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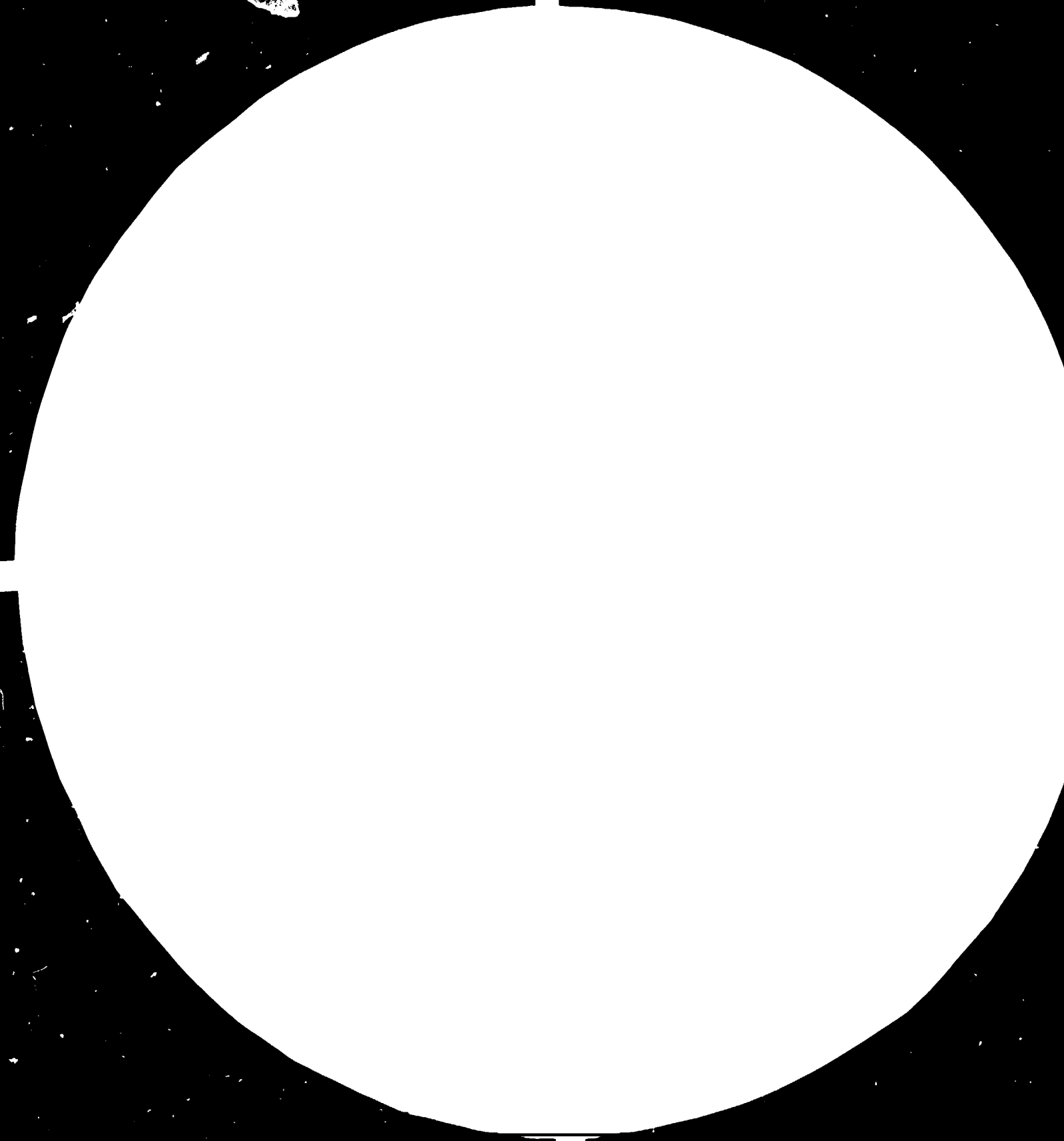
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POSSIBILITIES AND OBSTACLES OF INDUSTRIALIZATION OF THE
DEVELOPING COUNTRIES * .

[The international economic environment and the possibilities
of domestic productivity growth in developing countries]

by

Assar Lindbeck

* No attempt has been made in this report to be "diplomatic". I have regarded such ambitions to fall outside my duty -in particular at the present stage of the preparation of the report.

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INTRODUCTION

The world economy has been in a disappointing state for a number of years, largely due to the long and deep recessions in the OECD countries in the mid-seventies and early eighties, with strongly negative, though rather delayed effects on developing countries (from about 1979/80). We should, of course, try to learn as much as possible from this experience. It is important, however, that our discussion about the long-term economic prospects of developing countries is not unduly coloured by these short-term events. The long-term growth and development problems supersede both "ordinary" business cycles and deep "stagflation-type" recessions as in 1974-1976 and 1980-1983. This is why the present report will focus on the long-term "post world-recession problems" of the developing countries, in a world-economy context. Issues related to the recent recessions will be considered only to the extent that they have left an important legacy on the growth prospects of the world economy. Moreover, there are, of course, short-term implications of long-term policy strategies, as long-term policies are in practice ground out as the sum of a great number of short-term policy decisions.

During recent decades, UN conferences on long-term developing problems of the Third World have been concerned largely with issues of the external, i.e. the international economic environment of this part of the world. That aspect is certainly of utmost importance and will continue to be so in the future. Indeed, a successful build-up of productive capacity in the Third World depends strongly on a favourable international environment. Moreover, the interdependence of developed and developing countries - via manufacture trade, commodity markets, finance, investment and technology - have become not only more pronounced but also better understood in recent years.

However, when the international cyclical economic conditions improve again in the developed countries, the relative importance of domestic conditions for the economic performance of the developing countries will increase. Thus, even though the recent drastic deterioration in the economic situation in developing countries was largely initiated by events in the "outside world", it is important to recognize also the role of domestic conditions --institutions, mechanisms, attitudes and policies.

Among international, or external conditions, three factors will be emphasized in this report: (1) the access to the markets in developed countries, which is basically an issue about market expansion and protectionism; (2) the possibilities of generating an adequate and sustained flow of capital and credit to the developing countries; and (3) the possibilities of bringing about increased economic interaction and co-operation among developing countries. On the last issue, the developing countries have both an opportunity and a responsibility to show that it is possible to arrange more equitable international relations than those that have so far dominated the economic relations between North and South.

Two aspects will be focussed on, when considering internal conditions namely (1) the immaterial infrastructure, or the "human resources", emphasizing technological competence, managerial skill and entrepreneurship; and (2) the strength and efficiency of domestic markets and the economic incentives of households and firms. The main reason for emphasizing these two aspects of the internal conditions is that a strong case will be made for policies that stimulate domestic productivity growth and allocative flexibility. Indeed, to improve productivity growth and allocative flexibility of developing countries may be regarded as the main theme of this report, as far as internal reforms and policies are concerned. A main reason for this emphasis is the very poor productivity performance of developing countries so far.

By considering the internal factors on an equal footing with the external ones, it may be possible to contribute to a new start in the discussion of economic development, with more concern for the macro- and microeconomic environment of the actual decision-makers in the production system - both individuals in large firms and small entrepreneurs.

Thus, the main themes in this report refer to the possibilities to improve the international economic environment and to stimulate domestic productivity growth in developing countries, in particular by the accumulation of "human resources", including technology, managerial competence and entrepreneurship.

Needless to say domestic reforms are continuously pursued in developing countries. It is also important to stress that they are neither a substitute nor a requirement for improvements of the international economic environment of the developing countries. However, the credibility of the demands of the developing countries on "the outside world", to change its institutions and policies, would most likely be enhanced if the developing countries themselves show more concern for the importance of the economic structures within their own countries.

The report starts out with a brief account of the recent experience of industrialization in developing countries (chapter I). To evaluate the external environment of the developing countries, a discussion follows of the trends and future prospects in developed economies (chapter II), as well as of the interrelations between the developing countries, on one hand, and the developed market economies (chapter III) and the centrally planned economies (chapter IV) on the other hand.

On the basis of this discussion, the report takes up the important but difficult issue of the long-term policy options, or "reform options", of relevance for developing countries. Three basic areas are considered: the possibilities of reforming North-South relations (chapter V); the possibilities of strengthening South-South interaction (chapter VI); and finally the issue of domestic policy options for developing countries (chapter VII). The report ends with some concluding remarks (chapter VIII).

I. RECENT EXPERIENCE OF INDUSTRIALIZATION IN DEVELOPING COUNTRIES^{1/}

It is, at the very outset, important to repeat the truism that a removal of poverty and underemployment, and the build-up of acceptable living conditions in the developing countries, within a reasonable time, requires a rapid rate of economic growth in these countries. Considering the population trends, growth targets for GDP of the magnitude of 6 to 7 per cent per year are strongly motivated. That would usually mean that production (value added) in manufacturing would have to grow even faster, in fact in the neighbourhood of ten per cent per year for developing countries as a group. It is in the light of such ambitions that the actual growth performance in developing countries during recent decades should be seen, including the disappointing experience starting at the very end of the seventies.

Looking back at previous achievements, it is well known that the rate of economic growth increased sharply after the Second World War in the developing countries, in fact even more so than in the developed countries. In the period 1960-73, the rate of real GDP growth seems to have been about one percentage point higher in developing countries than in OECD countries, and in the period 1973-82 about two percentage points higher. These differences are, however, broadly wiped out in per capita calculations. As a result of the more rapid GDP growth in developing than in developed countries, the share of the latter in world GDP increased from about 14.8 per cent in 1938 to about 15.3 per cent in 1970 and to about 17.3 per cent in 1980^{2/}.

The faster rate of output growth in developing than in developed market economies is pronounced for the manufacturing sector as well. The growth rate of manufacture value added in the developing countries exceeded that for the rest of the world by 1.7 percentage points in 1963-1973 and by 2.4 percentage

^{1/} For a detailed assessment of this experience, see Industry in a Changing World, ninth edition of Industrial Development Survey, UNIDO, Vienna, 1983. When no reference is made in the present report to other statistical sources, data is obtained from that survey.

China is not included in the figures that are presented.

^{2/} Centrally planned economies are included by their Net Material Balances.

points in the period 1973-1980. As a consequence, the developing countries increased their share of world manufacturing value added from about 6 per cent in 1938 to 8 per cent in 1963 and to about 11 per cent in 1982. These achievements are of course less pronounced on a per capita basis, and the rate of increase in the labour productivity has, as will be emphasized below, been very slow. Moreover, practically the entire post World War II relative gain was made before 1978/1980.

