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Is Export-led Growth Passe?
Implications for Developing Asia

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FOREWORD

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ABSTRACT

Some authors have recently begun questioning the advantages of the export-led growth (ELG) strategy that some Asian countries followed and that yielded impressive results. They argue that ELG suffers from a fallacy of composition, in that not all developing countries can pursue it simultaneously, and recommend a shift to domestic demand-led growth (DDLG). This paper argues that although the encouragement of a gradual shift to DDLG is a welcome effort, ELG and DDLG need not be presented as incompatible strategies. The countries in the region need some form of ELG to achieve economies of scale. Hence, the ELG strategy is still the best option for most developing Asian countries. ELG is not simply about exporting, but exporting in the context of a development strategy based on upgrading. In the end, it is about achieving a golden combination between ELG and DDLG. Finally, the discussion of the policies to resume growth after the financial crisis has to be framed in the more general context of what is constraining growth today. In this author's view, demand is what constrains growth.

I. INTRODUCTION

Since the East Asian financial crisis erupted, most countries in the region have been immersed in a soul-searching exercise with a view to identifying what went wrong and led to the crisis and to the slowdown in GDP growth rates, and, ultimately, with a view to getting back to higher growth rates. The issue at stake is, therefore, what sort of policies and institutional reforms should the Asian countries implement to resume high and sustained growth? Since the beginning of the crisis, the official view has been that the financial crisis was the consequence of a fundamental flaw in the Asian financial system, in the form of “crony capitalism.” During the last few years, a group of economists have been working on a different hypothesis. In a recent paper, Thomas Palley (2002) has argued that after several decades of being presented as the optimal growth strategy, the export-led growth (ELG) model that the East Asian countries followed has ultimately given in and even harmed the growth prospects of developing countries. Blecker (2002 and 2003) also contends that the adoption of a development strategy that relied on high rates of growth of manufactured exports is the root cause of the problems for it led to growing excess capacity, intensified competitive pressures, and disappointing growth performance, at least for a couple of years. Kaplinsky (2000) and Ertuk (2001/02) suggest the possibility of *immiserizing growth* as a result of the creation of excess capacity in export-oriented manufacturing industries. During the 1990s too many developing countries entered the more advanced product categories thus creating excess capacity and fostering falling prices.¹

These authors argue that the reliance on export growth suffers from a “fallacy of composition.” The reason is that if too many countries try, simultaneously, to rely on export-led growth policies to stimulate growth under a given set of global demand conditions, the market for developing countries’ exports is limited by the capacity of the industrialized nations (Blecker 2002 and 2003). If demand in the developed countries stagnates, it translates into overinvestment and excess capacity in the developing countries. As East and Southeast Asian countries got immersed into the financial crisis, the first policy option considered by all of them in order to resume growth was the ELG strategy. However, the question with this strategy is that the fallacy of composition problem has gotten compounded, since during the last decade the PRC has been added into the equation. Export-

¹ In the early 1980’s, Cline (1982) had already asked whether the East Asian growth model could be generalized, taking into account the constraints on international market demand. He concluded that the generalization of the ELG strategy across all developing countries would result in untenable market penetration into industrial countries. Balassa (1989) refuted this view by arguing that competition among the developing countries would be ameliorated by a progressive shift into more capital-intensive exports. Likewise, successful developing country exporters would tend to increase their imports of skill-intensive manufactures.

led growth operates through a hierarchical process with less developed newcomers replacing more maturing export economies as their wages grow. The PRC poses an entirely different problem for it has a fairly large supply of labor so that it can keep wages very low and, seemingly, for a long time.

The argument of these authors is that the effort is doomed to fail due to global demand constraints. In the words of Blecker: “the current emphasis on export-led growth in developing countries is not a viable basis on which all countries can grow together under present structural conditions and macroeconomic policies” (Blecker 2003).² Palley (2002) goes further and contends that the ELG model followed by many developing countries during the last few decades was part of the so-called “Washington consensus” emphasis on trade liberalization.³ As a solution, Palley proposes a new development paradigm based on domestic demand-led growth (DDLG).

It is therefore of paramount importance to discuss whether the Asian countries can still rely on the ELG strategy, or whether, as some other authors have argued, they have to start shifting from ELG to DDLG. This is the purpose of this paper. It is argued that the encouragement of a gradual shift to DDLG is a welcome effort. However, perhaps this is not the issue. Firstly, because ELG and DDLG need not be incompatible strategies. Secondly, because the countries in the region need some form of ELG to achieve economies of scale. While it is true that serious consideration must be given to the possibility of developing internal markets for growth and an expansion of their demand (which presupposes a decrease in savings and an increase in consumption), as Palley recommends, still the ELG strategy is the best option for most developing countries, including the Asian countries. The reason is that ELG is not simply about *exporting*, but exporting in the context of a development strategy based on upgrading. In the end, it is about achieving a *golden combination* between ELG and DDLG. And thirdly, because the discussion of the policies to resume growth has to be framed in the more general context of what is constraining growth today. In this author’s view, demand is what constrains growth. It is also shown that the fallacy of composition argument is in itself fallacious.

The next section summarizes the main tenets of the ELG strategy. Section 3 sketches a very simple device that helps conceptualize the rationale behind countries’ preference for the ELG strategy, as opposed to stimulating the components of domestic demand. Such rationale is that the ELG

² If demand in the developed countries is growing at, let’s say, 6 percent per annum, not *all* developing countries can have their exports grow at 15 percent. If all simultaneously try, there will be excess industrial capacity. Or put in different terms: “total exports of manufactures from the developing countries can grow faster than domestic demand in the industrialized countries, provided that the former countries take away market share from the domestic producers in the latter” (Blecker 2002, 71).

³ The term “Washington consensus” was coined by Williamson (1990). In its original formulation, the idea encompassed: fiscal discipline, reorientation of public expenditures, tax reform, interest rate liberalization, unified and competitive exchange rates, trade liberalization, openness to FDI, privatization, deregulation, and securing property rights. Therefore, Palley is not quite correct in his enumeration of what the “Washington consensus emphasizes (see endnote 1 in his paper). What is true is that toward the end of the 1990s, the list was augmented with a series of so-called second-generation reforms that were more institutional in nature and targeted at problems of “good governance” (Rodrik 2003). The extended list includes: corporate governance, anticorruption, flexible labor markets, adherence to WTO disciplines, adherence to international financial codes and standards, “prudent” capital account opening, nonintermediate exchange rate regimes, independent central banks/ inflation targeting, social safety nets, and targeted poverty reduction (Rodrik 2003, Table 1). Lin and Liu (2003) question the usefulness of policy advice for developing countries from neoclassical economics, as embedded in the Washington consensus.

strategy is perceived, at the country level, as superior to that of stimulating the components of domestic demand since ELG allows countries to grow and generate trade surpluses and employment without generating inflation. Moreover, inflation (or deflation today) is exported to the trading partners. At the global level, on the other hand, there must be trading partners willing to accept not only trade deficits but also imported inflation (deflation) in order to generate employment. Section 4 proposes to look at the ELG strategy from a Keynesian point of view. This perspective offers important insights and up-to-date policy recommendations for developing countries. Section 5 offers an overall discussion. It is concluded that export-led growth is not passé.

