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Trade Can Be Good for Development
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International trade can have a significant positive effect on economic growth and development.

In the eighteenth century, technological breakthroughs put Britain on the path to becoming the first truly 'modern' economy. Between 1870 and 1950 Britain's population nearly tripled. Towns like Birmingham, Liverpool, and Manchester grew into huge cities, average incomes grew more than twofold, and the share of farming fell from just under a half to less than a fifth of total production. There were many social, political, and geographical factors that caused the Industrial Revolution, but Britain's trade with her neighbors and colonies played a decisive role in fueling the new industrial activity and spreading prosperity to other countries. Before long British cities became the workshops of the world, importing vast quantities of food and raw materials, and exporting manufactured goods to America, Asia, and Africa.

Meiji Japan's rapid industrialization in the early twentieth century was also the result of a combination of domestic and international factors. The Meiji rulers established stable political institutions and they were quick to adopt the Western technology they had seen during the Iwakura missions to Europe and the United States in the 1870s. They established a new education system for all young people, sent students to the United States and Europe, and emphasized modern science, mathematics, technology, and foreign languages.

The government built railroads, improved the road network, and pursued land and financial sector reforms. The availability of trading opportunities was also vitally important. It is hard to imagine the Meiji industrialization occurring if Japan had not been able to import vast quantities of machinery, transport equipment, and other capital goods from the West in exchange for exports of cheap cloth, toys, and other labor-intensive consumer products. And this trade would have been impossible if it were not for the steady flow of food and cheap raw materials arriving in Japan from its colonies in Taiwan and Korea.

Similarly, international trade played a major role in the industrial development of North America and Australia in the nineteenth century, and of the East Asian 'Tiger' economies, India, and China at various points in the second half of the twentieth century. These examples, together with the many instances where growth did not occur, show that trade was necessary for sustained industrial development, but it was not sufficient. Trade liberalization created opportunities for economic development, but other factors determined the extent to which those opportunities were realized.

This chapter lays the foundations for the policies that we propose later in the book. The notion that trade—free trade, unencumbered by government restrictions—is welfare-enhancing is one of the most fundamental doctrines in modern economics, dating back at least to Adam Smith (1776) and David Ricardo (1816). But the subject has always been marked by controversy because the issue facing most countries is not a binary choice of autarky (no trade) or free trade, but rather a choice among a spectrum of trade regimes with varying degrees of liberalization.

Almost every country today imposes some trade restrictions and taxes. Since World War II, the world has been moving gradually towards reducing tariffs and restrictions on trade. Some of the developed countries that have been the most ardent advocates of trade liberalization have been somewhat duplicitous in their advocacy. They have negotiated the reduction of tariffs and the elimination of subsidies for the goods in which they have a comparative advantage, but are more reluctant to open up their own markets and to eliminate their own subsidies in other areas where the developing countries have an advantage. As a result we now have an international trade regime which, in many ways, is disadvantageous to the developing countries. In a world in which many see global poverty—the more than 2 billion people living on less than a dollar a day—as the world's most pressing problem, this is especially disturbing. It seems obvious that if the developed countries truly wanted to promote development in the Doha Round they should reduce their tariffs and subsidies on the goods of interest to the developing countries.

But many of the developed countries' negotiators have turned this argument on its head. They suggest that the reduction of one's own tariffs is beneficial, and hence the developing countries would be helping themselves by liberalizing in the WTO, irrespective of the actions of the developed countries. On this basis they argue that the developing countries should accept almost any offer that is put on the table.

If matters were so easy a pro-development trade agenda would be trivial—the developing countries should simply unilaterally open up their markets, and the faster they do so, the better. In this book we argue that matters are not so easy and that a pro-development agenda is more complex.

This chapter provides the conceptual framework for the policies that we propose for the Doha Round. In the first section we take a quick look at the interpretations and misinterpretations of the contrasting trade policies and growth experiences of Latin America and East Asia. In the second section we examine the theory behind the claims that trade is good for welfare and good for growth. In the third, we turn to the difficulties confronting the empirical studies and explain why they remain such a subject of controversy. In the final two consider sections we discuss the policy implications of this theoretical and empirical evidence and we the way forward. In each section we develop our theme that trade liberalization can promote development, but the results of different trade policies have varied across countries, and the evidence suggests that the benefits of liberalization depend on a host of other factors. Thus the implementation of trade liberalization needs to be sensitive to national circumstances. The sequencing of liberalization is important, and there is much that can be done in conjunction with trade liberalization (by developing and developed countries alike) to ensure that developing countries are provided with meaningful new trading opportunities, and that they are able to benefit from them.

The lessons of East Asia and Latin America

The post-World War II world has seen several grand experiments in trade policy. The import substitution policies of Latin America and the export-oriented strategies of several East Asian countries are of particular interest. In both cases several countries undertook similar policies at similar times and saw broadly similar results. Economists have attempted to draw trade policy lessons from these experiences, but the conclusions have been contentious because each country pursued a multifaceted economic policy agenda from which it is difficult to isolate the contribution of trade policy alone to their economic success or failure.

The success of East Asia

The success of East Asia begins with Japan, which within a few decades after World War II had raised itself to the second largest economy in the world. It experienced sustained growth rates beyond those previously seen anywhere in the world. Japan's success was followed first by South Korea, Taiwan, Hong Kong, and Singapore; and then by Thailand, Indonesia, and Malaysia, and finally by China.

East Asia's growth over more than three decades was remarkable. In particular Japan and the other countries in East Asia refuted two of the classic propositions of development. First, they showed that inequality was not necessary to growth, whereas previously it had been widely believed that only through inequality could the requisite high savings rates be generated (Lewis 1955). Second, these countries proved that the initial stages of development did not have to be associated with an increase in inequality (*contra* Kuznets

1955). Instead the new prosperity was widely shared among its population and millions were lifted out of poverty. For example in Malaysia and Thailand, the incidence of poverty declined from almost 50 per cent in the 1960s to less than 20 per cent by the end of the century.

