Trade Policy and International Economy
(From the Viewpoint of Economic Development)

by

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Preface

In 2003 I was given the opportunity to give a lecture titled Trade Policy and International Economy mainly to government officials from developing countries and economies in transition. My lecture did not follow a particular textbook and some students told me that it could have been studied more easily if it had been summarized in one paper.

Inspired by their comments, I have written an outline of my lecture in this paper. Although I have omitted all the data, demonstrations of theories, and episodes described in the lecture, I believe that its essence can be understood by reading this paper.

I would like to express my sincere gratitude to the National Graduate Institute for Policy Studies (GRIPS) and the Ministry of Economy, Trade and Industry (METI) of the Japanese government for giving me this opportunity. All the views expressed in this paper are mine and the responsibility for them lies entirely with me. I would be most grateful for any comments or suggestions.

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I. Trade Theories and their Application to Developing Countries

1-1 Trade Theories of Classical and Neoclassical Economics

The standard trade theories of classical and neoclassical economics are the Ricardian model and the Heckscher-Ohlin model, respectively. Most international economics textbooks start with these models. In both, worldwide economic welfare improves without making any country worse off when international trade is liberalized. Both developed and developing countries become better off by trade liberalization, and developing countries can accelerate their economic development by liberalizing international trade.

However, both models cannot comprehensively explain the gaps in terms of income and industrialization between developed and developing countries. The income gap is the fundamental gap between developed and developing countries and its elimination is the final goal. This gap has become conspicuous since industrialization started in developed countries. We will therefore focus here on both the income gap and the industrialization gap.

In the Ricardian model, international trade is caused by the difference in technology and the income gap can be explained by the technology gap. However, the industrialization gap cannot be explained by this model, because the richer country does not necessarily specialize in industrial products. In the numerical example presented by David Ricardo himself, the poorer country, namely England, specializes in cloth, an industrial product.

On the other hand, the Heckscher-Ohlin model cannot explain the income gap because it is eliminated after trade liberalization. It is assumed that technology is the same between the countries in the model. The Heckscher-Ohlin model is still useful to a certain extent in explaining the industrialization gap, because international trade is brought about by the difference in production factor endowments and a capital-abundant country specializes in capital-intensive products. Capital-abundant countries tend to be rich countries in the real world, although that
is not the case in the Heckscher-Ohlin model. In the real world, capital is accumulated as a result of people's saving and capital tends to increase faster in higher income countries while the amounts of labor and land are determined by nature. Industrial products are usually more capital-intensive than agricultural products and heavy industry is usually more capital-intensive than light industry. For this reason, the Heckscher-Ohlin model can be interpreted as an incomplete explanation of why developed countries tend to be industrialized.

In sum, the standard trade theories of classical and neoclassical economics explain gains from trade in developing countries quite clearly, but they explain the gap between developed and developing countries only partially. This is one of the reasons why there are a variety of views on how and to what extent account should be taken of them to narrow the gap between developed and developing countries.

References

1-2 Theories of Government Intervention in International Trade

The trade theories of classical and neoclassical economics have been criticized by various counterarguments since their inception. Two representative counterarguments will be examined here.

The first is the “infant industry argument.” When only Britain had experienced an industrial revolution, some people in other less advanced countries invoked this argument and tried to protect their domestic industry from imports from Britain. It is well-known that the German historical school, especially Friedrich List, insisted on protecting German industry based on this argument in the early 19th century. List was not the first person to use it. The first Secretary of Treasury of the United States, Alexander Hamilton, had already put forward this argument to nurture US domestic industry in the late 18th
century and List was strongly influenced by him. According to Jacob Viner's *Studies in the Theory of International Trade*, this argument had already been used in Britain during the mercantilist period in the 17th century to examine the necessity of monopoly privileges granted to trading companies.

According to this argument, if free trade policy is adopted internationally when only some countries have realized industrialization, other less advanced countries will have a comparative advantage in non-industrial sectors and will be forced to specialize in them. The Ricardian model teaches us that gains from trade arise only in countries that have achieved complete specialization. However, the productivity of the industrial sector improves more quickly than in other sectors because it has greater possibilities of accumulation of capital and development of technology. If less advanced countries specialize in non-industrial sectors, they cannot realize industrialization and the high economic growth it brings about.

This argument was refined using Alfred Marshall's concept of external economies. When some activities give rise to external economies, the private rate of return is smaller than the social rate of return. In such a case, social welfare can be increased by giving incentives to the people who engage in such activities at the expense of others. If we apply this theory to trade policy, the government can increase national welfare by protecting some domestic industries at the cost of domestic consumers or providing subsidies to them at the expense of domestic tax payers when there are increasing returns to scale at the level of national industry. A typical example of an activity affecting external economies is technology development. When only developed countries specialize in industrial activities under free trade, the technology gap in the industrial sector will continue to widen between developed and developing countries.

The second representative counterargument is that market failures in production factor markets are serious. Trade theories of classical and neoclassical economics are based on the assumption that production factors can move between different
sectors without significant costs in the same country and the production point is always on the production possibility frontier. The counterargument insists that this assumption sometimes does not reflect the real economy and that the production point can shift to the inside of the production possibility frontier when relative prices change drastically and large amounts of production factors are required to move between different sectors. According to this argument, the movement of production factors between different sectors in such situations should be moderated by various measures such as safeguards.

Both developed and developing countries have used this argument. However, if trade liberalization has progressed further in developed countries than in developing countries in general, it may be taken into account more frequently in the process of trade liberalization in developing countries from now on.

References

1-3 Criticism of Government Intervention in International Trade by Neoclassical Economists

After World War II, many developing countries tried to nurture domestic industries by protecting them in accordance with the infant industry argument. However, many of them failed to nurture competitive domestic industries and experienced difficulties in their balance of payments several times. Typical examples of such countries are Latin American countries and India.

As a result, the reputation of the counterarguments against the trade theories of classical and neoclassical economics, particularly the infant industry argument, has declined and they have been criticized by neoclassical economists since the 1970s. Neoclassical economists insist that these counterarguments are
often used for the interests of particular groups without calculating the total costs and benefits exactly. If some industries really need to be nurtured receiving support from the government to increase national welfare, subsidies should in theory be used instead of trade restrictions because market distortions for consumers can be avoided in the case of subsidies. According to them, trade restrictions are often imposed because the cost of trade restrictions, namely the burden on consumers, is less visible than the cost of subsidies, namely the burden on taxpayers. In addition, they argue that it is often difficult for the government to know which industries need to be nurtured in order to increase national welfare. If so, they argue, the government should advocate free trade policy without exceptions to reject any political pressure using the counterarguments against free trade policy.

While many developing countries failed in industrialization after the war, some economies in East Asia, namely Japan and the NIEs (Newly Industrialized Economies) succeeded. Neoclassical economists such as Jagdish Bhagwati attributed their success to their export promotion policies. According to Bhagwati, bias-free incentives were realized in these economies because their export promotion policies neutralized their import substitution policies. As a result, production factors were allocated based on international prices without market distortions and these economies benefited in gains from trade. Their income increased relatively fast because of these gains from trade enabling them to increase savings and accumulate capital smoothly. Accordingly, they started with labor-intensive industries such as the textiles industry and gradually shifted to capital-intensive industries such as the machinery industry, as indicated by the Heckscher-Ohlin model.

Of course, bias-free incentives can be realized by laissez-faire trade policy, which is more desirable than the combination of export promotion and import substitution. Bhagwati argued, however, that the government always has something to do and government intervention in trade tends to be import restriction
because this is politically easier than export promotion for the aforementioned reason. Therefore, according to Bhagwati, the government’s explicit commitment to export promotion as an activist is of great value to induce firms to undertake costly investment for export.

The problem of collective action has been raised by economists as one of the reasons why the government always has something to do. If political parties simply selected the policy preferred by the majority of voters, they would choose the policy preferred by the median voter. In the context of trade policy, they would choose free trade policy, because free trade policy maximizes gains from trade for consumers who are the majority of voters. The actual democratic decision-making process, however, is quite costly because decision-making requires considerable information and a variety of analyses. While gains from trade influence many people, the benefit for each individual is small and they are often unwilling to bear the cost to realize them. In contrast, while losses from trade affect fewer people, the damage for each individual is large and they tend to bear the cost to prevent it. For this reason, free trade policy is not always achieved even though the majority of voters benefit from it and the total gains to society exceed the total losses.

References

1-4 Problems with the Criticism by Neoclassical Economists
It is not clear whether we should accept this criticism by neoclassical economists without any qualifications. When today’s main industrialized countries, such as Britain, Germany, the USA and Japan, achieved industrialization before World War II, they sometimes adopted free trade policy but sometimes invoked
protective measures. In addition, even after the war, many developing countries might have failed to nurture competitive domestic industry for reasons other than import substitution policy.

For example, Japan succeeded in industrialization relatively quickly after the war while India has not been so successful. Both countries protected domestic industry in order to nurture it in the post-war period. According to Bhagwati, the main reason why only Japan succeeded in nurturing competitive domestic industry is that it promoted exports when it restricted imports.

However, it is doubtful that this is the main difference between the post-war economic policies of Japan and India. India increased state-owned enterprises to promote industrialization, while in Japan almost all the players in the industrial sector were private companies. Even in the steel industry in Japan, where the largest producer before the war was a state-owned company, all players became private companies as a result of the privatization of Nippon Steel Corporation immediately after the war. The Indian government regulated the activities of large enterprises to protect small and medium enterprises. Conversely, the Japanese government did not restrict large enterprises for such a purpose at least in the industrial sector. When the Basic Small and Medium Enterprise Law was drawn up in 1963, the Japanese government was strongly pressured to stipulate its obligation to do so. However, such an obligation was not included in the law because not only large enterprises but also the government considered that such a stipulation was inappropriate for creating an efficient and competitive industrial sector.