The increased importance of manufactures in the developing countries is reflected also in the export sector. The share of manufactures in the total non-oil exports of the developing countries has increased from about 13 per cent in 1960 to no less than 48 per cent in 1980. The still rather modest level of sophistication of manufacturing by developing countries, however, is reflected in the fact that while about 70 per cent of the developed market economies' exports of manufactures are finished goods, ready for use, the corresponding figure for developing countries is just below 40 per cent (1980).

Moreover, the bulk of the output of manufactures of the developing countries is produced by a very small group of countries. For instance, in 1980 ten developing countries accounted for about 70 per cent of manufacture value added of all developing countries. One country, Brazil, accounted for almost a quarter of the manufacture value added of the developing countries. Together with the Republic of Korea, Taiwan, Iran, Indonesia, Thailand, Singapore and Hong Kong, it will also seem that Brazil has experienced the most rapid rate of growth of manufacture output in the period 1963-1980, while three other large countries--Venezuela, Argentina and Chile--experienced a significant decline in their respective shares of total manufacturing output of developing countries.

The developing countries in the lowest income range (per capital GNP of less than \$295 in 1978) experienced a gradual fall in their share of total developing country MVA from the early sixties to the early eighties. In 1980 they accounted for only about 11 per cent of total manufacture value added of the developing countries, to be compared with their share of developing country population of 51 per cent. If we look at the least developed countries, the figures are even more startling, as these countries during the

last two decades have accounted for only about 1.5 per cent of the manufacture value added of developing countries, though their share of developing country population has been about 10 per cent throughout the period. Moreover, while the figure for their output share has shown a downward trend, the figure for their population share has tended to increase.

These figures reflect a rather general observation in development economics, namely that the manufacture sector expands most rapidly at intermediate levels of per capita income, and that its share of GDP typically tends to increase in countries at such levels. One obvious reason is that the demand for non-processed agriculture products at those income levels does not rise rapidly with income, by contrast to the demand for manufacturing products, including processed food. Another reason is that a rapid rate of capital accumulation, which helps to bring about the rapid increase in per capita income, at the same time increases the comparative advantage of capital-intensive sectors like several branches of manufacturing, by contrast to most services and traditional agriculture. The same argument can be made for human capital, in the form of education and on-the-job training. For at the same time as a rapid process of accumulation of human capital boosts per capita income, the very same process will gradually change comparative advantages in the favour of skill-intensive activities and products, like parts of manufacturing, in particular of course sophisticated forms of manufacture output (though at very high levels of per capita income sophisticated services seem to be even more strongly stimulated by the accumulation of human capital).

To avoid painting too schematic a picture, it is important to point out that a number of well-known factors create strong variations around these trends for individual countries. The availability of natural resources is one such factor. For instance, the share of agriculture, which ranges from about 5 per cent to about 38 per cent of GDP in developing countries (in 1980), varies considerably even among countries at comparable levels of per capita income. The size of the domestic market is another important factor that influences the production structure, in particular within manufacturing, as small countries more than large ones have to specialize to be able to exploit comparative advantage and returns to scale. Differences in the economic

system and the economic policies pursued, for instance the emphasis on import substitution and export promotion respectively, has also a considerable influence on the production structure, and not just on the relative size of the foreign trade sector.

Granting modifications of this type, it is nevertheless true (1) that modernization and economic growth regularly are accompanied by an increased share for manufacturing in total output and employment (in the per capita income interval where developing countries are placed); (2) that the increased importance of manufacture is particularly pronounced at intermediate levels of economic development; and (3) that this tendency for manufacturing to grow in relative importance disappears only at very high levels of per capita income.

It is, of course, impossible to make reliable forecasts about the future trends of manufacturing production in different parts of the world. However, if, as a hypothetical example, we assume that recent tendencies (1960-1980) continue, the developing countries would account for about 16 per cent of total manufacturing output in the world in the year 2000, by contrast to the Lima target of 25 per cent --at the same time as the developing countries would be expected to account for more than 70 per cent of the world's population. This illustrates the slowness, so far, of the process of reallocating productive capacity in manufacturing to the developing countries.

II. ECONOMIC TRENDS IN DEVELOPED COUNTRIES

A. Reasons for deterioration of economic performance of OECD countries

The evidence of a deterioration in the performance of the developed market economies during the last decade is obvious: a cut in about half of the GNP growth rate; increased short-term macroeconomic instability; a doubling or even trebling of the trends values of the unemployment rate; and, until recently, also a rising inflation trend.

The slowdown of the GNP growth rate was to some extent "inevitable", as the extraordinary rapid growth rate during the fifties and sixties was partly based on historically uniquely favourable circumstances. For instance, the rapid productivity growth rate during the first two decades after the Second World War was enhanced by economic reconstruction after World War II, by the vast (delayed) outflow of labour from low-productivity agriculture as well as by the once-and-for-all liberalization of international transactions after the protectionist and autarkic tendencies in the thirties and forties. In the case of developed countries other than the U.S., productivity growth was also facilitated by technological "catch-up" to the U.S. technology. These favourable factors for productivity growth were bound to disappear sooner or later. It is also well known that the ever larger share of GNP which during the last decade has been devoted to services, in particular public services, and to environmental improvements of various kinds, has reduced the overall productivity growth rate of the national economy - as this is in fact measured.

The increased short-term macroeconomic instability in the OECD countries, by contrast, was to a considerable extent a result of a series of specific, partly accidental, macroeconomic "shocks" that impinged upon these economies. Obvious examples are the explosion of international liquidity around 1970 (largely due to the speculation against the dollar); the supply shocks in connection with the drastic increases in oil prices in 1973 and 1979; the so-called "real wage explosions" in several European countries around 1970 and 1975 (in particular relative to the falling productivity trend after 1973); and the often rather erratic policy responses by governments to these events.

With the economic policy actually pursued by various governments, the ensuing macroeconomic instability was reflected not only in drastically increased unemployment and high and fluctuating inflation, but also in drastic fluctuations in exchange rates, interest rates and raw materials prices.

The long-term growth potential of the OECD economies was seriously damaged by this short-term macroeconomic instability, which then accentuated the previously mentioned "unavoidable" slowdown of productivity and output growth. For instance, due to the length and depth of the last two recessions, the process of reallocation of resources slowed down because of the reduced demand for factors of production even in sectors with good long-term growth prospects. Moreover, capital formation was seriously hurt by the low level of capacity utilization, the cyclical fall in profits and the high real interest rates - as well as by the increased uncertainties about relative prices, macroeconomic developments, and government policy.

It may be argued, however, that the recent deterioration in both the short-term and the long-term performance of the developed market economies, as just discussed, to some extent reflect also some changes in the basic functioning of these economies.

(1) First of all, the rising inflation trend from the mid-sixties can be seen at least partly as an adjustment of wage and price behaviour to the expectations of unions and firms that the government will guarantee full employment regardless of what happens to wages and prices. Thus the gradual increase in the inflation trend would probably sooner or later have resulted in a more restrictive economic policy, with higher interest rates and greater unemployment, even without the specific inflationary "shocks" that impinged upon these economies in the seventies. In other words, the stagflation in the seventies and early eighties should be regarded as a result not only of a number of specific, "accidental" shocks, including the supply shocks, but also of changes in the behaviour patterns of firms and unions, and the restrictive economic policies that later on were induced by these changes, in particular the very high interest rates.

(2) Secondly, the increased instability of exchange rates and interest rates are not only consequences of "unfortunate" accidental disturbances. Increased exchange rate instability also reflects the consequences of deviations in the macroeconomic trends in individual countries that are strongly economically interdependent, in particular as reflected in highly integrated financial markets. Moreover, the greater fluctuations in interest rates than earlier reflect both a stronger determination on the parts of governments to fight inflation by monetary policy and increased emphasis in the pursuit of such policies on the control of the money stock rather than interest rates.

(3) Thirdly, there seems to have occurred not only a cyclical drop in profits, but also a trend-wise long-term fall in the profitability of firms in the developed countries, most pronounced in manufacturing. In some countries this is partly a result of overvalued currencies, or alternatively formulated, "excessive" real wages - in situations when profits were squeezed also by the increases in the relative prices of various intermediary inputs, such as oil and, temporarily in the early seventies, also raw materials.

However, the falling rate of return on physical assets in the developed countries may also be regarded as an expression of increased international competition and shifts in the comparative advantages in some manufacturing sectors in favour of developing countries. To the extent that this is the case, the falling rate of return on investment in some manufacturing sectors in the developed countries is a "normal" consequence of more competitive markets, and a signal that it is reasonable to shift the allocation of investment in such sectors to developing countries.

(4) However, the ability of developed countries to make such reallocations seems to have been reduced because of a long-term deterioration in the flexibility of the basic allocative mechanisms of the developed countries. We can notice increased demands by employees and firms to get help from governments to resist both reductions in relative income and contractions of productive capacity in sectors with deteriorating comparative advantages.

As we know these various developments have both accentuated traditional protectionism and stimulated the use of selective subsidies to ailing sectors and firms in many developed countries. In other words, at the same time as there is a greater need than earlier for a reallocation of productive capacity in the world economy, with a redeployment of certain types of manufacture production to the developing countries, not only macroeconomic developments but also some changes in the basic functioning of the economic systems of the developed countries of the West have reduced the ability and willingness of these economies to pursue such reallocations.

B. Likely future developments in OECD countries

An important question now is, of course, if the deterioration of the performance of the developed western economies during the last decade is permanent or if instead a return to a more successful development is likely to take place. I am then referring to the medium- and long-term developments, rather than to the cyclical situation in the early eighties. After all, business upswings have regularly occurred after every recession during the last one or two hundred years - indeed even after the major depressions in 1921-22 and 1931-36. There is no compelling reason why this would not occur after the recession of the early eighties as well, though the speed of the recovery is open to great uncertainty.

