Free Trade versus Infant Industry Promotion

The Possibility of Temporary Protection for Latecomer Countries

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1. Introduction

For Latecomer developing countries like Viet Nam, international economic integration is both an opportunity and a challenge. On the one hand, strong foreign influence acts as great pressure and incentive to change, and if this influence is properly guided and utilized, the country can enter a new age of dynamism and prosperity. On the other hand, facing this powerful force without adequate preparations is risky and may lead to macroeconomic instability, social strain and national identity crisis. In either case, this is a critical historical moment for these countries, and policy makers bear a very heavy responsibility. Integration must surely be pursued, but its manner and timing must be carefully designed in order to maximize its benefits and minimize its costs. Integration should be neither too slow nor too fast. It should be paced so as to stimulate realistic domestic reforms with the right amount of external pressure, not more, not less.

This paper discusses both theoretical and practical issues concerning the commitment to free trade by latecomer countries trying to catch up with early comers. It also offers some policy suggestions regarding how Viet Nam should implement AFTA obligations and proceed with WTO accession negotiations.

The dominant trade theory which supports free trade can be challenged for the lack of dynamic and historical considerations. However, the feasibility of temporary import protection for latecomers is severely constrained today by accelerated international integration on the one hand and limited domestic capability on the other. In order to justify industrial promotion through temporary import protection, latecomer countries should improve the capability of both government and domestic enterprises. Our proposal is that this capability should be nurtured—and externally demonstrated—primarily through presenting concrete and reasonable promotion strategies for a relatively small number of selected industries. At the same time, international economic rules surrounding IMF, World Bank, WTO, AFTA, etc. need to be modified so as to enable latecomer countries to execute reasonable industrial development policies (although this policy revision is beyond the power of the Vietnamese government). For Viet Nam, both of these conditions remain yet to be satisfied.

2. The Theory-History Nexus

<u>Comparative advantage doctrine</u>

Ever since the mid 19th century, the dominant academic paradigm in trade theory has been that of comparative advantage. Comparative advantage is said to be one of the most difficult concept for laymen to understand. Briefly, it says that if each country exports goods it is <u>relatively</u> good at producing and imports goods it is <u>relatively</u> poor at producing, all countries will gain regardless of income level or economic structure. As long as countries are different in technology (Ricardian model) or in factor endowments (Heckscher-Ohlin model), potential gains from trade always exist.

More concretely, comparative advantage can be explained by way of an example. Consider a professor and a research assistant with two tasks—writing an academic paper and making photocopies. The professor is better at both tasks than his assistant. Does this mean he should do both works and the assistant should remain aside, watching? Of course not. Efficient division of labor depends on relative skillfulness between two tasks for each person ("comparative advantage"), rather than relative skillfulness between two persons for each task ("absolute advantage"). If the professor is five times more efficient in paper writing than the assistant and two times in photocopying, <u>comparatively speaking</u>, the professor is more skillful in paper writing and the assistant in photocopying. The two should divide the tasks between them ("specialize") accordingly. If the story is reinterpreted as two countries engaged in the production of two goods, we have a theory of comparative advantage.

The comparative advantage theory was first clearly proposed by the British economist David Ricardo in the early 19th century in his attack against mercantilism, which favored official intervention in international trade. The policy implication of Ricardo's doctrine was immense and long lasting; it refuted the validity of trade protection and argued that free trade, not government intervention, was the correct public policy. Ever since, this theory has always remained at the "core" of economic teaching and trade policy debates. As an academic doctrine, the comparative advantage theory is one of static general equilibrium which is simple, elegant and symmetric. As such, it is easily expandable mathematically.[1]

However, from the perspective of latecomer countries, the main weakness of the dominant doctrine is its indifference to historical or structural context. The Ricardian model is so static and simple that it cannot deal with interesting dynamic questions, such as the way to overcome the technology gap, how to deal with strong competition from developed countries, or which industries should be selected for promotion under temporary protection. In fact, the dominant theory does not even provide any logical framework for discussing these crucial questions in a concrete and realistic way.

Trade theory in historical perspective

Economic theories evolve through internal academic innovation as well as external historical influences. The conclusion of the comparative advantage theory, that free trade is beneficial for all countries, is often presented as a universal truth and a (near) consensus in economic profession. However, historical circumstances in which this theory appeared in the United Kingdom in the 19th century were very unique. Despite the appearance of a general theory, the doctrine of comparative advantage is highly history-specific. Its conclusion also depends on various assumptions that can be challenged on theoretical and empirical grounds.

The emergence and popularity of free trade theory is greatly affected by the particular position of a country or an industry in the existing power relations of the global economy. Generally speaking, a country which has already achieved a dominant economic position tends to prefer free trade, imposing it on others who are "less enlightened." By prohibiting temporary import barriers, free trade serves the interest of the early comer by

[1] Around the theoretical "core" of comparative advantage, there are various sub-theories in the "protective belt," accumulated through past academic and policy debates and supporting or supplementing the core (see Irwin [1996] for more detail). Those Sub-theories have covered the following areas: (i) balance of payments impact; (ii) relationship between productivity and wage; (iii) modification when the home country is large ("optimal tariff theory"); (iv) whether tariffs are justified when there is domestic economic distortion (the answer is no); (v) redistribution effects of trade; (vi) the case where prices are sticky and frictional unemployment emerges; and (vii) the case where factors of production are mobile internationally. These model variations are theoretically important but

ensuring global markets for its products and frustrating latecomers' effort to catch up. On the other hand, latecomer countries wishing to industrialize against the competitive pressure from early comers promote alternative models which justify intervention and protection under certain conditions. Similarly, within a country, industries enjoying strong export performance lobby for free trade, while newly emerging industries threatened by imports demand protection.[2] Whether protected industries really grow under protection is a separate and important issue which will be discussed below.

