beneficiaries and non-beneficiaries and discourage trade deflection, i.e., imports into high-tariff countries via low-tariff countries. They are costly to administer, however. Administrative costs can be reduced to the extent that tariff discrimination is overcome. *Second*, the sourcing of inputs from partner countries will become more efficient if trade barriers between CEECs are dismantled. Sourcing from donor suppliers is encouraged by "donor country content" rules (cumulation of value added originating from donors and local value added). Cumulation of value-added components originating from the producing CEEC, the CEEC partner country and the EU play an important role in the PAS. It creates incentives to trade expansion among CEECs using EU inputs. Various stages of cumulation have been

designed.<sup>40</sup> The PAS aims at gradually moving through the different stages. Stages achieved so far are asymmetrical as they are more advanced for EU–Visegrád relations (diagonal cumulation) than for EU–Bulgaria or EU–Romania relations (bilateral cumulation). Hence, diagonal cumulation is to be extended to Bulgaria and Romania. This requires negotiations between the Visegrád group and the two countries, as well as between Bulgaria and Romania on removing trade barriers and on harmonization of customs valuation and other trade-related policy measures. More advanced stages of cumulation (i.e., European cumulation and full cumulation) are conditioned by the success to reach diagonal cumulation.

The PAS links accession to the EU with intra-CEEC integration and co-operation. The EU contributed to the aims of the PAS by accelerating tariff cuts, liberalizing anti-dumping procedures, setting in force the Interim Agreements and launching the Association Agreements for four CEECs (Czech and Slovak Republics, Bulgaria, Romania) in February 1995. The CEECs reciprocated by intensifying their integration and co-operation in various steps:

- In December 1992, the Visegrád countries concluded the Central European Free Trade Agreement (CEFTA) heading for a free trade area by 2001. In 1994, CEFTA liberalization schedules were revised in order to accelerate the removal of trade barriers. Accordingly, the free trade status for most industrial products will already be reached by 1 January 1997.<sup>41</sup>
- With the beginning of 1996, tariffs on agricultural products in intra-Visegrád trade will be lowered by 50 per cent. Two years later, such tariffs will be removed completely.
- Slovenia is a candidate for entering the CEFTA after having negotiated three bilateral agreements with Hungary, the Czech Republic and the Slovak Republic. It agreed to comply with tariff reductions of CEFTA, and to conclude bilateral agreements on mutual recognition of phytosanitary and veterinary certificates by July 1995.

All in all, endeavours on the CEEC side to comply with the EU incentives for deepening integration reveal a clear asymmetry. Intra-CEFTA integration proceeds and will be extended to Slovenia. The institutional links between CEFTA and Bulgaria/Romania, and between the two latter states are still very much weaker. This coincides with similar gaps between Visegrád countries and the two other CEECs with regard to multilateral commitments.

### 3. CEECs' Implementation of the Europe Agreements

It is stated in the Europe Agreements that the major precondition for CEECs' economic integration into the Community is that existing and future legislation will be more in line with that of the Community. Chapter III of the individual Agreements lists various areas such as rules on competition, indirect taxation, banking laws, company accounts, intellectual property standards, environment and consumer protection. Given the almost complete lack of market-oriented institutions under the socialist system, harmonisation with EU standards will not only be essential to meet the requirements of the "acquis communautaire". Legislative institution building is also indispensable for preserving macroeconomic stability and tightening budget constraints, for instance, through applying bankruptcy laws and preventing the state from excessive subsidization of loss-making companies. Furthermore, it will be instrumental to attract foreign investment and to minimize the risk of being exposed to contingent protection (e.g., safeguards, countervailing duties and anti-dumping procedures).

The progress achieved so far with respect to institution building differs between CEECs, notably between the Visegrád countries on the one hand and Bulgaria/Romania on the other hand. The Czech Republic appears to be fairly advanced, for example. Domestic prices and foreign trade were liberalized early in the transformation process. Convertibility for current account transactions was introduced timely. Voucher privatization was implemented in two

major stages, thereby transferring about 90 per cent of the capital stock into private ownership. The tax and social insurance systems were adjusted to EU standards, and legal prerequisites (insolvency law) for decentralized decision-making were fulfilled. Efficient macroeconomic management by credible public institutions helped to keep inflation and unemployment at bay. Moreover, restrictions on capital transactions were dismantled. It was announced that convertibility was to be extended to capital transactions, and restrictions for exporters to surrender hard currency earnings to the Central Bank were to be lifted.