It would be foolish to express a firm opinion about the likely general performance of the developed western economies over some longer periods, such as one or two decades. Nevertheless, we cannot avoid forming some opinion on the issue. As a starting point for a general assessment of the issue, it may be argued that it is not very likely that the developed western economies will be exposed to similarly severe "shocks" during the coming decade as during the last one. In particular, it is not very likely that oil price shocks of the same magnitude as in 1973 and 1979 will occur again. The obvious reason is that the gross underpricing of oil before 1973 now has been rectified (perhaps excessively so for a while), and that the opening of new oil fields, substitutions on the production and consumption side, as well as higher energy efficiency, have reduced the importance of OPEC oil for the energy requirements of the world economy. This is an important point, as the oil

price increases of the seventies by their abruptness had profound effects on the world economy. Indeed, as events turned out, also several oil exporting countries encountered severe economic problems in the wake of the oil price increases - due to overexpansion of domestic demand, distorted income relation and poorly allocated and managed investment in connection with the "rush" to spend the higher oil revenues. Indeed, among the group of middle-income countries, those exporting oil have experienced a slower rate of GNP growth than those that are oil importers (World Development Review). This experience suggests the various risks that are connected with having a large, high-profit sector that squeezes profits in other sectors--the so called "Dutch disease" (reflecting the consequences of the natural gas boom in Holland for other sectors). As we know, the subsequent world recessions, which were accentuated by the oil price increases, have heightened these consequences.

These various repercussions of "the oil price shocks" are likely to subside over the coming years, which will help to return the world economy to a smoother path. There is also at least a possibility that labour unions, employees associations and governments in developed countries have learned the danger of "real wage explosions" and wide fluctuations in exchange rates and interest rates.

Moreover, as inflation has now been brought down dramatically in the major OECD countries, and as this has occurred at the cost of large capacity slack and high unemployment, it is reasonable to assume that more expansionary economic policies will be pursued in the near future than during the last decade, and that therefore capacity utilization (for capital as well as labour) will, on the average, be somewhat higher during the coming decade than during the last decade. This assessment presupposes, in today's world economy of strongly international interdependence, that governments in several major developed countries will simultaneously pursue a macroeconomic policy that allows a cyclical recovery.

However, the improvement in capacity utilization will most likely take place at a rather "moderate" speed for the group of developed countries as a whole, because of the ambitions of governments in the major countries to avoid

a new round of high inflation. Due to the large labour slack within firms, and the previous retardation of the outflow of labour from the household sector, it is likely that unemployment will fall rather slowly during the coming five or ten years - from the 30 million level in 1984. Thus unemployment will most likely continue to be a severe problem in the developed market economies during the coming decade. This is an important legacy from the two recent deep recessions.

The tendencies to prolonged unemployment problems are accentuated by the fact that the low level of capital accumulation during the last decade, and the increased obsolescence of part of the existing capital stock, has made this too small to employ the entire labour force at existing real and relative wage rates. Hence, there is the risk that traditional ("Keynesian"-type) unemployment during the coming decade may be amplified with "structural" unemployment - because the factors of production are not mobile enough between various production sectors, with induced "mismatches" between the composition of demand and supply, and because real and relative wage rates are not flexible enough. Such limited mobility and flexibility could also induce "technological unemployment" as the future technological development will most likely require drastic changes in the allocations labour and relative wage rates.

For these various reasons it is important to get investment activity going again in the developed countries. To a considerable extent, that will follow "automatically" by higher capacity utilization. However, the likelihood of a new investment boom depend also on the possibilities of lowering the capital costs via reduced real interest rates. It is possible, but not self-evident, that this too will occur "automatically" by way of receding inflationary expectations and reduced macroeconomic uncertainty.^{3/} However, what may retard, stop or even reverse such a reduction of real interest rates is not only increased credit demand by the private sector and some resurgence of

^{3/} The high real interest rates in recent years reflect the often observed phenomenon that a movement from high to low inflation is connected with rising real interest rates (as these are in fact measured), as lenders and borrowers revise their expectations about inflation downwards only after a certain time-lag, which may last for a couple of years.

inflation, but also a possible inability of governments to reduce the large budget deficits during the next business upswing, which would depress the aggregate saving ratio and "crowd out" private credit demand.

Thus, even if investment activity most likely will be stimulated by higher capacity utilization in the development countries, as compared to the depressed levels at the end of the seventies and the early eighties, it is far from obvious that capital formation can be brought up to the levels of the fifties and sixties. Considering also that the rapid growth rate of total productivity during those periods, as explained earlier, partly reflected historically uniquely favourable circumstances, it is reasonable to expect that the capacity growth rate of OECD countries in the future, though being more rapid than during the seventies and early eighties, will be slower than during the fifties and sixties. Three per cent per year is probably more realistic than the figures of four to five per cent that characterized the capacity growth rates of the fifties and sixties in the developed countries, even though GNP may temporarily increase somewhat faster during the cyclical recovery from the 1980-83 recession, at least in some countries.

A more speculative issue is whether the previous trend towards less allocative flexibility of the developed countries will be reversed or not. On the one hand, it may be argued that some of the factors that have contributed to the recent reduction in the allocative flexibility of several OECD economies are likely to stay, such as an unwillingness to accept deteriorations in relative incomes, and demands for specific job security, as reflected in the ambitious of the labour force to stay in "accustomed" branches, geographical regions and firms. Moreover, distortions of exchange rates, partly an effect of national economic policies, have created artificial trading disadvantages for some countries (such as the US), which generates additional protectionist pressures.

On the other hand, higher capacity utilization and possibly also higher profits would be expected to improve the reallocation process by creating more expanding sectors, and perhaps also reducing protectionists pressure somewhat. Moreover, the remaining pool of unemployed labour, and the willingness of many people in the household sector to move into the open

labour market, may very well increase the elasticity of the supply of labour somewhat relative to the sixties and early seventies. It is, of course, also possible that both politicians and the general public have increasingly started to realize the long-run economic costs of a rigid economic system that cannot easily adapt to new circumstances. For instance, it is observed in several industrial countries that young people have recently become less "choosy" about jobs, in the sense of becoming more willing to take jobs that a few years ago were regarded as unacceptable, in manufacture industry and in services like retailing and cleaning. This may reduce the "mismatches" between labour demand and labour supply somewhat.

Assuming, hopefully, that the latter types of factors dominate the former, we may predict that the allocative flexibility of developed countries will improve again in the future. However, as long as unemployment is still high by historic standards, protectionism is not likely to subside drastically, which should moderate our optimism about the possibilities of the developed countries to shift out rapidly from sectors that are losing comparative advantages.

C. Recent and likely future trends in centrally planned economies

One of the most pronounced long-term developments in the world economy during the post World War II period is the industrialization of the centrally planned economies. Thus, while throughout the period 1963-82 the share of the developing countries of world manufacturing value added increased from about 8 to about 11 per cent, the corresponding share of the socialist countries rose from about 15 to about 25 per cent. This reflects not only a rather rapid growth of total output in those countries, but also a heavy concentration on manufacturing.

As in the developed market economies, we notice a pronounced slowdown in the rate of growth during the last decade in the centrally planned economies -for the total economy as well as for manufacturing. This is partly a natural consequence of reaching higher income levels. However, it would also seem that the economic systems of the centrally planned economies are not conducive to productivity growth in the more differentiated types of economies that are emerging in these countries.

The general direction of structural change within manufacturing among the more developed of the centrally planned economies is broadly similar to the structural trends in the developed market economies, with a gradually greater role for the engineering and chemical industries matched by a relative decline in the textiles, clothing and food industries. However, the service sector develops much slower. We can also detect some tendencies to more reliance on decentralized decision-making and markets in some of the centrally planned economies, which might increase their innovative and productivity enhancing capacity. If those trends continue, the future relationship of the centrally planned economies to the rest of the world will certainly be influenced.

III. INTERRELATIONS BETWEEN DEVELOPING COUNTRIES AND
DEVELOPED MARKET ECONOMIES

A. Impulses from developed market economies to developing countries

It is well known that recent trends in the developed market economies, as discussed above, have seriously damaged the international economic environment of the developing countries. Some of the most important expressions are:

(a) A serious blow to the export demand of the products of the developing countries - via low capacity utilization, slow GNP growth, inflexibilities and protectionism in the developed countries, the latter phenomenon often discriminatory against developing countries.

(b) High real interest rates, as a result of restrictive monetary policy in combination with inflationary expectations, large budget deficits and great uncertainties.

(c) A collapse (at least temporary) in the relative prices of a great number of primary commodities.

(d) Strongly negative effects on the balance of payments of some developing countries, and therewith connected difficulties of financing imports and of servicing the foreign debt.

(e) A reduced willingness of the developed countries to give foreign aid and technical assistance to developing countries, which is reflected also in a fall in the quality of the aid which has become "tied" to a great extent than earlier.

The serious consequences for developing countries of all this are well documented. For instance, as pointed out recently by the Secretary-General of UNCTAD, the political forces in developed countries in the field of trade policy "has shifted away from the question of how developing countries should be helped to compete with other suppliers in the markets of the industrialized

countries to that of how the domestic suppliers in those countries can be protected against developing country export".^{4/}

It is true that the internationalization of credit and capital markets during the sixties and seventies strongly helped many developing countries, in particular so-called NICs (Newly Industrializing Countries), to keep up domestic economic activity by the help of quite drastic increases in foreign debt, and that their heavy borrowing counteracted the economic down-turn in the entire world economy. Indeed, this development was strongly stimulated by changes on the supply side of international financial markets, including the supply of "oil-money", and the eagerness of western banks to expand their lending on the basis of their increased financial funds. However, as we now realize this heavy borrowing has backfired. One reason is that the use of the borrowed funds was not always conducive to long-term economic growth. But perhaps an even more important reason was that interest rates later on went up to unexpected and unprecedented levels, at the same time as the possibilities of servicing the debt were eroded by the drastic deterioration in export markets and the related collapse in the terms of trade of primary commodities. Moreover, even though it was quite rational to borrow short-term, to avoid being locked into very high interest rates for long periods, the short maturity of debt has strongly accentuated the liquidity problems for many developing countries. This liquidity problem not only influences government policies, which may be forced to a more restrictive stance than would be chosen otherwise. Liquidity problems also hit individual firms, in particular in the case of investment decisions, as funds cannot be obtained even for projects with good economic potential.

However, rather than indulging in the problems and failures of the immediate past, what are the implications for the developing countries of the likely future trends of the OECD economies? Let us then assume that the assessment above of these future trends in the developed countries is realistic, in order to show that even with this rather optimistic scenario the international economic environment poses serious problems for the developing countries.

^{4/} UNCTAD, TD/271, 19 May 1983, p.32.

It is true that the export markets for the developing countries would recover by a higher rate of capacity utilization and a return to a higher level of capacity growth than in the seventies. If the developed countries would improve upon the allocative flexibility of their economies, we could perhaps also hope for some reduction in protectionist pressure in these countries. The long-term trend for the terms of trade for primary commodities would also become somewhat brighter, which would increase the incomes of several developing countries, though it would hurt some developing countries that are heavy net importers of primary commodities.