Bhagwati's policy recommendation might be appropriate in the current situation in India, his own country. But even when we accept his criticism partly or totally, if we focus too much on the advantages of trade liberalization, we might forget to take account of other important factors in economic policy which are not highlighted by the trade theories of neoclassical economics.
II. Equalization between Rate of Return for Private Entrepreneurs and Social Rate of Return

2-1. The Rise of the Western World

Rapid economic development through industrialization started with the industrial revolution in Britain in the 18th century. That is why most people think of this as the origin of capitalism. Adam Smith laid the foundations of classical economics in Britain in the 18th century just after the industrial revolution began.

However, in *The Rise of the Western World*, Douglass C. North and Robert Paul Thomas argue that the real origins of rapid economic development in the western world can be traced back to the 16th and 17th centuries. According to them, as population grew during the age of feudalism in Europe, the market economy expanded and it needed to be protected by political units covering larger areas. As a result, feudal societies where market economies were protected by local lords began to be replaced by nation states in the 16th century. In countries where nation states were not established until the 19th century, such as Germany and Italy, economic development was delayed.

According to North and Thomas, even in countries where nation states were established, there were significant differences in economic development depending on the relationship between the state and the private sector. In order to maintain nation states and protect market economies effectively, taxes had to be imposed on the private sector. But if nation states imposed taxes unnecessarily heavily or in an improper manner, the private sector's activity would be discouraged and economic development hampered. In France, as a result of the Hundred Years War, the Estates General surrendered its control over taxation to the king and taxes increased enormously. In addition, the state enforced guild monopolies in return for revenues and state regulation of industrial activity spread widely. For these reasons, the French economy stagnated for a long period.

In contrast, in Britain, the state's power to tax continued to
be checked by Parliament. When the struggle between the Crown and Parliament on taxation intensified under the reign of the Stuarts, the Civil War occurred and Parliament became dominant. Furthermore, monopolistic special privileges associated with the Crown were replaced by intellectual property rights which encouraged invention and innovation. As a result, the British economy grew faster than the French economy and the industrial revolution followed this remarkable economic development in Britain.

In sum, nation states need to be established to protect the market economy, but nation states should be run at minimum costs for faster economic development. There are similarities between the comparison between India and Japan described in the last chapter and this comparison between France and Britain. In both cases, the economy grew faster in the country where the expansion of the government sector as well as government regulation of the private sector were limited after the establishment of a nation state.

References

2-2 The Role of Entrepreneurs in Industrialization

*The Rise of the Western World* emphasizes that the key for economic development is to bring the private rate of return close to the social rate of return. The government should play various important roles for that purpose. This is the meaning of protection of the market economy by the government. In addition, North and Thomas argue that this requirement was fulfilled most satisfactorily in Britain because the sentiments of a growing and powerful group of merchants and traders were reflected in economic policy through Parliament.

The role of entrepreneurs in real capitalism is not fully depicted in the market mechanism of neoclassical economics. Production factors, such as labor and capital, are combined in the
price mechanism as though no entrepreneur is needed. Profits for entrepreneurs become zero in the equilibrium and it is difficult to know how the price of their services is determined. Only when the size of a firm is determined, the marginal productivity of entrepreneurs’ services is taken into account.

In order to make up for this defect of neoclassical economics, one theory has been developed by Ronald Coase in *The Nature of the Firm* to show the role of entrepreneurs in the real world. According to Coase, the cost of combining production factors using the price mechanism is not zero in the real world. Therefore, production factors sometimes agree to follow the directions of entrepreneurs within certain limits and are combined in private firms. As long as entrepreneurs can combine production factors more efficiently than the price mechanism, private firms continue to expand. When the price mechanism is more efficient than entrepreneurs, the former replaces the latter.

When we consider the number and size of private firms in industrialized countries, we understand the importance of the role of entrepreneurs. Various production factors must be combined in a complex manner in modern industrial activities and many such combinations are directed by entrepreneurs in private firms. Therefore, efficient private firms need to be organized in developing countries for their industrialization. The combination of production factors is necessary not only in the industrial sector but also in the agricultural sector. However, much more diverse production factors are usually combined in the former than the latter. As a result, the activity of organizations is usually far more complicated in the former. In addition, modern industrial activities often need input from other industrial activities. Accordingly, when developing countries establish their first modern industrial sector, they usually have to rely heavily on imported input and it is sometimes difficult to realize such imports without causing macroeconomic problems. If we view the implication of these facts in the context of the Heckscher-Ohlin model, it is more difficult to climb the ladder of comparative advantage from agricultural to industrial activity than from one
type of industrial activity to another.

For these reasons, it is crucial to provide proper incentives for private entrepreneurs in the industrial sector. In other words, it is particularly important to make the rate of return for private entrepreneurs in the industrial sector close to the social rate of return. But this is sometimes difficult to do because entrepreneurs in the industrial sector face various market failures, especially in developing countries.

When nation states are established in wider areas, taxes need to be levied to cover their costs and a large proportion of such taxes is usually imposed on private firms, because they often deal with large amounts of money and earn high profits. Entrepreneurs usually must secure a large amount of capital, but capital markets are imperfect if there is no proper government intervention, especially at the initial stage of industrialization, because of uncertainty about the future. Entrepreneurs should be properly encouraged to introduce existing new technologies as well as develop new technologies by themselves. Technology is a form of information and can often be introduced without incurring large additional costs for society. Therefore if we ignore the necessity of the development of new technologies, social welfare is maximized when intellectual property rights are not protected. However, in order to give private firms incentives to make investment for the development of new technologies, intellectual property rights must be protected. A proper policy to make the private rate of return close to the social rate of return concerning technology must lie somewhere between these two extreme policies.

The governments of developing countries must play a very important role to eliminate these market failures and wait for efficient private firms to be organized in the industrial sector. For this reason, not only the analysis of industries but also close communication with private entrepreneurs is very important for the government to plan a proper industrial policy. When we examine the relationship between the infant industry argument and the trade theory of classical and neoclassical economics in the
industrialization of representative industrialized countries in the following two chapters, we will also pay attention not only to industries but also to entrepreneurs.

References
III. Industrialization and Trade Policy before World War II
(Britain, Germany, USA, Japan)

3-1 Britain

We have already seen that a competitive domestic market was nurtured in Britain in the 16th and 17th centuries by abolishing the monopolistic special privileges conferred by the Crown. According to The Rise in the Western World, this achievement in the domestic market led to the industrial revolution in the 18th century. However, if we turn our attention to trade policy, the British government intervened in international trade actively when the industrial revolution started in the textile industry in the 18th century. Imports of calico (cotton fabrics from India) were prohibited in the early 18th century. Exports of wool were prohibited from the 17th century to promote the domestic woolens industry. Export bounties on various commodities including textile goods began in the 17th century. Exports of woolens from Britain’s colonies in America were prohibited by the Woolens Act from the 17th century.

We cannot know what would have happened if the British government had adopted free trade policy when it nurtured its competitive domestic market in the 16th and 17th centuries. Those who faithfully follow classical and neoclassical trade theory may say that the industrial revolution would have taken place earlier, while those who support the infant industry argument may say the opposite. We can at least learn from the experience of Britain that an industrial revolution can occur when a nation does not follow free trade policy and makes only its domestic market competitive.

After the industrial revolution began in Britain, in The Wealth of Nations (1776), Adam Smith criticized government intervention in international trade for harming the wealth of the nation. In 1817, David Ricardo demonstrated the theory of comparative advantage, and following the abolition of Corn Laws in 1846, Britain promoted free trade in Europe. This experience of Britain bears a close parallel to that of the USA and Japan after
World War II. Before the war, the USA adopted protective trade policy. After the war, however, it began to take the initiative in liberalizing international trade when its industry became dominant in the world. Although Japan restricted international trade until the mid-1960s, it has been promoting free trade since its industry became internationally competitive.

References

3-2 Germany

Germany was not unified as a nation state until the 19th century. The Holy Roman Empire was not eager to unify Germany, and the Reformation which started in Germany in the 16th century made its unification all the more difficult. The prince of each territory of the Empire was allowed to choose between Protestantism and Catholicism and each became more independent as a result. This delay in unification was one of the reasons for the slower industrialization in Germany than in Britain, as we have seen in Chapter 2. After the defeat of Napoleon in 1815, import restrictions in continental Europe were abolished and imports of industrial products from Britain, which had already experienced an industrial revolution, increased. At that time, Germany was divided into many tariff areas and German industrial products could not be sold freely in the German market. This was one of the reasons why it was difficult for German products to compete with imports from Britain.

In order to solve this problem, manufactures and traders in Germany organized the “German Association of Traders and Manufacturers” and petitioned their governments to organize the German Customs Union. This movement was led by Friedrich List. As a result, the German Customs Union was established in 1834 under the leadership of Prussia and became the basis of the unification of Germany in 1871. Here we can see a similarity in the establishment of the nation states of Britain and Germany:
both were established to protect larger market economies. In addition, private entrepreneurs already existed in both countries and negotiated with the government. In Britain, enclosure started from the late 15th century when feudal authority declined as a result of the Hundred Years War (1339-1453) and the Wars of the Roses in the 15th century. In Germany, unification was triggered by petitions from traders and manufactures.