There were important differences among the polices pursued by the East Asian countries. Korea and Japan's industrial model focused on large domestic corporate conglomerates and actively restricted flows of foreign direct investment (FDI), which made up less than 5 per cent of GDP in the period 1987–92. By contrast Singapore and Malaysia both developed policies to attract large foreign multinational corporations and encourage clusters of activity to develop around them. FDI in these countries reached more than 30 per cent of GDP by 1992. However, at a deeper level, the Asian countries shared much in common. They had high rates of investment in physical and human capital, rapid growth of agricultural productivity, and declining fertility.

But it is the role of the state in Asia's growth miracle which has created the most controversy. Adherents of the orthodox view believe that East Asia's free market philosophy was the main source of its success. They stress the prevailing stability-oriented macroeconomic policies, including responsible government monetary and fiscal policy, low inflation, and the maintenance of an appropriate real exchange rate. They also stress the reliable legal framework, which promoted stability, investment, and competition.

These factors were certainly conducive to growth, but they are far from the whole story. In other respects the Asian countries' economic policies certainly did not fit the orthodox framework. Their economic model included a strong role for the public sector. At the core of success had to be well-functioning firms and markets, but government played a critical role. Governments acted as catalysts which helped markets by providing the requisite physical and institutional infrastructure, by remedying market failures, and by promoting savings and technology. Noland and Pack (2003) trace Japan's industrial policies back to the Meiji Restoration of the mid-nineteenth century, and the state-led development under the slogans 'shokusan-kogyo' (industrialization) and 'fukoku-kyohei' (a wealthy nation and a strong army). They point out that the economic terms of the treaties forced on Japan by the Western powers encouraged the development of state intervention. The rather onerous treaties required Japan to reduce its tariffs, and consequently encouraged Japanese policy-makers to formulate alternative ways of providing support to their domestic industries, including subsidized credit from state banks. These policy tools survived into the last decades of the twentieth century.

In the modern context, there are many examples of government selectively intervening in particular industries, although the consequences of these interventions is controversial. For example, the Japanese government initially cultivated heavy industries in the post-war period. The steel, aluminum, car, and shipbuilding industries all received support after the war and in subsequent decades more advanced industries, including electronics and semi-conductors, were supported as the government expanded credit to large firms for the purpose of fostering investment.

In many countries trade policy in particular did not follow the orthodox free trade prescriptions. The governments of many Asian countries pursued a two-track policy of protection for industries not ready to compete internationally and promotion for export-ready industries. For example, governments intervened in many industries by providing credit through financially supportive government banks, restricting competition from imports, constraining new domestic competitors, and developing export marketing institutions.

These elements of the East Asian policies certainly did not fit the orthodox 'laissez-faire' economic model. But there is controversy about the role of these industrial and trade policies, with both those who argue for and against government interventions claiming that East Asia supports their case. Proponents of laissez-faire economic policies contend that the industrial policies were irrelevant or even harmful. Some economists argue that total-factor productivity growth in the sectors which were supported by government policies that have been the beneficiary of industrial policy has not been particularly strong. But the methodologies for calculating total-factor productivity are notoriously weak, especially at the sectoral level. In addition, to the extent that industrial policies in one sector led to improved productivity in other sectors (so-called 'spillover effects'), the benefits of these policies would not be entirely captured by sectoral total-factor productivity. Still other economists argue that growth would have been even stronger had government not engaged in these industrial policies. But this is a particularly unpersuasive counterfactual, since no country has ever achieved faster sustained growth than the countries of East Asia (Stiglitz 1996).

East Asia's growth is held by some economists to be a primary example of how successful development can emerge from free market policies, including trade liberalization. Although there is debate about the role of industry policy in Asia's success, there can be no doubt that the policies pursued by these countries were broader than (and in some cases clearly violated) the strict free-market prescriptions of the Washington Consensus. Whatever one's beliefs about the desirability of active industry policy, there can be no doubt that there is ongoing controversy and debate about the role of trade policy, industry policy, and controls on capital flows (including regulation of foreign direct investment). There can also be no doubt that the successful cases of development over the last fifty years have pursued inventive and idiosyncratic economic policies. To date, not one successful developing country has pursued a purely free market approach to development.

In this context it is inappropriate for the world trading system to be implementing rules which circumscribe the ability of developing countries to use both trade and industry policies to promote industrialization. The current trend to force a narrow straitjacket of policy harmonization on developing countries is simply not justified by the available evidence. Economists have learned much about the process of economic development, but there is still a lot that we do not know, and in these areas developing countries should be given the freedom to develop their own policy strategies tailored to their own idiosyncratic circumstances.

Latin America and import substitution

In the years following World War II, Latin America tried a quite different economic strategy to that of East Asia. Like many third world countries, several Latin American governments took heart from the recent experiences of the richer countries. Many of the countries that had fought in the Second World War had achieved centrally planned growth in heavy industries as they mass-produced munitions, ships, aircraft, machinery, and chemicals for the war effort. Developing countries had also witnessed the 'big bang' of Stalinist industrialization in the Soviet Union during the 1930s. The Soviet Union experienced rapid capital accumulation and double-digit economic growth rates while the more liberal Western capitalist economies floundered in the Great Depression. The apparent industrial successes of wartime planning and the Soviet planned economies conspired to convince many developing countries that there was a large role for government in managing the industrialization process.

These observations were supported by development economists who believed that the problems in developing countries were structural and required radical government intervention to overcome. Arthur Lewis (1955) proposed that economic development required coordination because 'various sectors must grow in the right relationship to each other or they cannot grow at all'. He advocated a form of managed industrialization simultaneously occurring across many sectors to achieve 'balanced growth'. Other economists combined this idea with economies of scale and concluded that the problem of underdevelopment could only be broken by a 'big push' of new investments across many sectors which would reinforce each other. Paul Rosenstein-Rodan (1961) suggested that attempts at economic development which were too narrowly focused on a small number of sectors would run into the problem of inadequate demand, which would ultimately constrain growth.