II. EXPORT AND DOMESTIC DEMAND-LED GROWTH AND THE NEED FOR A NEW DEVELOPMENT PARADIGM

The ELG strategy consists in the encouragement and support of the production for exports. The rationale, going back to the classical authors, is that trade is seen as the *engine of growth*, in the sense that it can contribute to a more efficient allocation of resources within countries as well as transmit growth across countries and regions. Exports, and export policies in particular, are regarded as crucial growth stimulators.⁴ Exporting is an efficient means of introducing new technologies both to the exporting firms in particular and to the rest of the economy, and exports are a channel for learning and technological advancement.⁵ In the words of Thirlwall: “the growth of exports plays a major part in the growth process by stimulating demand and encouraging savings and capital accumulation, and, because exports increase the supply potential of the economy, by raising the capacity to import” (Thirlwall 1994, 365).⁶

Indeed, as a development strategy, the classical belief was that development could be transmitted through trade. This has been confirmed by the experience of some countries that today are among the richest in the world. Traditionally, ELG has been presented as the opposite of the import substitution (IS) policies, based on closing the economy to imports and encouraging domestic production, which many developing countries followed for years, and which ended up in a dead end. Starting in the 1950s, and for about three decades, many saw import substitution as a crucial element for development, and protectionist policies were adopted in much of the developing world. These policies typically favored the protection of infant industries. Although it was recognized that most likely there would be efficiency losses due to protection, the gains from increasing domestic production and moving down the cost curve would more than offset these inefficiencies. Over the

⁴ In the case of developing countries, ELG is often led by foreign investors.

⁵ In their reassessment of the evidence of the relationship between trade and growth, and in the context of the East Asian miracle, Lawrence and Weinstein (2001) do not find support for the view that exporting was a particularly beneficial conduit for fast productivity growth in Japan. On the other hand, they find that imports and lower tariffs did stimulate productivity and argue that the Japanese economy would have grown even faster than it did if it had reduced domestic protection and imported more.

⁶ At the theoretical level, models of export-led growth can be classified into two categories. First, those that emphasize the possibility that export growth may set up a virtuous circle of growth. This is that once a country is launched on the path, it is able to maintain its competitive position in world trade and perform continually better relative to other countries. The second category stress that export growth relieves a country of a balance of payments constraint on demand (Thirlwall 1994, 365).

past two decades a considerable amount of empirical evidence has tended to refute the previous arguments. Today, IS is associated with government intervention and inefficiency.⁷

In mainstream circles (e.g., Krueger 1997), ELG is presented as the desirable growth strategy for it appears to be pursued in a context of *laissez-faire*. Hence, policies in pursuit of an export promotion strategy are seen as getting closer to an optimum in the sense that the international marginal rate of transformation equals the domestic marginal rate of transformation (Meier 1995, 480). A large number of studies have found that export growth and export levels are highly correlated with output growth.

According to mainstream literature, the potential benefits associated with the ELG strategy with respect to IS are as follows (Meier 1995, 361-3; 479-83):

- (i) the domestic resource cost of earning a unit of foreign exchange tends to be less than the domestic resource cost of saving a unit of foreign exchange;
- (ii) as the ELG rests on exogenous world demand, a developing economy can overcome diseconomies of small size. And in general, technology-economic factors (e.g., minimum efficient size of plant, increasing returns to scale, indivisibilities in the production process) imply a superiority of development through export promotion;
- (iii) for being exposed to world competition, firms in the country can increase X-efficiency (i.e., the forces that intensify motivation that result in lower cost curves for the firm);
- (iv) a protrade strategy may attract foreign direct investment;
- (v) ELG contributes more than does IS to employment creation and improvement in the distribution of income; and
- (vi) as indicated above, the empirical literature tends to indicate that, indeed, a higher rate of growth of exports is associated with a higher GDP growth (Edwards 1993).⁸

Palley (2002), on the other hand, has indicated that the emphasis on ELG has had a series of negative effects. First, it prevented the development of domestic market growth. Second, it put developing countries in a race to the bottom among themselves. Third, it put workers in developing countries in conflict with workers in developed countries. Fourth, there is a relationship between export-led growth and financial instability by creating overinvestment booms. Fifth, due to the emphasis placed on global goods and commodity markets, this model aggravates the long-trend deterioration in developing-country terms of trade. And finally, and most important, export-led growth reinforces the dependency of developing countries on the developed world, thus becoming vulnerable to slowdowns in the latter's markets. Export-oriented economies are dependent on foreign (mostly Western) demand. The problem is that recessions in Europe, Japan, or US translate into slow growth in the developing world.

⁷ Authors like Amsdem (1989) and Wade (1988) have argued that, in the case of Asia, and perhaps with the exception of Hong Kong, China, this is far from the truth: the export-oriented economies of the region were, to a large degree, planned economies with governments exercising enormous control over investment and industrial policy. Most East Asian governments suppressed consumption, restricted foreign access to their markets, and encouraged (and provided tremendous support for) manufacturers to target international markets. Korea and Taipei, China implemented highly protectionist policies, often preventing competition from foreign produced goods in local markets.

⁸ Although there are many methodological questions regarding how to test this hypothesis.

The critics of ELG argue that this model suffers from a “fallacy of composition” problem in as much as it assumes that *all* countries can grow by relying on the growth of their exports, which, ultimately, depend on how fast demand grows in other countries. Moreover, there is a danger of ending up with *beggar-thy-neighbor* policies. The result is that “export-led development may work when adopted by one or even a few countries, but it takes a *zero-sum* dimension when adopted by all” (Palley 2002, 3). Developing countries have ended up competing with each other to sell in developed countries, in what Palley refers to as “export displacement” (Palley 2002, 3). Blecker (2002 and 2003), however, places three important qualifications on the fallacy of composition hypothesis. First, Asian nations and their ELG policies are diverse. Second, not all of Asia’s export growth was targeted to the industrialized countries. Intraregional trade has increased. Third, and most important, the constraints on export-led growth in terms of the growth of global markets for manufactured imports are not fixed and given. This has two implications. The first is that these constraints can be relaxed if the industrialized countries stimulate their economies and open them to the exports of developing countries. The second is that a simultaneous export growth will be successful provided the countries that use ELG also open their own markets to imports and maintain high domestic demand. In the words of Blecker: “What is not feasible is for all countries to attempt to achieve trade surpluses by promoting their exports while simultaneously restricting their imports or repressing consumer demand” (Blecker 2002, 72).