After a unified market was established by the German Customs Union, Germany proceeded with industrialization when Britain already had a strong comparative advantage in the industrial sector. In other words, Germany is one of the examples of the industrialization of latecomer countries, which is often associated with the infant industry argument. Indeed, Friedrich List actually advocated high tariffs to nurture domestic industry. However, perhaps contrary to many people's expectation, Germany set only moderate tariffs on industrial products at the first stage of industrialization until the 1870s. This pattern was also observed in Japan before World War II, though not for the same reason. In Germany, this type of trade policy was chosen because the German Customs Union was led by Prussia, which exported grain. Prussia was not so devoted to the protection of domestic industry.

Until the 1870s, industrialization in Germany proceeded without high tariffs. The textile industry expanded remarkably and the steel industry also grew to a certain extent, led mainly by the construction of railway networks. If we try to apply trade theory to the industrialization of Germany during this period, the Heckscher-Ohlin model is more applicable than the infant industry argument. Latecomer countries at the beginning of industrialization were usually endowed with less capital than more advanced countries. As a result, they started industrialization with labor-intensive industry, namely light industry, and gradually shifted to more capital-intensive industry without losing gains from trade.

However, in the second stage of industrialization since the 1870s, trade policy in Germany changed. A similar tendency was
observed in Japan before World War II. In the first stage of industrialization, the comparative advantage in Germany gradually shifted from the agricultural sector to the industrial sector. After this process had proceeded to a certain extent, a world recession took place in the 1870s and both the agricultural and industrial sectors called for high protective tariffs. The interests of both sectors coincided and high tariffs were actually imposed. After that, German heavy industry, especially the steel industry, expanded quickly by making concentrated investments and achieving economies of scale until World War I. During the second stage of industrialization in Germany and Japan before World War II, heavy industry developed rapidly with high tariffs.

References

3-3 USA
The relationship between industrialization and trade policy in the USA was a little different from that in Germany and Japan before World War II. In the case of the USA, high tariffs were imposed not only in the second stage but also in the first stage and the level of tariffs was higher than in Germany and Japan during both stages. As we have already seen in Chapter 1, when the USA gained independence from Britain in the late 18th century, the first Secretary of Treasury, Alexander Hamilton, insisted that the industrial sector should be protected from imports from Britain. This was not put into practice immediately, but high tariffs were imposed to protect the textile industry and steel industry in the 1820s. In the mid-19th century, tariff rates declined to some extent as a result of compromises with the agricultural sector in the South. However, after the North won the Civil War in the 1860s, the industrial sector in the North took the initiative in economic policy and high protective tariffs were imposed again and continued until World War I. After the Civil War, especially heavy industry developed dramatically under high
Higher tariffs could be imposed for a longer period in the USA than in Germany and Japan before World War II because international trade was less indispensable for the US economy. We cannot say for sure that industrialization in the USA would not have been delayed even if moderate tariffs had been imposed. The agricultural sector in the USA was more competitive than those of Germany and Japan and the US economy heavily relied on agriculture at the beginning of industrialization. Economic development in Latin American countries offers a clear contrast to that of the USA during the 19th century. The failures in industrialization in these countries through import substitution policy since World War II are well known. However, in the 19th century, the economic development of Latin American countries was brought about mainly by exports of agricultural products and natural resources since their independence early in the century. In other words, they benefited considerably from trade. They imposed a certain level of import tariffs, but these were determined mainly to maximize tariff revenues and were not used to nurture domestic industry effectively. As a result, as their income level rose due to increases in exports of agricultural products and natural resources, their imports of industrial products increased and their domestic industrial sectors could not grow steadily.

References

3-4 Japan
As in Germany in the 19th century, the industrialization of Japan progressed with low tariffs at first and high tariffs later before World War II. However, the reason for free trade policy at the first stage of industrialization was not the same as in
Germany. In the case of Japan, the main reason for its free trade policy was not the government’s interest in the agricultural sector, but the unequal treaties concluded with more advanced western countries when Japan embarked on international trade in the mid-19th century. These treaties deprived Japan of the right to decide tariffs, but it restored this right with the abolition of the treaties in the early 20th century and began to raise import tariffs after that.

The industrialization of Japan occurred later than that of Germany and the USA. While heavy industry grew quickly under high tariffs in the late 19th century in Germany and the USA, the industrialization of Japan proceeded mainly in light industry with low tariffs. Heavy industry in Japan began to expand during World War I due to increased demand from warring nations. It declined again after the end of the war and its full-scale development was only realized before World War II. In the second stage of industrialization in Japan, high tariffs were imposed to protect heavy industry after the abolition of unequal treaties. However, increases in demand caused by wars also contributed to the development of heavy industry.

References
IV. Industrialization and Trade Policy after World War II
(Japan, Taiwan, South Korea)

4-1 The Importance of Financing for Industrialization after World War II

After the end of World War II, the USA replaced Britain as the most advanced country in the world and other countries promoted industrialization to catch up with the USA. Some of these countries, such as Japan and the NIEs, were quite successful, but many other latecomer countries did not do so well. Trade policy for industrialization in most latecomer countries after World War II was different from that in Germany and Japan before the war. Their industrialization in the post-war period started with import restrictions in contrast to the relatively free trade policies in the first stage of industrialization in Germany and Japan.

One of the reasons for this difference was the disparity in the initial conditions for industrialization. At the onset of industrialization before World War II, neither Germany nor Japan had deep experience of industrialization or rich accumulations of industrial facilities, but they already had a certain level of accumulation of private entrepreneurs in the industrial sector. In the immediate post-war period, West European countries and Japan already had experience of industrialization and accumulations of entrepreneurs, but their industrial facilities had been severely damaged during the war. Therefore they tried to restore them as quickly as possible. On the other hand, the industries of Latin American countries had been established when international trade collapsed during the war and were not internationally competitive when trade was restored after the war. These countries wanted to make their industries competitive using their existing industrial facilities. In many countries which gained independence after the war, their nation states were usually established before private entrepreneurs in the industrial sector had accumulated sufficiently and domestic entrepreneurs had to be nurtured first.
Because import restrictions were imposed immediately after the war, financing became crucial for successful industrialization. Import restrictions led to decreases in imports, but they also have the effect of raising production costs and decreasing exports, as pointed out by neoclassical economists (see Chapter 1). When imports are restricted, both imports and exports decrease and economies move toward autarky. However, industrialization needs various imported input, such as raw materials, modern machinery, and new technologies. In autarkic economies, it is not easy to finance such imports. When economies rely on financing from abroad for this reason, they are vulnerable to various changes in environment. For importers of natural resources, sharp rises in their prices cause serious problems. When droughts come, increases in imports of food bring about serious problems. Many developing countries which have not been so successful in realizing industrialization through import substitution policy after the war, such as Latin American countries and India, have experienced serious problems in their balance of payments for this reason. This is one of the most important lessons we should learn from the criticism of the infant industry argument by neoclassical economics.

In the industrialization of Germany and Japan before World War II, import restrictions were adopted after industrialization had proceeded to a certain extent under relatively free trade policies. Therefore, capital accumulation had reached a considerable level when high tariffs were imposed. In the industrialization of the USA in the 19th century, a large amount of agricultural products were exported from the beginning. In addition, capital account transactions were not restricted under the gold standard before World War II and capital flowed out from Britain, as opposed to the general controls on them under the Bretton Woods system after the war. For these reasons, when we examine industrialization in the post-war period, we will pay close attention to financing for industrialization, as well as the development of entrepreneurs and industries.
4-2 Japan

Immediately after Japan's defeat in 1945, it experienced a serious shortage of food and daily necessities and had to rely on aid from the USA to import them. However, the USA government ended this aid around 1950, expecting Japan to restore its industry independently with the unified exchange rate of 360 yen to the dollar set in an economic policy package called the Dodge Line in 1949.

After that, Japan continued to suffer from lack of foreign exchange until the mid-1960s, because the restoration of industry required considerable imports while Japan's industrial products did not become internationally competitive immediately. In response, the Japanese government restricted imports in order to save on foreign exchange as in West European countries. In addition, it promoted exports to increase inflows of foreign exchange.

When the Japanese government accelerated the restoration of industry during this period, it did not take a step-by-step approach to industrialization from the beginning. Before the war, industrialization had progressed in labor-intensive industry first and heavy industry products were imported in this phase. In contrast, immediately after the war, the Japanese government protected not only labor-intensive industries but also capital-intensive industries, such as the steel industry and the automotive industry. In addition, government support in the form of long-term low interest loans and tax reductions was provided to various industries simultaneously to make them internationally competitive as quickly as possible.

In the context of the criticism of the infant industry argument by neoclassical economics, this is a typical example of bad trade policy. The criticism argues that when all industries are protected and promoted simultaneously in a country, it cannot benefit in gains from trade and becomes vulnerable to balance of payments problems. According to this criticism, labor-intensive products should be exported while capital-intensive products are imported in the first stage of industrialization and capital-intensive
products should be exported while labor-intensive products are imported in the second stage of industrialization.

Japan did not enjoy considerable gains from international capital flows either when it suffered from a foreign exchange shortage up to the mid-1960s. Japan received a certain amount of foreign loans from organizations such as the World Bank, but their weight in Japan’s total balance of payments was very small. The amount of foreign direct investment inflows was still smaller because the Japanese government restricted them in order to protect domestic firms during that period.