The prevailing economic wisdom was thus that economic development required industrialization and the development of vibrant manufacturing industries, and that industrialization would not happen on its own. At the time, developing countries' production consisted mainly of agricultural goods. Since most of the manufactured goods consumed in these countries were imported, they came to the conclusion that the path to success lay in encouraging domestic firms to produce the consumer goods that had previously been acquired from abroad. Accordingly many developing countries embarked on 'import substitution' policies. It was argued that they should import only 'essential' capital goods. Not only would scarce foreign exchange thereby be directed to where it had the highest social returns, but the resulting demand for locally produced goods (because other imports were restricted) would promote industrialization. Moreover, only through protection could their industries compete with the well-established firms of Europe and the United States.

In Brazil in 1951 the government of Getúlio Vargas established a system of import licensing to give priority to imports of fuel and capital goods. They subsequently augmented this with a multiple exchange rate system, whereby priority imports were brought in at a favorable rate, while imports of goods that were deemed to be domestically producible; were hit with higher exchange rates. Later, trade policy was added to the mix when the Tariff Law of 1957 increased protection for domestically produced goods. In the 1950s, 1960s, and 1970s similar import substitution policies were pursued by developing countries across the world, including Chile, India, Ghana, Peru, Brazil, Mexico, Argentina, Ecuador, Pakistan, Indonesia, Nigeria, Ethiopia, Zambia, and others.

Of course, the idea that these developing countries should attempt to use trade policy to actively promote industries in which they are uncompetitive is anathema to the simple logic of comparative advantage that David Ricardo had elucidated more than a century before. The reason so many countries rejected comparative advantage in the context of their economic development strategies lay in the prevailing belief that the concept of comparative advantage was insufficient because it was too static. Developing countries did not want to rely on the primary commodity exports that were compatible with their existing capabilities because they saw them as having limited long-term demand prospects and falling terms of trade. Instead they believed that comparative advantage could be developed over time toward more 'desirable' industries with the help of active industrial and trade policies.

Latin American countries grew rapidly in the decades of import substitution. But then, in the early eighties, one country after another found itself in difficulty; they defaulted on their debt, and the continent entered 'the lost decade', during which growth halted and the region's income per person actually fell. Economic growth rates, which had averaged 6 per cent for the region in the 1970s, fell to almost zero in the 1980s.

The contrast between Latin America's stagnation in the 1980s and South-East Asia's remarkable growth led many commentators to draw conclusions about the relative effectiveness of their trade policies. This stark regional contrast did not appear to be attributable to resource endowments or global factors, and thus it appeared that the difference must lie in the policies each region pursued. In this regard, many economists believed that the major important differences between the two groups of countries were the policies of integration, openness, and free trade, i.e. import substitution in Latin America versus export promotion in Asia. The neo-liberal view was that Latin America's problem was too much state intervention in developing national industries, which caused them to be inefficient and uncompetitive and required too much government spending, which ultimately caused runaway inflation.

By the early nineties, the IMF and the World Bank were championing the view that import substitution was one of the main causes of stagnation in Latin American countries. Certainly there were many problems with import substitution. For one thing, it rested on the controversial belief that temporary industry support from government could promote long-term development—often referred to as the 'infant industry' argument. This analysis argues that there is some dynamic element to industrial development which, when combined with a market failure, can justify temporary government intervention. One branch of the argument suggests that firms may need to go through an initial period of learning before they are able to compete successfully with more established foreign firms. However, if a firm eventually becomes profitable, then it should be able to finance its learning phase through private capital markets (assuming that effective capital markets exist), and if the benefits of this learning stay wholly within the firm then there is no case for government intervention. Only some imperfection in the capital market justifies government action and, even then, the best policy (if available to developing countries) would be to improve the capital market rather than impose trade distortions.

Another branch of infant industry theory posits the existence of dynamic external economies. For example, pioneering firms may invest in providing workers with new knowledge and skills that can be appropriated by other firms when workers move or start their own firm. Or alternatively, pioneering firms may generate new knowledge which becomes a public good available to all subsequent firms. However, the infant industry argument was refuted by Robert Baldwin (1969), who showed that, even when market imperfections existed, temporary industry protection might be futile. It might not provide an incentive for firms to acquire more knowledge than they otherwise would. Also, by subsidizing domestic production, infant industry protection might encourage later entrants to bring their investments forward, which could actually make the pioneer firm worse off. Baldwin showed how these simplistic arguments against free trade were theoretically flawed.

However, an alternative to the neo-liberal view argues that Latin America's failure had less to do with import substitution and more to do with exogenous factors independent of domestic policies. The combined effects of a global recession and the policy response of the developed countries had a deleterious effect on the region. According to the South Centre (1996: 42) Latin American countries simultaneously experienced four kinds of shocks: 'a demand shock to developing country exports; a consequent fall in commodity prices and a terms of trade shock; an interest rate shock; and a capital supply shock'.

This alternative view puts the blame for the lost decade not so much on the import substitution strategy, but on the debt policy of Latin American Countries combined with unfortunate global circumstances. These countries borrowed heavily during the seventies, enabling them to avoid the global recession which followed upon the oil price shock. But by the end of the 1980s the region's foreign debt had exploded and debt service payments reached $33 billion per year—nearly one-third of the region's export earnings. Latin American countries were left to bear the risk of interest rate fluctuations; and when the US Federal Reserve raised interest rates to unprecedented levels, many countries were pushed over the brink. Among the evidence for this interpretation is the fact that all of these countries, both those in which these problems were relatively large and those in which they were not, went into default, and at about the same time, shortly after the increase in American interest rates. If the underlying problem had been the import substitution strategy, then presumably the unwinding of that strategy would have taken place differently in different countries. Yet not one single Latin American country experienced much growth during the 1980s, regardless of their policy differences.

This alternative view suggests that it was Latin America's open capital markets rather than its relatively closed trade policy which led to the lost decade. In the 1970s Latin American countries operated the most open capital markets in the developed world—evidenced by their high share of global FDI flows. In terms of financial liberalization, Latin America was far more open than South East Asia, where controls over foreign capital flows were strict. Latin America's reliance on foreign capital flows and foreign direct investment are what made it particularly vulnerable to global economic shocks.