Today's industrialized countries also had periods of industrial promotion under import protection in the past. Some examples are given.

United Kingdom: Until the middle of the 19th century, the British market was protected from foreign agricultural commodities and especially cheap Indian cotton products. Mercantilism, a doctrine that seeks to generate trade surplus by restricting imports and promoting exports, was theoretically defeated by Ricardo's model of comparative costs. It is true that Ricardo was a great economist, but his model also served important political purposes. The emergence of the Ricardian theory coincided with Britain's historical turn from protection (e.g., Corn Law) to free trade, and Ricardo in effect defended the interest of the new merchant class (of which he was a member) who wanted free trade against the interest of the landed class. As the UK's global dominance in manufacturing was firmly established by the mid 19th century, the country began to preach free trade to the rest of the world. Free trade helps to secure the superiority of the first comer by not allowing latecomers to promote modern industries that would compete with the British. The historians' term "imperialism of free trade" describes the British policy during this period of pursuing "informal rule [free trade] if possible, but formal rule [colonization] if necessary." Thus, free trade and military conquest were two alternative means to pursue the same British overseas interest.

United States: From even before political independence and throughout the 19th century, America was sharply and geographically divided between free trade advocates in the

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not very relevant or helpful in solving the actual problems that Viet Nam faces.

[2] The textbook analysis of consumer and producer surpluses contends that, while protection may benefit certain producers, the country as a whole will lose if consumers' utility and government revenue are properly taken into account. While this argument may be used politically to resist unreasonable demands by interest groups, it shares the common analytical weakness of the dominant paradigm; it is static and devoid of any historical or structural context. Moreover, empirically, the static efficiency effect is usually very small and can be easily dominated by other dynamic effects, whether positive or negative.

south and protectionists in the north. Northern industrial states demanded protection against British products while southern plantation states with competitive cotton exports wanted free trade, ensuring cheap imports and free access to the British market. Alexander Hamilton represented the northern voice, advocating industrialization under protection and a centralized federal government, while Thomas Jefferson preached free commerce in the interest of southern planters. The US eventually grew to be a free trader, but only after a civil war and the completion of successful industrialization in the late 19th century. The American tariff rates were very high during the most of the 19th century.

Germany: Industrial revolution of Germany began much later in the late 19th century, under the heavy hand of the state. German customs union was created and public investment in railroads and heavy industries was vigorously implemented. Latecomers' protection was justified by the infant industry protection argument of Friedrich List who contended that proper trade theory depended on the particular development stage of a country. According to List, creation of manufacturing base and upgrading the commodity composition of trade were more important national goals than pursuing pure commercial profits.

Japan: After opening up to the world economy in the mid 19th century, Japan found itself desperately lagging in industry and technology. For the first half century following that, Japan had no tariff rights and had to industrialize under the uniform tariff of 5 percent. However, this did not seem to hurt the economy greatly since Japan was a primary commodity exporter (mainly silk, followed by tea, seafood, grain, copper, coal, etc.) and there was virtually no domestic manufacturing industry worth protecting.[3] However, by the early 20th century Japan had succeeded in light industrialization (textile) and was ready to develop heavy industries. This coincided with regaining of full tariff rights in 1911. Japanese tariffs were raised selectively to protect machinery, chemical, and other new industries. High protection was finally removed after WW2, during the 1960s and 70s when Japan had already achieved a status of an advanced economy with high technology.

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[3] Sir Rutherford Alcock (1809-97), first British ambassador to Japan, demanded the removal of Japan's political and social impediments to trade (i.e., NTBs) and argued the merits of unlimited trade as an automatic equilibrating mechanism. In his book [Alcock 1863], he also wrote that, if persuasion did not work with the Japanese government, military power might become necessary to improve the situation. By contrast, the Japanese leader and prime minister Hirofumi Ito (1841-1909) criticized the principle of free trade, saying that it would only serve British interest. According to Ito, free trade would greatly harm Japan which was only "half-developed" at that time.