In sum, the Japanese government tried to nurture a very broad range of industries simultaneously without relying on foreign capital inflows or resorting to devaluation of its currency and succeeded in this attempt. Various Japanese industries became competitive around the mid-1960s and Japan has not suffered from lack of foreign exchange since then. Up to that time, Japan did not rely heavily on foreign loans nor devalue the Japanese yen, although some West European countries devalued their currencies during this period. Special procurements by US forces during the Korean War in the early 1950s alleviated the lack of foreign exchange in Japan to a certain extent. Nevertheless, if there was something like a miracle in the economic development of Japan after World War II, this process of the restoration of industry should be raised as its first example.

However, the miracle was possible because Japan already had many private firms and the experience of industrialization when she started to restore her industry from the serious damage of the war. As we have seen in Chapter 1, even in steel industry where the largest producer was a state-owned company before the war, all players became private firms in the post war period. Japan’s experience in industrialization before the war was quite deep in both light and heavy industry. Therefore, the Japanese government was able to determine the real comparative advantages of the economy from the medium- and long-term perspectives relatively smoothly through close communication with private firms and induce various economic resources that
could be used effectively to exploit these advantages. The economic situations of Taiwan and South Korea immediately after the war were quite different from that of Japan in these respects. Therefore, they needed to modify Japan's policy to adapt it to their economies.

References

4-3 Taiwan

After the war, Taiwan was liberated from Japanese colonial rule and started industrialization on its own initiative. However, the ability of private entrepreneurs was at a lower level in Taiwan than in Japan because they had not had enough opportunity to develop it under Japanese colonial rule. As a result, Taiwan had to nurture private entrepreneurs in the industrial sector when it embarked on industrialization. This is why Taiwan had to adopt an import substitution policy in the 1950s. Germany and Japan in the 19th century did not protect domestic industry so intensively at the first stage of industrialization. However, the situation in these two countries at that time seems to have been quite different from that in Taiwan in the 1950s, because relatively efficient private entrepreneurs already existed in the former case.

Under the import substitution policy in the 1950s, private entrepreneurs were nurtured mainly in nondurable consumer goods sectors such as the food-processing and textiles industries. Since Taiwan lacked both private entrepreneurs and the experience of industrialization, it was difficult to nurture all industries simultaneously from the beginning, as in post-war Japan.

When import substitution policy is adopted to nurture domestic industry, it is usually difficult to finance imports for industrialization. In the case of Taiwan during this period, quite generous aid from the USA was available. In the case of Japan, US aid faded out around 1950. In contrast, in Taiwan and South
Korea, US aid continued until the mid-1960s. After the Korean War in the 1950s, the USA concentrated its aid on Taiwan and South Korea in order to prevent them from becoming communist regions.

Some economists have emphasized only the importance of export promotion policy since the 1960s and neglected the importance of US aid during this period. They argue that US aid was extended not only to Taiwan and South Korea but also to other developing countries, but these other developing countries were not as successful in industrialization as Taiwan and South Korea because they did not adopt export promotion policy. The accuracy of this argument is questionable. US aid was certainly extended to other developing countries as well. Following the Cuban revolution and the Vietnam War around 1960, US aid to Latin American and Southeast Asian countries increased considerably. From the 1960s, however, it gradually shifted from grants to loans, due to the relative decline of the superiority of the US economy in the world. The impacts of grants and loans on the balance of payments in the medium and long run are quite different. In addition, private entrepreneurs must be nurtured at the initial stage of industrialization. Since US aid was extended to Taiwan and South Korea earlier than to other developing countries, they were able to use it more effectively for industrialization.

Around 1960, Taiwan's economy entered a new phase. Firstly, the process of import substitution of nondurable goods almost ended and their domestic producers could not expand their production in the domestic market further. Secondly, the US government wanted to reduce its aid to Taiwan and requested Taiwan to cease being dependent on it. In this situation, Taiwan had two choices. One was the expansion of import substitution policy from nondurable goods to durable goods and capital-intensive goods. The other was the transition from import substitution to export promotion. Taiwan chose the latter. As a result, Taiwan had to liberalize imports of input for nondurable goods produced in Taiwan so that they could become
internationally competitive. In addition, since it was unclear whether promoted exports could cover decreases in US aid immediately, Taiwan promoted foreign direct investment (FDI) inflows to compensate for the decrease in aid.

This policy change was very successful. After that, Taiwan’s exports of industrial products increased quickly and Taiwan’s fast economic growth continued without causing balance of payments problems even after US aid faded out around the mid-1960s. In addition, domestic firms continued to be dominant in the Taiwanese economy even after inflows of FDI were promoted. FDI inflows actually increased to a certain extent due to this promotion policy and they played an important role in increasing exports and improving the technology of Taiwanese industry. However, the share of foreign-owned firms in total exports increased only up to around 20% and did not rise any more. At the same time, technology transfer from foreign-owned firms to domestic firms progressed swiftly and Taiwanese domestic firms became more sophisticated. In terms of the balance of payments, increases in FDI inflows contributed to compensating decreases in US aid during the late 1960s. However, total capital outflows exceeded inflows from the 1970s and the importance of FDI inflows to protect the balance of payments faded out.

These facts show that capable Taiwanese private entrepreneurs had already accumulated considerably in the industrial sector and that Taiwanese private firms had become quite efficient when this policy change took place around 1960. If there is something which can be called a miracle in the economic development in Taiwan after World War II, this fast accumulation of private entrepreneurs should be raised as its first example. Why was Taiwan able to accumulate capable private entrepreneurs so quickly? One reason is inflows of a large number of private entrepreneurs from mainland China after the war. We should also not forget that Taiwan nurtured domestic private entrepreneurs in the 1950s by adopting an import substitution policy using US aid effectively. For these reasons, the accumulation of private entrepreneurs in Taiwan reached a level
comparable to that of Germany and Japan when they started
industrialization with relatively free trade policies in the 19th
century.

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4-4 South Korea
South Korea also received generous aid from the USA and
adopted an import substitution policy in the 1950s. However, it is
said that President Syngman Rhee was corrupt and US aid was
not used effectively in South Korea during this period. At any rate,
the South Korean government continued to nurture domestic
entrepreneurs even after the USA reduced its aid in the form of
grants in the 1960s. However, the South Korean government
could not do so by maintaining import substitution policy. If
import substitution policy had been maintained even in this stage,
South Korea would have faced balance of payments problems
before long, because it had to import inputs for industrialization
without US aid.

The South Korean government combined foreign loans and
export promotion from the 1960s. Imports were needed for
industrialization, but exports could not be expected to grow
immediately to ensure that those imports were financed
simultaneously. Domestic private firms could not have been
expected to be dominant in the South Korean economy if foreign
direct investment inflows had been promoted as in Taiwan.
Therefore, foreign loans were introduced to finance necessary
imports by planning to make repayments by promoting exports.
Although it wanted to cut grants to South Korea, the US
government was still ready to provide loans. In addition, after the
conclusion of Treaty on Basic Relations between Japan and the Republic of Korea, Japan was also able to provide loans to South Korea.

However, foreign countries were suspicious about the South Korean private sector’s ability to make repayments in foreign currency although the South Korean government tried to promote exports by making full use of the private sector. As a result, the South Korean government guaranteed loans from abroad and allocated them to private firms according to their ability to export. In this system, the role of the government was more dominant than in the post-war systems for industrialization in Japan and Taiwan. Meanwhile, due to the existence of this system, macroeconomic environment was less stable in South Korea than in Japan and Taiwan, because it relied heavily on foreign loans and its balance of payments was more vulnerable. Even after South Korea joined the OECD, it was seriously damaged by Asian currency crisis in the late 1990s in which Japan and Taiwan were not so deeply involved.

However, by using this system, the South Korean government succeeded in not only nurturing domestic private firms in light industry in the 1960s but also in raising competitive heavy industry with economies of scale, such as the shipbuilding industry and the automobile industry, from the 1970s. In order to foster competitive heavy industry with economies of scale, huge investment needs to be concentrated in the hands of a limited number of firms. For this purpose, close relations between the government and private firms are often helpful, as shown in the second stage of industrialization in Germany, the USA and Japan before World War II. In South Korea, close relations between the government and private firms were maintained due to the existence of this system even after import substitution was replaced by export promotion in the 1960s. This enabled the government to focus available resources on a limited number of private firms which undertook heavy industry projects and some of these firms became internationally competitive.

Taiwan also tried to foster competitive heavy industry in the
1970s, but was not as successful as South Korea, because it was
difficult to promote close cooperation between the public and
private sectors after import substitution policy using US aid
ended in the 1960s. In the case of Taiwan, heavy industry with
economies of scale was often promoted relying heavily on public
companies, but they could not become as competitive as Korean
private firms.

References
V. Foreign Direct Investment (FDI) and Developing Countries

5-1 Combination of FDI Policy and Trade Policy

While Taiwan nurtured domestic entrepreneurs when it restricted imports using generous US aid, South Korea did so by using the very close relationship between the government and the private sector. However, most other developing countries could not receive such generous aid, nor did they have such a close relationship between the government and the private sector. Meanwhile, after World War II, FDI, especially from the USA, significantly increased although international capital flows before the war were mainly portfolio investment. As a result, many developing countries began to use foreign owned firms for industrialization instead of nurturing domestic private entrepreneurs. FDI was expected to bring both substantial funds and competitive entrepreneurs.