Both an improvement of the export markets and a partial recovery in the terms of trade for primary commodities would certainly make it possible to increase investment activity in the manufacturing sector of developing countries relative to the catastrophic levels in recent years. The investment activities of transnational corporations would be expected to improve as well, though the quantitative importance of this factor depends strongly on government policies towards these firms in developed as well as in developing countries.

Improvements of export markets would also improve the debt service situation. A gradual fall in real interest rates, which may or may not occur, would accentuate this effect.

However, the prospects of still very high levels of unemployment in the developed countries, and the related pressure for protectionism, should make it clear that it is an open question how much developing country exports can really gain on a future cyclical upswing in the developed countries. Moreover, it is obvious that not even quite favourable developments of the OECD economies can remove the need both for a consolidation of existing debt and for a major improvement in the future availability of long-term and short-term credit on reasonable terms. The maturity pattern of recently acquired debt of developing countries simply is not adequate for developing purposes.

It is also likely that some difficult problems will emerge for developing and semi-developed countries in connection with the emigration (temporary as well as permanent) of unskilled labour to developed countries. Not only may the prolonged unemployment problems in the OECD countries, as predicted above, perpetuate the existing resistance to immigration of unskilled workers to these countries. The earlier mentioned increased willingness of young people in developed countries to take "low-prestige jobs" will reduce the need for immigration of unskilled labour from developing and semi-developed countries, with obvious consequences for the labour market situation in several of these countries.

B. Impulses from developing countries to developed market economies

That the economic performance of the OECD countries is important for the economies of the developing countries is well understood today. Indeed, this understanding is the foundation for the perennial suggestions of fundamental reforms of the economic relations between North and South. However, it is important to realize that the economic trends of developing countries today have a profound influence on the OECD economies as well - as markets for exports, as sources of imports of important products, as outlets for real and financial investment, and often also as sources of manpower and human capital. Thus, the self-interest of the OECD countries to contribute to a successful economic performance of the developing countries has increased dramatically. The "mutual interest" has strengthened by highly increased economic interdependence between North and South.

For instance, the fraction of the combined exports of manufactured goods of the United States, Japan and the EEC (excluding the Communities' intra-trade) that goes to developing countries has increased from about 31 per cent in 1970 to about 40 per cent in 1980. By way of comparison, the combined share of imports by the same group of countries from the developing countries rose from 10 to 19 per cent of the total imports of manufactured goods of the former. Indeed, the OECD area as a whole has a considerable trade surplus on the developing countries (though the US has a deficit) - a fact that has not been appreciated enough in the general discussion in OECD

countries when complaints are expressed that trade with developing countries "destroys jobs" in the developed countries. In fact, for the same group of developed countries, manufactured exports to developing countries were in 1980 four times higher than the manufactured imports from the developing countries.^{5/}

Indeed, available studies indicate that more jobs have been created by the export growth to developing countries than the jobs that have been lost by import growth from these countries. Of course, these are often different types of jobs. While those that are lost are often jobs in labour-intensive, low technology activities and jobs in "smoke stack" industries, those that are gained are often in sectors that are using human capital skill intensively. Thus this shift in the composition of the demand for labour is exactly what is needed to improve living standards and to bring about better working conditions in developed countries in a long-run perspective, though the short-term income losses and social tensions that often accompany these developments tend to create strong political pressures to slow down, or even to stop or reverse, the reallocative process.

It is also worth noticing that developing countries account for sizeable shares of OECD imports of many specific products of crucial importance for the production process in developed countries - imports that could not easily, or without heavy costs, be replaced by domestic production. In addition to oil, obvious examples are natural gas, coal, iron ore, bauxite, copper, rubber and a number of minor metals^{6/}.

^{5/} More specifically, no less than 39 per cent of exports of manufactures from the US (36 per cent in the case of total exports) goes to developing countries today. The corresponding figure for Japan is 45 per cent (45 per cent also in the case of total exports) and for EEC (the latter area being regarded as a consolidated unit) the figure is 38 per cent (37 per cent in the case of total exports). This should be compared with the imports of manufactures to these various areas from the developing countries, amounting to 21 per cent, 27 per cent and 15 per cent, respectively.

^{6/} Quantitative information from World Bank Commodity Trade and Price Trends; and World Trade by Commodity Classes and Regions, in Monthly Bulletin of Statistics, May 1983.

Though direct foreign investment in manufacturing in developing countries by firms that are based in developed countries is a rather small share of total investment in manufacturing in the OECD countries, such investments are of considerable importance for specific firms in the OECD countries. While such investment increased in real terms from 1960 up to 1970, it has fallen thereafter^{7/}.

As we know, the trends of financial investment has until recently been the opposite. For instance, according to available figures (which most likely are quite incomplete) the total gross financial claims of the OECD countries on developing countries have increased from USD 220 billion in 1976 to USD 625 billion in 1982. As a consequence, by the end of 1981 the share of developing countries in the liabilities of banks in the BIS reporting area was no less than 31 per cent, and the corresponding figure for claims was 35 per cent (BIS Reports). For several individual banks, the claim on developing countries are often several times their equity capital. All this vividly illustrates the importance for the Western financial system of a sound economic and financial performance of the developing countries--an issue that has become increasingly understood recently.

These various developments, resulting in strong interdependence between developed and developing countries, have turned the two groups of countries into each other's "chain prisoners", with stronger international transmission both of changes in long-term economic growth trends and of macroeconomic fluctuations.

What would then the main consequences be for the OECD countries of a weak economic performance of developing countries? Some of the most important consequences would be expected to be the following.

First of all, if the developing countries stagnate, or if they would be forced to cut back their imports drastically, the export industries in

^{7/} OECD Development Cooperation Review.

developed countries would be severely hurt. For instance, a drop in imports of manufactures by 10 per cent of developing countries, uniformly distributed on countries, would reduce total manufactured exports by 3.9 per cent for the United States, by 4.5 per cent for Japan, and by 3.8 per cent for EEC (the latter being regarded, again, as a consolidated area).

A setback of the economic performance of the developing countries would also reduce the opportunities for real investments by western corporations in these countries, which would hurt both groups of countries as such investments often increase the overall efficiency in the allocation of economic resources in the world economy. This would further reduce the ability of developing countries to supply important products to developed countries, with risks for disturbances of the production process in developed countries as well.

A more imminent risk is that a number of developing countries would be unable to service their debt, with obvious possibilities of bankruptcy of financial institutions in western countries and ensuing financial crises, with risks of serious world-wide macroeconomic repercussions. Moreover, if the debt problem cannot be handled in a satisfactory way, developing countries would be forced to take actions to restrict their import from the developed countries drastically. This is another example how the two recent world-wide recessions, and the policies then pursued, have left an important legacy that will impinge strongly on the growth prospects of the world economy in a medium and long term perspective.

IV. INTERRELATIONS BETWEEN DEVELOPING COUNTRIES AND DEVELOPED SOCIALIST COUNTRIES

Up to the present time, the interdependence between the centrally planned economies and the developing countries have been quite modest - except in the case of a few specific developing countries. This holds for trade, investment, finance, as well as technology.

It is also of interest to notice that manufactures play a very small role in the exports of developing countries to centrally planned economies, while such goods play a relatively more important role for the trade flows in the opposite direction (as is also the case for trade between developing countries and developed market economies). Indeed, manufacturing exports to centrally planned economies from the developing countries, as a share of total exports of manufactures from these countries, has declined from about 10 per cent in 1970 to about 5 per cent in 1980. On the other hand, the developing countries have accounted for roughly 19 per cent of the total exports of manufactures by the centrally planned economies throughout the period 1970-1980. Another way to highlight the same issue is to note that while about 61 per cent of total CMEA imports (in 1979) were manufactures, only about 8 per cent of the imports from developing countries were manufactures. While the exports of developing countries to the centrally planned economies is dominated by agriculture products, fuel and crude materials, the trade flows in the opposite direction is dominated by producers' capital goods.

There are several reasons to expect increased trade between developing and centrally planned economies in the future. One reason is that several of these countries most likely will shift to more emphasis on consumption in the future, which would be expected to result in domestic demand for a more differentiated consumption basket. That would give developing countries a chance to increase their exports to centrally planned economies not only of tropical and semi-tropical agriculture products but also of various types of agro-based manufactured goods and other manufactured consumer goods. It is more difficult to forecast what types of goods that will account for the increased exports of the centrally planned economies to developing countries.

However, likely candidates are products using moderately capital-intensive production techniques and middle-level know-how.

Alongside with the build up productive capacity in manufacture in developing countries, we would also expect these countries to get a production structure that is increasingly similar to that of some centrally planned economies. Though this will increasingly make the manufacture sector of some developing countries and some centrally planned economies competitors on various markets, the very same development would also open up the possibility of increased intrasector trade between the two groups of countries --a development that would be stimulated by higher incomes and hence a more differentiated demand structure in both groups of countries.

If there will also be increased flows of finance, direct investment and technology between centrally planned economies and developing countries is basically a question about future policies of the governments of these few countries - an issue about which it is difficult to make useful forecasts.

V. OPTIONS FOR NORTH-SOUTH RELATIONS

Against the background painted above, what are the basic options for developing countries? It is convenient to divide such a discussion into three broad issues: North-South relations; possibilities of more South-South integration and co-operation; and internal reforms within the developing countries.

The issue of North-South relations concerns the possibilities of creating and perpetuating a favourable "external" economic environment for economic growth in the developing countries. As this is a multifaceted problem, it is possible to take up only a few of the most important aspects on this large issue here.

(1) First of all, a successful long-term international reallocation of productive capacity in manufacturing, in favour of developing countries, requires that the developed market countries keep their markets open, i.e. that they avoid protectionism and also that they limit their attempt to bail out ailing firms and sectors. This is perhaps the most important contribution that the developed market economies can make to the industrialization process in the developing countries in a long-run perspective. To achieve this requires not only reasonably high levels of capacity utilization and a reasonably rapid rate of economic growth. It also presupposes considerable allocative flexibility, which may be facilitated by positive adjustment policies by the governments in developed countries.

One reason why protectionist actions in the developed market economies tend to discriminate against developing countries is that trade between these groups of countries often imply trade between industries, so called "interindustry trade", and not just trade within industries, i.e. "intraindustry trade". Trade expansion of the former type usually requires much more troublesome reallocation of resources than the latter type. For while an expansion of interindustry trade means that labour and capital have to leave their plant, and often also the geographical regions where the factors are engaged, reallocation of resources in connection to increased intrasector trade can often be accomplished by way of reallocations within

firms. Moreover, the production sectors in developed countries that feel the pinch of competition from developing countries are often sectors with large and old firms, where strong interest groups have had time to emerge, both among the firms and among the employees. This fact boosts the protectionist pressures.