Ertuk (2001/2002) and Palley (2002) have argued that the East Asian financial crisis had an underlying cause located in the real economy, and was not just the result of financial speculation. The pursuit of the ELG strategy has left the region with an industrialization strategy that is excessively dependent on external demand for mass manufacturing goods and foreign capital as well as with poorly developed internal markets and domestic firms. The consequence of the first problem is that the region has mortgaged its economic future, for it is tied excessively to the volatile global business and trade cycles. The second set of problems, i.e., poorly developed domestic economies, lies in the region’s domestic economic structures and rent-based culture (Lian 2003). Most countries in the region groomed a privileged rent-seeking class mostly composed of domestic corporate owners. During the 1970s and 1980s and up until the early 1990s, this was not a problem as, due to social and political stability, MNCs came to the region and contributed to the development of the export sector. Today, this is a problem reflected in the recommendations to improve corporate governance in the region.

With this background, Palley (2002) argues that developing countries need a new model of development based on growth of their internal markets (e.g., domestic consumption). The push for domestic demand-led growth can serve two useful purposes. First, it will reduce overdependence on exports. And second, given the present cyclical difficulties and competition from the PRC in foreign markets, domestic demand can provide an important cushion.

In principle, export-led growth should not be more desirable in terms of generating employment than internally generated demand growth. Achieving sustained growth does not depend solely on investment, technology, and other supply factors but also on a steady expansion of expenditures for personal consumption. Countries in the region understand this and have begun working in this direction. For example, many of the measures implemented in Thailand during the last couple of years under Prime Minister Thaksin (e.g., the local enterprise initiatives), are ideas whose objective is to alter Thailand’s production structure with a view to reducing the country’s dependence on exports. Since coming to power in 2001, he has been determined to move the country from mass

manufacturing for exports into domestic-demand led growth. The key is to create demand among households and businesses without creating another bubble. This is certainly not an easy road because it calls for an in-depth restructuring of the economy. Also, it has to be done in a way that avoids the problems inherent in import substitution, industrial policies and “picking the winners”.⁹ These policies failed, in most cases, partly because export capability is essential for firms to retain competitiveness.

Palley certainly acknowledges that developing countries need to export. What he argues is that “the global trading system must be made the servant of domestic development, and domestic development must not be forgone for the sake of international competitive advantage” (Palley 2002, 4). Domestic demand growth rests on four pillars: (i) improved income distribution; (ii) good governance; (iii) financial stability; and (iv) a fairly priced supply of development finance. And the policies needed to put these pillars in place are: (i) labor and democratic rights; (ii) financial reform; and (iii) a combination of debt relief, increased foreign aid, and increased development assistance through the expansion of SDRs.

III. THE PREFERENCE FOR EXPORT-LED GROWTH

Besides the arguments summarized above about the benefits of the ELG strategy (in particular when compared with the IS strategy), there is another reason that explains, from a purely macroeconomic point of view (and which underlies Palley’s line of reasoning), countries’ rationale for pursuing an ELG strategy and which seems to be in all policymakers’ minds. The authorities of each and every nation desire to see a surplus on their current account balance of payments, though not all can succeed.

This argument is that nations find that by pursuing an ELG policy, rather than policies that stimulate some components of internal effective demand, they can move toward higher employment levels without inducing domestic inflationary wage demands. With ELG, any latent inflationary (deflationary) forces can be exported to one’s trading partners. This implies that for every successful economy that pursues a mercantilist trade surplus policy there must be offsetting failure nations that incur trade deficits and import inflation (deflation). History is plenty of episodes where nations scramble for trade trying to export their own unemployment (e.g., the great depression).

During the 1980s, nations such as Germany; Hong Kong, China; Japan; Republic of Korea; Singapore; and Taipei, China were labeled “economic miracles” because they were able to expand output and employment through ELG. This policy leads to an increase in foreign reserves and increases international creditor status without causing domestic inflation. Today, probably the PRC represents the best example of a successful country following ELG policies.¹⁰ On the other side

⁹ Thailand’s recent “Competitiveness Plan”, promoted by the government, identifies five sectors where the country can develop niches. These sectors and the objectives are: (i) software [world center of graphic design]; (ii) auto industry [the Detroit of Asia]; (iii) fashion [world center of tropical fashion]; (iv) food [kitchen of the world]; and (v) tourism [tourism capital of Asia].

¹⁰ A segment of the press accuses the PRC of practicing throat-cutting mercantilist policies due to the combination of trade surpluses, accumulation of reserves, and maintenance of a cheap currency through artificial means. This line of reasoning is, to a certain degree, unfair for it forgets that the PRC’s imports have increased enormously in recent years. Moreover, the same argument maintains that the PRC today is exporting deflation as a consequence of its low wages, maintained thanks to the existence of an abundant labor supply. This argument has not been substantiated empirically.

of the equation, successful export-led growth economies force trade deficits, possible loss of international reserves, and indebtedness on their trading partners.

Why do many nations see export surpluses as a more powerful tool to stimulate income than home investment? A trade surplus is advantageous, first because it solves the problem of effective demand. And second, from a simple accounting viewpoint, a trade surplus represents “foreign investment.” This has employment and multiplier effects. Any increase in activity at home most likely induces an increase in imports, so that an increase in income and employment derived from an increase in home investment must be partly offset by a reduction in foreign investment. On the other hand, an increase in the trade surplus due to increasing exports does not reduce home investment, but creates conditions favorable to raising it, as the experience of many Asian countries shows.

With the help of a very simple device, we can see why governments have an incentive to pursue ELG policies rather than to stimulate the internal components of demand.¹¹ Profit maximization requires the equality of marginal revenue (MR) and marginal cost (MC), and since in a purely competitive economy MR equals the price (p_d), then, $MR = p_d = MC$, where p_d is the price level of domestic output. Moreover, the money wage rate (w) divided by the price level of domestic output (p_d) equals the marginal product of labor (MPL). This implies: $w/MPL = MC = p_d$.

Now assume there is a certain degree of monopoly (μ) in the economy, such that $MR = p_d \mu$, where μ is a function of the price-elasticity of demand. Then, $p_d = (1/\mu)MC$, and $w/MPL = MC = p_d \mu$, or $p_d = w/[MPL\mu]$, or $w/p_d = MPL\mu$.