Thus just as there are alternative interpretations of the role of trade and industrial policy in East Asia's success, there are alternative views on the role of trade and industrial policy in Latin America's failure. Certainly the import substitution policies were far from perfect and there were some bad investments and some corruption. But what these examples show is that open trade regimes are not enough to guarantee growth and the process of successful liberalization is considerably more complex than the neo-liberal Washington Consensus would suggest. The Asian countries pursued complex economic development policies which combined government intervention with export promotion and controls on the volume and quality of capital inflows. Moreover they sequenced their liberalization and paid attention to social policy, including education and equality, as well as investing heavily in infrastructure and technology.

Mexico

In 1994, Mexico entered the North American Free Trade Agreement (NAFTA), a far-reaching trade liberalization agreement with its northern neighbors, the United States and Canada. If ever there were an opportunity to demonstrate the value of free trade for a developing country, this was it. NAFTA gave Mexico access to the largest economy in the world, which was right next door.

After ten years, Mexico's experience of trade liberalization under NAFTA has been mixed. Certainly there have been several benefits. Trade liberalization has stimulated trade, with Mexico's exports growing at a rapid annual rate of around 10 per cent per year through much of the 1990s. Foreign direct investment has also significantly increased. And NAFTA played a critical role in Mexico's recovery from the Tequila Crisis of 1994–5 (Lederman, Menendez, Perry *et al.* 2000).

On the other hand, growth during the first decade of free trade was slower than it had been in earlier decades (prior to 1980), mean real wages at the end of the decade were lower, and some of the poorest had been made worse off as subsidized American agricultural products flooded the market and lowered the price received for their domestic production. Inequality and poverty both increased under NAFTA and by the end of the decade, Mexico was losing to China many of the jobs that had been created since the signing of NAFTA. Even the manufacturing sector, which had seen significant output growth, has experienced a net loss in jobs since NAFTA took effect.

Three lessons emerged from Mexico's experience which are of particular relevance to our discussion in later chapters on how trade and trade liberalization may affect development. The first is that trade liberalization by itself clearly does not insure growth, and its impacts may well be swamped by other factors. Mexico suffered from low levels of innovation—low research and development expenditures and low levels of patenting activity compared with the economies of East Asia. It also has weak institutions, including poor regulatory effectiveness and high levels of corruption.

Secondly, one of the reasons that Mexico did poorly in competition with China was that China was investing heavily in infrastructure and education. Mexico's limited tax revenues, exacerbated by the loss of tariff revenue, was one reason why it did not make the necessary investments.

Thirdly, NAFTA was not really a free trade agreement. America retained its agricultural subsidies. NAFTA pitted the heavily subsidized US agribusiness sector against peasant producers and family farms in Mexico. US farmers export many of their products into Mexico at costs far below those of the local market, driving down prices for local farmers. Moreover, America continued to use what were effectively non-tariff barriers to keep out some of Mexico's products. These policies had deleterious effects on rural livelihoods. One-fifth of Mexico's workers are employed in the agricultural sector and 75 per cent of Mexico's poverty is found in rural areas. While some large Mexican agribusiness sectors have expanded their exports, much of Mexico's rural sector is in crisis. Local farms are threatened by cheap imports from the US, falling commodity prices, and reduced government support. Four-fifths of the population of rural Mexico lives in poverty, and more than half are in extreme poverty.

Mexico's experience with NAFTA provides a cautionary tale. The goal of economic integration should be to raise living standards, but it is clear that trade liberalization by itself is not sufficient to achieve this. There is no doubt that trade and investment are vitally important for economic growth but the real challenge is to pursue liberalization in a manner which promotes sustainable development.

Trade liberalization, welfare, and growth

The intuition behind the notion that trade is welfare-enhancing is simple. Imagine two people exchanging goods with each other. They would voluntarily trade their goods if and only if they both benefit from doing so. Thus government intervention to prohibit, restrict, or tax their trade restricts their ability to realize welfare gains from such mutually beneficial exchange.

However, trade among countries is somewhat more complex. In the basic economic model, trade is beneficial because it allows each country to specialize in the goods that they produce relatively efficiently. This principle of 'comparative advantage', established by the nineteenth—century economist David Ricardo, is the core of trade theory and is the foundation of its normative implication in favour of free trade.

In addition to the gains from specialization according to comparative advantage, trade may deliver benefits and costs through four other channels. Trade liberalization opens foreign markets, expanding the demand for domestic firms' goods and enabling them to serve a larger market and realize gains from economies of scale. Trade liberalization may also affect a country's terms of trade—the price at which it sells its exports relative to the price it pays for imports—where an improvement in a nation's terms of trade is good for that country in the sense that it has to pay less for the products it imports, that is, it has to give up fewer exports for the imports it receives. Liberalization may also introduce more competition from foreign firms to the domestic economy, which may result in changes to the efficiency of local production. Finally, trade liberalization may, through various channels, affect the rate of economic growth.

Most of the arguments for free trade are based not on growth but on efficiency, i.e. liberalization leads to a change in the level of welfare rather than any change in the long-run rate of growth. The basic results were formalized in modern economics by Paul Samuelson (1938), who showed that free trade is superior to autarky, and later (1962) that it is also superior to any intermediate regime of trade restrictions.