In their requests to developed countries to remove the protectionism against developing countries, the latter have a very strong case, as open markets in the developed countries in a long-run perspective are favorable not only for the developing countries but for the world as a whole, by way of a . reallocation of resources in the world economy in conformity with comparative advantages. Few observers would deny that such a reallocation must include a fast build-up of industrial capacity in the developing countries and that the developed market economies, for such a process to take place, have to shift resources away from several traditional manufacturing sectors to sectors of production that fit the developed countries better in a long-run perspective--both in manufacturing and services. Often this will be production that requires highly specialist skills and proximity to research and development facilities. In many cases, this will imply the production of new types of goods and services. A pronounced protectionist policy stance of the developed countries would then not only be a severe blockage of the industrialization process of the developing countries but also an obstacle to improved living standards in the developed countries themselves.

Thus, it is of utmost importance that the developing countries continue to put forward concrete proposals and demands for the purpose of increasing the access to markets in the developed countries. These demands have to include progressive removals, according to a fixed time-table, of protectionist measures facing the exports of the developing countries, not least in manufacturing--including the quotas and the so-called "voluntary" restraints, covering also those that have accompanied the General System of Preferences. Increased active participation of the developing countries in GATT may also be a useful method to push this point among representatives of developed countries.

However, suppose that some developed countries would nevertheless engage in protectionist actions, temporarily or permanently, in certain sectors. It is then extremely important that this should be announced in advance, so that developing countries can avoid severe misallocation of their scarce resources for investment. This is particularly important for "newcomers" among the exporters from developing countries, as such newcomers are often especially hard hit by protectionist actions.

(2) Secondly, the discussion above illustrates how important it is that (a) capacity utilization, (b) capacity growth and (c) macroeconomic policies in the developed countries are conducive to the economic performance of the developing countries. Without a reasonably high and stable level of capacity utilization, and a reasonably rapid growth rate, it is impossible to achieve favourable market conditions for the exports of the developing countries, including reasonable stability in the prices of primary commodities. To achieve this, an active stabilization policy in the developed countries is certainly necessary. A complication with an active stabilization policy, however, is that this often creates violent swings in interest rates and exchange rates, and these fluctuations too can have a disruptive influence on developing countries. A delicate trade-off between stability of the target variables of economic policy, such as the unemployment rate and inflation, on one hand, and stability of the instruments of stabilization policy is therefore necessary. The conditions for this trade off can be improved by choosing adequate policy tools. Though this issue is mainly a domestic problem of the developed countries, recent experience show than it is important that the repercussions on other countries are taken into account when policy strategies are chosen in individual countries, in particular in the major developed countries.

(3) It is also well understood today that drastic reforms are necessary in the North-South relations in financial markets, both to reduce the acute debt problem and to guarantee sufficient future capital flows. In a short-term perspective, it is necessary to transform short-term debt into long-term debt to avoid permanent preoccupation with the rolling over of debt and the related uncertainties in financial markets. Moreover, for some countries at issue is not only a "liquidity problem", related to on unfavourable maturity pattern of

debt and temporarily high interest rates. Some countries may simply have borrowed too much on commercial terms considering the returns that they have been able to obtain on the borrowed funds.

This is not the place for a detailed discussion of how to achieve a consolidation of the debt situation and to guarantee a satisfactory flow of financial resources in the future. However, it is important to point out that there are many practically useful reforms that are possible in this field. For instance, the banks in the OECD countries may themselves transform part of the short-term debt into long-term debt instruments, in co-operation with other types of credit institutes, which in some cases will require government approvals and support. It may also be necessary to make some institutional reforms to prevent losses for the depositors in western banks - without necessarily bailing out the shareholders who should have watched after the lending policies more carefully.

Governments may also help to create new "intermediation institutes" between the banks and the debtors in developing countries. These intermediation institutes may then take over part of the claims on the debtor countries and instead offer the banks claims on themselves. To clarify to banks that they, as well as the debtor countries, have to be more careful in supplying credit that is used for consumption or bad investment, rather than for an efficient capacity build-up, it is probably reasonable that some banks will have to make losses in the process. Under present conditions, postponements for a number of years of debt service payments may also be necessary in some cases.

Moreover, considering the magnitude and the international character of the problem, participation of intergovernment institutions like the IMF and the World Bank has to be an important part both of the consolidation of the debt situation and of the provision of future capital flows at realistic conditions. A main reason is that private banks have become more careful, and hence more restrictive, after the experiences of severe debt problems in connection with lending to both developing countries and some centrally planned economies. Thus, the international banking community cannot be expected by itself to play the same important part in financing

balance-of-payments deficits of the developing countries as during the seventies. This would to some extent force the IMF and the World Bank to play new roles and to modify their criteria for financial engagements.

By contrast, unilaterally declared "moratory" of debt payments by a number of developing countries would certainly not be in the long-term interest of the world economy, as such actions would threaten to destroy the international financial markets for a long time to come.

Obviously, both a solution of the acute debt problem and a continuation of a steady capital flow to developing countries require that developing countries have a good access not only to international financial markets but also to export markets in developed countries. Thus, to avoid severe financial problems and severe setbacks of the entire national economies of both developed and developing countries, there has to be a certain minimum of consistency between debt service, capital movements and trade flows. This simple point cannot be stressed too much.

(4) Another important issue in North-South relations concerns the mechanism of international technological flows. It is quite clear that such flows are potentially crucial for a successful industrialization of the developing countries. In the case of "conventional technologies", there are several alternative and complementary mechanisms of such technology flows that have proved to be useful--purchase of machines and intermediary inputs, patents, production on the basis of licences, subsidiaries of transnational firms, joint ventures, studies abroad, etc. For most of the industries with "conventional techniques" the prospects for the future technological flows are probably quite as good as ever. This is important for developing countries, as most of their investment probably have to build on such conventional techniques, in industries characterized of "technological maturity". However, in new technological fields, there is an obvious possibility that the "technological protectionism" of developed countries may be accentuated, and that many new technologies of potential importance for developing countries therefore cannot be easily acquired. Developing countries have good reasons to insist that technological protectionism of that type is minimized.

(5) It may also be a good idea for the developing countries to join the consumers' interest in the developed countries, as a way of reducing the strong influence on the policies in the developed countries of special producers' interest - firms as well as labour organizations. It is an important future task of developing countries to consider how such a co-operation, or "union", with the consumers' interest in the developed countries could possibly be brought about.^{8/} For instance, associations of the manufacture firms in the consumer goods sector in developing countries may take contact with the consumers co-operative movements in OECD countries, as these movements to some extent operate as a pressure group for the consumers in these countries. Organized co-operations with associations of private retailers in the OECD countries may also be a useful way of joining pressure groups with similar interests as the manufacturing firms in developing countries. Moreover, information and advertising campaigns in the developed countries, for the purpose of convincing the consumers in these countries how much they can gain by buying from developing countries are also worth considering.

In all these cases, conflicts easily arise with specific producers' and labour union interests in developed countries. However, this is occasionally a price that has to be paid by developing countries when joining the consumers' interests in developed countries.

(6) The centrally planned economies, too, should of course be urged to open their markets to products from the developing countries. Indeed, it is hard to see why the socialist countries should have a smaller responsibility than the OECD countries to do so, in particular as the centrally planned economies, as earlier pointed out, often and increasingly compete with developing countries in "third markets", i.e. in the developed market economies, with rather similar products. Strategic arguments concerning self-reliance and national defense can hardly be an argument for not opening their markets for the products from developing countries--considering how small parts that trade

^{8/} A modest start has been made in the agreed Terms of Reference for UNIDO's consultations, where it is said that consumers' groups should be represented to meetings.

with developing countries constitute today. And "embargoes" by the developing countries cannot possibly be expected, in particular not in a co-ordinated fashion.

Moreover, recent experience of unstable markets and the proliferation of protectionism in the developed market economies imply that diversification of the exports of the developing countries looks more attractive than earlier. One important element of such a diversification could be increased exports to the centrally planned economies, whereby the total market risks of the exports of each developing country could be reduced.

Most likely, much of the future trade expansion between centrally planned economies and developing countries will be based on long-term agreements. We may also expect more flexible, and perhaps also rather "unconventional" trade arrangements in the future. Some of these may also include firms in the developed market economies. In fact, there are already some experiences of that type. One example in the tripartite agreements that have been concluded between enterprises in a socialist country, a developing country and a developed market economy. The Western firm then often has the role of subcontractor and may be paid in the currency of the developing country, earned by the socialist country as part of its trade surplus with the developing country. We may also expect a further extension of the relations between developing countries and socialist countries beyond trade in goods, for instance by the latter countries not only supply equipment but also train personnel.

Thus, the case for stronger economic relations between developing countries and centrally planned economies is in principle a strong one. However, for such relations to be of considerable importance for the developing countries, the socialist countries have to allow a drastic increase in the access to their markets for the exports of the developing countries, in particular for manufacturing products.

(7) In addition to the policy changes in developed countries discussed above, it has become increasingly clear in recent years that the basic rules that regulate the international trading and payments system need to be looked over in a systematic way.

The Bretton Woods and GATT systems have in many respects served the world economy well, as reflected in the enormous expansion of world trade and capital movements during the post World War II period. However, the world economic situation is certainly quite different now as compared to the time when the systems were created in the late forties. An obvious illustration is the increasing tensions between a highly, and increasingly, internationalized economic system and nationally-based political systems. Another illustration is the drastic changes in the relative economic importance in the world economy of different nations and groups of nations.

So far, the adjustments of the Bretton Woods and GATT systems over time have taken place on an ad hoc nature, rather than by "grand design" as when the systems were created originally. Obvious examples are the exchange rate rules (or absence of them), the principles of balance of payments adjustments, the conditionality rules of IMF and World Bank lending, the supply of international reserves, the regulation of international credit and capital flows, the co-ordination (or rather the lack of it) of macroeconomic policies of individual nations and the roles of protectionist devices and selective subsidies. In all these fields, the need to take a comprehensive look at the international trading and payments rules is overwhelming.

