THE RETURN OF INDUSTRIAL POLICY

Douglas Irwin

Should developing economies follow the United States and China by building national champions?

Geopolitics is rapidly changing the landscape of world trade. The policy environment of just a few decades ago seems like a distant memory. During the reform period of the 1990s and 2000s, developing and transition economies opened up their markets and embraced globalization. That period saw the creation of the World Trade Organization, establishing a rules-based system of nondiscriminatory trade. It was also marked by an absence of geopolitical tensions as China focused on growth and Russia struggled with stabilization.

Now policymakers debate the future of globalization. They worry about the fragmentation of the world economy and the flouting of global trade rules. Trade interventions are on the rise, in the form of industrial policies and subsidies, import restrictions based on national security and environmental concerns, and export controls to punish geopolitical rivals and ensure domestic supply.

What should developing economies do to navigate this new environment? Should they adopt similar policies, turning inward to protect key sectors with subsidies and trade controls?

The debate about whether developing economies should step into or back from the world economy is perennial. In the 1950s, many observers were pessimistic about the export prospects of low-income countries and feared they faced ever declining terms of trade. Global economic forces were seen as exacerbating inequality and pushing developing economies further behind. Import-substitution policies were needed, it was thought, to make their economies more self-reliant and less dependent on other markets.

Misreading history

Part of the reason for turning inward was a particular interpretation of history. The belief that richer countries were successful because they protected manufacturing gave respectability to industrial policy. That turned out to be a misreading of history. Despite high tariffs, the United States developed as an open economy—open to immigration, capital, and technology—and one with an exceptionally large domestic market that was fiercely competitive. Furthermore, the high-tariff United States overtook free-trade Britain in per capita income in the late 19th century by increasing labor productivity in the service sector, not by raising productivity in the manufacturing sector. In Western Europe, growth was related to the shifting of resources out of agriculture and into industry and services. Trade policies designed to protect agriculture from low prices likely slowed this transition in countries such as Germany.

While across-the-board import substitution fell out of favor decades ago, the debate over industrial policy continues to this day. The experience of successful East Asian countries has given it a positive gloss, but even here standard history can mislead. In 1960, South Korea was saddled with an overvalued currency and exports of just 1 percent of GDP. The country's ability to import depended almost entirely on US aid. After devaluing its currency in the early and mid-1960s, Korea's exports became more competitive and exploded, reaching 20 percent of GDP by the early 1970s. The main policy involved setting a realistic exchange rate that allowed exports to flourish along with cheaper credit for all exporters, not targeted industries. Industrial policy did not really start until the Heavy and Chemical Industry Drive of 1973–79, which was later terminated because of its excessive costs and inefficiency. But Korea's rapid growth had already been unleashed before the industrial policy era.

The debate over industrial policy has long been locked in a stalemate. Some see it as essential to productivity growth and structural transformation, while others see it as abetting corruption and fostering inefficiency. Some point to Argentina's costly attempt to promote the assembly of electronics in Tierra del Fuego, while others point to gleaming high-tech factories in China and Korea. The effects are easy to exaggerate. Quantitative models suggest that the gains from even optimally designed industrial policies are small and unlikely to be transformative.

What is new is that the United States has joined China in an explicit embrace of industrial policies. China has been in the game at least since President Xi Jinping reasserted state control over the economy, moving away from the outward-oriented policies of Deng Xiaoping and his successors. The Made in China 2025 initiative, consisting of large subsidies to targeted industries, has given way to the idea of "dual circulation," focused on reducing external dependence by strengthening domestic sourcing by local firms, and the drive for self-sufficiency in key technologies. The United States began protecting the steel and aluminum industries, ostensibly on national security grounds, during the Trump administration. With the CHIPS Act and the Inflation Reduction Act, the US introduced

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subsidies to "reshore" production of semiconductors and adopted restrictive national content regulations for electric vehicles to ensure domestic production. And the European Union has always had industrial policies, announcing in 2020 an industrial strategy to enhance its "open strategic autonomy" in the transition to a green and digital economy.

Where does this leave developing economies? Should they follow the new Washington-Beijing-Brussels Consensus of building up certain national industries through government subsidies and trade restrictions? That would be a risky strategy. The subsidies could end up being expensive, and the benefits could prove elusive. Trade restrictions risk starting a damaging inward turn to protectionism that would reduce export earnings and thereby shrink the critical imports they purchase.

Large-scale industrial subsidies seem to be a luxury that rich countries can indulge. Just because the US, China, and the EU can afford subsidies does not mean that others should follow. As Ricardo Hausmann has warned, "Copying other countries' solutions to problems you do not have, or focusing on trendy issues that are not really important, is a recipe for inefficiency, if not disaster." Fiscally strapped developing economies cannot afford lavish subsidies for domestic producers when fiscal balances are precarious and the payoffs uncertain. Scarce public funds may be more effectively spent on improving health and education and helping poor people rather than being directed to domestic industries.

Industrial subsidies, import substitution

China illustrates how industrial subsidies can be an inefficient way of spending scarce resources. In 2006, China identified shipbuilding as a "strategic industry" and began massive production and investment subsidies, mainly through cheap loans. Evidence suggests that these policies did not produce large benefits but were wasteful (due to excess capacity) and distorted markets (forcing more efficient countries to adjust by reducing their output). China's global market share grew at the expense of low-cost producers in Japan, South Korea, and Europe but without generating significant profits for domestic producers. The subsidies were dissipated through the entry and expansion of less efficient producers, which created excess capacity and led to increased industry fragmentation. The loans were political in the sense that state-owned enterprises rather than more efficient private producers received the bulk of the support. The shipbuilding industry did not generate significant spillovers to the rest of the economy, and there was no evidence of industry-wide learning by doing.

Sacrificing trade gains

Likewise, a turn to trade restrictions risks sacrificing some of the gains developing economies have reaped from participating in world markets. Many countries have made economic progress in recent decades by engaging with the global economy rather than closing markets in the hope of spurring indigenous innovation. China did not get rich through industrial policy but by improving productivity in agriculture, allowing foreign investment in manufacturing, and unleashing the private sector. India's 1991 reforms to dismantle the "License Raj" of red tape that stifled private enterprise and open the economy continues to propel growth, although more reforms are needed. Bangladesh has also reaped benefits from opening up to foreign investment, which brings in capital and technology, so much so that the country now has a higher per capita income than India. Other countries, too, from Ethiopia to Vietnam, have achieved more from economic engagement than from economic isolation, because they benefit from technology and investment from the rest of the world.

While it has become fashionable to disparage the neoliberal economic policies of the Washington Consensus, the openness of that reform period saw convergence—not the divergence that had been the historical norm—between the rich and poor countries around the world. Starting around 1990, developing economies began to grow more rapidly and catch up to the higher income levels enjoyed by advanced economies.

The recent debate about whether globalization is dead or not is sterile. Globalization is not dead but changing. Developing economies would be ill-advised to turn their backs on the global economy and give up the idea of supporting exports and acquiring technology from beyond their borders. They still have much to gain from the rest of the world and a lot to lose by returning to the closed-door policies of the past. FD

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