

## WHY TRADE LIBERALISATION IS GOOD FOR GROWTH\*

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There are three titles that might have been assigned for this paper: 1) Why Is Growth so Rapid with Outer-Oriented Trade Strategies?; 2) Do Countries with Outer-Oriented Trade Strategies Grow Faster? and 3) the one actually assigned. They are not the same. Of the three, the first is probably the most difficult to answer. The second is a factual question, and the empirical demonstration is straightforward (Sachs and Warner, 1995). The third, by focussing on trade liberalisation, implies that developing countries have highly restrictive trade regimes and thus asks if a move away from those regimes is good for growth. It is far easier to show why, especially over time, liberalising a restrictive trade regime is conducive to more rapid growth than it is to show why outer oriented trade strategies have been so highly successful.

Trade strategies and development strategies are closely related, and it is useful to start by defining a few terms. An import-substitution (IS) industrialisation strategy was adopted by most developing countries in the years following the Second World War. In most cases those countries were then predominantly agricultural and exporters of primary commodities.

The belief then was that rapid industrialisation was the essential (if not the sole) feature of economic growth and that only by domestically producing goods then imported could developing countries industrialise.<sup>1</sup> Under IS, it was intended to provide protection to new industries during their developmental period until they could compete with their counterparts in industrialised countries. In practice, the IS strategy pulled most new resources into import-competing activities (with a number of negative consequences discussed later) and one result was that export earnings grew less rapidly than the demand for foreign exchange and usually less rapidly even than real GDP.

An almost universal policy response was then to impose restrictive import licensing in response to 'foreign exchange shortage'. The stated reasons for this were the need to 'conserve scarce foreign exchange' for 'essential' developmental needs. The outcome was, of course, a restrictive trade regime. For reasons to be discussed below, as IS strategies continued, trade regimes increased in restrictiveness and growth slowed.

Hence, to discuss trade liberalisation is to address the removal (or at least reduction) of incentives for IS industrialisation. And, because – again to be discussed below – growth spurred under an IS industrialisation strategy slows

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<sup>1</sup> See Krueger (1997) and the references therein for a fuller statement of the logic behind the IS policies.

down over time, trade liberalisation is therefore associated with more rapid growth than the final phases of IS which precede it. It was and is in response to this phenomenon that trade liberalisation offers the only known way to escape from the ever-slowning growth rates of developing countries. Many liberalisation episodes in fact take place in response to economic crisis.<sup>2</sup>

By contrast, by the early 1960s a few then-developing countries<sup>3</sup> – most notably Korea, Taiwan, Hong Kong and Singapore – had abandoned import substitution and adopted outer-oriented trade strategies. The results were spectacularly rapid growth.

By outer-oriented is meant a trade strategy that is *not* biasing incentives in favour of import-competing industries and that provides roughly equal incentives to all exporting activities. Thus, an exporter shipping goods for \$1 million of foreign exchange can expect to receive approximately the same amount of local currency regardless of the nature of the goods actually shipped.

It is important, in this regard, to note that outer-oriented does *not* mean more incentives for producing for export than for the domestic market. It does, however, imply relatively uniform across-the-board incentives for exports, and that the growth and industrialisation strategy relies on rapid growth of exports.

It should now be evident why the three questions differ. There is no doubt that the countries following outer-oriented strategies grew faster. Moreover, even among larger samples of countries, there is no question that more rapid growth of exports is associated with a more rapid rate of growth of real GDP.

There are, however, questions about why the East Asian economies grew more rapidly. These focus on issues such as whether productivity growth was more rapid in East Asia,<sup>4</sup> how much the government intervened in the market,<sup>5</sup> and other policies that were complementary to the outer-oriented trade strategy. It is for that reason that an article on why an outer-oriented trade strategy is so successful would be more difficult than one on why trade liberalisation is desirable. We know an outer-oriented trade strategy has led to more rapid growth, but there are arguments as to exactly why.

## 1. Trade Strategies and Development

Trade policy is integrally tied up with overall development strategy. Although we have learned through painful experience that productivity and output growth in agriculture, services, and manufacturing are all essential for growth,

<sup>2</sup> See Little *et al.* (1993) and Michaely *et al.* (1991) and the individual studies on which they are based.

<sup>3</sup> These all had very low per capita incomes in the 1950s. Korea was estimated to have one of the lowest per capita incomes in Asia. Korea and Taiwan both followed policies of import substitution in the 1950s, and then changed to outer oriented trade policies in the 1960s. Singapore's history with regard to early trade strategy is somewhat more murky because it did not separate from Malaya until 1965. Hong Kong, of course, followed a *laissez-faire* policy continuously. The World Bank now classifies Korea, Hong Kong and Singapore as high-income countries. See World Bank (1997), pp. 214–5. Taiwan is not included in the Bank's *World Tables*, but has a higher per capita income than Korea.