To summarize, improved North-South relations in the economic field presupposes both changes within individual developed countries and revisions of international rules in trade and finance. Among changes within individual developed countries, the most important ones are probably (1) a removal of protectionism, (2) a more successful macro-economic policy, so that the level of capacity utilization and the growth rate can be kept at reasonably high levels, and finally (3) increased stability of financial markets. However, all this also requires, in many cases, improvements in the functioning of some basic economic mechanisms in developed countries, including higher allocative flexibility, by way of better functioning domestic markets, for labor and capital, a redirection of economic incentives in favor of productive effort, reforms of the system of wage formation to reduce the inflationary bias in these economies, etc. Indeed, in addition to the demands for reforms of the international rules of trade and finance, the quest for an improvement of the external economic environment of developing countries turns out to be mainly a list of desirable changes in mechanisms and policies within developed countries.

VI. OPTIONS FOR SOUTH-SOUTH RELATIONS

During the first phase of modernization during the fifties, sixties and seventies, it was natural that developing countries were highly dependent on the developed countries in the fields of trade, finance, direct investment and technology. As time passes, however, not only will the relations between developed and developing countries change character - by increasingly being characterized by mutual interdependence rather than one-sided dependence. The possibilities of mutually beneficial interaction between different developing countries would be expected to increase, as these countries gradually build up both their productive capacity and their ability to participate as active partners in international exchange. By way of comparison, when the presently developed market economies were developing nations about a century ago, they were engaged in strong mutual economic exchange with one another in trade, finance and technology. They did not need, for their development, large and rich markets "outside" the group of what was then "developing countries". Thus, even if future international economic transactions between developed and developing countries are potentially highly beneficial for both parties, it is clear that a strong case can be made for strongly increased economic transactions among developing countries as well.

There are many reasons for this. In particular, unexploited possibilities for trade among these countries, based on comparative advantage and scale economies, certainly exist and would be expected to increase over time as productive capacity is built up. Indeed, in the seventies, before the deep international recession of the early eighties, trade among developing countries grew faster than their trade with the rest of the world. By way of comparison, when looking at economic relations between developed countries, we note that both similarity of income levels and geographic proximity seem to have strongly enhanced international economic transactions, in particular trade in manufacturing. This seems to be the case in particular for trade within various production sectors, i. e. "intraindustry trade". This type of trade also tends to increase rapidly as income rises, making it possible for individual countries to bring about a more differentiated basket of domestic use of consumer and producer goods, without having to abstain from division of labour and the exploitation of returns to scale in production. In other

words, intrasector trade tend to expand by higher per capita income, in order to satisfy greater demand for product variety without losses in efficiency of production. This type of trade would therefore be expected to increase rapidly between developing countries as their per capita income advances. By increased sophistication of the labour force, trade in services, such as finance, insurance and various types of information, may also expand rapidly among developing countries. We would also expect that world trade in raw materials will increasingly be concentrated among developing countries, as many developing countries would be expected to "take over" industries that process raw materials--so called "smoke stack industries".

Experience shows, however, that the development of successful international exchange depends highly on sophisticated and properly designed rules, institutions and incentives. Thus, for the potentialities of international economic transactions among developing countries to be exploited to the widest extent, it is important to facilitate the emergence of rules and institutions that are conducive to these developments. Indeed, there is a strong case for organized attempts of developing countries to co-operate with each other in the build-up of such rules and institutions, in particular internationally oriented institutions. UNIDO should have an important role to play in this context. In this report it is possible only to suggest, in a rather general way, some useful avenues for such a co-operation.

(1) The most obvious example is perhaps the formation of free trade arrangements, and perhaps also common markets, between developing countries. There exist, of course, already various arrangements of that type, such as the Andean Pact, ASEAN, the Caribbean Common Market, etc., though these have certainly not yet developed to their full potential. Thus, there are good reasons to look very carefully into how the obstacles to arrangements like these could possibly be removed, or if a system of freer trade among developing countries should rather avoid regionalization.

A particularly important benefit of trade liberalization among developing countries is that such liberalization may make domestic markets more flexible. It is interesting to notice that the trade liberalization of the OECD countries in the fifties had the side effect of breaking down much of domestic rigidities and regulations. It is important to realize, however,

that there is always a risk that new types of protectionist devices are built up after a while when the effects of freer trade on domestic allocation of resources are felt. An obvious example is the "neo-mercantilist" policies in the seventies in the developed countries, in the form of selective subsidies, including specific trade discrimination against the developing countries,

(2) Expanded South-South trade requires the development of marketing institutions that specialize in such activities, by contrast to North-South trade, for which specific marketing institutions already exist. Indeed, governments in developing countries are well advised to remove existing obstacles for the development of such institutions. In some cases it may even be necessary for the government to take initiatives to the creation of firms that specialize in South-South trade, though there is no necessity for firms like this to be owned or operated by the state.

The possibilities of common infrastructure investment of two or more developing countries is another example of the potentiality of important future cooperation. The issue is not only joint ventures of physical infrastructures for countries with strong geographical proximity. Of great importance could also be joint ventures in the field of non-material infrastructures, in particular in technical research, education, training and R and D activities. Common institutions of that type for many developing countries--occasionally perhaps all of them--is clearly an important future challenge. In many cases, it would also be extremely important to involve some developed countries with high competence, in the fields under consideration, in the build-up of such institutions.

(3) South-South economic interaction would also be stimulated by the establishment of more transnational firms that are owned by interests in the developing countries. Indeed, developments along these lines have already started, for instance in the case of India and Hong Kong. New legislation and bilateral or multilateral agreements between governments of developed countries are clearly need to exploit the potentialities fully in this field. Reforms of rules and regulations in credit markets and foreign exchange markets would also be required.

(4) Legislative action and international negotiations are necessary also to make it possible to integrate various markets for services between developing countries, for instance in the fields of finance and insurance. It should then be possible to draw on the experience of the integration of service markets among developed countries--both to exploit the possibilities fully, for instance to deal with protectionism in these markets, and to avoid the negative side effects as much as possible. However, an integration of financial markets would, to be efficient, require a greater degree of convertibility than at present of the currencies of the developing countries, which in many countries require both more realistic exchange rates, which is important for other reasons as well, and more "market-conform" regulations of financial markets.

(5) It is also important to realize that strong international integration between various developing countries presupposes that individual countries abstain from far reaching import-substitution policies. Increased economic integration between the countries of the South is contradictory to far-reaching forms of import substitution policy by individual developing countries. However, to resist temptations to further import-substitution policies should not be regarded as a "sacrifice". Economic research has convincingly shown the disadvantages of pronounced import substitution policies (Little-Scott-Scitovsky; Krueger; Bhagwati; Balassa; Keesing). This is not surprising as most developing countries are hardly larger than major western cities as economic units. Even though a comparison of developing countries with western cities is rather brave, it is nevertheless interesting to notice that no respectable person seem to have suggested import substitution policies for these cities.

It is finally important to emphasize that stronger South-South cooperation and interaction is not mainly a substitute but above all a complement to North-South relations.

VII. DOMESTIC OPTIONS FOR DEVELOPING COUNTRIES

The discussion so far about policy strategies has emphasized the international economic environment of the developing countries. However, it is equally important to consider the internal conditions within various developing countries. The importance of the latter issue is illustrated by the quite different success, or failures, of various developing countries in "utilizing" the existing international economic environment for domestic economic development. These variations in economic performance is found also among groups of countries that have experienced rather similar changes in their "external environment", such as the groups of oil-exporting and oil-importing countries, respectively.

Many developing countries have been quite successful in achieving a high level of savings and investment. In fact, both gross capital formation and gross saving in developing countries seem to be about 25 per cent of GNP (figures from 1976-1979). Moreover, industrial production has during the seventies grown at a rather impressive rate. However, it is now time to bring about a more efficient allocation and management of investment and production and to speed up the rate of technological development for the purpose of increasing productivity at a faster rate. For instance, while output in manufacturing increased by 5 per cent in 1973-80, the accompanying increase in labour input was as high as 4.2 per cent, which implies that the increase in labor productivity was only 0.8 per cent. This is a very poor performance for labor productivity growth, as compared with the average of developed countries during the post-world war period. For instance, in the period 1960-73 when output growth in manufacturing was rapid in the OECD countries, labor productivity increased by about 5.8 per cent per year, and in the period of slower output growth in 1973-78, labor productivity increased by 3.4 per cent per year.^{9/} Many developing countries are simply getting too small increases in output and labor productivity from their investment. (The marginal capital-output ratios are unnecessarily high.)

^{9/} A. Lindbeck, "The Recent Slowdown of Productivity Growth", Economic Journal, March, 1983.

It is not possible, and hardly appropriate, to prescribe recommendations for individual countries in this report. All have their own historical background, their unique natural and human resources, as well as their own principles, ideologies and political limitations. It is also difficult to prescribe general principles that are equally appropriate for all developing countries. Indeed, one of the most striking tendencies during the last decades is the increased heterogeneity of the group of developing countries. However, there is enough experience to conclude that certain types of reforms of policies and institutional would be helpful for a great number of developing countries. It is with this limited ambition, and with great humility, that we may dare put forward some thoughts about conceivable future domestic reforms.

The relative importance of the various points to be mentioned below differs considerably between for instance the small and rapidly growing NICs (where the upgrading of product quality has become a crucial factor); the large developing countries (where production for the domestic market is more important); the oil-exporting developing countries (where investment "rushes" of poorly allocated and implemented investment have to be avoided); and, finally the least developed countries (where the highest priorities have to be given to basic education, sanitation and agricultural development, as well as the mobilization of domestic and foreign saving for a "take-off" process of economic modernization). It is also obvious that recommendations for domestic policies have to differ substantially for market-oriented "mixed economies" and developing countries that rely mainly on state ownership and central planning. The discussion below about internal reforms refers mainly to the former types of economies, though several of the points certainly are important for economies characterized by the domination of state ownership and central planning as well.

When considering reforms of domestic policies and institutions it is important to be clear about the specific purpose of the reforms: to promote industrialization and productivity growth in manufacturing in ways that are conducive to the development of the entire national economy. The reason for emphasizing industrialization is not only that UNIDO is designed to do just

that, but also that industrialization sooner or later is a key to economic development, as illustrated by several hundred of years of experience of various countries in the world.

This should of course not make us forget other sectors, such as services and agriculture. For instance, an industrialization process is easily hurt, or may even fail, if agriculture is neglected. The reason is not only that higher incomes in non-agricultural sectors require increased supply of food for consumption among the income earners in those sectors. Agriculture is important also as a supplier of intermediate products for industry. Practically all outputs of agriculture serve, except in some of the least developed countries, as inputs in industry, in particular of course in the food processing industries. Experiences of economic development has also shown the great importance of the agricultural sector as a market for the products of manufacturing - both goods for final consumption by the farm population and intermediary products of various types in agriculture, with machines, building materials and fertilizers being the most obvious examples. Indeed, as the bulk of the population for a long time to come will work in agriculture, a successful development of agriculture is crucial for a successful national economic development. A modernization of agriculture will be important also for achieving a geographically dispersed income growth in society - both among regions and population groups. The purpose is not only to give all populations groups a chance to participate in the developing process, but also to prevent congestion, or even chaos in some of the large urban agglomerations. Obvious policy tools for this purpose are, besides a dynamic development of agriculture, public services and tax and transfer systems that redistribute income among regions and population groups.