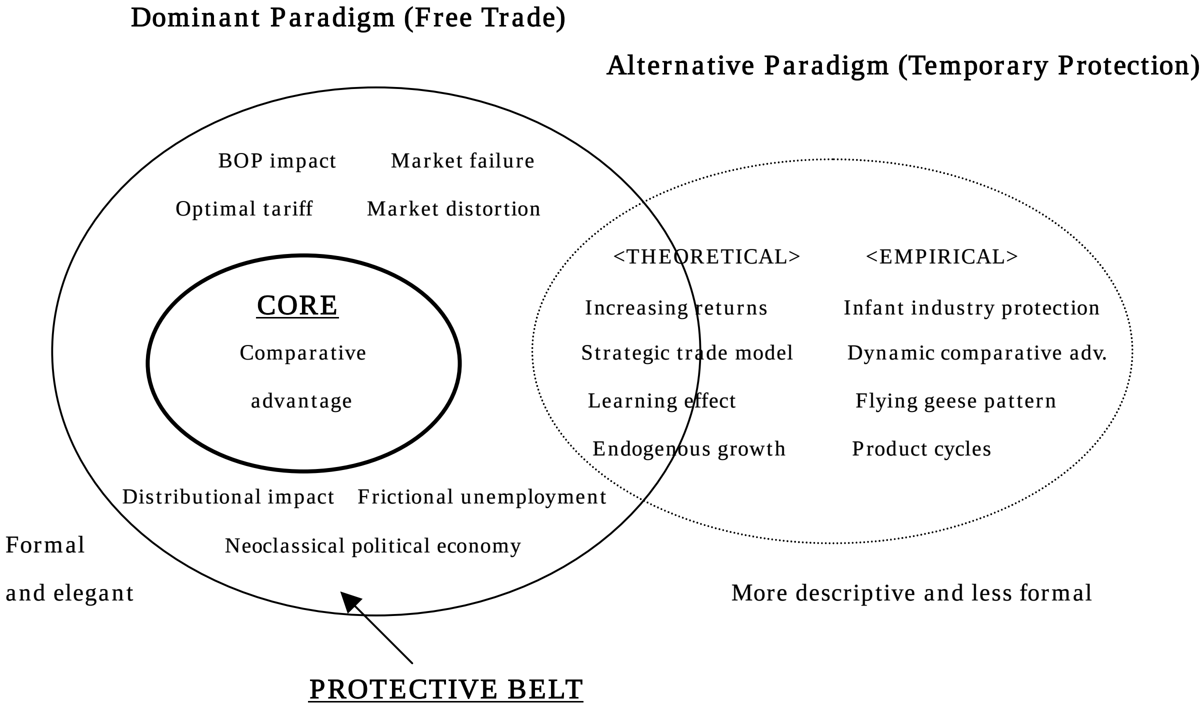
Australia: In the late 1920s there was an argument for protection in Australia, advocated mainly by J. B. Brigden. He argued that primary commodities, in which Australia had comparative advantage, exhibited decreasing returns. Specializing in them would result in higher costs at home and depressed prices abroad, thus reducing the real income of the Australian people. Moreover, free trade would have adverse distributional effects as a handful of landlords benefited at the cost of the working majority. However, as it turned out, Australia did not subsequently succeed in industrialization and has remained a sparsely populated primary commodity producer to this date, despite its relatively high income.

Alternative views: lack of guideline

One of the problems for latecomer countries, who must face a very competitive world even before establishing any modern industries, is the absence of a useful system of intellectual arguments to guide their policy of temporary import protection. Even though the "imperialism of free trade" seems unfair and unreasonable to them, there are few convincing theories to effectively counter it.

Compared with the dominant paradigm of comparative advantage in support for free trade, the alternative paradigm in support of temporary import protection is less clearly defined. Empirically, the alternative paradigm asserts that effective protection of certain industries is necessary (but not sufficient) in the catching up process ("infant industry protection argument" of Hamilton and List above). It also presents a set of theoretical models justifying intervention based on the notion of increasing returns, broadly defined.[4] However, the alternative paradigm is without the mathematical elegance and integrity of the comparative advantage theory. Many of the models in the alternative paradigm are often descriptive rather than theoretical, and look more ad hoc. The dominant paradigm considers the alternative paradigm outdated and already proven to be irrelevant or even harmful. Although the alternative paradigm gathers many avid followers, it has less academic appeal due to its absence of formal structure and institutional apparatus. The current theoretical landscape is presented schematically below.

[4] Increasing returns models can be interpreted as belonging to and an extension of the protective belt of the dominant paradigm. However, its policy implications are often quite the opposite of the dominant paradigm which justifies free trade rather than protection.



Although not very popular among the practitioners of the dominant paradigm, theories that recognize the importance of history and the specific position of each country do exist. They are usually called the "stage of development" models. For example, Kuznets [1971] introduced the notion of "Modern Economic Growth" in which the impact of the British Industrial Revolution was transmitted to the rest of the world through technical innovation and social change. Similarly, Gerschenkron [1962] analyzed the advantage and disadvantage of backwardness in the context of Western European industrialization, again with the United Kingdom as the leader.

Furthermore, some Japanese economists have presented models that can explain the patterns of industrialization in non-Western countries. The flying geese pattern model, proposed by Akamatsu and further developed by Kojima [2000], is particularly famous. Watanabe [1995] also presents his "structural transformation chain" model of Asian economies. These models point to the historically common pattern of successful industrialization in which some products are first imported, then domestically produced and finally exported. Establishment of these industries takes place sequentially, from food processing to textiles and garment, steel, chemicals, then to machinery, electronics, and information technology. Countries with different stages of development specialize in different products, and active trade and FDI among them raise the overall level of regional industrialization. This dynamic process is now well known, especially in East Asia, and these Japanese economists contributed to this common understanding.

However, although the models of Kuznets, Gerschenkron, Akamatsu, Kojima and Watanabe can successfully describe "stylized facts" in the past, they are not very useful as an operational future guideline for countries faced with practical questions of integration. Concrete strategies cannot be readily derived from these generally descriptive theories (this by no means lessens the intellectual value of these models, however).

