2075
(04)
CS2673-4

UNITED NATIONS
AFRICAN INSTITUTE FOR ECONOMIC
DEVELOPMENT AND PLANNING

DAKAR

INSTITUTE OF DEVELOPMENT STUDIES
UNIVERSITY OF SUSSEX

BRIGHTON

52nd SEMINAR ON

STRATEGIES FOR INCREASING PRODUCTIVE EMPLOYMENT IN AFRICAN COUNTRIES
DAKAR 10 NOVEMBER-12 DECEMBER 1975.

THE EMPLOYMENT IMPLICATIONS OF TRADE AND EXCHANGE RATE POLICY

BY

BERNARD WASOW

OCTOBER 1975.

THE EMPLOYMENT IMPLICATIONS OF TRADE AND EXCHANGE RATE POLICY

Foreign trade and exchange rate policies are often too complicated for the non-economist to understand and even some economists find the connection between these policies and employment obscure. Yet trade and exchange rate policies can be very important in determining the pattern of industrialization, and this pattern has profound implications for employment. We will examine how these policies <u>can</u> influence industrialization and employment, how they <u>do</u> in practice exert their influence and how they <u>ought</u> to be used to promote development. We will then briefly consider the institutional, political economic, basis of these policies.

Trade Policy and Employment

Let us see how these policies affect employment, on a purely formal level first. Employment is simply equal to the employment per shilling of capital equipment.[1]

In this framework, changes in employment (E) can come essentially from two sources: either the capital stock changes (through investment) or the employment per unit of capital (the "factor intensity") changes. In practice, of course, both types of change occur together. Capital accumulation tends to increase employment, while "capital deepening" (increasing capital per worker) tends to retard this growth. With regard to exchange rate and trade policies, we can ask how these affect the rate of investment, how they affect the type of investment and, therefore, how they affect employment.

---

1. $E = \frac{E}{K} \cdot K$

When we ask this question, we should be clear how policies can affect the variables in question. The most important way in which trade and exchange rate policies have their effect is through changing the rate of return to factors of production devoted to various activities. For example, if foreign competition is banned than it becomes more profitable to produce a good domestically. Thus investment in production of that good is stimulated. It is common in almost every country of Africa, I believe, to have an imported commodity become scarce as import restrictions are clamped down, and then to see the appearance of a locally produced version of the item. The policy of protection which initiates this sequence is usually justified as necessary for the survival of the "Infant Industry" (even if the "infant" is part of a multinational giant). Thus it is implied that investment; foreign investment in particular, is stimulated by industrial protection. Such claims must be treated cautiously however for two reasons. First the total effect of policies aimed at stimulating foreign investment should include the effect on local investment as well. It may be that a large corporation, partiqularly a foreign one, establishes itself at the expense of local producers. The success of a multinational shoe producer, for example, may be achieved at the expense of local craftsmen or small local factories. (It may be that the new investment is far more capital-intensive than the displaced industry). Thus increase in some investments brought about by trade policies must be balanced against other investments displaced by the same policies. In addition, increase in investment in one sector may well occur at the expense of investment in quite another sector: textile investment, for example, may grow while investment in food processing stagnates simply because trade policies have manipulated profit rates to provide incentives for such a pattern. Thus the fact that a certain investment may have resulted from a trade policy decision is no proof that employment, or indeed even investment as a whole has been augmented by the decision.

The second reason for treating the effect of trade policy on the rate of investment with caution is that these effects must be considered in a long time perspective. Typical of the very inward-looking import substitution policies practised in many nations of Latin America has been a rapid burst of investment in protected industries followed by periods of stagnation. These examples are important for Africa because the small economies of Africa cannot hope to sustain investment unless development proceeds on a scale which transcends national borders. Industries catering exclusively for internal markets will not grow dynamically in most cases because they will be uncompetitively small. In addition, the multinational corporations which take advantage of the opportunities created by protectionist policies are often more interested in recouping their investments through repatriating profits than they are in reinvesting this surplus

When we turn to the effect of trade policies on factor intensity, we should distinguish two types of effects. The overall factor intensity depends both upon the factor and on the importance of individual sectors within the total economy. Economists do not agree entirely as to the effects of incentives such as trade policy on the choice of technique, and hence on factor intensity, within a given sector. Whether trade policy can have significant effects on the type of equipment used is a moot question. However, there is little disagreement about the impact trade policy can have on the type of industry which prospers witin a country. If trade policies increase the profitability of capital intensive sectors of the economy (those which use much equipment per worker), then these are likely to attract investment rather than other sectors.

Trade policies affect the structure of industry in a more subtle way as well. Insofar as trade policies can help create a class of wealthy local middle men and entrepreneurs, they will affect the distribution of domestic income. And the distribution of income, in turn, helps determine the pattern of demand and production. Thus, the structure of the

domestic economy can reflect the distribution of income which itself results in part from trade policy. It has been argued, for example, that one effect of the Phillippines protection policy had been to create many industries which produce goods for the owners of other industries. Television, air conditioner and automobile assembly, for example, are industries which provide commodities and generate income primarily for the elite.