How widely achievements in institution building differ among CEECs is exemplified by the case of Romania. Handicapped by lack of political consensus and guidance, progress in privatizing state-owned industrial enterprises and banks was limited. Bankruptcy laws could not be enforced against vested interests. Important legal requirements for efficient financial markets (e.g., stock exchange operations) were delayed, which hindered the mobilization of domestic equity capital. The lack of credible institutions rendered it difficult to contain inflationary pressures. Relatively liberal investment laws, allowing foreigners to invest in all major sectors, remained largely ineffective because of uncertainty arising from high and volatile inflation. Moreover, access of non-residents to real estate is still very much impeded.

The degree of institution building achieved in other CEECs typically ranges between these two country cases. A detailed discussion would go beyond the scope of this study. Yet, in-depth analyses (Buch et al. 1994: 30–37) point to the crucial importance of financial market reforms for overcoming the institutional void after the collapse of the socialist regime. Financial institution building requires, inter alia: introducing a two-tier banking system, releasing commercial banks from inherited bad debts, removing the bias in credit allocation in favour of state-owned enterprises (SOEs), and recapitalizing and privatizing banks. Recent evidence suggests that CEECs which have made significant progress in these respects were among the first to benefit from the trade options of the Europe Agree-



ments. It fits into this picture, for example, that export expansion was sustained in the case of the Czech Republic.

The implementation of institutional reforms is a major challenge to domestic policies, rather than being a field in which external financial assistance has an important role to play. Indirect support and technical assistance of partner countries may be helpful, however, and is actually an element of the PAS following the Essen Summit. Guidance on the compatibility of state aid and competition policies with EU regulations is a case in point. It can help CEECs to stop privileged credit allocation to loss-making SOEs and to fight monopolistic enterprise behaviour. Technical assistance in designing an appropriate legal framework governing FDI may reduce the costs of information between local and foreign counterparts. Notably smaller FDI projects may be attracted in this way. Furthermore, financial institutions in CEECs may be linked more closely to foreign institutions and data bases (including rating and accounting agencies) if extended financing of telecom infrastructure is provided through PHARE. Finally, companies in CEECs may be advised on technicalities of accountancy practices in the EU. This may help implementing the announcement of the Essen Summit to accept price undertakings of companies allegedly dumping their exports, rather than imposing anti-dumping duties.

Accession of CEECs to the "acquis communautaire" is without precedent in ESAEs. Frequent disputes with the US and the EU on dumping, other "unfair" trade practices and violation of intellectual property rights illustrate

that broadly based compliance with US or EU legal standards was not attempted by ESAEs. Only recently, they have given in somewhat to external pressure. ESAEs reluctantly began to endorse principles of harmonization of trading rules during the UR.

All in all, policy-specific conditions shaping the external economic relations of CEECs differ in three respects from conditions prevailing in ESAEs:

- From the very beginning of their transformation, CEECs aimed at becoming reliable partners in a dense network of binding institutional commitments. Thereby, they attempted to tie their own hands with regard to external policies and to benefit from stable access conditions for their exports. By contrast, ESAEs' approach to world markets tended to be unilateral, non-negotiable and discretionary.
- CEECs' main political target is full EU membership. This overriding concern is shaping the entire spectrum of policy instruments in the transformation process. The policies of ESAEs were never oriented towards privileged relations with one trading partner. Rather, so-called dialogue partner systems (e.g., operated by ASEAN with major OECD countries) are deliberately balanced.
- Full EU membership is conditioned on the removal of trade barriers among CEECs. Hence, there is strong external pressure to sub-regional integration, which ESAEs never faced.

## D. Summary and Policy Conclusions

Two related questions have been raised in this study: (i) What lessons may Central and East European countries (CEECs) draw from the experience of East and Southeast Asian economies (ESAEs) with export promotion? (ii) Can the Asian success in penetrating world markets be repeated by CEECs pursuing Asian-like economic policies? At first sight, these questions

may seem to be redundant. As a matter of fact, many CEECs were quite successful in redirecting exports towards Western markets after the collapse of administered trade within the former CMEA. Close institutional links to the EU and the preferential treatment of CEECs' exports by their "natural trading partner" provide favourable prospects for export growth to continue.