In the neoclassical model the aggregate marginal productivity labor curve is the demand curve for labor. Figure 1 shows a standard downward-sloping marginal product curve, indicating that a decrease in the wage rate will cause more labor to be hired, i.e., diminishing marginal physical product of labor ($(\partial MPL/\partial L) < 0$). Labor’s real wage rate (w_r) is, by definition, the money wage rate divided by the price level of the consumer products (p^c) bought by labor, that is, $w_r = w/p^c$. Assume for simplification that the price level of domestically produced consumer goods (p_d^c) equals p_d , the price level of all domestically produced goods (e.g., the GDP price deflator). In a closed economy the real wage rate can be written as $w_r = w/p^c = w/p_d^c = w/p_d = MPL\mu$. In an open economy, on the other hand, the price level associated with domestic consumption expenditures (p^c) is a weighted average of the price of consumer good imports (p_m^c) and domestically produced consumer goods (p_d^c), that is, $p^c = (1-\phi)p_m^c + \phi p_d^c$, where ϕ is the proportion of aggregate domestic consumption expenditures spent on imports.

Assuming again $p_d^c = p_d$, the real wage rate can be written as

$$w_r = w/p^c = \frac{w}{(1-\phi)p_d + \phi p_m^c} = \frac{w}{(1/\lambda)p_d} \text{ where } 1/\lambda = (1-\phi) + \phi(p_m^c/p_d).$$

And assuming $p_m^c < p_d$, i.e., the price of imported goods is less than the price of domestic goods, it implies that $(p_m^c/p_d) < 1$ and, therefore, $(1/\lambda) < 1$.

Now recall that $p_d = w/[MPL\mu]$, and from the above we have that $w_r = \frac{w}{(1/\lambda)p_d}$. Combining these two expressions leads to $w_r = MPL\mu\lambda$, where $\lambda > 1$.

¹¹ This section draws on Davidson (1996, chapter 16). I am grateful to Paul Davidson for his comments.

FIGURE 1
 MARGINAL PRODUCT OF LABOR AND LABOR SUPPLY

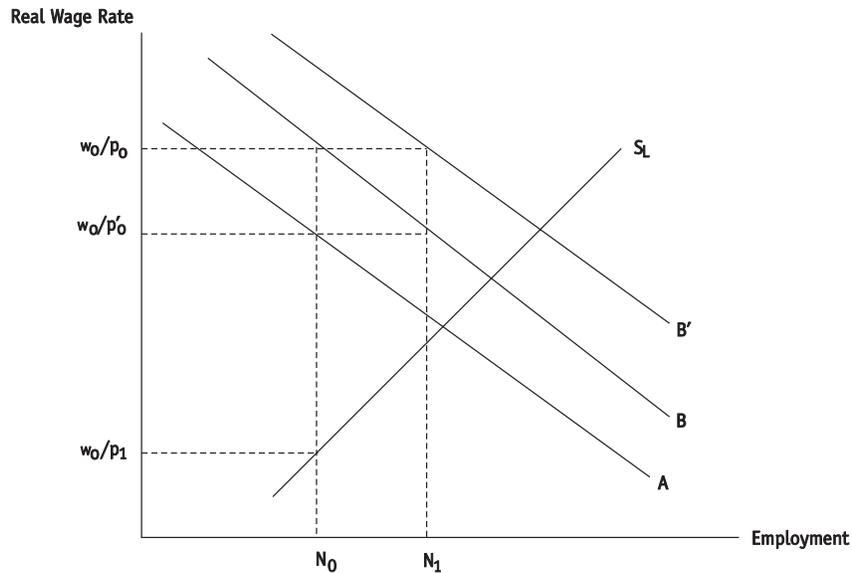


Figure 1 also shows the aggregate labor supply S_L and the real wage curve. The closed-economy real wage curve is given by $A = w_r = MPL\mu$. A comparison of this equation with that for the open economy $B = w_r = MPL\mu\lambda$, indicates that the latter is some multiple λ , a function of the price of domestically produced (p_d) and imported (p_m^c) goods and of the domestic consumption expenditures spent on imports (ϕ), of A (the closed economy real wage curve). This is because the price level of imported goods is below that of domestic goods at any level of employment and $\phi > 0$. Furthermore, the more open the economy, i.e., the greater ϕ and λ , and the greater the distance between B and A.

Let's begin by assuming that the prevailing real wage rate in the economy is w_0/p_0 . In this case, there is unemployment in the system, and such real wage rate exceeds the minimum real wage rate w_0/p_1 necessary to attract N_0 workers into the labor market. Let's now discuss the effects of the two policies of export-led and domestic-demand-led growth and their implications on the country that pursues them.

A. Export-Led Growth

The ELG model depends on a trading partner willing to expand its demand so that the country in question can sell its exports. When this happens, the exporting country's real wage curve shifts upward as the improved export-import relationship of the economy (trade surplus and increase in reserves) leads to the appreciation of the exchange rate. Then, imported goods will become cheaper in terms of domestic money (as p_m^c declines), λ will increase, and consequently the real-wage curve will shift from B to B'. Note, however, and this is the key issue, that the real wage rate remains at w_0/p_0 as employment rises from N_0 to N_1 . Even though domestic output prices ($p_d^c = p_d$)

rise, the domestic consumer does not experience inflation in the market basket of goods she purchases (p^c) as the cost of living is affected by lower import prices (p_m^c) due to the exchange rate appreciation. Under these circumstances, there is less pressure to increase money wages as the domestic economy expands, and previously employed workers (N_0) do not experience a decline in real wages as additional workers are employed, thus promoting social stability.

B. Domestic Demand-Led Growth

If, on the other hand, the government implements a policy of stimulating domestic spending (or the central bank lowers interest rates, for example) with a view to increasing employment from N_0 to N_1 , then the real wage rate will fall to w_0/p_0' (on the same real wage curve B) as the average price level (p^c) increases. In Figure 1, N_1 is still less than the full employment level, but the economy will experience inflation with successive government attempts at increasing employment. And as workers push for cost-of-living adjustments to compensate for the increase in prices, the resulting inflation will exacerbate the problem.

The conclusion is that export-led growth policies can be expansionary without inducing inflationary pressures for the countries that pursue them. Moreover, from the political point of view, ELG weakens labor unions' ability and legitimacy to demand higher nominal wages. On the other hand, domestic-demand-led policies can result in expansion but with inflation, and the resulting lower real wages of the previously employed workers may induce further wage-price inflation as workers may try to recover their previous real wage rates.

From a global perspective, on the other hand, the effects of the ELG strategy are different: unemployment and inflation are simply being passed on to the trading partners whose rising trade deficits lead to depreciating exchange rates. For them, the resulting higher domestic prices for imports translate into a reduction in the purchasing power of the domestic money-wage rate. Unless they are threatened by unemployment, workers in these nations will demand increases in nominal wages, at least to offset the loss due to the depreciation of the currency. But this will create inflationary pressures. If these nations implement policies to maintain employment while workers demand their real wages to be protected, inflationary tendencies will be exacerbated. This leads to a situation at the global level that could be labeled *competitive* growth.