More recent methods include computer-aided econometric data analyses, such as calculation of effective tariff rates, revealed comparative advantage (RCA) analysis, and computable general equilibrium (CGE) models, conducted by university economists and international organizations. While these look awesome and highly complicated to laymen, they also share the same vital defect with the dominant paradigm, namely, they are all static. Studying the recent past in detail does not permit the researcher to predict the future correctly, especially of a country going through the dynamic process of marketization and international integration. Evolution of a new system and social response to it cannot be predicted by extrapolating the past using fixed coefficients.

What seems to be keenly desired in a country like Viet Nam is neither abstract theory nor computerized data analysis. Nor is the general assertion of efficiency of idealized free trade very useful. The Vietnamese government would like to have an operational guideline which can analyze the actual problems on the way to integration and suggest concrete policies to deal with them, step by step. However, such a convenient theory may not exist, if only because such wisdom exists in the accumulation of actual practice. The secret of industrial promotion cannot be learned passively from outside using an operation manual.

3. Increasing Pressure to Integrate

Globalization since the 1990s

As the Soviet Union collapsed and the US economy prospered thanks to the IT Revolution and booming asset markets, the US-led global economy emerged in the 1990s. In such a unipolar world, pressure to integrate with the global economy naturally intensified for developing and transition countries. For Viet Nam which began to integrate only in the

1990s, the integration shock is even greater. Integration is required in a large number of areas including law, labor practice, accounting, enterprise management, trade, finance, governance, environmental protection, etc. and even in building a civil society and democratic institutions. Integration may occur spontaneously or under duress: sometimes through voluntary action of the country and other times through regional peer pressure or external loan conditionality. International organizations are ready to help—or press—latecomers to open up and accept international codes of conduct.

As time passes, the challenge of integration for remaining developing countries has become even greater [Ishikawa 2000]. First, the relative gap in the level of achievement of the market economy between advanced and developing economies has widened during the last several decades. Second, after some successful countries (such as NIEs) exit to the industrialized world, the average institutional capability of the remaining countries is very low ("losers' bias"). Third, pressure to integrate has intensified without simultaneous improvement in domestic capability. In the post cold war period, latecomer countries with very weak competitiveness, policies and institutions are often unable to properly manage the integration process and encounter serious difficulties. Many of them hasten to integrate without sufficient preparations, often inviting social crises or the loss of macroeconomic control.

<u>Dynamic disciplinary effects of free trade</u>

The challenge of integration cannot be avoided and, in fact, it should be welcomed. In the long run, opening up to foreign competition is a prerequisite for sustained economic development and systemic transition. Without that move, domestic industries will stagnate and fall hopelessly behind in technology and productivity. Free trade invigorates the national economy through the following channels (provided that at least some domestic enterprises can meet the challenge):

--Improving static efficiency of resource allocation (Harberger triangle effect—but this may not be very large empirically)
--Forced exit of inefficient producers
--Disciplinary effect on surviving industries for constant improvement
--Importing more effective rules and systems from abroad
--Defeating domestic monopoly (whether natural or policy-created)
--Protect the government against political capture by interest groups
--Avoiding retaliatory trade measures by other countries (reciprocity)

Risks of premature free trade commitments

However, commitment to trade liberalization also carries risks for latecomers. Quick integration with very unstable and competitive global markets, without proper preparations in industrial competitiveness, policy capability and institutional building would lead to the following:

--Sudden loss of output and employment beyond socially tolerable limits

--De-industrialization and primary commodity lock-in

--Increased price and demand shocks from abroad

--Emergence of new income gaps between rich and poor and across regions

--Foreign economic dominance

--Environment destruction and resource exploitation beyond recovery

--Social and political instability

--Loss of cultural and national identities

Brutal markets and the lock-in effect

Some of these risks may be further elaborated.

Forceful penetration of the global market system into domestic society not only can unleash positive dynamism but also may bring serious social tension. Economic anthropologist Karl Polanyi has been most eloquent on this inherent dilemma [Polanyi 1957]. He argued that economic systems prior to the 19th century were all “embedded” in society. That is to say, economic activities such as production, exchange and consumption were all subordinated to the unique structure of each society. However, after the British Industrial Revolution, the market system based on machinery and factory production began to invade society. The market system is so powerful and “self-regulating” that it transforms society according to its requirements rather than being shaped by it. If the market system demands a large number of wage earners, contract-based transactions, modern firms and a stock exchange, society is obliged to supply them. For Polanyi, it was particularly worrisome that primary factors of production—labor, land and money—which were not originally intended to be bought and sold were now transformed into pseudo-commodities. Uninhibited, the logic of the market economy—which he called “Satanic Mill”—would destroy human character, social relationship and natural environment. The brutality of unrestrained markets is so severe that it spontaneously triggers the emergence of defense mechanisms by workers, businesses, charity groups and the government.

Another aspect of the unrestrained global market system is to widen the gap between early comer and latecomer countries. In a world of increasing returns (i.e., a large set-up cost followed by a subsequent rise in productivity), free trade tends to solidify the position of initial achievers and condemn latecomers to economic underdevelopment. If a latecomer country joins the global market prematurely, its economic structure may even regress backwards (de-industrialization is actually observed in CIS and Mongolia). As the existing weak industrial base collapses under severe foreign competition, its economy is locked into the status of a primary commodity producer, in which its current comparative advantage lies. As IT and advanced manufacturing are monopolized by early comers, it is difficult for latecomers to enter these fields, let alone excel in them.