Various considerations suggest, however, that even a natural trading partnership with the EU does not guarantee export expansion and diversification on a sustainable basis. The most generous conditions for access to foreign markets cannot substitute for consistent and stable domestic policies. Asian governments are enjoying strong reputation in this respect. By contrast, CEECs had to start economic transformation from scratch. Institutional prerequisites for a market economy were largely absent, and governments lacked experience in pursuing market-related economic policies.

CEECs are still struggling with legacies of the past such as distorted production structures, obsolete capital stocks and inherited non-performing debt. While some countries have made considerable progress in overcoming internal bottlenecks to income growth and trade expansion, economic transformation has remained deficient in other places. As a result, domestic and foreign investors have adopted wait-and-see attitudes, which hampers the recovery of production for both local and foreign markets. All this suggests that it is a more daunting task to achieve sustainable growth of income and exports in CEECs than in ESAEs, which initiated catching-up processes from low income levels.

Access to Western markets is also a function of the strength of actual or potential competitors. In this respect, too, CEECs are facing an uphill struggle. First, they are still handicapped after their decade-long isolation from world markets. Second, ESAEs supplying a similar range of products have established themselves as competitive frontrunners. Third, demand in OECD markets has become more sluggish than in the 1960s and 1970s.

The significantly different starting conditions suggest that, in the short run at least, the Asian success in penetrating world markets is not easily to be repeated by CEECs, notwithstanding their privileged relations with the EU. Furthermore, economic transformation involves policy challenges going beyond the Asian experience in export promotion. Notably the latecomers among CEECs have to deal with institution building, macroeconomic stabilization and real adjustment (including large-scale privatization)

at the same time. Unless reforms in these areas are firmly rooted and can be regarded as irreversible, uncertainty with respect to future investment conditions will remain high. Consequently, the effectiveness of specific policy measures such as export incentives is likely to be limited.

It follows that policy options available to well reputed Asian governments could not reasonably be taken by CEECs in the early phases of economic transformation. This applies to the ESAEs' preference of maintaining national sovereignty in trade-related policies in the first place. If CEECs had followed the Asian way of unilateral and discretionary liberalization, producers and investors would have been subjected to further uncertainties during the difficult transition period. To contain uncertainty, CEECs had no alternative but to take the opposite option of tying their own hands and reducing the scope for policy manoeuvring. Hence, they committed themselves to multilaterally binding liberalization by actively participating in the Uruguay Round. Though reluctantly, CEECs complied with EU demands for institutionalized integration and co-operation among themselves, in order to improve the prospects for accession to the EU. Finally, and most importantly, CEECs agreed to meet the requirements of the "acquis communautaire", which extend well beyond trade-related policies. In other words, CEECs had to import credibility and, thereby, compensate for institutional deficiencies and the lack of reputation after the demise of the socialist regime.

The strategy of tying one's own hands constrains by definition the possibilities of CEECs to draw on Asian experiences when designing export promotion programmes. Tariff schedules consist of bound rates almost exclusively since the completion of the Uruguay Round, so that discretion with regard to tariff protection is no longer possible. WTO membership involves adherence to codified rules on various trade-related policy instruments. Notably subsidies are to be phased out as an export incentive, while many ESAEs had applied this instrument in the early stages of export-orientation. Likewise, the Europe Agreements include regulations on state

aid, etc., which effectively bind the CEECs. Compliance with the “*acquis communautaire*” will further reduce discretion (e.g., with respect to indirect taxation and competition policy), which ESAEs made frequent use of.

Nevertheless, the Asian experience does offer some important lessons on the appropriate design of export promotion programmes:

*First*, specific export incentives should be complementary and require sound macroeconomic policies to be effective. Furthermore, the success of export promotion depends on the availability of essential infrastructure (including legal provisions for enforcing contracts).

*Second*, exporters should have unrestricted access to domestic and imported inputs. The policy regime must aim at a balanced incentive system. This means that any implicit taxation of export activities resulting from import substitution policies must be compensated. This can be achieved through duty drawback or exemption schemes.

*Third*, export processing zones may be established to assure a free trade status for export producers, until imports are largely liberalized. However, the effectiveness of such zones is limited at best if they cannot exert competitive pressure on the rest of the economy, neither by sourcing nor by final output.