It is also well known that long periods of productivity improvements in agriculture preceded the industrial revolution in the presently developed countries in the 18th and 19th century. Moreover, some of the presently developed countries have for long time been successful exporters of agriculture products -Denmark, New Zealand, Canada, Australia and USA being obvious examples. But sooner or later, a pronounced industrialization process is necessary for generating considerably improved incomes and living conditions.

The main question to be asked is then what internal conditions within the presently developing countries that in particular have restricted a successful industrialization process, and what can be done to remove these obstacles, and indeed replace them with conditions that are as favourable as possible to a successful industrialization process. However, it is then important to emphasize that the purpose of those proposals is not to favor manufacturing at the expense of other sectors. Basically, all types of productive efforts depend to a considerable extent on some basic features of the social, political and economic environment that confronts firms and individuals. Thus, to a considerable extent, policy prescriptions to stimulate economic development in general are usually highly favorable also for the manufacturing sector, and vice versa. However, it is also possible to consider some specific features of society that are particularly important for just the manufacturing sector. If these specific features are made more favorable for manufacture production, several other sectors would often also gain, due to the linkages between various sectors, as illustrated above by the relations between agriculture and manufacturing. Moreover, if the rate of increase of (total) productivity can be increased in manufacturing, so that larger output increases can be achieved with given investment outlays, larger resources would be available for investment in other sector. For these various reasons, a more rapid rate of productivity increase in manufacturing should be welcomed by other sectors as well. Similarly, a rapid increase in labor productivity of agriculture will not only widen the markets for manufactured output, but also help create expectations among managers of manufacture firms that real wage rates will go up gradually in the future, and that therefore rationalization of production, i.e. productivity increases, are necessary.

For these general reasons, one-sided critique of the outside world, without consideration also of the need for some reforms of domestic mechanisms and institutions and policies, should if possible be avoided. Indeed, economic modernization implies not just increased output and higher productivity but also, and largely as a prerequisite for this, reforms and modifications of economic and social mechanisms and institutions. In a short report like this it is possible to give only a few examples.

For instance, it hardly has to be mentioned that that economic development has to be accompanied by the development laws, rules and public institutions of a different nature than those that exist in "traditional" or colonial-type societies. Obvious examples are laws that regulate and enforce contracts in all fields of economic activity and that protect property rights; labour-management relations that allow an efficient and socially responsible use of the labour force; an efficient functioning public infrastructure in fields like transportation, energy, education, research, technical standardization and information; tax systems that make it possible to finance an expanding public sector, to disperse the benefits of growth and to make the government less dependent on tariffs as a source of income, etc.

Moreover, it is extremely important that the rules of the economic "games" are reasonably stable, so that it is possible for the various agents of the economic system to predict the relation between productive performance and rewards. Increased "game stability" would also increase the respect for the rules and may hence reduce the risks of various types of cheating and corruption.

However, what will in particular be emphasized in this report is the importance of releasing decentralized initiatives and to build up "human resources".

Initiatives, incentives and the functioning of markets

To bring about domestic reforms that release initiatives requires a strengthening of productivity-enhancing economic incentives and improvements in the functioning of markets - for labour, capital, goods and services. Some developing countries (as some developed today) have made it very difficult for people with ideas and a ambitious to take productive initiatives on their own. Government regulation of production, investment, trade, prices and wages often prevent productive initiative among energetic and creative people and organizations. It is not always understood that reforms which released individual initiatives preceded and paralleled the industrialization and modernization process in the presently developed countries during the last two hundred years.

To release vigorous initiatives in the production system also requires that the incentive system is appropriate. Policy makers and public administrators in many countries do not seem to be fully aware of the fact that the incentive systems in their countries often are highly unfavourable for economic modernization, capital accumulation and productivity growth. (Though this point is often regarded as particularly important for "mixed economies", it is highly relevant for centrally planned economies as well). Existing incentives and regulations often direct resources away from high to low productivity activities, as well as to rent-seeking activities for the purpose of exploiting the returns to bargaining with government authorities. Different forms of corruption breed in such an environment. It is mainly when public authorities have something to sell - such as licenses for production, investment, imports, exports, credit, etc. - that corruption becomes a serious problem. It is therefore important to replace "negative" productivity-restraining regulations and incentive systems with policies that allow, and indeed stimulate, high-productivity initiatives, flexibility and a more efficient allocation of resources - and that reduce the scope for corruption.

Obvious examples of inappropriate incentive system are highly overvalued exchange rates, which keep the profitability level of large parts of the manufacturing sector on too low levels for successful expansions of production, investment and employment. It is also well known that the tariff structure often distort the comparative advantages, and hence direct the allocation of resources in ways that are not in the best long-run interest of the country. Moreover, low profitability, often in combination with "aggressive" (politically directed) investment by state enterprises, have often squeezed out private economic activities in some parts of manufacturing. Thereby the mix between private and state activity have often shifted over in favor of the latter without apparent economic rational.

Indeed, the efficiency of investment is in many countries a particularly severe problem for state enterprises, which have often invested without much concern for the profitability, often simply because decision-makers in the public sector have not looked after the rate of return on capital investment very well. Indeed many examples of irresponsible borrowing and investment

during the last decade are found just among state enterprises. To force the managers of firms to look at rates of return on capital, rather than on some arbitrarily chosen output targets, is crucial for future success in many developing countries.

If politicians and public administrators concentrated more on the general rules, the economic incentives and the public infrastructure (physical as well as intangible) and, if they intervene less in individual firms, a more efficient allocation of investment can often be brought about. However, that presupposes that managers of individual firms, also publicly owned firms, have strong incentives to look after the rate of return of the capital stock that they administer.

Human resources

It is by now also well understood that an important task for the development process is to develop human resources, in a wide sense of the term--from elementary training to advanced specialists in engineering, management and research. What has perhaps not always been enough appreciated is the importance of middle-level management, including engineers, technical personnel, as well as market oriented consulting firms. In all developing countries there is also an enormous need to improve upon the system of vocational training.

This report is not the right place to develop exactly how the accumulation of human resources can best be achieved. The topic is simply too large and complex, which is illustrated already by the fact that while the bulk of the population of the Third World countries lives in the rural areas, where they are not reached very effectively by formal education, it may at the same time, in some cases, be important that developing countries catch up with major developments in newly emerging technology areas, such as biotechnology, genetic engineering and data and micro processors. Moreover, it is useful if various countries experiment with different strategies so that a rich menu of possibil-

ities is tried, which will increase the pool of international knowledge that is available for developing countries in the future.

To keep the efforts to develop human skills within the resources of developing countries, each country has of course to be quite selective. Without generalizing too broadly, it may be argued that a dramatic shift of the proportions of the resources that are devoted to various subjects--at primary, secondary as well as advanced levels--are strongly needed in most developing countries. For instance, from the point of view of enhancing economic development, technical and managerial training is often under-emphasized relative to training in the humanitarian and social sciences. It also seems that the physical infrastructure, i.e. buildings for various institutions, are often favoured relative to "intangibles" like training programmes, training of instructors, fellowships, laboratory equipment, instruments, literature and new learning aids.

It is also important that public efforts in the field of education and training recognize the need to build up competence that is relevant at the microeconomic levels in society, i.e. in particular within individual firms. For that reason, it is important that production firms are used as much as possible for education, training and research and development. Tax concessions to firms that contribute in that process, and increased public support for R and D are conceivable methods.

Needless to say, it is important that developing countries not only imitate the technical and managerial training and research that is pursued in developed market economies. Many branches of technology and management have to be developed by the countries of the Third World themselves--though in many cases in co-operation with institutions in developed countries. Obvious examples are tropical agriculture, soil analysis and management for developing countries, integrated development in arid areas, aquaculture, tropical medicine, etc. However, also in manufacturing it is important that indigenous technological development, directed to the specific needs of developing countries is stimulated. To develop labor-intensive technologies is perhaps the most obvious example. Research and training to promote local entrepreneurship in small and medium-sized industrial enterprises, with special concern for specific conditions in the various developing countries, is another obvious example.

Though technical assistance from developed countries is an important input in the build-up of domestic competence in the technical and managerial fields, the bulk of work has of course to be done in and by the developing countries themselves. By way of comparison, some of the presently developed market economies that started their industrialization quite late, but proved to be exceptionally successful--Germany, Japan and Sweden--emphasized domestic technical schools on all levels quite early in their modernization process. The same holds for some of the most successful NIC's during recent decades.

Training of students abroad is important but this method has narrow limits, considering the enormous scale of the necessary build-up of competence in the field of technology and human resources in general. Moreover, vast reliance on the training of students abroad accentuates the "brain-drain" problem. In the case of training via practical work in Western firms, we also notice increasing reluctance by industry in developed countries to take trainees at high levels due to the need to protect confidential information.

For these various reasons, it may be a good idea that developing countries in their negotiations for foreign aid and technical assistance, related to the financing of human resources development for industrialization, give priority to the training of trainees.

A few developing countries have already now rather ample supply of highly competent scientists, engineers and technicians. With proper institutional conditions in such developing countries it should be possible to allocate a much larger fraction of world R and D spending to these countries in the future - by firms owned by developing countries as well as by transnationals from developed countries. Such a development is facilitated by the fact that the salaries of the technicians and scientists in those countries are only a small fraction of the salaries of people with similar competence in developed countries. A development of that type may also contribute to reduce the "brain drain" to developed countries--an issue that has to be faced sooner or later. Perhaps some contribution to a solution of that problem could be made by stimulating transnational firms to put some of their R and D activities in developing countries.

Beside technological competence, the two most important bottlenecks in the area of human resources are perhaps managerial skill and entrepreneurship --in the private as well as the public sector.

The role of managerial skill is not only an issue of the competence of managers at the top of the organizations. Particular attention has to be directed to middle-level management, supervisory staff and people providing specialist services at the middle level, e.g. procurement and inventory management; production management, control research and marketing; tool room service; raw materials and product testing; machine assembly and equipment maintenance; staff recruitment; advertising; project development, etc.