From the 1950s, Latin American countries accepted a large amount of FDI inflows for this purpose. However, at least during the period when they adopted import substitution policy up to the 1970s, FDI inflows did not have the expected results. When domestic markets were protected, it was relatively easy to attract FDI inflows, because foreign owned firms were protected in those markets once they were established inside them. However, such foreign owned firms usually did not have enough incentive to become internationally competitive and export their products. In addition, they often continued to import a large amount of input for production and raised capital in host countries. As a result, they often did not contribute to the improvement of the balance of payments and Latin American countries experienced serious debt crises in the early 1980s.

Meanwhile, some Asian countries combined FDI policy and trade policy in another way from the 1960s. We have already seen that Taiwan promoted FDI inflows after adopting export promotion policy in the 1960s, but its dependence on foreign owned firms did not deepen significantly even after this policy change. In contrast, Singapore adopted a combination of the
promotion of FDI inflows and exports from the late 1960s and achieved industrialization and economic development by heavily relying on foreign owned firms. Until the early 1980s, Singapore ran current account deficits and FDI inflows made up for its lack of domestic capital. Since the late 1980s, Singapore has run current account surpluses, but a large amount of FDI has continued to flow into the region until today, compensating its lack of private entrepreneurs.

Seeing the success of Singapore, Southeast Asian countries such as Malaysia, Thailand and Indonesia began to change their import substitution policy into export promotion policy in the mid-1980s. At that time, the Japanese yen was appreciating sharply after the Plaza Agreement and Japanese manufacturing firms were shifting their plants to foreign countries where production costs were cheaper. As a result, these Southeast Asian countries received a lot of FDI inflows from Japan, accelerating their industrialization and economic development.

Some people are still doubtful about the sustainability of economic development that depends heavily on FDI inflows. One basis for their criticism of FDI inflows is empirical studies on total factor productivity (TFP). In *The Myth of Asia's Miracle* (1994), Paul Krugman argued that economic growth in Singapore was not sustainable because the contribution of the improvement of TFP to its economic growth was very low. The improvement of TFP reflects technological progress. Meanwhile, entrepreneurs often play a crucial role in introducing innovations, as Schumpeter argued. Therefore, according to their criticisms, the fact that the improvement of TFP is smaller in Southeast Asian countries where foreign entrepreneurs play a very important role than in Taiwan or South Korea where domestic entrepreneurs are dominant might show the inefficiency of foreign entrepreneurs.

However, Singapore's per capita GDP has become close to that of developed countries even though its economy is still dependent on foreign owned firms. In addition, developing countries that delayed liberalizing both international trade and FDI inflows have experienced debt crises one after another (Latin
American countries in the early 1980s, India in the early 1990s). Meanwhile, Southeast Asian countries that liberalized both international trade and FDI inflows, such as Thailand and Indonesia, also experienced the Asian currency crisis in the late 1990s. However, most people thought that the currency crisis was caused by portfolio investment and that this type of crisis could be avoided by proper foreign exchange policy even if FDI inflows were liberalized and promoted, because FDI could not be withdrawn as quickly as portfolio investment.

For these reasons, most developing countries combine the promotion of FDI inflows and exports today. Some developing countries, such as China and India, have succeeded in achieving high economic growth with this type of policy combination. This has become the norm in the policies of developing countries. They are trying to proceed with industrialization by promoting FDI inflows and competing with each other to attract more beneficial FDI inflows. This economic phenomenon is an important part of the trend that people call globalization. Since the world economy has not experienced this economic phenomenon before, it is difficult to predict how the relationship between developed and developing countries will change in the future as a result of this policy combination.

References

5-2 Theories of FDI
The uncertainty concerning the influence of FDI on the relationship between developed and developing countries in the future is also due to the fact that there is still less consensus regarding FDI theories than trade theories. FDI theories are broadly divided into two types. The first type analyzes FDI as international capital flows, which include both FDI and portfolio
investment. However, portfolio investment can fluctuate for speculative reasons and is not as reliable as FDI. Therefore, FDI might be regarded as the most reliable international capital flows.

This type of FDI theory is an extension of neoclassical trade theory. When one country is abundant in capital and another country is abundant in labor, both countries gain when capital flows from the capital-abundant country to the labor-abundant country. International capital flows influence the income distribution in both countries. In the capital-abundant country, capitalists are better off and workers are worse off, and vice versa in the labor-abundant country. According to the Heckscher-Ohlin model, international capital flows do not occur when international trade has been freely conducted, because prices of production factors have been made equal through free international trade. This substitutability of international capital flows for international trade was demonstrated by Robert A. Mundell in 1957. However, the real world is usually different from the Heckscher-Ohlin model. For example, when one or both countries completely specialize in one product, the prices of production factors do not become equal between the countries. In such cases, the liberalization of international capital flows benefits both countries even after international trade has been completely liberalized.

According to this type of FDI theory, the host country of FDI can benefit in increases in corporation income taxes in addition to gains from international capital flows, because under the prevailing international arrangement the host country has the right to levy corporation income taxes first. Developing countries are usually host countries rather than home countries, because they tend to be scarce in capital. Therefore, the promotion of FDI inflows can benefit them in the form of increases in corporation income taxes at the expense of corporation income taxes in home countries.

The second type of FDI theory analyzes FDI as international operations of multinational enterprises. Steven Hymer argued that the direction of FDI is sometimes different from that of
portfolio investment and cannot be explained by the difference in the interest rate. He insisted that this tendency exists because one important purpose of FDI is to control foreign firms for running international operations. After Hymer presented this argument, various theories of FDI developed on the basis of it. One representative argument of this type insists that the existence of propriety assets causes FDI. Examples of propriety assets are technology, know-how and brand. Since they can be transferred abroad but cannot be sold to foreign firms effectively, they are transferred to foreign countries inside multinational enterprises. We have already seen in Chapter 2 that Coase argued that transactions are conducted inside firms when the cost to use the market mechanism is higher.

This type of FDI theory is very diverse. Some are optimistic and others are pessimistic about the influence of FDI inflows on developing countries. Some optimistic theories emphasize that FDI brings to developing countries important technologies that cannot be transferred to them without FDI flows. Other optimistic theories treat the management resources of multinational enterprises as if they are capital and argue that free international transfers of management resources bring about benefits in both host and home countries as in the first type of FDI theory. In contrast, some pessimistic views emphasize that part of the profits of multinational enterprises arise from their oligopoly status. They argue that if developing countries rely heavily on foreign firms, it will become difficult for them to nurture domestic entrepreneurs and enjoy such profits through domestic firms' activity.

Some of this type of FDI theory insist that the promotion of FDI inflows by developing countries can be effective because of the oligopolistic nature of multinational enterprises, and for this reason developing countries can make them compete with each other by promoting FDI inflows. According to these theories, oligopolistic enterprises tend to follow their competitors' new trials to keep their market shares, and therefore if a developing country succeeds in attracting one multinational enterprise, its
competitors tend to make FDI in the same country. However, if many countries compete with each other to give incentives to attract multinational enterprises based on these theories, this might result in the "prisoner's dilemma" and only multinational enterprises might gain at the expense of taxpayers in those countries.

References
VI. International Rules on Trade and FDI

6-1 GATT/WTO Rules and Trade Friction between the USA and Japan after World War II

Even if latecomer countries can accelerate their economic growth following the infant industry argument, this growth can be maintained in the long run only when other countries maintain a free trade policy. If other countries retaliate against latecomer countries by restricting imports from them, economic welfare in the latecomer countries as well as the world as a whole will not be maximized in the long run. One advantage of the trade theories of classical and neoclassical economics is that all countries can benefit through free trade without any country becoming worse off.

Around the mid-19th century, Britain promoted a free trade policy advocated by classical economics and relatively free trade was realized. However, two big latecomer countries, namely the USA and Germany, raised tariffs from the 1860s and the 1870s respectively while Britain maintained its free trade policy. As a result, these two countries' industry caught up with British industry, but the growth rate of international trade gradually declined. Between the First and Second World Wars, the gold standard was restored to increase international trade again. However, the Great Depression occurred soon after that and protectionism prevailed in the world economy. As a result, international trade stagnated further during this period.

After World War II, the General Agreement on Tariffs and Trade (GATT) was concluded to restore international trade. However, free trade following GATT rules was not realized immediately. One reason for this was the widespread destruction of the economies of West European countries and Japan during the war. As a result, West European countries and Japan continued to restrict imports until 1958 and 1964, respectively, to deal with balance of payments difficulties by invoking Article 12 of GATT, although GATT prohibited quantitative restrictions in principle.
Having extended large amounts of aid to them, the USA allowed these import restrictions in order to make these countries self-supporting as soon as possible. The USA assisted Japan in acceding to GATT in 1955 without abolishing quantitative import restrictions, although this was opposed by some West European countries. On the other hand, when exports of Japanese industrial products to the USA increased and damaged US industry in the late 1950s, the US government wanted them to be restricted.

GATT allowed members to impose quantitative import restrictions for limited periods as safeguard measures when their domestic industries were seriously damaged by increases in imports. The USA did not invoke safeguard measures by itself, but forced Japan and some other countries to impose voluntary export restraints (VERs) even though such measures were not allowed in GATT. There were some conceivable reasons for this policy of the US government. Firstly, if the USA had invoked safeguard measures, it would have had to provide compensation for safeguard measures to exporting countries in accordance with GATT. However, the US government did not want to provide compensation. Secondly, if the USA had invoked safeguard measures without providing compensation, the exporting countries would have been allowed to take retaliatory measures against the USA based on GATT. However, the USA wanted to prevent retaliatory measures. Thirdly, if the USA had invoked safeguard measures, they would have had to be taken against all exporting countries following the most-favored-nation treatment stipulated in GATT. However, the USA wanted to restrict imports from countries whose exports had increased sharply. In the case of VERs, the USA did not need to provide compensation, worry about retaliatory measures, or restrict imports from countries other than Japan.