Summing up, the ELG strategy encourages nations to settle problems of unemployment and inflation by pushing them off to their trading partners. If all nations act this way, the end result might be a global recession and stagnation. If one nation acts as the engine of growth and continues expanding (despite running trade deficits, e.g., the US) the trading partners that pursue export-led growth will experience an economic miracle that may be attributed to their excellent economic policies.

It must be indicated that the above account of the ELG strategy, although valid, is slightly different today. The reason is that the argument, as described, applies in the context of developed and developing countries where labor has economic muscle to push for higher money wages in an attempt to obtain higher real wages. In such nations, ELG could keep labor happy without demanding money wage increments that exceed productivity. The important phenomenon that today modifies the story is the flood of cheap manufacturing exports from the PRC (and some other countries), which, as long as the exchange rate vis-à-vis the US dollar is kept (artificially) relatively

constant, is allowing them to expand export markets and absorb the huge surplus of labor from the countryside. As indicated above, many countries (both developing and developed) are fearful that many of their firms may be forced to lay off workers due to lack of competitiveness vis-à-vis firms from the PRC. Interestingly, the PRC government is also worried about rising unemployment as jobs are lost in unprofitable state companies, and deflation remains an issue. This has weakened workers' bargaining power in some sectors in some other nations, and via the import term in the price level equation $p^c = (1-\phi) p_d^c + \phi p_m^c$ this has led to either very low rates of inflation or even deflation (if domestic prices of imports decline by more than the increase in prices of domestically produced goods).

So far, the PRC is perceived as a successful nation and inflows of capital continue arriving, thereby putting pressure on the exchange rate to rise. Of course, the ELG strategy still has the advantage that it creates jobs, but, through double-entry bookkeeping at the international level, it *forces* trade deficits, loss of reserves, and increases in international indebtedness on the trading partners. And, as a consequence, it also exports one's unemployment, so that it passes, *to some extent*, a deflationary force which, in a global economy, can feedback on all export-led growth nations. The short-term gain for the successful export-led growth nations is that they can accumulate significant sums of foreign reserves—and therefore become more attractive to foreign capital inflows. The question then becomes that unless the nation also has some form of capital controls, the initial build-up of foreign reserves can later on lead to a hot money outflow and a currency crisis.

The issue of the PRC's undervalued currency, its trade surplus (around 1 percent of its GDP), and the huge amount of foreign reserves has created a heated debate not only across Asia but also in the US, where some voices blame the PRC for the loss of American jobs in manufacturing. Hence, these voices are asking the US Administration to push the PRC to float the yuan. Against this background, it must be mentioned that the PRC is one of the very few engines of growth in the world economy today. Putting a break to the PRC's growth could pose more problems than it solves. Second, an increase in the yuan might lead to price hikes on a wide range of products (e.g., clothes, appliances) in the US. Third, the PRC's banking system is in serious trouble. If the Chinese were allowed to hold foreign currencies, this might lead not to an increase in the value of the yuan but to a bank run, leading to a collapse of the currency in a manner similar to what other East Asian countries experienced in 1997-1998.

Is the accumulation of massive reserves and the undervalued currency a sign of ruthless mercantilism? At this point the discussion is probably more rhetoric than serious economics. What is clear is that the accumulation of reserves is the result of the growth model chosen, dependent upon exports and, perhaps, not enough on markets for products and services at home. And what is true is that this situation will have a negative impact sooner or later for it is leading to credit creation and a bubble in the property sector, which will burst. And it must be added that much of the argument against the PRC today is simple rhetoric, reminiscent of the focus on Japan during the 1980s. Since joining the WTO, the PRC's trade barriers have come down and imports have increased. Moreover, the huge US trade deficit will not be solved with a revaluation of the yuan, as the US administration claims. It is the result of a country (government and private citizens) that saves substantially less than it invests. This difference, the other side of the trade deficit, must be borrowed abroad (ironically, in large part from the PRC and Japan), at a rate of over one billion dollars a day. Of course there is nothing wrong with this as long as it reflects the choices and preferences of individuals. The savings-investment gap reflects two things. On one hand, that

Americans live beyond their means. On the other hand, it means that the rest of the world allows this situation and is willing to finance it. The problem with it is that globalization means that mistakes in one country have powerful repercussions elsewhere.¹³

IV. A DEMAND-DRIVEN VIEW OF EXPORT-LED GROWTH

Without implying that the above analysis is incorrect, and that the critics of the ELG model have not raised important questions, there is a different way of analyzing the ELG model and its implications. This is through the analysis of the balance of payments (BOP) and how the latter impinges on the growth performance of countries. The essence of this is that the fundamental idea behind the ELG model is that the BOP is the fundamental constraint to growth. Mainstream growth theory largely ignores BOP (monetary) considerations. In classical growth theory, the BOP was assumed to look after itself through internal or external price adjustment, thereby avoiding any link between the state of the BOP and the accumulation of resources for economic growth. Solow's (1956) growth model was a closed-economy model where the demand side of the economy was completely ignored. In this setting, savings determine investment, and aggregate demand equals aggregate supply. New neoclassical growth models are also supply-oriented and there are no demand constraints. Although some endogenous growth models are for the open-economy, their focus is on growth and exports, not on growth and the BOP.

In Keynesian theory, on the other hand, it is demand that drives the economic system to which supply adapts. Growth is not simply a question of current supply availability. This does not imply, however, that supply constraints do not exist and/or that the supply side is not important, in particular in the developing countries; in many cases, however, they are not binding. In developing countries labor is an abundant factor, while capital, the theoretically scarce factor, can be brought into the country (i.e., imported). What is needed is to foster the *ability* to export in order to pay for full-employment imports (i.e., the value of imports that would occur when resources are fully utilized). This is what determines the level of employment and growth in the long run. If exports fall short of full employment imports, income, and employment will fall. This leads to a fall in imports that will bring their value into line with that of exports. In other words, income adjusts to bringing about equilibrium in the external sector. The implication is that if a country is below its growth of productive potential (i.e., the supply constraints are not binding), then its growth rate will be determined by the growth of demand. Thus, growth rates across countries, in this framework, must differ *because* the growth of demand differs among countries (McCombie and Thirlwall 1994).

But why does demand grow at different rates in different countries? One possibility is that governments, through fiscal and monetary policies, are unable to expand demand at the desired rate to fully utilize resources because of a number of reasons, e.g., they have to keep the budget balanced. Thus, according to this argument, the reason why growth rates across countries vary is that governments are restricted to expanding demand at different rates for various "ad-hoc" reasons. A more probable reason, however, is that governments are constrained from pursuing

¹³ I wonder if the PRC has an absolute advantage and this is what rules trade, not comparative advantage.

these demand management policies by a single overriding factor, namely, the balance of payments constraint (McCombie and Thirlwall 1999). In the long run, countries need to have a balanced current account, and in a growing economy this implies that the rate of growth of the value of exports equals the rate of growth of the value of imports. The term BOP constraint means that a country's performance in external markets, and the response of the world financial markets to this performance, constrains the growth of the economy to a rate below that which the rate of unemployment and capacity utilization would warrant.