Some latecomers resist this natural tendency of "winner-takes-all" and try to catch up. The driving force for this deviation does not come from laissez-faire but from combined efforts of government and businesses under a strong sense of nationalism. Temporary import protection has been a key ingredient in the catching up strategy, but under globalization its use is highly restricted. Some argue that, even under free trade, today's developing countries can have certain new industries with FDI promotion and non-trade measures not prohibited by WTO. However, permissible industries are often concentrated in light and low-tech industries (such as food processing, textile and garment, footwear, tourism, etc.). Heavy industries and advanced manufacturing which require large initial investment under increasing returns (such as steel, chemicals, fertilizer, machinery, automobile, etc.) are likely to be ruled out. Whether that is an acceptable development path is an open question. Another unresolved issue is whether leapfrogging into high technology (such as information, telecommunications, finance) is possible or even desirable from the viewpoint of the national economy.

4. Lack of Domestic Capability

Desirability of catching up is one thing. Feasibility of such a strategy is quite another problem. Industrialization under integration pressure requires strong capability of both government and business enterprises. Without it, the country would repeat the many misapplications and outright failures of protection policies of other countries in the past. Risks involved in temporary import protection are proportionally greater if the country lacks such capability. At present, whether the Vietnamese government and business community possess such capability is seriously in doubt. These domestic weaknesses are the most serious barrier against integration. Since this point is well recognized in Viet Nam, this section can be brief.

Underdevelopment of market and limited private response

A vigorous market economy does not spontaneously emerge in any society. On the contrary, societies that achieve it are relatively rare. And even for those countries which are now fully industrialized, development of the market economy has been a long evolutionary process with many pitfalls; it was not created by short-term social engineering. The growth of the market economy requires certain historical preconditions regarding productivity, distribution system, social organization, etc. Today's remaining low-income countries are generally not well equipped with these conditions. In fact, it can be even said that the lack of these conditions is the main reason why they remain unindustrialized. Underdeveloped private businesses may fail to respond positively to policies intended to help them, such as deregulation, privatization, trade liberalization, SME promotion, creation of a stock exchange, or establishment of an internationally accepted legal framework.

Weak government and political capture

Another serious problem is the inability of government to properly design and implement industrial promotion under temporary import protection. In the standard economics textbook, the roles of government include correcting market failure, supplying public goods, macroeconomic management and income redistribution. In a latecomer country, government has additional and even more important roles: it has to implant a new market economy in society as well as manage the external integration process. However, as is well known, governments in these countries are often characterized by low capacity, rigidity, red tape, corruption, low salary, political influence, etc. Not only the economy is underdeveloped but government which is supposed to guide it is also underdeveloped.

When the government is incapable of distinguishing infant industries from inefficient senile industries, policy intervention only distorts resource allocation without accelerating growth. If the government is additionally susceptible to political pressure, protection policy can easily be hijacked by interest groups, leading to permanent protection of hopeless industries. Analyses of "neoclassical political economy" by economists in support of free trade such as Anne Krueger (rent-seeking); Jagdish Bhagwati (directly unprofitable profit-seeking, or DUPS) and Ronald Findlay (interest lobbying) highlight these political risks.[5]

World Bank and institution-building

The World Bank's view on the institutional capability of developing countries evolved substantially during the 1990s. Previously, under the strong influence of neoclassical development economics, the World Bank promoted openness and small government in all member countries and counseled against selective industrial policy. However, in its 1993 "East Asian Miracle" report, the Bank noted that some economies with strong institutions (Japan, Korea, Taiwan, etc.) successfully conducted financial and trade interventions. In the 1997 World Development Report, the Bank further rejected the idea of minimalist state and agreed that the state's role in development was very important. A two-part strategy was proposed in which (i) the state's role must be in proportion to its present capability; and (ii) capability should be improved over time. Theoretically then, for countries achieving high capability, even selective industrial policy is permissible. Today, however, the World Bank policy under CDF and PRSP seems to have degenerated into imposing uniform and abstract programs for institutional improvement, such as partnership, good governance, accountability, transparency, civil society, etc, regardless of the initial conditions of a particular country. Whether such an undifferentiated approach is useful at all remains to be seen.

5. Current Issues for Viet Nam

In the remainder of the paper, Viet Nam's integration policy questions are discussed more in detail.

Need for policy consistency

When a developing country faces strong pressure to integrate, there can be a variety of policy responses. For example:

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[5] One historical example of managing integration while strengthening domestic capability is provided by Japan's accession to GATT and OECD during the 1960s. Using international commitments to guard against inefficient protectionism, MITI urged domestic producers to improve competitiveness before trade barriers were lifted, rather than lobby for more protection. At the same time, the government provided result-oriented incentives to enterprises which successfully raised productivity.

Pattern 1—Successful integration: under national consensus, both government and businesses, though encountering many problems, endeavor to improve productivity, policies and institutions to achieve industrialization under integration (Meiji Japan, NIEs).

Pattern 2—Gradual integration with ownership: regardless of external pressure, the country proceeds gradually and experimentally to introduce markets and open up its economy at its chosen speed, thus avoiding both radicalism and back-tracking (China—but only large countries with political clout can choose this path).