Significant trade friction between the USA and Japan started in textiles in the late 1950s. The Japanese government imposed VERs on cotton goods in 1957. These measures developed into the Short-term Arrangement on Cotton Textiles (STA) in 1961 and
the Long-term Arrangement on Cotton Textiles (LTA) in 1962 involving other exporting and importing countries. In 1974, this further evolved into the Multi-Fiber Arrangement (MFA) covering not only cotton goods but also other fibers. From the 1960s, trade friction spread from textiles to a variety of industrial products. VERs began to be imposed by the Japanese government for the USA on steel in 1966, on color TVs in 1977, and on automobiles in 1981. West European countries followed suit and also requested Japan to impose VERs for them as well. VERs for West European countries were imposed on steel in 1972 and on VCRs in 1983.

However, the USA changed its policy toward trade friction after it ran record current account deficits in the early 1980s. Since VERs benefited US industries but harmed US consumers, the USA began to use unilateral retaliatory measures against alleged unfair markets in foreign countries based on Section 301 of the Trade Act of 1974. In these measures, the USA threatened to take retaliatory measures in the form of import restrictions in order to make Japan and other countries increase their imports from the USA. The first main target of this policy was the Japanese semiconductor industry. The US government began to investigate alleged unfair business practices in the Japanese semiconductor industry in 1985 based on Section 301 of the Trade Act of 1974.

This policy of the USA completely contradicted GATT. In GATT, alleged unfair markets of some members must be investigated through the dispute settlement procedures of GATT, not by other members. However, the Japanese government could not expect these procedures of GATT to accept Japan’s claim and reject the USA’s claim at that time. GATT was still weak, and some other countries were still suspicious about the fairness of the Japanese market. Therefore, the Japanese government compromised with the USA as it did in VERs and promised to make efforts to increase sales of foreign semiconductors in Japan in the US-Japan Semiconductor Agreement in 1986. However, the US government imposed 100% tariffs on Japanese computers, color TVs etc. as retaliatory measures against Japan in 1987.
unilaterally insisting that the Japanese government’s efforts were not sufficient. The Japanese government had to continue to make efforts to increase sales of foreign semiconductors, but these efforts were more harmful to the Japanese economy than VERs. In a market economy, it is technically possible for a government to restrict exports, but it is impossible to force the private sector to import a certain amount of semiconductors.

The second major target of this policy was the Japanese automobile industry. The US government threatened to impose 100% import duties on Japanese luxury automobiles in 1995, alleging that the Japanese auto parts market was unfair. This time, the Japanese government did not compromise with the USA. The WTO had been established at the beginning of 1995 after the long negotiations of the Uruguay Round, and the authority of the GATT/WTO rules had been strengthened. More countries now understood the fairness of the Japanese market compared to ten years earlier. Therefore, the Japanese government decided to bring this case to the WTO and, as a result, the USA did not take retaliatory measures.

After this event, Japan came to invoke GATT/WTO rules more frequently. All VERs of Japan were abolished following GATT/WTO rules. Trade frictions between the USA and Japan began to be resolved using GATT/WTO rules about a half century after the establishment of GATT after World War II.

Meanwhile, developing countries also began to use GATT/WTO rules more frequently after the establishment of the WTO. Before the Uruguay Round started, many developing countries still adopted import substitution policy and they were not so eager to use GATT rules to expand their exports. Therefore, their scope of bindings on non-agricultural products was usually narrow. However, during the Uruguay Round, many of them changed their import substitution policy into export promotion policy, because they began to adopt a combination of the promotion of FDI inflows and exports, as we have seen in Chapter 5. As a result, their scope of bindings expanded remarkably, and in the case of countries like India, their average bound rates also
declined as a result of the Uruguay Round. In addition, the Soviet Union collapsed during the Uruguay Round and many economies in transition tried to achieve economic growth by combining the promotion of FDI inflows and exports. Many of them applied to join the WTO to expand their exports after its establishment. For these reasons, GATT/WTO began to attract considerable attention among developing countries as well about a half century after the establishment of GATT. However, some people doubt whether developing countries will be really satisfied with the outcome of their active participation in the WTO. One of the reasons for their doubt is the difficulty of predicting how the relationship between developed countries and developing countries will change after the latter adopt a combination of promoting FDI inflows and exports.

References

6-2 International Rules on FDI
Unlike trade rules, international rules on FDI were not included in GATT until the establishment of the WTO. FDIs were protected from expropriation at the post-establishment stage mainly by bilateral agreements during this period. However, until the conclusion of the Uruguay Round, some developing countries came to adopt the combination of promoting FDI inflows and exports and to prefer free international FDI flows. As a result, some rules on FDI were included in the GATT/WTO rules. Local content requirement was prohibited explicitly in the Agreement on Trade-Related Investment Measures (TRIMs). In addition, the General Agreement on Trade in Services (GATS) stipulated most-favored-nation (MFN) treatment by negative list approach and national treatment by positive list approach at both the pre-
and post-establishment stages concerning the service sector, because the commercial presence of foreign suppliers usually played a more important role in trade in services than in trade in goods.

This international agreement on FDI on a multilateral basis was epoch-making. However, it covered only some specific sectors and activities and was not a comprehensive agreement. Some developed countries, especially the USA, tried to achieve a more comprehensive multilateral agreement on FDI among developed countries first, and expand it to developing countries later. For that purpose, they started negotiations to make a Multilateral Agreement on Investment (MAI) in the Organization for Economic Cooperation and Development (OECD) in 1995, but they found that even developed countries had diverse views on the liberalization of international FDI flows and abandoned this attempt in 1998. In the WTO as well, the Singapore Ministerial Meeting in 1996 decided to establish a working party to examine the relationship between trade and investment. However, no consensus had been reached about whether negotiations for multilateral investment rules should be included in the Doha Round until the Cancun Ministerial Meeting in 2003. As a result, such negotiations were not included in the Doha Round and the current GATT/WTO rules are the only multilateral rules on FDI as of now.

Meanwhile, countries that needed more comprehensive international rules on FDI began to make such rules on a bilateral or regional basis. A typical example is the North American Free Trade Agreement (NAFTA) in 1994. Mexico needed NAFTA to increase FDI inflows from and exports to the USA. NAFTA is famous as one of the major free trade agreements (FTA). However, the crux of NAFTA is the combination of the liberalization of trade and investment, and its Chapter 11 about investment set an influential precedent for other international rules on FDI. NAFTA stipulated both MFN treatment and national treatment by negative list approach and covered not only the service sector but also other sectors including manufacturing.
In addition, NAFTA allowed private investors to commence arbitral proceedings to directly challenge host countries' policies. Due to this provision, member countries have been forced to change their policies sometimes as a result of foreign private investors' claims. In the WTO, only governments can join dispute settlement procedures.

Japan has also concluded a series of Economic Partnership Agreements (EPA) including FTAs since its EPA with Singapore in 2002 and has included the NAFTA type of FDI rules in them, although a lot of FDIs have been implemented without such FDI rules. It is difficult to predict how such rules will influence FDI flows and the relationship between developed and developing countries in the long run.

References
VII. International Finance

7-1 The Self-Regulating Specie Flow Mechanism and "Dutch Disease"

Up to Chapter 6, we have discussed trade and investment in real terms based on the assumption that demand and supply are always balanced without money as in the general equilibrium theory of microeconomics. However, the balance of payments is often imbalanced and financed by international money flows. Developing countries have been damaged by debt or currency crises several times.

When mercantilism was replaced by classical economics in Britain, not only Adam Smith but also David Hume, who advocated the self-regulating specie flow mechanism in 1752, played an important role. Hume argued that if England had trade surpluses by restricting imports and promoting exports, gold would flow into the country to finance them and would be used as money, price levels would rise, English products would become less competitive internationally, and ultimately England would not be able to maintain trade surpluses.

Classical economics combined this self-regulating specie flow mechanism with Ricardo's theory of comparative advantage and considered that international trade did not need government discretionary intervention from both the microeconomic and macroeconomic viewpoints. We can understand the economic phenomenon known as Dutch disease in relation to this combination. Dutch disease is the damage to industry in a country when its exports of natural resources or agricultural products increase sharply. When exports increase, foreign currency flows into the country and inflation or currency appreciation occurs. As a result, its industry becomes less competitive internationally. We have already examined such conflicts between industry and agriculture in Germany and the USA in the 19th century in Chapter 3.

References
7-2 Money in General Equilibrium and Monetary Policy in Britain in the 19th Century

One question arises regarding Hume's self-regulating specie flow mechanism. Even when gold was used as money domestically, banknotes convertible to gold were also used as money. Is the quantity of money including banknotes proportionate to the amount of gold?

In order to analyze this question, we will examine money in terms of general equilibrium theory. According to that theory, general equilibrium can be reached even if money is regarded as one commodity, such as gold. However, in the classical dichotomy, the quantity theory of money is attached to general equilibrium theory and relative prices in real terms are determined in general equilibrium theory while absolute prices are determined according to the quantity theory of money. Which of these views is closer to the real world?