There are three reasons why the current account is important.¹⁴ First, if a country runs into BOP problems due to the performance of exports and imports, there will be implications for real output and employment. It is obvious that import penetration can worsen the BOP and be detrimental to the affected domestic activities. This implies that the BOP has implications for the functioning of the real side of the economy, and not just the financial sector. Second, no country can grow faster in the long run than the rate consistent with BOP equilibrium on current account unless it can finance ever-growing deficits, but this is unlikely, especially for a developing country. In the short term, growing current account deficits may be financed by higher interest rates, but this is unlikely to provide a long-term solution.¹⁵ And third, and related to the previous reason, high interest rates favor the accumulation of monetary assets and discourage investment in productive assets upon which growth ultimately depends.¹⁶

How does the BOP constraint operate? If a country gets into BOP difficulties as it tries to expand demand before the short-term capacity growth rate is reached, demand must be reduced and supply is never fully utilized. When this occurs, investment is depressed, technological progress slows down (as evidence suggests that this is partly determined by the rate of growth), and a

¹⁴ In practice, countries require the basic balance, i.e., the current account plus long-term capital flows, to be in equilibrium for reasons discussed below.

¹⁵ Some developing countries are able to build up growing current account deficits financed by capital inflows that allow them to grow faster than otherwise would be the case. These fast growth rates are generally below the growth of productive capacity and in case they are financed by short-term capital flows, there is a great danger of volatility. This may have been the situation of the East Asian countries during the period of hyper growth experienced during the last couple of decades. On the other hand, after the financial crisis of 1997-1998 the situation reversed and showed how dangerous a large net short-term overseas debt-to-income ratio can be.

¹⁶ Related to the above is the question of why do countries, in particular developing, need to have their current account in equilibrium in the long run? The reason is that otherwise, financial markets become very *nervous*, as was seen during the East Asian financial crisis of 1997-1998 and is apparent today with many other developing countries. The category of international transaction that dominates world business today is portfolio investment, which is by far the largest component, and for all intents and purposes is the one that determines fluctuations in exchange rates. Purchases of portfolio capital depend on the expectations of market participants. Experience shows that when the net foreign debt to GDP ratio of a country begins to rise, financial markets react and punish the country. The probability of capital flight and plunging exchange rates increases. Short-term capital flows are extremely volatile as they are subject to the "herd" instinct of foreign investors. The probability of capital flight and plunging exchange rates increases as the current account deficit grows, and in many cases, its occurrence becomes a self-fulfilling prophecy.

Some countries rich in natural resources can, however, run sustained capital inflows that are used for development purposes. The crucial question with respect to the developing countries is whether the foreign capital is used productively, e.g., investment for increasing exports rather than for purchasing foreign consumption goods for the small wealthy elite or for grandiose projects. If it leads to increased exports, then this will generate the foreign exchange needed for the interest payments and remitted profits from the loans.

country's goods compared with foreign goods become less desirable, thus worsening the BOP further.¹⁷ On the other hand, if a country is able to expand demand up to the level of existing productive capacity, without BOP difficulties arising, the pressure of demand upon capacity may well raise the capacity growth rate. This creates a virtuous circle in the opposite direction to the one described above. How can this be achieved? There are several instruments: one is the encouragement of investment, which would augment the capital stock and bring with it technological progress. Also, the supply of labor may increase by the entry into the workforce of people previously outside or from abroad. A third mechanism is by moving factors of production from low productivity to high productivity sectors. Finally, the ability to import more may increase the country's capacity by making domestic resources more productive.

The above is, incidentally, the essence of the export-led growth mechanism. The expansion of exports can raise the overall growth rate of the country without the BOP deteriorating simultaneously and lead to the virtuous circle. It must be pointed out, however, that the same rate of export growth in different countries will not necessarily permit the same rate of growth of output. This is because the import requirements associated with a particular growth rate will differ among countries. Consequently, some countries will have to constrain the growth of demand sooner than others for BOP equilibrium.

McCombie and Thirlwall (1994, 1999) have shown that the BOP equilibrium growth rate (y_B) is given by the simple rule $y_B = \frac{\epsilon}{\pi} z$ known as Thirlwall's law, where z is the growth rate of world income, ϵ is the income elasticity of demand for exports and π is the income elasticity of demand for imports.^{18, 19} This model implies that a country's BOP equilibrium growth rate is determined by the rate of growth of world income (z) multiplied by the ratio of income elasticities of demand for exports (ϵ) and imports (π). The authors interpret the model in the sense that it is the ratio

¹⁷ As investment and technological progress decline the products a country makes will suffer and become of lower quality relative to those of a country that is constantly investing and striving to improve its products.

¹⁸ This expression is derived from a Keynesian model where growth is demand-driven. In this model, the growth of exports is determined by the growth of world income and the rate of change of relative prices. The growth of imports is specified as a function of the growth of domestic income, together with the rate of change of relative prices. Substituting these into the definitional equation for the balance-of-payments, expressed in growth rate form gives the growth of domestic income as a function of the growth of world income, the rate of change of relative prices.

¹⁹ An important assumption (a necessary condition) in the derivation of the model is that rates of change of the exchange rate are *not* likely to be an effective tool. Experience suggests that while devaluations can improve temporarily the balance of payments for any given growth rate, it is ineffective in allowing the trend growth rate to increase. The reason is that it is difficult for a nominal depreciation to be converted into a real depreciation if there is an inflationary feedback from higher import prices to higher domestic prices because of real wage resistance or a high import content in exports (as is the case in many developing countries). Moreover, rapid and large short-term falls in the real exchange rate can have serious adverse effects on the level of economic activity, as the East Asian financial crisis has shown. The experience of the last few decades indicates that variations in effective exchange rates have had little effect on trade flows, and that large surpluses and deficits have persisted in spite of large changes in exchange rates. Relative price changes and price elasticities of demand have become increasingly less important in determining trade patterns and the balance of payments. The large swings in exchange rates of the 1980s were probably the result of short-term capital flows or speculative bubbles.

of income elasticities (ε/π) that *determines*, in a causal sense, the relative growth rate of a particular country (y_B/z).²⁰ This model emphasizes the joint negative effects of excessive openness to imports, as reflected in a high-income elasticity of import demand (π), and the positive effects of exports via a high-income elasticity of export demand (ε) or rapid world income growth (z). Moreover, the model provides a rationale why exports are so critical in the growth process; this is that they relieve the BOP constraint given by the import requirements of rapid growth.