At least equally important among human resources for economic modernization and industrialization is the development of entrepreneurial capabilities. The importance of this factor is well put in a special document^{10/} for the preparation of UNIDO IV:

"What needs to be firmly stated is that it is entrepreneurs in the private and public sectors (their quantity, orientation, abilities, sectoral distribution, etc.) that determines whether industrialization will at all take place and whether this can be at an accelerated or a slow pace. It is also entrepreneurs that create the demand for industrial manpower and industrial employment and help to develop the technical elements of local culture by undertaking the innovations of social and material inventions. Any effort, therefore, which is devoted to enlarging the supply of entrepreneurs, to improving the quality of their functioning, inducing their transfer from well-established or over-crowded areas of production to new ones where their presence and activities are essential for organizing the production of new product lines, etc. must be a prime consideration of policy-makers and planners."

Experience from many countries over long historical periods illustrate the enormous role of entrepreneurship for the domestic development process, not least in small and medium-sized firms, and newly started firms. Because of the difficulties of quantifying the importance of this factor, it easily "disappears" both in domestic development plans and in the political and administrative discussions, which has often concentrate the attention to existing firms and large firms. However, all developing countries that opt for industrialization and modernization are strongly urged to facilitate the

^{10/} UNIDO/ID/WG.394/3, 29 April 1983, p.5.

emergence of vital entrepreneurship by formal education and training programme, and also, and in particular, by stimulating entrepreneurial initiatives. It is only by letting many people try to become entrepreneurs that we can find out who the talented ones are. It does not make much sense to have private entrepreneurship if the entrepreneurs are drastically prevented from acting, by way of rigid and detailed government regulation, or by tax or subsidy systems that induce existing entrepreneurs to be engaged not in efficient production activities but in short-term financial speculation or "rent-seeking" activities by way of continuing bargaining for favors with government authorities. Indeed, as expressed in a preparatory document for UNIDO IV:

"When the role of indigenous entrepreneurship come to be recognized, attention tended to concentrate on their needs for financial resources (credit) rather than on ways that particular environments helped or hindered the entrepreneurial function"11/

To stimulate indigenous entrepreneurship is important also to avoid excessive dependence on foreign entrepreneurs and foreign transnational firms, even though these, when they do not dominate a country, can stimulate domestic entrepreneurs and raise their aspiration level.

Domestic aspects on the external relations

It is well known that some developing countries during the sixties and seventies made spectacular economic progress partly by the help of an export oriented development strategy. However, it is also well known that these countries face severe problems about the access to export markets, and in some cases about foreign debt, and that some of these problems may be accentuated if many more developing countries try to follow the same development strategy. However, there are certain things that could be done to facilitate export oriented development strategies - in addition to the earlier emphasized points of convincing developed countries about the importance of letting their market expand and be kept open, and of contributing to a steady flow of credit and capital.

11/ ID/WG.394/3/ 29 April 1983

First of all, the earlier discussed reforms of domestic production incentives, such as removals of productivity-reducing regulations and the stimulation of decentralized initiatives and entrepreneurships, are particularly important on export markets, as these require particularly high flexibility of the domestic production system. Indeed, when more developing countries at quite different levels of real wages enter as competitors on world markets, very high flexibility will be required of individual countries to be successful, due to continuously changing competitive situations.

However, developing countries are also well advised to try to avoid "crowding" their export goods into the same types and products and qualities as most other developing countries. Indeed when possibly, the group of developing countries are well advised to diversify both on products and on markets (countries). Thereby both the risks of protectionists policies in developed countries, and the consequences of such policies, should they arise, would be minimized. For it is quite clear that it is often not the aggregate value of imports from developing countries that trigger protectionist policies in developed countries, but rather disturbances in specific sectors in specific countries.

Of course, there are limits to such diversification, without loosing comparative advantages and returns to scale. However, it is easily forgotten that many developing countries have the possibility of pursuing successful production in many different types of industrial branches. We should not let our fantasy be restricted by the very conventional definitions of "industrial branches". Indeed, it is not really the industrial branch as such that is important when we look for comparative advantages in production, but rather the type of activity, regardless of branch.

Another important point to consider for "externally oriented" policies of developing countries is the great danger of borrowing for the purpose of expanding either consumption or poorly allocated and managed investment. Thus a future concentration of borrowing for investment, rather than consumption purposes, and improvements in the domestic mechanisms that allocate investment are particularly crucial for countries that borrow heavily abroad. Looking back at the experience during the last decade, it would seem that it has been

poorly allocated investments, rather than increased consumption by borrowed funds that have been the main "mistake" in this field among developing countries. For instance, in the case of "middle-income countries", the share of GDP that goes to consumption has fallen from about 84.5 to 77.5 per cent from 1965 to 1982, and the investment ratio risen from 21.6 to 26.5 per cent. In the case of the non-oil exporting-middle income countries the ratio of imports to GNP rose from 24.4 to 33.5 per cent of GDP (World Bank: World Development Review). Indeed, the deterioration of the current account from -2.7 to -6.8 per cent of GDP between 1965 and 1982 for the latter group of countries should really be classified as overabsorption and low allocative efficiency of investment rather than "overconsumption".

Moreover, for developing countries that are anxious to host transnational corporations, it is important to provide a reasonably favourable environment for them - in terms of rates of returns on investment, certainty about continuous operations, and reassurances about the respect for property rights, including the possibilities of distributing profits to the home country. The often rather negative attitudes in developing countries towards transnational firms during the last decades have made many of these reluctant to invest in developing countries. Many multinationals have simply lost confidence in developing countries as hospitable environments - in the same way as many developing countries earlier lost confidence in transnational firms. When now, in the eighties, the governments in several developing countries believe that multinationals could make important contribution to the industrialization process, more hospitable attitudes and policies towards transnational firms are necessary, in order to restore confidence. This holds regardless of whether a country plans to allow foreign-owned subsidiaries or wants to confine the activities of transnational firms to joint ventures. Needless to say, mutually acceptable rules of conduct in the relations between governments and transnational are necessary.

It is also important to realize that the types of foreign direct investment which is made in a developing country is highly influenced by the choice between import substitution and export oriented incentives in the domestic economy. Export oriented incentive structures tend to result in direct investment that are oriented towards world markets, rather than the

domestic markets. Often this means that technologically more dynamic types of foreign direct investment will materialize, than in the case of import substitution policies. For instance, the possibilities of being a part in the international "product-cycle", where the production of new products flow from high-wage countries to low-wage countries over time, is much greater in countries with export-oriented than with import-substitution strategies in manufacturing. There are many illustration examples of this.

VIII. CONCLUDING REMARKS

Economic development is a process that embraces all sectors of the national production system. Indeed, there is no good reason to discriminate against specific sector in favor of others. However, even without discrimination in favour of manufacturing, to facilitate industrialization is a necessity for the developing countries. Ideas, sometimes expressed, that developing countries should play down, or even avoid industrialization, is a dangerous form of "daydreaming".

It is also important to confirm previous statements by UNIDO that a successful industrialization of the developing countries presupposes a drastic increase of the share of developing countries in total world production of manufacturing goods. It was exactly to make this point, strongly and concretely, that the Lima target of 25 per cent of manufacturing output within a few decades was codified. What has to be emphasized much more than earlier, however, is the need to speed up the rate of productivity growth in developing countries as their performance in this respect has been quite poor so far, in particular in view of the high investment ratio (and the accompanying rapid increase in the capital stock).

To make such a development possible, both the international economic environment and domestic conditions have to become more conducive for a broadly based industrialization process, with a rapid build-up of industrial capacity in developing countries and related reallocations of manufacturing production in the world economy as well as a rapid rate of domestic productivity growth in developing countries. Thus, it is important that developing countries put demands not only on the international institutional arrangements and the policies of developed countries, but also on their own policies and institutional arrangements. Thus not only are in North-South and South-South economic interaction complements rather than substitutes, but so are also external and internal reforms.

It is easy to make lists of potentially favourable factors for a successful industrialization process in the developing countries. It is more difficult to set priorities. Even though this report has deliberately made a

rather narrow selection of points of relevance for the developing process, the number of issues that have been touched upon is still rather substantial. It may therefore be worthwhile in ending the report, to restate that the most urgent problems to solve today in order to facilitate the industrialization process probably are (1) that the export markets in developed countries will expand and be kept open; (2) that sufficient flows of capital and credit are provided for developing countries, (3) that South-South economic interaction is stimulated and (4) that reforms of institutions, mechanisms and policies within the developing countries themselves are implemented, so that the market opportunities, at home and abroad, can be sized. In addition to physical infrastructures, the report has, among many important domestic reforms, emphasized efficient economic incentives, and competence in technology, management and entrepreneurship--as well as institutional and political reforms that release initiatives, so that such competence can be fruitfully used.

In briefest possible form, the main thrust of this report could perhaps be described as follows:

Increased productive capacity and productivity in manufacturing in the developing countries is a precondition for improving living standards considerably in a long-run perspective. This requires continuous adjustments of the production structure, and hence requires high allocative flexibility, in both developed and developing countries. A successful reallocation of productive capacity to developing countries therefore presupposes a reasonably high level of capacity utilization, and the abstinence of protectionism, in the developed market economies, as well as a continuous flow of financial resources and technical know-how to the developing countries. These are basic demands that developing countries can, and should, put on the outside world.

However, it is equally true that the developing countries themselves have to improve their own domestic institutions and mechanisms to make markets flexible and incentives appropriate, and to build-up capacity in human resources, including technology, management and entrepreneurship. In other words, it is important that developing countries accentuate their attempts to increase domestic productivity. Not only is increased labor productivity the

only realistic foundation for a substantial long-term increase in living conditions in developing countries. It will also expand domestic markets, which is a crucial element in economic development, as foreign markets will always only be a modest fraction of the domestic markets. Moreover, if productivity increases can be brought about in all sectors of the economy--agriculture and services as well as manufacturing--this will create expectations among managers in all sectors about rising real wage rates, which will increase the interest in productivity--increasing actions by the management.

It is, by way of concluding, important also to confirm that a successful industrialization of the developing countries is not only a necessity but also a realistic possibility. Indeed, to quote one of the documents made in the preparation of UNIDO IV, "The South offers a growth frontier to the global economy just as the American West did during the 18th and 19th centuries. It offers enormous scope for absorption of technology and employment of surplus labour. It contains a wealth of natural resources and investment opportunities, extensive potential consumer markets, and an abundance of initiative, incentive, and enterprise."¹²

^{12/} UNIDO, ID/WG/391/9, 30 March 1983, p.3.