Before we turn to the discussion of how trade and exchange rate policies are in fact used, let us consider another important proposition. It is, I believe, from a misunderstanding of this proposition that many policy errors arise. It is almost never possible to help one sector or industry without hurting other sectors. This idea is quite obvious - if one industry hires a top executive, other industries are deprived of his services; if one crop grows on a piece of land some other crops will have less land on which to grow. Yet in spite of the simple nature of this idea, governments very often proceed as if they could aid each sector of the economy, one after the other, without having any wider effects. A particularly ironic example of this problem lies in the government sector itself: The Civil Service is frequently disadvantaged when skilled, able personnel leave it for the private sector. The irony lies in the fact that government trade policies very often create they very income which private firms then use to hire away skilled Civil Servant. Many of the foreign firms (and local firms) which employ skilled local manpower, at other employers' expense, can afford to do so only because their profits have been greatly expanded by protection.

Trade Policy in Practice

How, then, do trade and exchange rate policies op rate in practice and how does this affect employment? It is not unfair, I think, to characterise these policies as operating usually on the following implicit principles:

a) Protection is negotiated commodity by commodity. (General tariff changes are usually introduced for revenue purposes and pay little heed to the effects on resource allocation). Consumer goods are likely to receive high levels intermediate goods lower levels and capital goods very little protection.

b) Export promotion is usually given much less concrete policy aid than is import substitution.

c) Exchange rate revision is considered a policy of very last resort. Almost any degree of import control is considered preferable to devaluation for dealing with balance of payments problems.

These three tenets are conducive to a pattern of industrialisation which is far from what ought to be achieved. Inward-looking import substituting consumer goods industries grow rapidly while manufactured exports, intermediate good and capital goods industries grow slowly. Such growth is limited, however, When the domestic market is satisfied, further growth becomes very difficult. Exports, already difficult when aimed at the rich capitalist countries because of their protectionist policies, are even more difficult when aimed at most other Third World countries which practise even more extreme protectionist policies. The overvaluation of the exchange rate (which often results from point (c) above) makes export prospects seems still more limited. Sectors which need a 50% or 100% price bonus to compete in the domestic market are given such tariff protection. Other sectors which could export with a 20% price bonus cannot exploit their potential because trade policy fails to aid them at all. Thus import controls, export pessimism and over-valuation of the currency tend to form a system which is self-reinforcing.

The system we described above is not likely to promote rapid growth of employment. Because protection is often negotiated to give one firm or a few control of the local market, large experienced firms

with much capital are liable to be successful in winning such favours. These firms are likely to be foreign-based and more capital-intensive than potential local producers. In addition, those firms which can produce profitably using the local resource base at prevailing prices are less likely to push for protection. Hence rapid, short-term growth of relatively capital-intensive enterprises owned by multinational firms is likely. This pattern is unlikely to produce sustained high investment over the long run; it is also likely to favour capital intensive firms. These firms will prosper at the expense of less heavily protected firms.

The Kenya Example

Research I have conducted with M. Phelps confirms much of this pattern of Kenya. Sectors such as paints, textiles and tyres are highly protected and quite uncompetitive internationally (textiles may be improving). Paint is a good example of a sector created by protection which appears to contribute almost nothing to the economy. Because of small scale, the chemicals imported into Kenya are hardly less expensive than imports of paint would be. Yet tariffs on paint, coupled with almost free entry for chemicals have created profits for the process of mixing and tinning paints. All the major paint producers are foreign owned; employment has increased very little over the last five years. In contrast, sectors such as leather tanning and working, vegetable dehydration, and lorry/bus body building, which appear to be much more competitive internationally, receive almost no help through trade and exchange rate policy. These sectors have much greater potential for sustained growth, and they are linked much more intimately to the domestic economy (and hence can create more jobs indirectly). They have much more potential for attracting long-term increases in investment and for generating sustained growth in employment. Yet the pattern of trade and exchange rate policy is such as to encourage production in the unviable sectors and, on the other side of the coin, to retard growth in the potentially competitive sectors of the economy.

Policy Revision

From our discussion, several desirable policy revisions emerge.

1. Efforts must be made to equalize protection among sectors to prevent some sectors from benefiting greatly at the expense of others. Intermediate goods and capital goods should also receive such protection. Large and powerful firms should not be given special protection.

2. Export promotion should include active and uniform price subsidization (of manufactures at least) to make exporting attractive. I believe that special bonuses for exports to Africa should also be considered to promote inter-African trade. (Such policies for Africa should be negotiated cooperatively to avoid misunderstandings, such as charges of dumping). Strong efforts should also be made to form associations to control the supply of exports, to keep prices up, and to gain concessions from the rich capitalistic countries.

3. Devaluation should usually be used when balance of payments problems become chronic.

Is it Possible?

Let us, in conclusion, consider the political economy of trade and exchange rate policy. This is, in a sense, a discussion of the feasibility of the above policy recommendations. While it is certainly true that powerful multi-national corporations have the means to turn decisions in their favour, I believe that the failure of trade policy adequately to promote development and employment is not due to this fact alone. Even investments in Tanzania have often followed sub-optimal patterns (as in the cases of the tyre plant and the fertilizer plant). The powerful interests have an easy job in winning concessions because policy makers inadequately perceive the costs of the concessions they make, and because

the very system of granting concessions gives too little guidance to decision makers. If equal protection of industrial enterprises (with, say, a uniform "adjustment period" concession) were the rule, then it would not be so easy for big firms to win special favours for themselves. Once a big firm is established in a small African economy it creates many vested interests which preserve its privileged position. But at the time at which terms are being negotiated, I believe that it would indeed be possible to achieve terms more favourable to the prospects of long-run sustained investment in sectors with real employment growth potential and less favourable to the foreign firm bent only on exploiting the domestic market.