The central tenet of the balance-of-payments-constrained growth model is that a country cannot run a balance of payments deficit for any length of time that has to be financed by short-term capital flows and which results in an increasing net foreign debt-to-GDP ratio. If a country attempts to do this, the operation of the international markets will lead to increasing downward pressure on the currency, with the danger of a collapse in the exchange rate and the risk of a resulting depreciation/inflation spiral. There is also the possibility that the country's international credit rating will be downgraded. Consequently, in the long run, the basic balance (current account plus long-term capital flows) has to be in equilibrium.²¹

While a country cannot grow faster than its BOP equilibrium growth rate for very long unless it can finance an ever-growing deficit, there is little to stop a country from growing slower and accumulating large surpluses. This may occur when the BOP equilibrium growth rate is so high that a country does not have the physical capacity to grow at that rate y_B . This is the case of some oil-producing countries and Japan during the postwar period up to 1973. In a sense, Japan could be described as "resource-" or "supply-constrained" rather than BOP-constrained because the growth of its exports was so fast that it reached its growth of productive potential and thereafter began to accumulate trade surpluses. It is important to note that this does not mean that Japan's growth was determined in the neoclassical sense by its rate of technical change and labor supply.

From the above, Thirlwall's law can also be written as $\frac{y_B}{z} = \frac{\varepsilon}{\pi}$. This indicates that if $(\varepsilon/\pi) < 1$ and if the growth of the country in question is constrained by the need to maintain a BOP equilibrium, then the country will be constrained to grow at a slower rate than the rest of the world. As Prebisch (1950) warned long ago, a development strategy based on the export of goods with a low-income elasticity leads to deteriorating terms of trade. Certainly the problem is more serious upon consideration of the rate of population growth, an important problem in many developing countries. In per capita terms, the situation will be even worse.

²⁰ McCombie and Thirlwall (1994) derived also an extended model that includes the role of capital flows. The BOP constrained

growth becomes $y_B^* = \frac{\theta}{\pi}x + \frac{(1-\theta)}{\pi}f$, where θ and $(1-\theta)$ represent the shares of exports and capital flows as a proportion of total receipts (exports plus capital flows) and f denotes the growth rate of real capital flows.

²¹ For those countries where $y > y_B$ one would expect real capital inflows to have grown faster than the volume of exports. This should relax the BOP constraint on growth to a certain extent. McCombie and Thirlwall show that most of the difference between the two growth rates can be accounted for by real capital inflows growing faster than exports with the effect of relative price movements having a slightly negative effect, i.e., it tightened the BOP constraint on growth. On the other hand, for those countries with $y < y_B$ one would expect real capital flows to have grown slower than export volume.

As we have argued, according to the balance-of-payments constrained growth model, the reason why countries grow at different rates lies in differences in the rate of growth of demand, and the major constraint on the rate of growth of demand in most countries is the BOP. But why does the BOP equilibrium growth rate differ across countries? In the context of this model, this is tantamount to asking why countries should differ in the values of their income elasticities of demand for exports and imports. The answer lies, first, in the types of goods exported: are they the ones for which world demand is rapidly growing, such as manufactures or financial services, compared with, say, primary commodities? Secondly, are the *characteristics* of the types of products within each category of good or service such that they will give a firm in a country a competitive edge over their competitors' goods?²² In other words, disparities between countries in the income elasticities of demand for exports and imports largely reflect differences in nonprice competitiveness, broadly defined. *The message for a country whose export growth rate is relatively slow and with a relatively high import elasticity is that the goods it produces are relatively unattractive both at home and abroad.*

What is it meant by the "characteristics" of the goods produced? It has been documented that many manufacturing industries engage quite often in nonprice rather than price competition. Schumpeter argued that "in capitalist reality, as distinguished from its textbook picture, it is not that kind of [price] competition which counts, but the competition from the new commodity, the new technology, the new source of supply, the new type of organization.... This kind of competition is as much more effective than the other as bombardment is in comparison with forcing a door" (cited in Nelson and Winter 2002, 33-4). However, for different reasons, nonprice competition appears to be neglected in theoretical analyses. *Price competitiveness* can be defined as the relative price of foreign in terms of domestic tradable goods. McCombie and Thirlwall (1994, 265) define *nonprice competitiveness* as follows: "Non-price competitiveness encompasses, by definition, all those factors other than price that affect consumer choice. These include quality, reliability, speed of delivery, the extent of and efficacy of the distribution network, and the availability of export credit and guarantees." From a theoretical point of view, this corresponds to factors that determine shifts in the demand curve for products as opposed to movements along the demand curve associated with price variations.

Finally, McCombie and Thirlwall (1994) interpret disparities in ϵ and π as reflecting differences in nonprice competitiveness. The implication is that the supply side is important to the extent that these supply factors (e.g., investment in new technology, research and development effort, education and training in skills), determine the income elasticity of demand for exports and therefore, play a crucial role in explaining the growth of exports and, hence, income. This stands in marked contrast to the way in which the neoclassical approach emphasizes the supply side, where the mere growth of factor inputs (and technology) are the causal factors in the growth process.

²² Thailand, for example, has begun making wine out of exotic fruits such as mangosteen and lemongrass, products in which Thailand has a comparative advantage and which, if commercialized adequately, could have a high-income elasticity of demand for exports.

V. EXPORT-LED GROWTH IS *NOT* PASSÉ

The discussion so far leads to the following three issues:

- (i) The discussion and distinction ELG versus DDLG is, perhaps, meaningless. First, because Asian countries need some form of ELG to attain economies of scale, especially the smaller countries. And second, because both strategies need not be mutually exclusive.
- (ii) The BOP-constrained growth model indicates that it is possible to discuss the ELG strategy in a framework where it has positive policy implications.
- (iii) The discussion of the policies to resume growth in the region has to be framed in the more general context of what is constraining growth today. In my view, demand is what constrains growth.

The question that emanates from the discussion is whether Asian countries can, today, generate enough domestic demand-led growth so as to shift from export growth. And, does this demand process require an active role of the government? The answer to the first question is in the negative for most countries. This is not to say that, in the final analysis, development will manifest in increases in private consumption levels. But unfortunately, income levels are still too low in many cases. A shift toward domestic orientation will require significant internal changes and reforms that will take time. Most countries in the region need to export in order to achieve economies of scale in production (i.e., the trade-dependent nature of these economies). We have yet to see how far Prime Minister Thaksin's efforts in Thailand, in what has been described as a "dual track" strategy (Lian 2003) by relying on external demand (first track) and simultaneously developing domestic demand and supporting domestic enterprises (second track), can go. Thaksin is making big efforts toward shifting economic policy with a view to reducing Thailand's overdependence on external demand and foreign capital. Thailand's economic policies cannot be interpreted as inward-looking for they do not contain, so far, any element of IS. Since coming to power in 2001, he has been determined to induce a shift from mass manufacturing for exports into DDLG. Thaksin's objective is to *alter* Thailand's production structure with a view to reducing the country's dependence upon exports. The key is to *create* demand among households and businesses without creating another bubble (i.e., to avoid a household-led spending boom fueled by borrowing like in the US). Thaksin's strategies aim at boosting domestic demand and *strengthening* local enterprises and at developing indigenously owned production capacity.