During the war against France around 1800, the British government suspended the convertibility of banknotes to gold or silver and sharp inflation occurred. This led to the “bullion controversy.” Bullionists such as Ricardo claimed that the general price level would be stabilized only if the convertibility of banknotes to gold was restored. On the other hand, the anti-bullionists argued that banknotes could be issued appropriately even when their convertibility was suspended because they were issued at interest only in response to business needs. The convertibility of banknotes only to gold was restored in 1821 at the rate before its suspension and the gold standard was established in accordance with the bullionists’ view after Napoleon was defeated. After that, the general price level continued to drop to even below the level before the suspension and the bullionists’ prediction was not necessarily realized. The bullionists considered that the price of gold would be stable before and after convertibility was restored, because they regarded gold...
as a commodity. However, in actuality, demand for gold increased and its price rose after the convertibility of banknotes was restored only to gold. This experience shows that money should be introduced into general equilibrium theory with the quantity of theory of money and should not be introduced as a commodity.

After the introduction of the gold standard, the British economy experienced several business fluctuations. People belonging to the "currency school" claimed that business fluctuations were accentuated by fluctuations of the amount of banknotes, which should correspond exactly to the amount of gold reserves in the Bank of England. Conversely, people belonging to the "banking school" claimed that banknotes were not issued improperly because they were issued at interest in response to business needs.

In the mid-19th century, the Bank Act of 1844 was enacted following the views of the currency school, resulting in a system where the amount of reserves of the Bank of England in the form of banknotes was directly controlled by the amount of its gold reserves. However, business fluctuations did not stop even after that, because this law did not regulate the loans and deposits of the Bank of England or private banks. Not only gold and banknotes but also deposits served as money.

Based on these experiences, banknotes are not linked to gold and the government and the central bank are expected to control the price level and/or the total money supply including deposits directly in most countries today. Accordingly, it is not rare today even for developing countries to issue their currencies without linking them to gold or the currencies of developed countries, such as the dollar. However, we should not forget that the Bank Act of 1844 was maintained until the beginning of World War I, despite its many defects. In addition, the convertibility of main currencies into gold was maintained until the US government suspended it unwillingly in 1971. Developed countries built confidence in their currencies under their convertibility to gold for a long time. Developing countries that do not have such a history need to make very prudent efforts to build confidence in their currencies.
References

7-3 The Foreign Exchange System between the Wars

During World War I, the gold standard was suspended and worldwide inflation occurred. After the war, countries began to consider how to restore the gold standard to reactivate international trade. The USA had no trouble in restoring convertibility at the old par in 1919, only one year after the end of the war, because it had not been deeply involved in the war and had experienced only mild inflation. In contrast, European countries, not only losers such as Germany and Austria but also winners such as Britain and France, could not restore the gold standard so quickly, because they suffered much more serious damage in the war. Britain and France imposed a huge burden of reparation payments on Germany in the Versailles Treaty in 1919 and Germany experienced hyperinflation. Britain and France also experienced higher inflation than the USA and had to rely on abundant imports from the USA to restore their economies.

After hyperinflation in Germany ended in 1923, European countries began to prepare for the restoration of the gold standard. Britain and France approached this task differently. Britain restored convertibility at the old par in 1925 although it experienced high inflation during World War I. John Maynard Keynes opposed this policy, arguing that it would overvalue the pound. If the pound was overvalued, he argued, British industry would less competitive internationally, it would have trade deficits, gold would flow out and it would experience severe deflation. However, Winston Churchill, the Chancellor of the Exchequer at the time, argued that any deviation from the prewar price would have undermined world confidence in the stability of the British financial institutions that had played the leading role in international finance before the war. He and the rest of the British government expected the self-regulating specie
flow mechanism to effectively weaken the deflationary momentum triggered by the restoration of the gold standard at the old par. According to the self-regulating specie flow mechanism, if Britain had trade deficits, other countries would have trade surpluses and they would cause inflation. In contrast to this policy, France devalued the franc by 80% and restored the gold standard.

As things turned out, the self-regulation specie flow mechanism did not function as expected by Britain. In order for this mechanism to function properly, the money supply of each country must change in response to changes in international reserves. The amount of high-powered money is decided by domestic reserves as well as international reserves. If central banks try to vary the money supply in response to changes in international reserves, their domestic and international reserves must change in the same direction. According to Ragnar Nurkse, however, these two reserves changed in the same direction only 26 out of 106 times between the years 1925 and 1929. In other words, central banks often took steps to insulate the domestic money supply and domestic price levels from the influences of changes in international reserves. In addition, when international reserves were already small and decreasing further, central banks had no choice but to change the money supply in the same direction as international reserves. Had they failed to do so, they would have run out of international reserves and failed to maintain the convertibility of the banknotes. Thus, Nurkse's data show that central banks very often offset the effect of changes in international reserves when international reserves were increasing. This is known as "sterilization policy." After World War I, the USA enjoyed sizable surpluses in the current account and large amounts of gold flowed into the country. Inflows of gold also increased quickly in France in the late 1920s, after the franc was devalued. The central banks of the USA and France offset the effect of gold inflows to prevent inflation and maintain the international competitiveness of their domestic industries. By 1932, these two countries held more than 70% of the world's gold.
As a consequence, the gold reserves in Britain became small and its industries were seriously damaged by continuous deflationary pressure.

Under such circumstances, the Great Depression, which started in 1929 in the USA, triggered financial crises in Europe and the gold standard collapsed. After hyperinflation in Germany stabilized in 1923 and the gold standard was restored in European countries in 1925, a large amount of private capital flowed from the USA to Germany. At this time, Germany began to pay reparations and seriously lacked capital to restore its economy. In contrast, the USA had large current account surpluses. In such a situation, it was quite natural for private capital to flow from the USA to Germany after the fixed exchange rate system was established by the gold standard and the foreign exchange rate risk accompanying international capital flows became small. German banks provided long-term loans inside Germany using private capital from foreign lenders.

After the Great Depression started in the USA in 1929, the rapid curtailment of private capital from the USA began and triggered a chain of financial crises. When information on the difficulties of the Credit-Anstalt, the biggest bank in Austria and a borrower of large amounts of foreign loans, was disclosed in May 1931, foreign creditors rushed to withdraw their loans and the bank collapsed. This incident in Austria raised doubts about the financial condition of Germany. Foreign creditors withdrew capital from Germany and the German Central Bank lost nearly one third of its foreign exchange reserves in the first 12 days of June 1931 alone. When negotiations were held between the central banks of Germany and other countries to mitigate the crisis, Germany's largest textile company went bankrupt. As a result, the Danat Bank, the main creditor to the failed textile company, fell victim to a run and ultimately collapsed. The German Central Bank could not maintain the convertibility of the mark and introduced exchange controls in July 1931.

As the British balance of payments was chronically weak when the Danat Bank failed, the foreign exchange value of the
pound was shaken as well. Foreigners and foreign central banks holding British pounds lost confidence in Britain's commitment to maintain the convertibility of the pound and reacted by converting their pound holdings into gold. The Bank of England called for loans from the central banks of the USA and France, but the loans extended were not enough. In September 1931, Britain abandoned the gold standard and most other countries followed suit.

This experience shows that the combination of the fixed exchange rate and free capital account transactions is vulnerable as long as a country does not abandon its monetary policy autonomy by adopting the currency board system. When the Asian currency crisis occurred, some people said that it was a new type of crisis caused by international private capital flows. However, the collapse of the gold standard had already been triggered by international private capital flows before World War II when a large international imbalance between supply and demand for capital arose and a combination of the fixed exchange rate and free capital account transactions was adopted. Before the Asian currency crisis started, most countries seriously damaged by it adopted foreign exchange systems that are similar to this combination in order to promote foreign capital inflows. This fact shows us how important the study of history is.

References

7-4 From Fixed Exchange Rate to Floating Rate after World War II

Before World War II ended, the Allies had already agreed on the Articles on Agreement of International Monetary Fund (IMF) at Bretton Woods in the USA in 1944, and international transactions started within the framework of this agreement after the war. The ultimate purpose of this agreement, known as the
Bretton Woods system, was to promote international trade by requiring members to liberalize current account transactions. It was still based on the fixed exchange rate like the gold standard before the war and expected the self-regulating specie flow mechanism to function. However, it explicitly allowed members to control capital account transactions, having learned from the collapse of the gold standard. In sum, the Bretton Woods system was the combination of the fixed exchange rate and capital account controls.

However, this system functioned only for a short period. European countries and Japan controlled not only capital account transactions but also current account transactions until the late 1950s and the early 1960s, respectively, because they suffered serious damage during the war and could not keep enough foreign exchange reserves to maintain their fixed exchange rates without such controls. After they liberalized current account transactions, the USA found it difficult to maintain this system. In the 1960s, the USA fought the Vietnam War while frequently adopting expansive Keynesian policies within its borders. The result was a gradual rise in inflation and gradual decrease in the current account surplus. US dollars began to be sold in exchange for gold and gold began to flow out of the country. The US government restricted capital outflows in various ways but could not stop the outflows of gold. Finally the USA suspended the convertibility of the dollar into gold in 1971. In order for the self-regulating specie flow mechanism to function, the USA should have caused deflation while other countries with trade surpluses such as Japan and Germany should have brought about inflation. However, neither the USA nor other countries did so. History once more showed how difficult it is to make the self-regulation specie flow mechanism work.

After the USA suspended the convertibility of the dollar into gold, the major countries gradually adopted the floating system and the Bretton Woods system collapsed. In addition, some years after floating their currencies, most of them liberalized capital account transactions. Britain did so in 1979, Japan in 1980,
Australia in 1984, and France in 1990.