However, the underlying assumptions which yield that conclusion are highly restrictive, and often fail to capture relevant features of developing countries' economies. The standard argument in favor of trade liberalization is that it improves the average efficiency in a country. Imports from foreign producers may destroy some inefficient local industries, but competitive local industries are supposed to be able to absorb the slack as they expand their exports to foreign markets. In this way, trade liberalization is supposed to allow resources to be redeployed from low-productivity protected sectors into high-productivity export sectors. But that argument assumes that resources will be fully employed in the first place, whereas in most developing countries unemployment is persistently high. One does not need to redeploy resources to put more resources into the export sector; one simply needs to employ hitherto unused resources. In practice trade liberalization often harms competing local import industries, while local exporters may not automatically have the necessary supply capacity to expand. So liberalization often seems to result in labour temporarily going from low-productivity protected sectors to zero-productivity unemployment. Unfortunately, most of the models which attempt to address questions of welfare gains from trade liberalization assume full employment, and therefore provide no answers to this key question. But the issue of unemployment is not just a theoretical problem. Concern that trade liberalization will lead to increased unemployment is perhaps the most important source of opposition to liberalization. And the concerns are particularly relevant in countries where there is no unemployment insurance and weak social safety nets.

A second assumption of the model underlying the conclusion that trade liberalization is welfare-enhancing is the existence of perfect risk markets. This ignores the fact that there is high volatility in international markets, and trade policy can reduce countries' exposure to risk (Dasgupta and Stiglitz 1977). In national economies, consumers are insulated from the full force of output fluctuations by built-in insurance: if there is a reduction in the quantity of output firms can produce, then they can charge a higher price for it. Thus their incomes vary less than output. Trade may weaken this automatic insurance, since in small economies prices will be determined on the world market and will be unrelated to domestic output. Because income will be more variable, risk-averse firms will invest less in some sectors with high returns but high variability; and as the economy moves into lower-return, less variable activities, total output will decline. Under quite plausible conditions, one can show that free trade is Pareto-inferior to autarky—everyone is worse off—which is just the opposite result to that of the conventional wisdom (Newbery and Stiglitz 1984). These market failures underline the importance of sequencing. It makes a great deal of difference, for instance, whether trade liberalization occurs before or after risk markets or social insurance programs have been created.

One of the strengths of the market economy is that prices provide all the coordination that is required, i.e. there is no need for a central planner. But in developing countries, markets are often absent or, even when present, often do not work well, and prices accordingly are not able to perform this critical function. The problem, in some sense, is intrinsic. The process of economic development entails the creation of whole new industries. But some industries are dependent on inputs from other, 'intermediate' industries, for example, the car industry is dependent on the steel industry for fabricated metals. Intermediate goods industries will not be created until the final goods industries that use those intermediate goods are created; but the final goods industries cannot be created until the intermediate goods that they require are available. It is too much to expect markets for goods not yet produced to function well! Curiously, these arguments have been used both to support and to criticize trade interventions. In one sense, trade helps countries get around the need for planning. A country does not need to develop its own intermediate goods industries if it can import intermediate goods. In addition an open developing country does not need to rely on its own local demand. It can take advantage of the global market to attain the requisite economies of scale in tradeable goods. However, many of the key intermediate inputs are non-tradables, so there is still a need for coordination, especially if there are significant scale economies in the non-tradeables. This, in turn, provides one of the critical arguments for trade restrictions: to get the necessary scale, one may have to restrict competition from foreign producers.[1] The existence of these market failures suggests a need for government intervention. The appropriate form for the intervention needs to take into account limitations on the information available to government and the nature of the (irremediable) market failures.

The need for government revenue can also, in some circumstances, provide a rationale for trade taxes. One corollary of the classic Diamond–Mirrlees production efficiency theorem (1971) is that it is optimal in a small open economy for the government to raise revenue from tax on the net demand of households rather than from border taxes (see Dixit and Norman 1980). In many developing countries, however, tariffs are the main source of government revenue,

[1] Especially, as suggested above, in the presence of capital market imperfections.

and where this is the case, the optimal tariff structure may not be uniform (Dasgupta and Stiglitz 1974). Max Corden (1974) argues that, particularly in developing countries, the collection costs associated with trade taxes are likely to be much smaller than those of income and commodity taxes. Where this is true, trade taxes might be the best revenue-raising device. Recently international institutions have been encouraging developing countries to reduce their trade taxes in favour of indirect commodity taxation such as a value-added tax (VAT). However, many developing countries have large informal sectors which are beyond the reach of indirect taxation. In these circumstances, M. Shahe Emran and Joseph Stiglitz (2004) have shown that a switch from trade to indirect taxes may be welfare-reducing.

Trade liberalization will also affect inequality. Opening up to trade does not make everyone in a country better off. Instead it changes the distribution of income and creates winners and losers. The standard economic argument is that the net gains from trade liberalization are positive so the gainers can compensate the losers and leave the country better off overall. Unfortunately, such compensation seldom occurs. These distributional consequences are an important practical consideration. They provide much of the political opposition to trade liberalization. And they become more salient in global international trade regimes which are viewed to be 'unfair'.

Moreover the standard theory assumes that taxes and subsidies to compensate the 'losers' from trade liberalization are costless. But there may be large inefficiencies associated with redistributive schemes. Once the distributional consequences are taken into account, trade liberalization may not be Pareto-superior; it may not be possible to make everyone better off. Concerns, about inequality may place a limit on the desirability of liberalization in situations, especially where a market distortion creates a link between the distribution and allocation of resources. Sudhir Anand and Vijay Joshi (1979) describe the situation (fairly common in developing countries) where workers in the urban sector receive a higher wage than those in the rural sector[2], giving the

[2] While in their model the wage differential is simply given exogenously, efficiency wage theory (e.g. Shapiro and Stiglitz 1984) provides an explanation for such differentials.

government an incentive to intervene to increase employment in the urban industries. Anand and Joshi show that, under fairly general conditions, a Pareto-efficient outcome cannot be achieved using subsidies. In their model the rigid factor price creates an unavoidable trade-off between efficiency and equality even when the standard best-policy instrument is available and can be financed by lump-sum taxation. They conclude that '[d]epartures from technical efficiency may be called for as part of the rational response by governments to the limitations they face in carrying out desirable income distribution policies'.