With respect to the role of government, the Asian Development Bank (2003) argued that a competitive economy is simply a well-functioning market economy, which consists in a partnership between state and markets plus the development of market-friendly institutions. This is the macroeconomic aspect of the term competitiveness. The essence of this partnership is the correct division of the tasks to be performed by markets and government. While the role of government is fundamental in this transformation process by ensuring a stable macroeconomic environment, setting up the legal system, and implementing supply-side policies that affect the export and import elasticities (e.g., education, infrastructure), it should not go into areas where firms have to deliver, namely, the provision of private goods and services. The question is whether policies such as Thailand's "local enterprise initiative", or *encouraging* the production of wine out of exotic fruits such as mangosteen and lemongrass, will lead to a reduction of the dependence on external demand and foreign capital. I believe the answer is not in the short to medium run. In the long run (25

years?) the strategy might well succeed, but it is a long shot. Moreover, the question is that emphasis on “altering” the country’s production structure, “creating” demand, “encouraging” production of certain goods, or “strengthening” local enterprises, brings to one’s memory old-style industrial policies with favorable treatment of some selected industries (“picking the winners”), thought to be more reputable if disguised in a package of *new competitiveness policies* (see footnote 9).

The main message of the BOP-constrained growth model is that if the Asian countries wish to grow faster in the context of the ELG strategy, they must relax their BOP constraint on the growth of demand. If they raise the rate of growth of productive capacity without simultaneously raising the rate of growth of demand, because of BOP problems, the situation will lead to unemployment. If, on the other hand, the BOP equilibrium growth rate can be raised by making exports *more attractive* and by *reducing* the income elasticity of demand for imports, demand can be expanded without generating BOP difficulties. In some sense, it is demand that generates its own supply by encouraging investment, absorbing underemployment, raising productivity growth and so on. The implication is that differentials in income elasticities can, through the BOP constraint, force nations with trade deficits to reduce their growth rate to one that is compatible with the oversavings of their trading partners.

In other words: it is not just about growing by exporting, but about growing by exporting the right products and services, the ones for which world demand is elastic. This is a very powerful message with important policy implications for the developing countries of Asia. The above is very different from thinking of the ELG strategy as merely an exercise in exporting, which of course depends on expanding global exports markets and on an optimistic scenario of growth in Europe, Japan, and US. The problem of dependency of developing countries on the developed world acquires a different perspective since developed countries also depend on the other developed countries because most of their trade is intra-industry. What matters, once again, is the type of products exported. The above should not be interpreted as implying that the rate of growth of a country is the result of subjective decisions of foreign consumers. As Kaldor argued:

“The growth of a country’s exports should itself be considered as the outcome of the efforts of its producers to seek out potential markets and to adapt their product structure accordingly. Basically in a growing world economy the growth of exports is mainly to be explained by the income elasticity of foreign countries for a country’s products; but it is a matter of the innovative ability and adaptive capacity of its manufacturers whether this income elasticity will tend to be relative large or small” (Kaldor 1981, 603).

Therefore, there need not be a fallacy of composition, since firms in different countries can search and specialize in different niches in order to accomplish this objective. With underutilized resources and the existence of a BOP constraint, ELG is not a zero-sum game. If country A (developing) exports to country B (developed), the growth rate of country A will increase. This will provide foreign exchange to purchase imports from country B. World growth has increased and so will imports. Palley (2002), on the other hand, seems to think that if B’s share of imports from A declines and from, say, C increases, somehow it means that the net effect is zero. However, it could well be that C increases its exports to B and imports more from A, thereby increasing A’s growth rate with overall world growth rising. It could be argued that the distribution of exports does become important here.

This is not to deny that if *all* Asian developing countries specialize in the same product then overcapacity will occur and growth rates fall. As indicated above, each country (rather, each firm) needs to find a niche where *not all* produce, say, semiconductors. The success of the East Asian economies means, in fact, that these countries are facing pressures to vacate the markets in which they succeeded (e.g., textiles, clothing, electronics) and shift to higher value-added exports as the PRC and others enter those sectors. Their success also implies that their markets for low-skilled manufactures are expanding, thus providing export opportunities for the next generation of industrializing countries (Akyüz et al. 1998).

This is something that globalization has made very clear (Asian Development Bank 2003). What must be accepted is that inherent in the success of a market economy is the fact that there must be loser firms. These are the firms that have not been capable of delivering the goods and services that consumers wanted. In a world characterized by globalization and intense competition, the pressures on firms to deliver have increased because now firms have to compete not only against other domestic firms but also against firms from other countries. This requires a big effort on the part of firms to be competitive in terms of cost reduction as well as in terms of capacity to create new products, find new niches, and open new markets. One thing is to acknowledge that today's world is tough. Another, quite different, is to blame globalization for the failure of some firms.

Palley's (2002) proposals for a new development paradigm based on domestic demand-led growth, summarized at the end of Section II, are compatible with the message of the model in the previous section as well as with that of the Asian Development Bank (2003). The latter's message is that in order to survive in the current environment characterized by intense competition, firms have to make efforts to enhance their entrepreneurial and technological capabilities with a view to delivering the products and services that consumers demand. This is the microeconomic aspect of competitiveness discussed in the *Asian Development Outlook 2003*.

Finally, the issue that Asian countries have to think about is what is constraining growth today? It is in this context that the discussion of ELG versus DDLG has to be understood. The answer, in my view, is insufficient aggregate demand. Thus, it is not likely that growth will be increased *exclusively* by policies that stimulate supply, such as policies to increase national savings, to increase the educational achievement of the labor force, to loosen labor market regulations, or to stimulate private initiative by improving the investment climate. Certainly, entrepreneurial initiative is important in stimulating and introducing innovations. A highly educated, trained, and motivated workforce will be more productive. And likewise, maintaining international competitiveness matters. What is being argued is that in a world characterized by excess capacity and deflationary forces, what Asian countries need is policies to stimulate demand.²³ Then, and only then, will supply-side policies have a positive effect.

²³ In fact, it can be argued that the recoveries from the financial crises in Malaysia and Republic of Korea have had little to do with supply-side reforms. They were primarily due to successful, Keynesian-style, countercyclical reflationary policies.

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