There were certain reasons why capital account transactions could be liberalized after currencies were floated. Firstly, speculation moderates changes in foreign exchange rates under the floating system, whereas it increases the volatility of foreign exchange rates under the fixed exchange rate system. Under the fixed exchange rate system, speculation can be made without risks when a country has a large imbalance in its balance of payments. For example, when a country has a large current account deficit and its foreign exchange reserves continue to decrease, it has only two choices: devaluation or the continuation of the current exchange rate. Revaluation is almost impossible, because revaluation hastens the decrease in foreign exchange reserves and larger devaluation must follow immediately. Therefore, speculators who sell its currency will gain in the case of devaluation, or will not gain nor lose in the case of the continuation of the current exchange rate. In such a circumstance, rampant speculation can easily accumulate in one direction and when the country cannot maintain the current rate, its exchange rate will devalue drastically. In contrast, under the floating system, speculation cannot be made without risks, because the exchange rate always may change in both directions. Therefore, speculation does not accumulate in one direction and moderates the volatility of exchange rates.

Secondly, monetary policy is effective without controls on capital account transactions under the floating system while it is ineffective without them under the fixed exchange rate system. Under the fixed exchange rate system, capital flows between countries almost without foreign exchange rate risks. Therefore, when a country tries to raise domestic interest rates to implement tight monetary policy, foreign capital flows into that country and nullifies the tight monetary policy if there are no capital account controls. As a result, the country can use only fiscal policy, but it is usually difficult to implement sufficiently flexible macroeconomic policy only by fiscal policy. In contrast, in the case of the floating system, interest rates in a country are not
necessarily equal to the international interest rate because of the existence of foreign exchange rate risks. Therefore, a country can raise or lower domestic interest rates for monetary policy without controlling capital account transactions.

References

7-5 The Foreign Exchange System in Japan after World War II
As we have already seen in Chapter 4, after the exchange rate of the Japanese yen was unified and fixed at 360 yen to the dollar along the Dodge line in 1949, Japan suffered lack of foreign exchange until the 1960s because the Japanese economy suffered serious damage during the war. During this period, the Japanese government controlled not only capital account transactions but also current account transactions to deal with lack of foreign exchange. The Articles on Agreement of International Monetary Fund expected that lack of foreign exchange would be coped with by tight macroeconomic policy and current account transactions would be liberalized. However, that expectation was unrealistic in the immediate post-war period. For example, when Britain was actually persuaded to do so and restored the convertibility of the pound in 1947, holders of pounds all over the world rushed to convert their pounds into dollars and Britain was forced to suspend convertibility again in just one month.

In the 1960s, the current account balance of Japan moved from deficit to surplus and it liberalized current account transactions. As a result, Japan became an IMF Article 8 country in 1964 and subsequently controlled only capital account transactions. As we have already seen in the previous section, the USA experienced high inflation in the 1960s and suffered from
speculative capital outflows. Both the US and Japanese governments tried to restrict capital flows from the USA to Japan, but the foreign exchange reserves of Japan significantly increased from the late 1960s. Finally, the USA suspended the convertibility of the dollar to gold in August 1971 and the Japanese yen began to float after that. From this experience, we know that capital account controls contribute to the maintenance of the fixed exchange rate system to a certain extent, but when fundamental disequilibrium is too serious, they can be evaded and the fixed exchange rate system cannot be maintained only by them.

From December 1971 to February 1973, the fixed exchange rate of 308 yen to the dollar was restored based on the Smithsonian Agreement, but the Japanese yen floated again after that. Even after floating the yen, the Japanese government maintained capital account controls until 1980, because it was still unsure whether free capital account transactions would function well under the floating system. Meanwhile, under the floating system, the Japanese government did not necessarily have to settle current account imbalances using its foreign exchange reserves as it had done under the fixed exchange rate system and could completely stop intervening in the foreign exchange market, because it could expect the current account to be adjusted by the movements of the exchange rate. However, the Japanese government tried to moderate the movements of the foreign exchange rate both by using capital account controls and by intervening in the foreign exchange market. It thought that foreign exchange rates might fluctuate without such efforts, because it might be difficult to settle current account imbalances using only the movements of foreign exchange rates especially when capital account transactions were controlled.

As such, the Japanese government encouraged capital outflows, restricted capital inflows and bought dollars when the yen was appreciating and vice versa when the yen was depreciating. In the 1970s two oil crises occurred. The Japanese yen appreciated until the outbreak of the first oil crisis in October 1973, depreciated until 1976, appreciated again until the
beginning of the second oil crisis in 1979, and depreciated again after that. When the yen appreciated for the second time after 1976, the Japanese government was criticized by foreign countries, especially the USA whose trade deficits increased significantly at that time, as trying to depreciate the yen and increase Japan’s trade surpluses. Meanwhile, many countries began to be confident that free capital account transactions could function well under the floating system. Accordingly, the Japanese government announced in 1978 that it would relax its capital account controls in the near future and actually liberalized them in 1980. Since then the combination of the floating system and free capital account transactions has been maintained until today.

Under this combination, current account imbalances are theoretically determined by the gap between savings and investment. Current account imbalances are financed by capital account imbalances and do not necessarily need to be adjusted in principle. In this sense, the meaning of current account imbalances with free capital account transactions is significantly different from that with capital account controls. In the early 1980s, Japan’s current account surpluses increased sharply after it abolished capital account controls while the USA’s current account deficits also increased significantly, because a large amount of capital flowed from Japan to the USA. Theoretically, such current account imbalances are not problematic. In actuality, however, they exacerbated trade friction between Japan and the USA. As a result, developed countries jointly intervened in the foreign exchange market at the request of the US government to depreciate the US dollar and appreciate the Japanese yen after the Plaza Agreement in September 1985 and the yen appreciated from around 240 yen to 140 yen to the dollar. This sharp appreciation of the yen became one of the main causes of the emergence and the collapse of the bubble economy in the late 1980s in Japan. From this experience, we know that current account imbalances can become very large under the combination of the floating system and free capital account transactions and
that such large current account imbalances must be dealt with carefully even though they are not problematic theoretically.

References

7-6 Currency Crisis in Indonesia
The Asian currency crisis started in Thailand, but as things turned out, Indonesia was most seriously damaged by it. When the crisis had just started, most people thought that Indonesia would not be hit as severely as Thailand, because the Indonesian rupiah was not as overvalued as the Thai baht and the ratio of current account deficits to GDP was not as large in Indonesia as in Thailand. This disparity was mainly caused by the difference in the foreign exchange rate regimes of the two countries before the crisis. Thailand pegged the baht to the dollar and did not adjust the internal and external difference in the inflation rate while Indonesia depreciated the rupiah continuously to make this adjustment by adopting the “crawling peg” system.

However, the peg system and the crawling peg system also have certain things in common. In both systems, exchange rates in the future are fairly surely guaranteed by the government and capital can flow internationally without significant foreign exchange rate risks. We have already seen from the case of Germany between the wars (Section 7-3) that such foreign exchange rate systems are vulnerable when they are combined with free capital account transactions. Once asset holders become suspicious about the government’s ability to maintain the existing system, they can speculate without significant foreign exchange rate risks. The government cannot use monetary policy effectively in order to control inflation because international capital flows
nullify its effects.

Therefore it is uncertain whether Thailand could have avoided the currency crisis if she had depreciated the baht continuously by adopting the crawling peg system like Indonesia. If she had done so, the inflation rate in Thailand might have been higher. Before the crisis, inflation rates were higher in Indonesia than in Thailand. When Indonesia implemented the combination of the crawling peg system and free capital account transactions from 1986 until the currency crisis in 1997, inflation could not be curbed significantly and the rupiah continued to depreciate against the US dollar. One reason for this outcome was that tight monetary policy was not effective under this combination due to induced foreign capital inflows. As a result, confidence in the rupiah could not be developed during this period, which was one of the reasons why the currency crisis spread easily from Thailand to Indonesia.

After experiencing the crisis, Indonesia adopted the floating system like Thailand but unlike Malaysia, which fixed the exchange rate by significantly strengthening controls on capital account transactions. In order to avoid the repetition of currency crises, Indonesia should first curb inflation strictly fully utilizing the monetary policy that is now effective under the floating system. In the case of developed countries, nothing is usually done about capital account transactions to stabilize exchange rates under the floating system. However, in the case of developing countries, capital account transactions are sometimes partly controlled to avoid speculative attack on their currencies. Firstly, both Thailand and Indonesia promoted the non-internationalization of their domestic currencies after the currency crisis by prohibiting lending to foreign countries in their domestic currencies. If domestic currencies do not exist in foreign countries, speculative attacks on them cannot occur from abroad.

However, speculative attacks can occur domestically as well. Indonesia has not imposed any effective controls to deal with this problem. In contrast, the Thai government is restricting the conversion from Thai baht to foreign currency for capital outflows
to cope with such a possibility. It is said that Indonesia has not introduced this type of control because Chinese Indonesian business people play a very important role in the Indonesian economy. They have a lot of assets in foreign countries, especially in offshore banks in Singapore, and if such a control were imposed, they might not invest in Indonesia and the recovery of its economy would be delayed further. It is difficult to confirm the truth of this view. There is no consensus about what kind of controls should be imposed on capital account transactions to stabilize foreign exchange rates when developing countries adopt the floating system and there is no single answer to this question, which can apply to all developing countries.

References