Guest-Editors' Preface

The Role of Government in Competitive Economies

Over the post-World War II period, the close relationship between government and business in the context of industrial policy has promoted many countries' progress toward economic growth and industrial competitiveness. Governments have combined a variety of policy instruments such as taxes, exchange rate measures, and financial incentives as a comprehensive supporting package for their policy goals. Governments have applied depreciation allowances for new plant facilities, subsidies for R&D, import barriers, construction of infrastructures, and have mediated in labor-management conflicts. Governments have regulated, restricted, promoted, and influenced domestic industries and foreign trade.

During the early stages of economic development, the role of government is very important to the achievement of eventual success. Long-term planning, government-initiated projects and government controls on private industries tend to dominate. Government-initiated projects, government approval and licensing requirements that effectively restrict competition and administered pricing systems have been used extensively with various degrees of success by a great many countries.

As economies become industrialized and more market oriented, government intervention leads to distortions in resource allocation. Restrictions imposed upon the operations of the pricing mechanism lead to inefficiencies in the functioning of markets in both the real and the financial sector. The push toward privatization in many industrial, developing and socialist countries is seen as the way to achieve greater economic efficiency and to provide the incentives needed for the productive involvement of individuals in the market economy.

Integration of the world economy has led to the gradual liberalization of the financial sector in most countries to problems of volatility and lessened effectiveness of government monetary policies.

The world in the post-World War II period had been divided into three groupings: a few advanced, rich, developed industrial countries, a group of socialist (communist) countries and a large number of developing countries. The world of socialist centrally planned economies, where most transactions involved state enterprises and decisions were made by a central planning authority rather than the market, has been effectively destroyed. Now China, the countries of Eastern Europe and of the former Soviet Union are engaged in a dramatic transition toward market economics. They face many of the same problems that the developing countries have been facing.

In order for a market economy to function effectively it is necessary that the property rights of the individual participants in the market are recognized, codified and enforced. It is the security provided by clearly defined and enforced property rights that makes it possible for market participants to save and invest without inhibition. Once the political risk of illegal expropriation is eliminated and other discretionary behaviour of government is constrained, market participants can concentrate their efforts on overcoming the risks of competition in the marketplace.

According to traditional economic theory free trade promises to raise income levels for trading countries. It is then up to governments to decide

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whether, and how, to use those gains from trade, how to distribute them among domestic sectors or whether to compensate the groups losing from freer trade and economic liberalization. Governments recognize that foreign trade and foreign investment flows are crucial to national interests and try to co-ordinate foreign and domestic economic policies. That is, foreign trade and investment are closely related with international political relations in a world system with many interdependent linkages.

Developing countries have traditionally been exporters of primary commodities. It is generally accepted that the worsening trade imbalance of most developing countries largely associated with unfavorable terms of trade involving the exports of these primary commodities. Even their industrial products have fared badly, and there has been underutilization of their industrial capacity, owing to stagnating demand for such goods. The problem developing countries face is not only how to implement industrialization but also how to select industries suitable to their input endowments as well as their export potentials.

The most promising possibilities for long-term expansion by developing countries lie in the realm of manufactured product exports, since world demand grows most rapidly in industrial products. There is a horizon of industrial products suitable to the capabilities of many developing countries. The key approach is to select the appropriate industrial products that respond to changing world trade patterns, and, in particular, can be integrated into the market of industrial countries.

Developing countries face conditions of rapid change in world trade and financial patterns. Thus it is desirable, if developing countries are to make the most of their opportunities, that they redirect their own exports in accordance with the changing world economy. This goal is not easily reached because it means the repression of the inefficient part of the economy, which might be heavily entrenched.

Poor countries do not usually become rich and developed by freely competing with industrial countries. Their industries are simply no match for competition, unless governments initially protect their nascent industries. The relevant issue in many cases is not whether to protect or not, but what activity to protect, by what means and for how long. Hereby, under the policy of infant industry protection or of take-off strategy, government should co-operate with business towards promoting the competitiveness of a country's firms.

In other words, government has to create the conditions and the environment for economic growth. Protection should be a goal-oriented policy for a limited time period. Tax benefits, credit support, investment enhancement, information and knowledge transfer, infrastructure building, R&D support, education and training provision are some of the diverse forms that government assistance can take.

As developing countries search for strategies to solve the critical problems of industrialization and export, they should adapt their trade policy to the framework of dynamic world trade patterns which result from changing income levels among nations and changing product structures of trading countries. Thus, developing countries should recognize and continuously alter their industrial and export products in accordance with the changing world economy. Shifting their emphasis from one to another group of industrial and export products as domestic and foreign market patterns change, developing countries should expand growth industries characterized by high income and export elasticities in the markets of industrial countries.