Ricardo Hausmann and Dani Rodrik (2004) demonstrate another type of market failure based on information externalities. They emphasize the importance of entrepreneurship in developing countries. These entrepreneurs are engaged in a process of 'discovering' which economic activities will be successful in their country. Hausmann and Rodrik point out that successful (and failed) entrepreneurs provide information to the market which is of great social value yet is poorly remunerated. If the entrepreneur fails in his venture, he bears the full cost of the failure: if he is successful he shares the discovery with others who enter the new industry. 'The entrepreneurs who figured out that Colombia was good terrain for cut flowers, Bangladesh for t-shirts, Pakistan for soccer balls, and India for software generated large social gains for their economies', but could keep very few of these gains to themselves. Thus 'it is no great surprise that low-income countries are not teeming with entrepreneurs engaged in self-discovery' (Rodrik 2004). Coordination failures may occur when the profitability of new industries depends on the simultaneous development of upstream and downstream industries, or when new industries are characterized by scale economies and have non-tradeable inputs (Rodrik 1996).

While most of the economic theory of trade liberalization has focused on static welfare gains, the long-term effects of trade liberalization are determined by its effect on the economy's rate of growth. Recent models of endogenous growth have important implications for the theoretical relationship between free trade and economic growth, although their results are not fully understood, and their policy consequences remain to be thoroughly established.

There are several possible arguments for why increased trade may lead to faster sustained growth rates. One argument is that larger markets will lead to larger returns to investments in R & D. This would suggest that a global regime with free trade will be associated with higher overall growth rates. A similar argument is that, with learning by doing, with strong spillovers within a country (i.e. the learning in one firm spills over to other firms) but not across countries—where, accordingly, the pace of innovation is related to the scale of production within the country—if there is more specialization, then there will be more learning. A third argument focuses on the fact, again noted earlier, that with a larger market, there can be a larger variety of inputs, which can sustain not only more efficient production but a faster pace of innovation.

These theories suggest the importance of knowledge, learning, and human capital. One possible implication for policy (though not necessarily trade policy) is that countries may benefit by promoting more technologically dynamic sectors. Research by Dani Rodrik and others suggests that developing countries may need to 'embed private initiative in a framework of public action that encourages restructuring, diversification, and technological dynamism beyond what market forces on their own would generate' (Rodrik 2004). For example, the theory of comparative advantage told South Korea, as it emerged from the Korean War, that it should specialize in rice. But Korea believed that even if it were successful in increasing the productivity of its rice farmers, it would never become a middle- or high-income country if it followed that course. It had to change its comparative advantage, by acquiring technology and skills. It had to focus not on its comparative advantage today, but on its long run, its dynamic comparative advantage. And government intervention was required if it was to change its comparative advantage.

The existence of these market failures or learning externalities may suggest a need for government intervention, but they do not, by themselves, justify trade policy as the best instrument. Research into policy choices has been developed into a general theory of distortions (see Corden 1957) which generally show that tariffs and other introduced trade distortions are usually the *n*th-best policy instrument, after various types of subsidies including training, employment, output, and knowledge diffusion subsidies (if those are available). But often, in poor and backward developing countries, these instruments may not be immediately practical or affordable. This underlines the importance of sequencing. Even if trade policy is the *n*th best instrument, trade liberalization should not occur until one of the $n - 1$ preferred alternatives is feasible and successfully implemented.

However, in many cases the market failure might be endemic or not readily able to be countered by government action. Much of the earlier literature on correcting market distortions made the critical error of treating the distortion almost as if it was an accidental mistake, which government could easily correct. For example, if markets were imperfect because wages were rigid, the solution was to make wages more flexible, i.e. if the reason for the rigidity was government minimum wages, there was an obvious answer—eliminate the minimum wage. To take another example, if there were capital market failures, the solution was to create perfect capital markets. These direct interventions to correct market failures were preferred to indirect government action, including distortionary trade policies.

But both wage rigidities and capital market imperfections can arise from information imperfections (Stiglitz 2002) and these might be difficult to correct with direct action. So long as it is costly to acquire information, there is no easy way of eliminating these market imperfections. To be sure, government too faces information (and other) constraints; but the nature of those constraints, as well as the objectives, differs between the government and private firms. Optimal interventions may involve trade, as the discussion below makes clear.

Consider, for instance, the infant industry argument for protection presented earlier. Critics of the infant industry argument contend that if a firm will eventually become profitable, then it should be able to finance its learning phase through private capital markets, and, accordingly, if the benefits of this learning stay wholly within the firm then there is no case for government intervention. Only some imperfection in the capital market justifies government action, and even then, the best policy, if available to developing countries, would be to improve the capital market rather than to impose trade distortions.

But the modern theory of asymmetric information explains why capital market imperfections are inherent, and not just a happenstance, and why governments cannot simply remedy these capital market imperfections (Stiglitz and Weiss 1981). These capital market imperfections are particularly relevant here, for banks would have to be willing to lend to enable firms to sell below cost, in the hope that by doing so their productivity will increase so much that they will become a viable competitor. It should be obvious that such loans would be viewed, at best, as highly risky. (And banks would likely view themselves at a marked informational disadvantage in judging whether the firm's claims about its future prospects—in spite of large current losses—have credibility.)

Once capital market imperfections are taken into account, then protection may be optimal, as Dasgupta and Stiglitz (1980) show. They argue, in particular, that protection may have advantages over other instruments, e.g. subsidies, when government has limited sources of income and limited ability to target. Interestingly, these are among the reasons that some argue for private production of knowledge, through intellectual property rights, as opposed to public production, through direct government subsidies. The government cannot identify who will be good producers of knowledge, and therefore cannot target the subsidies; the market is a self-selection mechanism. Intellectual property rights increase the returns to private production of knowledge, at a cost—temporary monopoly rights. Protectionism limits competition from abroad, but allows competition from within. By increasing the private returns, it helps to better align private and social returns to innovation. This is even more relevant in the infant economy argument for protection.