<sup>4</sup> See Young, (1992) and (1994).

<sup>5</sup> See World Bank (1993) for one view.

and that overemphasis on any subset of economic activities is almost certain to result in retarding the development process, the linkages between trade policy and development-cum-industrialisation strategy are crucial.

First, development does entail more rapid changes in economic structure (from agriculture to industry, from household production to market production, and so on) than does continuing growth in developed countries. Moreover, developing countries typically depend on imports for the preponderance of manufactured goods used domestically and are, at least in initial stages of development, highly specialised.<sup>6</sup> Consequently, there is even greater sensitivity to trade policy than in developed countries: protection of some industries, and especially high protection, will pull resources, and especially new resources, into those industries and out of disprotected industries. Thus, whereas an increase or decrease in protection in developed countries normally results in changes at the margin in the composition of output, in developing countries the structure of protection (or lack thereof) virtually determines the direction in which new resources are allocated and, in the context of low income countries, therefore the entire pattern of production, especially in manufacturing.

Second, developing countries have production patterns which are skewed toward labour-intensive services, agriculture, and manufacturing. In accordance with comparative advantage, they import most capital-intensive goods and services. Since the latter category includes many investment and intermediate goods, developing countries' growth is contingent upon their ability to import those goods and services. When, instead, they confront relatively slow growth of foreign exchange earnings, they substitute domestically produced goods at higher cost for these capital-intensive items. Not only does this substitution process pull resources out of labour-intensive areas (such as textiles and clothing) where comparative advantage resides, but it implies slower growth because a given fraction of national income saved implies a lower level of real investment as the prices of capital goods are higher.

Third, because people have such low per capita incomes, most developing countries' markets are relatively small, outside of food and housing. Protection of production activities in these small markets results in a dilemma: either the number of firms producing a given good must be very small, or the size of individual plants may well be below minimum efficient size. If the number of firms is very small, the absence of competition results in low-quality high-cost production over and above that resulting from comparative disadvantage as producers have monopoly or quasi-monopoly positions. If the number of firms is large, each one is producing on a very small scale with consequent higher costs. By contrast, a liberalised trade regime permits low-cost producers to expand their output well beyond that demanded in the domestic market. Whereas industrialisation based on protection of domestic industries thus

<sup>6</sup> This is both because of their factor endowment which typically lies well away from the world mean and also because of the small size of their domestic markets (discussed further below).

results in ever-higher capital intensity of production (as the 'easy import substitution' phase is exhausted), the open trade regime permits enjoyment of constant returns to scale over a much wider range.<sup>7</sup>

Fourth, because import substitution policies pull new resources (and even existing resources from agriculture) into import-substitution industries, export growth lags, if exports do not decline absolutely. Import substitution itself is import intensive, both because rising rates of investment in 'modern industries' have a high component of imported goods and because many IS industries rely on imports of intermediate goods and raw materials. Hence, the demand for foreign exchange for imports grows at a rate normally well in excess of GDP while the supply of foreign exchange from exports grows more slowly. The authorities have typically been reluctant to increase the price of foreign exchange, believing that doing so would make goods 'essential for development' more expensive. The result has been an ever-widening gap between the demand and the supply of foreign exchange at the prevailing official exchange rate. The authorities' response has been to move to ever more restrictive import licensing and exchange controls (the latter so that exporters will not be able to keep their earnings abroad) along with increasing black market activity and smuggling.<sup>8</sup> At some point, the negative effects were sufficiently undesirable that policy makers adopted a stabilisation programme. This resulted in a stop-go pattern of economic activity, itself with negative effects on the overall growth rate.<sup>9</sup>

Fifth, because of its centrality, decisions with respect to trade policy almost force a number of other policies. Import substitution regimes normally give bureaucrats considerable discretion either in determining which industries should be encouraged or in allocating scarce foreign exchange in a regime of quantitative restrictions. Open trade regimes force much greater reliance on the market, if for no other reason than that bureaucrats cannot very effectively force foreigners to accede to their edicts.

That, under import-substitution regimes, bureaucrats have control over import licensing implies great power over all producers, not only producers of tradables. It typically makes all foreign exchange scarce, thus inducing the imposition of additional regulations (to 'conserve scarce foreign exchange'). One consequence is a major temptation to corruption. Another is a belief that all producers are cheating (which may be true), which in turn leads to additional scrutiny of import licensing applications, delays in receiving needed imports, and other production inefficiencies.

Sixth, as import substitution continues, most regimes become increasingly complex. The costs of the regime, and the likely costs and benefits of alterna-

<sup>7</sup> See Ventura (1997) on this.