Pattern 3—Big bang integration: although domestic capability is still weak, bold integration and marketization measures are adopted as a matter of principle, causing serious harm to people's living and domestic industries (Mongolia, Kyrgyzstan).

Pattern 4—Reversal: realizing the danger of integration, the country regresses back to control and regulation (temporarily?) to protect itself, antagonizing IMF (Uzbekistan, Turkmenistan; emergency measures against currency crisis adopted by Malaysia and Kazakhstan can be interpreted as a mild form of this).

Pattern 5—Inconsistency and delay: While the country clearly understands the need for integration in general, it is unable to make concrete preparations due to the lack of political will or policy capability. As a result, mutually inconsistent policies are implemented, such as committing to AFTA while introducing trade barriers (Viet Nam). If left uncorrected, the country may fall into either Pattern 3 or 4.

Each country going through integration is unique. Some countries continue to argue the general merits and demerits of market versus government, or the superiority of big bang transition versus gradualism. But Viet Nam is relatively free from such abstract debates and knows well that market and government must be combined properly and that extreme policies should be avoided. However, the main problem with Viet Nam is the lack of concrete action. During the past five years of the Japan-Viet Nam Research Project, initially identified problems—such as the need to temporarily promote selected industries—remain basically the same, but no effective effort to identify candidate industries has been made (see below). In 1998-99, the Project urged the Vietnamese authorities to officially declare a firm long-term commitment to integration and marketization while utilizing the limited time and methods to promote a small number of carefully selected industries with temporary protection. However, no action has been taken so far. In the mean time, the AFTA deadline is approaching quickly.

Viet Nam's inability to act promptly comes from various sources. For example, consensus-based decision making, decentralized responsibility among various ministries and organizations, political tug-of-war between central and local governments, pressure from affected industries, shortage of experienced officials and a general lack of time and knowledge, all contribute to slow action. While policy rigidity provides stability in normal times, it would lead to economic stagnation when the country must respond quickly to changing circumstances. Although the governing system cannot be altered immediately, there should be a constant effort to concentrate and speed up the decision-making process even under the existing system. At present, the Vietnamese government and industries are ill-prepared to face the challenge of integration. If consistent policies cannot be designed, temporary import protection for selected industries should not be implemented. This is so not only because such policy would invite international criticism but also because of the expected enormous cost to the national economy.

Selecting industries

For temporary import protection, the first crucial step is to select a small number of candidate industries for promotion. This point has been clearly recognized in Viet Nam, but no effective procedure for industry selection has so far been discovered. Existing economic theories are too abstract to be useful for such a practical problem. Therefore, Viet Nam must devise its own method to identify prospective industries (although other latecomer countries also face the same problem).

One possible methodology is to list the general criteria by which to choose candidate industries. For example,

--Labor intensity and employment impact
--Forward and backward industrial linkage
--Possibility of rapid productivity growth and technology absorption
--High income and price elasticities of demand (domestic and overseas)
--International market conditions and competitors' behavior
--Balance of payments impact
--Social impact and regional equality within the country
--Possibility of use of domestically available raw materials

Problems with this approach are two-fold. First, information requirement is enormous. Unless each industry is studied very intensively, these criteria cannot be actually used to select candidate industries, but no organization—domestic or foreign—has conducted in-depth research on so many aspects of so many industries. Second, even if necessary information is gathered, how to consolidate these multiple criteria into one and rank industries is unknown. At present, this approach remains too general to be operational.

Another approach is to infer the competitiveness of each industry from a relatively simple indicator, such as the price gap between domestic and foreign products or the current level of import protection. One such approach has been taken by the Vietnamese government itself. It is reported that the government has been conducting an internal study to assess the competitiveness of some (but not all) industries on an experimental basis and without direct policy implications. According to the press report, industries are classified in three groups:

--<u>Group 1: Competitive</u>—coffee, cashew, rice, pepper, aqua-products, garment, footwear, small diesel engine, tourism, construction service;

--<u>Group 2: Competitive if proper support is provided</u>—tea, rubber, vegetable, wood product, industrial salt, some tropical fruits, some flowers, poultry, electronic assembling, engineering, chemicals, cement, shipbuilding, banking, telecommunications, sea transport, air transport, auditing, software, insurance service, legal consultant service, healthcare;

--<u>Group 3: Not competitive</u>—sugarcane, cotton, oil-generating plant, soyabean, corn, cow milk, pork products, steel.

However, this classification may be challenged, as some industries look misclassified. Moreover, it is not clear what analytical method is used to arrive at this conclusion. It is also reported that this classification is mainly based on the "effective" rate of protection (the tariff rate on the value-added component of each product). However, the current level of protection cannot be used to judge the potential of an industry in the future. A more careful approach should be used to evaluate the dynamic comparative advantage of a country. Among highly protected industries, we should distinguish truly infant industries from dying industries with no future.

Our alternative proposal is to accumulate good studies on individual industries. Rather than searching for general criteria or a simple indicator, in-depth studies of a dozen or so key industries should be conducted, one by one, on a continuous basis. At the same time, concrete policy issues for each individual industry should be identified and discussed among government officials, business leaders, industrial experts and international donors. This will be a time-consuming process, but without accumulating such specific information, useful promotion policy cannot be designed or implemented. Past industry studies by either domestic or foreign experts (including those by JICA and UNDP) have often been too general or superficial. However, in the past several years JICA has mobilized a number of Japanese experts and economists to study Viet Nam's steel industry from various angles, and important policy issues have now been identified (see my other paper). Such effort should also be extended to other industries so that policy makers will be able to prioritize industries from a broader perspective, not just from the viewpoint of one industry.