Theoretical arguments which caution against a full embrace of free trade abound. But the question for policy-makers is not whether these arguments exist, but whether they carry enough weight to be acted upon. In a thoughtful article, two noted proponents of free trade for developing countries, T. N. Srinivasan and Jagdish Bhagwati (1999), review the above theory and many other theoretical arguments which caution against the universality of the benefits of free trade. They concede that it is possible to build many theoretical models in which free trade will 'reduce current income and even growth . . . if market failures are present'. But they challenge interpreters of this evidence to ask themselves the following question: in formulating policy, 'do we view these models as representing a "central tendency" in the real world or merely "pathologies"?', and they caution policy-makers not to become prisoners of the nihilistic view that 'because anything can be logically shown, nothing can be empirically believed and acted upon'. In order to determine whether the case against unconditional trade liberalization for developing countries is important or merely a series of inconsequential theoretical possibilities, it is necessary to turn to the empirical evidence.

Empirical evidence

A number of studies have attempted to show that there is a systematic relationship between growth and trade and/or trade liberalization, using cross-country studies. The hypothesis has been that, holding other things constant, countries that have liberalized more or which trade more have grown more.

Our previous discussion suggests that only under certain circumstances will that be the case. Given the complex and contingent relationship between trade liberalization and economic growth, and the manifold difficulties associated with empirically testing this relationship (discussed briefly below), it comes as no surprise that most economists, even most of those that have no reservations about liberalization, accept that the empirical literature has been inconclusive (Winters 2003). The economic growth literature has been successful in demonstrating the importance of some variables for economic development, including education, institutions, health, and geography. However, the relationship between trade liberalization and growth is much more controversial.

The weakness of the evidence in favour of a direct relationship between trade liberalization and economic growth has not prevented some economists from pursuing free trade at full throttle. The IMF's former First Deputy Managing Director, Stan Fischer (2000), boasted that the 'Fund is a powerful voice and actor for free trade' and suggested that this is because 'integration into the world economy is the best way for countries to grow'. The IMF may be right to promote liberalization (by developed and developing countries alike), though that is hardly its mandate, and it would do better focusing on trying to enhance global financial stability. But it should be pointed out that the empirical evidence that it even has a positive effect on growth is mixed, that it almost certainly is not the most important factor in growth, that the theory suggests important caveats, and that our experience of successful countries indicates that the reform process should be managed gradually and carefully. Integration through exports, as in East Asia, has a far more convincing record than integration through rapid liberalization. In short, trade liberalization should be a tailored policy, not a one-size-fits-all.

It is difficult to identify the evidentiary source of the bullishness for unqualified trade liberalization. Certainly there were several studies in the early 1990s which purported to show a positive relationship between trade openness and economic growth (see Dollar 1992; Ben-David 1993; Sachs and Warner 1995), but even these were careful to qualify their results. In the conclusion to their paper, Jeffrey Sachs and Andrew Warner point out several of the important caveats to their study. Their studies focus on trade, not on trade liberalization. Francisco Rodriguez and Dani Rodrik (1999) have persuasively shown that the conclusions of these studies should be interpreted with extreme caution. They found that the indices of openness used in these studies conflated the effects of trade policies with other phenomena. In particular the studies were identifying the negative effects of macroeconomic imbalances, instability, and geographic location, and misattributing them to trade restrictions. Rodriguez and Rodrik pointed out that because of these methodological weaknesses, the policy conclusions drawn from these studies are not strongly supported by the data they present.

To recognize the weakness of the empirical evidence in this field is not to argue that trade protection is good for growth. Rodriguez and Rodrik themselves point out that there is no credible evidence that trade restrictions are systematically associated with higher growth rates in the post-war period. But it does suggest that the relationship between trade liberalization and growth is not simple. Preliminary research being conducted at Columbia University, for instance, suggests that trade liberalization may have positive effects on countries with low unemployment rates, but negative effects on countries with high unemployment rates. More generally, the empirical evidence supports the view that the benefits of trade liberalization depend on a range of other factors which are difficult to observe separately because of measurement problems[3] and other econometric difficulties[4].

Policy implications

Theory and empirical evidence indicate that trade liberalization can be a positive force for development in poor countries, but that these benefits depend on other, concomitant factors. Given this, we would expect the focus of current economic research to be on how differences across countries affect their experience of liberalization, and we would expect the focus of policy research to be on how trade policies can best be tailored to the particular circumstances of different countries.

We would not expect a consensus of answers among policymakers, but we would expect a consensus of approach. However, international trade negotiations exhibit no such consensus—the acrimonious breakdown of talks at Cancún and Seattle and the ongoing polarization among academics, NGOs, and international institutions are testament to that. There are still those on the right who would press developing countries to move immediately and uncompromisingly towards free trade. And there are still those on the left who believe that the way to help developing countries is to shield them vigorously from the forces of reform and liberalization.

[3] For instance, most of the empirical studies treat trade regimes as a binary variable (i.e. countries are either 'open' or 'closed'), which ignores the subtlety and dynamics of different trade regimes. Studies which analyse trade-weighted average tariff rates will underweight the importance of high tariffs because the quantity of imports in those tariff lines is likely to be low. Many studies ignore non-tariff barriers, and those that include them have a hard time distinguishing which are important and which are not.

[4] For instance, many of the indices used to analyse openness may be endogenously related to other policy or institutional variables which have an independent negative effect on economic growth, making these indices inappropriate variables with which to analyse the direct effect of trade liberalization on growth.

The theoretical and empirical evidence may not speak clearly on all issues, but it certainly rules out the extreme positions on both sides. It is therefore worth asking why these extreme positions have proved so enduring. On the left, the fault probably lies with overzealous altruism. The anti-globalization movement has done much to raise awareness about important international issues, but as is often the case with unstructured social movements, their public message has become distorted and, at times, extreme. Unfortunately those within the movement who can attract the most publicity are not always those with the strongest analysis. The unfortunate message from the hard-line activists is that a good round of trade negotiations is one that requires the developing countries to do nothing in the way of reform. They encourage developing countries to look outward to the developed countries as the primary source of and solution to their problems. Fortunately the officials from developing countries are not swayed by these arguments. They have become adept at sorting through the mixed messages from the North and are not persuaded that liberalization of developed countries' trade policies is a substitute rather than a complement to their own internal reform.