*Fourth*, export promotion measures should be granted on a temporary basis. This helps containing costs which may overstrain governments struggling with fiscal problems anyway (as in some CEECs). Moreover, phasing-out support on a pre-determined schedule creates incentives to improve productivity and, thereby, become competitive by world market standards. Overall, the Asian experience suggests that government interventions must encourage, rather than impede structural change.

*Fifth*, foreign direct investment (FDI) may contribute significantly to export growth. It should be kept in mind, however, that FDI inflows depend on favourable growth prospects and macroeconomic stability, rather than costly promotion measures in the form of tax privileges and other subsidies.

*Finally*, institutional support can be helpful in reducing the costs of information of local producers and foreign importers. Officially sponsored institutions should focus their activities on assisting the marketing of smaller and new-coming exporters.

The EU has made significant contributions to increase the effectiveness of trade policy reforms in CEECs, notably by granting privileged market access according to the Europe Agreements and by accelerating trade liberalization in the context of the pre-accession strategy. Yet, there is further scope for external support. This applies to agriculture in the first place. Progress in reforming the CAP would enable CEECs to make full use of their comparative advantage in agricultural production and to have undistorted access to international input markets. Moreover, the EU should refrain from contingent protection, in order to reduce uncertainty of CEEC exporters under which conditions goods and services are allowed to enter EU markets: Compliance of the EU with multilateral rules on dispute settlement, anti-dumping procedures, etc., would be an important step to prevent the EU from using its superior collective bargaining power as a leverage.

The risk of serious trade conflicts between CEECs and the EU may be somewhat reduced through technical assistance. Advising CEEC companies on technicalities of accountancy practices in the EU is a case in point. Likewise, CEECs may be assisted in setting up guidelines on state aid and competition rules that are compatible with EU provisions. Technical assistance is also useful in designing an appropriate legal framework governing FDI, and in establishing institutions that may help to reduce the costs of information of local producers and foreign counterparts. Financial assistance has a relatively small role to play in this context. It should be directed towards infrastructure needed to further improve the links of CEECs with Western markets. Communication and transportation facilities are critically important in this respect as demonstrated by serious bottlenecks at EU-CEEC customs borders.