Tariff reduction strategy

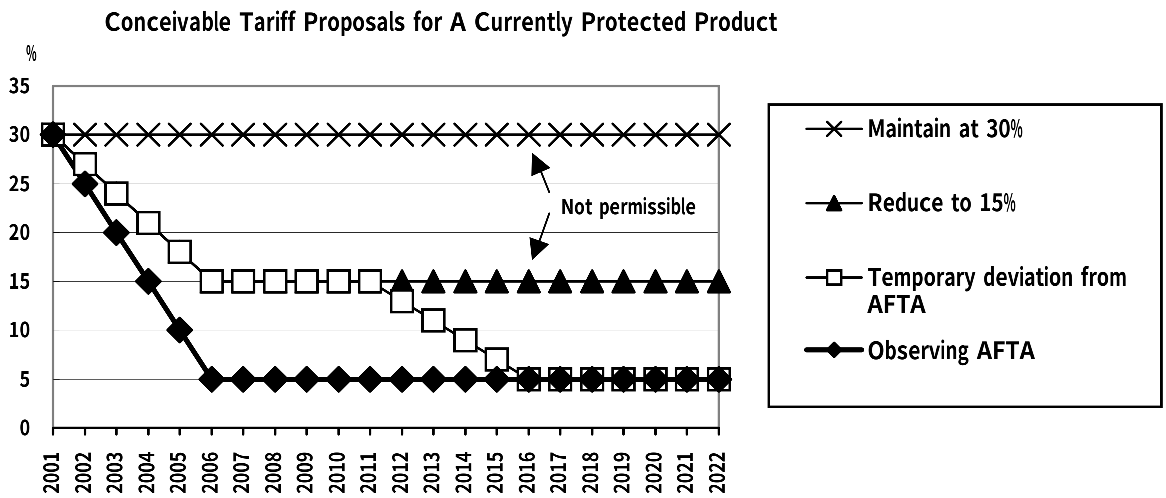
Before Viet Nam can effectively negotiate WTO entry, it has to prepare a tariff reduction schedule. But to do so, a long-term, concrete and mutually consistent policies for individual industries must be designed first. That in turn requires in-depth studies of each industry as mentioned above. Without such a national development strategy, individual tariff lines cannot be calculated or negotiated in a meaningful way. The currently prepared five-year plan and ten-year strategy are too general. The problem with Viet Nam is that it has no such national development strategy even after several years of international integration.

Without clear tariff strategies for individual industries, we can only point out two general principles that Viet Nam must adhere to.

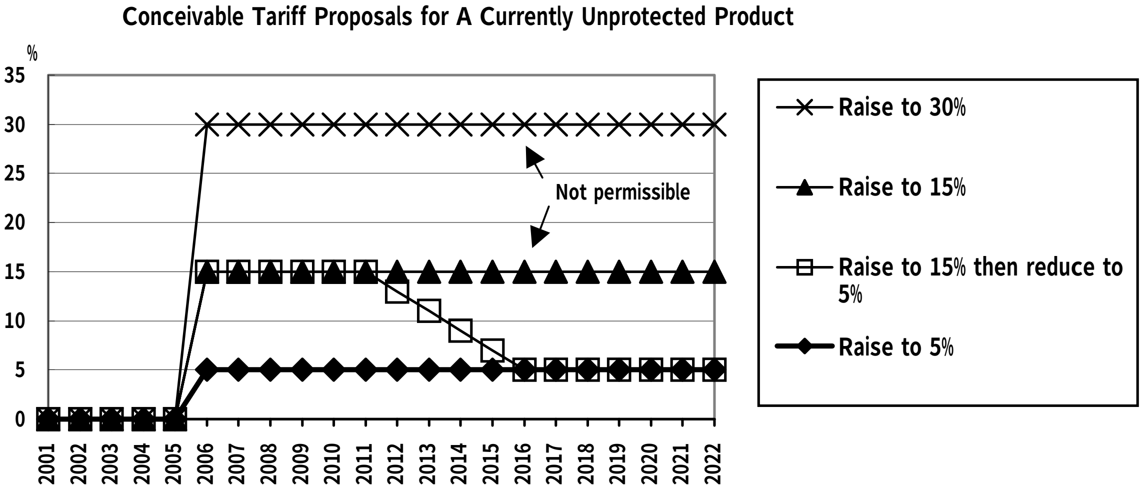
First, all non-tariff barriers (NTBs) including especially quantitative restrictions such as import bans and import licenses must be converted to corresponding tariffs as an initial step ("tariffication"). This task has been already started, but it would require a significant systemic change in Viet Nam's trade regime; removal of quantitative restrictions should not be offset by new hidden barriers such as operational procedure and domestic policy.

Second, under the regional obligation of AFTA and the global obligation of (future) WTO, permanent protection of any industry is out of question, and all industries should as a matter of principle expect free trade except for very special circumstances. These circumstances include temporary protection of a limited number of industries for the reason of either (i) industrial promotion under a very specific and realistic development plan; or (ii) severe injury of domestic producers due to sudden penetration of imports. In either case, protection must be conducted within the framework of AFTA and WTO.