There is a tendency among the anti-globalization movement to view the extreme position taken on trade liberalization by many on the right as a revealing testament of their malevolence or wilful disregard for the problems of the world's poorest countries. Of course, at least on the part of the academics who make serious contributions to the debate, there is no such malevolence or disregard. How then can they continue to insist, in the face of the theoretical and empirical evidence, that developing countries pursue rapid and unfettered trade liberalization? One answer is that they are more concerned about government failure than market failure.

Many economists have serious reservations about the ability of officials from developing countries to manage anything but the simplest, most liberal trade policy regime. Alan Winters, Director of the Development Research Group at the World Bank, notes that '[t]here are undoubtedly hundreds of individual cases where a one-off policy intervention would be beneficial, for example where protection would allow learning or training, or generate a terms-of-trade gain, or support a poor family while it learned new skills.' (2003: But he rejects the use of such second-best interventions to overcome market failure because, among other things, he believes that developing country officials are not skilled enough to identify and implement them effectively. He says, 'the application of second-best economics needs first-best economists, not its usual complement of third- and fourth-raters'. The same argument was espoused by Anne Krueger, the First Deputy Managing Director of the IMF, in her presidential address to the American Economic Association in 1997. She claimed, 'most [trade] policy implementation is carried out by government officials ... [who lack] ... the degree of sophistication needed to interpret research results' (Krueger 1997).

This reason for adopting and espousing the simple orthodoxy of free trade is not that such policies are optimal in a standard economic sense, but that any more complicated development strategy would be beyond the capability of the officials of developing countries.

There are many reasons why government interference in the economy may fail. One is that governments are not possessed of full information about market failures; indeed they will usually have less information than the private sector. This impedes the identification of both the market failure and the (potentially unintended) side effects of its solution. It may be possible to overcome these information problems, but this may be costly, and the government needs to insure that the net gain is larger than for alternative policies. There are many examples of failed trade and industry policy experiments. But some failures are to be expected. All that needs to be true is that the government intervention delivers social returns on average across a range of projects within each policy. He points out that if we observed no failures, the policy would arguably be too timid, and should be boosted to equate the social cost of investing with the expected private rate of return for the projects it supports.

Another important concern linked to government failure is that simple trade regimes are more transparent and less prone to corruption and rent-seeking activities. Less distorting policies usually offer fewer opportunities for corruption.

In our view, the fear of government failure is real, but it is not overriding. It is yet another reason why free trade is, in the long run, the preferred regime, but it does not trump all development objectives, market failures, and adjustment costs in the short run. Policies should be designed to minimize the risk of government failure, for example through carefully designed institutions and policies (see Rodrik 2004) and international technical assistance. The remaining risk should be appropriately weighted within the policy-makers' decision-making process.

None of today's rich countries developed by simply opening themselves to foreign trade. As Ha-Joon Chang (2001) has documented, all the developed countries used a wide range of trade policy instruments which should make their WTO ambassadors blush when they sit down to negotiate with today's developing countries. Chang's evidence does not prove that interventionist trade policies were, or are now, the best policies for development, but it does show, at the very minimum, that the risk of government failure can be managed in countries as they develop.

China and India provide more proximate evidence of this fact. Both have successfully integrated into the world trading system, and both have benefited greatly from international trade, yet neither followed orthodox trade policies. China has been particularly careful to ensure that its economic development strategy is gradually implemented and carefully sequenced. Certainly China has become more open in recent years, and has benefited from doing so, but trade liberalization certainly did not cause China's growth. China began to grow rapidly in the late 1970s, but trade liberalization did not start until the late 1980s, and only took off in the 1990s after economic growth had increased markedly. The Indian story is similar: growth increased in the early 1980s while tariffs were actually going up in some areas and did not begin to come down significantly until the major reforms of 1991–3.

The way forward

Certainly the case for moving towards free trade in the long run is compelling. Theory teaches us that when markets are perfect, trade-distorting policies will be welfare-reducing, and even when markets suffer from distortions, trade policies may not be the best instruments to overcome them.

However, developing countries are different, and these differences are important. Developing countries certainly do not have perfect markets. Many of their markets are missing or incomplete, particularly markets for insurance and credit. Public goods are undersupplied, coordination failures are rife, and the social benefits of entrepreneurship are larger than the expected private returns. The adjustment costs associated with liberalization would be large and exacerbated by high unemployment and weak social safety nets.

Often there will be better instruments than trade policy with which to overcome these market failures and soften the adjustment costs associated with reform. But poor governments with small public resources have a limited number of instruments at their disposal. Often it would be a mistake for these governments to liberalize their trade regime before they have put compensating policies in place.

Thus the debate is not about whether the world should move towards free trade, but about how different countries should liberalize, and how quickly they should liberalize.

There is a middle ground between the extreme positions of the free-traders and the anti-globalizers. This middle ground recognizes the ultimate goal of free trade, but also believes that rushed liberalization can be harmful. Policies in the middle ground need to be found by investigating the effects of market failures on the experience of liberalization in different countries. Developing countries should attempt to promote development by correcting these market failures through policy interventions, including trade policies, if, and only if, they are the best available instruments. Policy-makers should recognize the potential for government failure arising from their interventions. They should neither ignore this risk, nor fear it. Instead they should look for ways to overcome it and, where those are not apparent, appropriately weight the risk in their policy-selection process.

Developed countries must do their part. They can help to integrate developing countries into the world trading system and ensure that they benefit from it. As we explain later in the book, developed countries need to reform their own trade policies in ways that open trading opportunities for the developing countries.

The developed countries also play a large role in the politics of global trade negotiations and are responsible for much of what happens in the WTO. The developed countries have a responsibility to build the global trade architecture in ways that enhance the participation of the developing countries.

In this book we suggest a policy program within the WTO which would benefit the developing countries. Developed countries are a crucial part of this program because so much of world trade is affected by their policies and because they are the most powerful actors within the WTO. But developed countries are neither the whole problem nor the whole solution. Their trade policies are important, but their reform is a complement to, not a substitute for, reform within developing countries.