<sup>8</sup> The nominal exchange rate typically is altered at times of 'foreign exchange crisis', which happened to most countries periodically under import substitution. Those alterations were typically 'too little, too late', and, while providing for some liberalisation of trade regimes in the short run, did nothing to alter the underlying policy stance toward IS. Over the longer run, the restrictiveness of the trade regime increased. See Krueger (1978) for a discussion.

<sup>9</sup> See Diaz Alejandro (1978) for the argument.

tive choices, become increasingly less transparent to decision-makers. Additional governmental resources become engaged in attempting to make the licensing system work, almost always to the detriment of other essential government functions, including the development of infrastructure.<sup>10</sup>

## 2. Static Inefficiencies of Import Substitution

Even if all that IS did was to misallocate resources and result in static inefficiency, the gains from liberalising might be sufficient so that the growth rate accelerated for a period of years. If, for example, the resource cost of static misallocations were 20% of GDP and it required 5 years after liberalisation to reallocate resources appropriately, the realised growth rate would be between 3 and 4 percentage points higher during the transition to the more efficient growth path because of gains in economic efficiency.

If, in fact, growth is at a standstill prior to the liberalisation effort, the apparent gain can be even greater.<sup>11</sup> Static sources of loss include the production cost of trade distortions, the losses associated with rent-seeking for import licenses and corruption, the losses associated with delays and other costs imposed by quantitative restrictions, and the losses associated with producers' monopoly positions in the domestic market.<sup>12</sup> The total far exceeds the production cost,<sup>13</sup> the trade theoretic measure defined as the difference in the international value added under existing incentives and that which could be achieved under a regime that more accurately reflected international marginal rates of substitution between goods.

## 3. Dynamic Costs of IS

However, it would appear that the dynamic losses under IS far outweigh the static losses. That is ironic, because the early arguments for IS always were based on the assertion that, while comparative advantage showed that free trade was superior from a 'static resource allocation' viewpoint, dynamic

<sup>10</sup> The inadequacy of transport and communications facilities in developing countries that have followed import-substitution policies is well known. The precise mechanisms that result in their inadequacy are not clear. It is evident, however, that - almost by definition - a liberalised trade regime cannot persist unless ports, roads, and communications are adequate to service a large and rapidly growing volume of trade. Bottlenecks become visible very quickly.

<sup>11</sup> A large number of countries have reversed slow growth for a period of years after liberalisation. For example, the Turkish rate of economic growth in the 1956-58 period was about 2-3% annually. After liberalisation in 1958-60, growth averaged around 7% for the next 7 years. The same pattern was observed after the 1980 Turkish liberalisation. In Ghana, real GDP was declining at 1-2% annually prior to the 1984 structural adjustment programme began. It averaged around 5% a year for the next half decade or more.

<sup>12</sup> One frequently encounters the argument that countries cannot liberalise their trade regimes because they depend upon tariff revenues for support of their fiscal programmes. In fact, when quantitative restrictions and import prohibitions are the mechanisms by which excess demand is suppressed, there is scope for trade liberalisation accompanied by *increased* government revenue at lower rates of protection through tariffs or their QR-equivalents.

<sup>13</sup> See Johnson (1960) for a rigorous definition of the production costs of a tariff.

considerations (presumably derived from the infant industry notion) outweighed the static, and tilted the balance in favour of IS.

In practice, the outer-oriented trade strategies win the dynamic gains argument easily because IS strategies were and are associated with increasing costs and slowing growth over time.

There are a number of reasons for this, many of them emanating from phenomena already described. First of all, if a country embarks on an IS strategy, the 'easy' IS opportunities will likely be largely exploited first. These opportunities may lie relatively close to the country's comparative advantage.<sup>14</sup> As the IS proceeds and the 'easy' opportunities are already exploited, the new activities induced by protection would lie further away from comparative advantage. For developing countries with relative abundances of relatively unskilled labour, lying further away from comparative advantage means more human- and physical-capital using activities. This, in turn, means rising incremental capital-labour ratios. For a given savings and investment rate, that implies a declining rate of economic growth.

In addition to rising capital-labour ratios because new activities are more capital-using, the fact that the domestic market for many industrial commodities can be small further intensifies the problem. Once such relatively widely-consumed (at low income levels) items as shoes, clothing, and radios are produced, the size of the market for other manufactured goods can dwindle rapidly. Underutilised pieces of capital equipment (because either of indivisibilities or because of multiple products) also contribute to increasing incremental capital-output ratios and hence reduced growth rates.<sup>15</sup>

Other factors also contribute. The stop-go pattern, described above, clearly reduced growth rates. So, too, did increasing corruption and greater smuggling in response to larger black market premiums. One can even argue that the tension between the private sector and government officials rose over time.