Conceivable tariff proposals for a currently protected product are presented schematically in the diagram below (assume that the initial tariff is 30%). Among these, maintaining the tariff permanently above the AFTA ceiling is unlikely to be accepted by the international community, whether at 30% or 15%. The only permissible tariff proposal is either strictly adhering to AFTA or <u>temporarily</u> deviating from it, provided that such deviation is moderate and accompanied by a reasonable and concrete development strategy for that industry. Note that tariff rates in the diagram are for illustrative purposes only. It is not certain, for example, whether 15% can be accepted even for temporary protection.



For a currently unprotected product (assume that the initial tariff is zero since there is no corresponding domestic industry at present), if Viet Nam wishes to create that industry in the future, the tariff can be raised to a non-zero level. In that case also, similar constraints will apply. The new tariff must be 5% or less, or if going above that level, it must be moderate, temporary and accompanied by a reasonable and concrete development strategy.



In addition, the tariff system must be consistent across different industries. Protecting one industry often harms other industries which use the output of that industry. When industries are linked through input-output relations, the cascading pattern of tariffs (higher tariffs for downstream industries relative to upstream) is usually advisable.

WTO entry problem

As of June 2000, WTO has 137 member countries accounting for over 90 percent of global trade. For latecomer non-member countries, merits of joining WTO include (i) forestalling unfair commercial treatment by other countries; (ii) catalyst for domestic reforms; and (iii) access to WTO's dispute settlement mechanism. On the other hand, possible demerits are industrial collapse, unemployment, foreign dominance, etc. associated with rapid liberalization without adequate preparations, as discussed earlier. Generally speaking, today's WTO membership applicants lack necessary information or preparation to enter WTO. In a hasty attempt to join WTO, some countries even accept many unreasonable demands imposed by the existing members. For transition economies, understanding the principles of WTO, revising domestic laws, and implementing them will take enormous time and energy.

Moreover, countries wishing to enter WTO today face a number of additional difficulties.

First, the negotiation process tends to be costly, complex and prolonged. As an initial step, preparing the Memorandum and answering questions addressed to it already requires great effort. Bilateral negotiations with certain large member countries are excruciating. For very poor countries, negotiation and traveling costs of the official delegation are not negligible.

Second, demands from existing members are escalating. WTO does not stipulate the precise condition for entry, and everything is up to the negotiating parties. In the accession process, existing members are extremely powerful and applicants are disproportionately powerless, and this power imbalance leads to unreasonable demands being imposed on new members. Privatization, price liberalization, and export tax elimination are outside the jurisdiction of WTO, but they are nonetheless often required (called "WTO plus"). New members are regularly denied of waiver, exemption, or delayed execution enjoyed by existing LDC members. As a result, new members are forced to implement tariff reduction, TRIPs, TRIMs, export subsidy cuts, service trade liberalization, etc. much faster than the existing LDC members with similar levels of development.

Third, special treatment for low-income countries are often denied to new members. WTO is supposed to grant the following privileges to LDC members: (i) import protection for industrial development or against payments crisis (GATT article 18); (ii) access to developed country markets (GATT Part 4); and (iii) lower tariffs on LDC exports (GSP). However, in actual accession talks, these LDC "rights" are rarely conferred. Even the definition of "low-income country" is on the negotiation table, as in the case of China.

Fourth, with each passing year the conditions for entry are tightened. Thus, latecomers face the dilemma of joining now by yielding to unreasonable demands, or participating later with better preparations but with tougher requirements. Slow preparations as in the case of Viet Nam will make this dilemma even more serious.

Need for integration-friendly international environment

While most of the preparations for integration must be made on the Vietnamese side, the world economy must also change significantly to encourage and assist the integration of latecomer countries. At present, both in trade and finance, global markets are too unstable and competitive for latecomer countries to join safely. Moreover, the rules and mechanisms that regulate the world economy—including those of IMF, World Bank, WTO, ASEAN—are often unfair to latecomers (as in WTO entry negotiations discussed above), without consideration of the unique characteristics of each country (as in most IMF conditionality), or unable to prevent or cope with economic crises (in the Asian crisis, high interest rates and bold structural reforms during the panic may have worsened the situation).

More specifically, the following areas should be reformed before latecomer countries are asked to implement a rapid liberalization and integration program.

--Multiple integration rules should be applied to countries with different initial conditions and stages of development, rather than imposing uniform rules on all.

--Similarly, procedures which suppress the ownership and uniqueness of each country, such as an excessive application of CDF or IMF conditionality, should be avoided.

--Conditions under which latecomer countries can use temporary import protection must be clearly spelled out.

--Power imbalance between new entrants and existing members of WTO and other organizations should be corrected; there should be a "level playing field" for integration. Existing WTO members should not make unreasonable entry demands.

--Global financial and exchange rate instability must be regulated and reduced.

--IMF's capability to prevent and cope with currency crisis must be greatly improved.

Of course, Viet Nam alone cannot solve these global problems. Improving these systems is mainly the joint responsibility of large countries (including Japan) and international organizations. However, smaller countries can also raise issues and influence the global debate, as Malaysia did at the time of the Asian crisis. When developing countries have a legitimate cause for concern, they can jointly exert significant pressure on advanced countries. But to do so, the claimant country should have clear economic philosophy, good domestic policies and effective diplomacy.

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