Financial activities and markets have been regulated by governments in most countries. This regulation has not been uniform in all countries during the post World War period. Gradually with brief interludes of reversion, most developed countries' financial transactions were liberalized. This process was stimulated by the collapse of the Bretton Woods pegged-rate international monetary system in 1973. It was accelerated in the 1980s when financial transactions were liberalized, pushed by political, technological and economic reasons.

The international capital markets became more integrated as capital flowed with fewer restrictions. This freedom of capital movements has led to the greater integration of the world's major capital markets and to the expansion of trade and investment opportunities.

As many developing countries have become economically more successful, they have tried to take advantage of financial markets in order to mobilize domestic resources and channel foreign capital to promising areas. They have opened their capital markets to foreign investors with considerable success as their booming stock markets indicate. However, this increased integration in the world's financial markets is not an unmixed blessing; increasing volatility and lessened government control of their financial sectors can leave these countries exposed to the vagaries of the world economy without providing them with the tools to protect themselves.

This special issue focuses on the role of government and its contribution to the creation of an environment favorable to expanding industries and economic development. The papers cover issues such as the provision of the necessary legal foundations, the evaluation of protection and industrial policies and changes in the financial sector.

Because the economies of Japan and some other East Asian countries have been enjoying phenomenal growth rates over recent decades, their economic policies have received world-wide attention, particularly their trade policies, industrial policies and government-industry co-operation in general. Most of the papers in this issue considers explicitly the Japanese and Korean cases. The editors believe that the topics covered are interesting in themselves and have wide applicability.

Boettke makes the case for a stable legal and political framework with recognition of property rights as necessary for economic development. He argues that the application of planning models of economic development as exemplified by the Soviet Union has not been successful because it does not take into consideration the need for incentives for individuals and the distinct social and cultural backgrounds of the people involved.

He concludes that the laws necessary for the move to a growth-oriented economy must be based on existing cultural practices and social arrangements which encourage production and exchange. Certain societies are not likely to develop as the existing sociocultural arrangements are not conducive to development. Efforts toward economic development and growth require the existence of both the market institutions and the proper cultural underpinnings in order to be successful.

Djimopoulos looks at the historical antecedents of the trade policies followed by Japan and Korea. He claims that these policies were based on the application of ideas from the writings of Adam Smith, Alexander Hamilton and Friedrich List and of the post-World War II discussions of differential price and income elasticities of demand for manufactured and agricultural products and the dependence of developing on developed countries.

He emphasizes the role of the governments of Japan and Korea in achieving the goal of development through exports of manufactures under regimes of openness toward foreign processes and ideas and relative isolation from foreign interference in their domestic economies.

Choi reviews the Korean experience of economic growth in the 1960s and 1970s and the role of government during that period. He states that the rapid rate of economic growth was not so much the result of the economic policies pursued by the Korean government or of its direct involvement in planning and managing the economy, which may have been counter-productive. Rather it was the emergence of a ruling elite whose effort to achieve legitimacy led it to the pursuit of economic growth through an encompassing state.

He concludes that the encompassing organization created in Korea may not be appropriate for other developing countries and that a more market friendly orientation may lead to equal growth without the attendant problems created by the dominant state.

Gong also considers the role of the Korean government in the development of industrial policy and the successful industrialization of the country but from a different viewpoint. After tracing this policy through the export promotion period of the 1960s, he looks at the shift of emphasis to the heavy and chemical industries and the predominant role that the Jaebul played during the 1970s and 1980s. The rapid growth of these big business groups under government guidance led to the sales of the eight largest Jaebul accounting for one half of the total GNP by 1980.

Gong tries to evaluate the recent shift in emphasis in government policy towards greater specialization by the Jaebul.

He concludes that the Jaebul subsidiaries have been more efficient than independent firms in the same industries and therefore that the policy of concentration of big business subsidiaries in only a few industries may not lead to any greater increase in competitiveness.

Kim looks into some specific aspects of the Japanese policy for development and compares them with policies in the United States. The important aspect of the Japanese industrial policy involved the co-operation of government and business and the overall co-ordination of worker education, research and development and manufacturing of new products.

The government's role was extremely important in assisting private business in obtaining access to foreign technology and developing and adapting it to the Japanese and world markets. The Japanese industrial policy involved the formation of human capital, the importation of foreign technology and its adaptation to Japanese conditions. Government aid was instrumental in the success of the Japanese economy according to Kim.

Oh looks at the lessening government interference in financial activities and examines the consequences. Liberalized markets lead to a more efficient world allocation of resources, increases in production and in well-being. The functioning of foreign exchange markets has improved and interest rates have tended to become equal internationally.

Financial liberalization has undermined the effectiveness of monetary policy in controlling the quantity of money and of interest rates as a policy tool. Liberalization would therefore seem to imply the greater co-ordination of monetary policies by governments in order to avoid some of the problems caused by greater capital mobility and volatility.

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