## Endnotes

- 1 The section on Hong Kong draws on GATT (1994b) for a great part of factual information
- 2 The section on Indonesia is based on GATT (1991, Vol. I; 1995, Vol. I) and Pangestu (1992).
- 3 For a detailed analysis of earlier trade and exchange rate policies see Pitt (1991), who has listed various changes in import entitlement schemes (*Bonus Ekspor*) from the 1950s to the 1970s.
- 4 For statistical references on Malaysia see GATT (1993b, Vol. I).
- 5 The following analysis draws on GATT (1992b, Vol. I), Kihwan and Lee (1994) and Kim (1991).
- 6 Statistical and other factual information on Singapore is taken from GATT (1992a; 1994a) unless otherwise mentioned. See also Aw (1991).
- 7 The section on the Philippines draws on GATT (1993a, Vol. I and II) as well as Shepherd and Alburo (1991).
- 8 For more details than given here see GATT (1991a, Vol. II).
- 9 The section on Taiwan draws on Linnemann et al. (1987), Wu (1991) and Okuda (1994).
- 10 The section on technology transfer is based on World Bank (1993) and on the discussion initiated by this book, especially several articles in the special issue of *World Development* April 1994 and Rodrik (1994).
- 11 Wortzel and Wortzel (1981) study the behaviour of locally owned exporting firms in five Asian countries in three major export industries (consumer electronics, athletic footwear, clothing). A detailed account of technology acquisition by Korean enterprises is given by Enos and Park (1988).
- 12 The section on technological capability draws especially on Lucas (1993), Pack (1994) and Lau and Wan (1993).
- 13 In many engineering applications, for example, a rule of thumb says that each doubling of cumulative output reduces labour input to 60 per cent of its previous level.
- 14 For a comprehensive discussion, see Nunnenkamp et al. (1994).
- 15 On this point and related arguments, see ADB (1994), Agarwal (1994) and Riedel (1991).
- 16 For detailed analyses, see Langhammer (1995), Fukasaku (1992) and Riedel (1991).
- 17 Data mostly refer to 1992 and are from World Bank *World Development Report* (1994).
- 18 The high share of textiles and clothing in Hong Kong's merchandise exports is largely due to entrepôt trade, i.e. Chinese exports flowing through Hong Kong.
- 19 For a more detailed analysis of intra-Asian trade, see the references given in footnote 16, and various issues of ADB *Asian Development Outlook*.
- 20 See Section C.II for a discussion on "natural" trading partners in the European context.
- 21 Again, however, entrepôt trade plays a role; South Korea and Taiwan direct much of their trade with the PR China through Hong Kong (Riedel 1991).
- 22 For detailed calculations, see Fukasaku (1992) and Langhammer (1995).
- 23 Various articles in the *Asian Development Review* deal in substantial detail with intra-Asian FDI, e.g. Chen (1993), Yue (1993), and Riedel (1991); see also various issues of ADB *Asian Development Outlook*.
- 24 See Langhammer (1995) and the sources given there.
- 25 For an account of major determinants, see ADB (1990) and Riedel (1991).
- 26 For details, see Langhammer (1995), Panagariya (1993: Table 4) and Riedel (1991); see also Section B.I.
- 27 See also Diehl (1994), Raiser (1994), and Sachs and Woo (1994).
- 28 For a detailed discussion, see Buch et al. (1994).
- 29 See various issues of World Bank *World Development Report*.
- 30 See Balassa and Bauwens (1989), Wonnacott and Lutz (1989), and Jacquemin and Sapir (1991).
- 31 See Collins and Rodrik (1991), Wang and Winters (1991), and Havrylyshyn and Pritchett (1991).
- 32 International trade statistics, quoted from Richter (1994: 31–33).
- 33 See EC Commission, Secretariat General, Document SI(94) 1000. 10 December 1994.
- 34 One recent estimate puts hourly labour costs for production workers in industry at between DM 1.34 and DM 4.54 in the CEECs. The corresponding figures for China, Indonesia, Malaysia, and Thailand range from DM 0.65 to DM 2.66; in the four NIEs hourly labour costs are between DM 7.45 and DM 9.92 (*IWD-Informationsdienst des Instituts der deutschen Wirtschaft*, 2 March 1995).
- 35 It is calculated by first computing the percentage share of every product in total food or non-food EU imports from each country. This gives two values (percentage shares), one from each country, for every product group. The index is defined as the sum, over all food or non-food product groups, of the smaller of the two values (Finger and Kreinin 1979).

- 36 Trade overlaps were also calculated for sub-regions (resource-rich ASEAN countries; more industrialized NIEs) and for different aggregation levels. In essence, findings are similar to those presented in Table 10. Tables are available upon request.
- 37 The importance of geographic and cultural proximity is exemplified by the fact that the average size of foreign manufacturing firms with German direct investment increases considerably with the distance of the host country from Germany. The average number of employees in 1992 was 167 for non-EU industrialized countries in Europe (including German-speaking Austria and Switzerland), 210 for the EU, 291 for industrialized countries outside Europe, and 462 for non-OPEC developing countries. Unfortunately the data source combines the CEECs with other former centrally planned economies (including China) and OPEC countries, so that no meaningful conclusions can be drawn for this group (Deutsche Bundesbank 1994). It is plausible to presume that the smaller average size of investment projects in Europe is indicative of a smaller average size of donor country firms. Hence proximity to Western Europe can be expected to give CEECs a head start on tapping capital as well as technological and managerial resources from small and medium-sized firms based in the EU and well-acquainted with local market conditions.
- 38 The debate was initiated by Cline (1982) and Ranis (1985). Empirical evidence with respect to declining terms of trade due to export expansion is provided by Lücke (1993) and Faini et al. (1992). An up-to-date summary of the debate, and a discussion of welfare effects of export expansion in a general equilibrium context, are given in Martin (1993).
- 39 This is the result, for example, of the CGE simulations by Martin (1993) where the general equilibrium effects discussed in the following are quantified.
- 40 They range from so-called bilateral cumulation (EU donor content plus value added of a single CEEC), via diagonal cumulation (bilateral cumulation plus value added of CEEC partners that are linked to the EU by several agreements; EU/Visegrád/Bulgaria/Romania), and European cumulation (EU plus remaining EFTA countries/Visegrád/Bulgaria/Romania) to full cumulation (all processing within an all-embracing European trade zone without inputs necessarily having to originate from one of the partner countries).
- 41 For details on the initial agreements see Richter and Tóth (1994) and Inotai (1994).

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