In recent years, the focus on endogenous growth has pointed to another source of reduced growth rates under IS. It focuses on the opportunities for growth through use of ideas, and knowledge capital. Here, the argument is that imports provide domestic producers and consumers with new ideas (which are an externality) and that the restriction of imports (in response to lower export earnings) reduces the growth rate by reducing the rate at which people accumulate and use knowledge capital.<sup>16</sup>

To be sure, *anything* that is a property of trade that leads to an endogenous growth mechanism could equally well account for differences in growth rates between alternative trade strategies. It might be that exporters acquire more knowledge by their interaction with foreign buyers than do producers for the

<sup>14</sup> This appears empirically to have been roughly the pattern actually followed. However, in theory, a would-be producer, deciding upon which activity to undertake, would consider not only his costs relative to prices of imports, but also the degree of monopoly power he would attain. This latter would not necessarily be correlated with the excess of domestic production costs over world prices.

<sup>15</sup> In fact, developing countries' savings rates rose dramatically from the 1950s to the 1980s, while growth rates on average did not. See World Bank (1983).

<sup>16</sup> See Grossman and Helpman (1991).

domestic market. Or learning by doing might take place more rapidly in export industries. But that countries whose economies are relatively more insulated from international trade do seem to fall behind in production techniques, quality, and other attributes of production associated with knowledge and new goods seems evident. It remains to determine how this source of growth might be quantified.

Finally, feedback mechanisms to policy makers under IS seem weaker than those under outer oriented regimes. The obvious point is that the tariff equivalent of import quotas or prohibitions is not known. But there are others. With import licensing, policy makers are less sensitive to the degree of overvaluation of the exchange rate than they are under outer-oriented trade regimes, where diminishing rates of export growth serve as a signal that things are not going well, and pressures rise from export interests (which relatively are more important and more influential than under IS) to adjust the exchange rate. The high costs of poor infrastructure are less evident than under a more open trade regime, and those costs spill over far beyond the tradable goods activities in an economy.

#### 4. Need for Supporting Policies

While most countries liberalise from an initial situation that is sufficiently extreme so that gains are almost inevitable, trade policy does not operate in a vacuum. Other policies supporting trade liberalisation may be necessary and in any event can greatly increase the benefits.

The most obvious such policy pertains to exchange rate determination. The move from a regime in which quantitative restrictions have restrained foreign exchange expenditures to foreign exchange availability to one in which producers and consumers are to be free to choose at prevailing prices requires an adjustment of the nominal exchange rate. In fact, even if one moved from a regime in which there had been a uniform tariff of  $x\%$  to one in which the tariff was  $0.5x$ , an alteration in the nominal exchange rate would be called for.<sup>17</sup>

There have been a number of instances where trade liberalisation was not accompanied by a change, or at least a meaningful change, in the nominal exchange rate. In such circumstances, excess demand for foreign exchange has once again emerged and the authorities must either adjust the exchange rate or reimpose quantitative restrictions. Until they do so, however, incentives for domestic production of import substitutes have fallen while there has been no increased incentive for production of exportables (whose price remains unchanged in domestic currency as long as the nominal exchange rate is unaltered) or for production of home goods. The result is often a period

<sup>17</sup> Of course, as an alternative, one could always subject the domestic economy to deflation, but in most instances that would require a period of domestic recession until expectations as to the price level adjusted. It should be noted that removal of quantitative restrictions is in itself deflationary, but the additional imports accompanying the liberalisation would have to be financed by additional foreign exchange earnings, which must be induced by the exchange rate adjustment (or by an absolute drop in the price of nontradable goods as well as the domestic price of imports).

during which the level of economic activity declines. Such a period not only leads to output losses, but also to political pressures to reverse the liberalisation.

Often, too, other regulations are built into the system which buttress quantitative restrictions. If they are not removed when an attempt at import liberalisation is made, the entire effort can be thwarted.<sup>18</sup>

Beyond the policy mistakes which prevent accelerated growth from starting or persisting after liberalisation, there are a number of policies whose alteration can greatly enhance the gains. It was already mentioned that infrastructure inadequacies become glaringly apparent with an open trade regime. Often, the evidence has been sufficient to convince leaders that improvements must be made.

Other growth-inhibiting policies can also usefully be altered. These include but are by no means limited to labour market regulations, policies favouring procurement by public sector enterprises, reform of tax laws and/or administration, and changes in agricultural pricing policies.

In most instances, failure to address these issues results in smaller gains from trade liberalisation than would otherwise have occurred. But in extreme cases, policies may be so restrictive that little can happen before they, too, are altered.

## **5. What Differences are There between Trade Liberalisation and Outer Oriented Trade Strategy?**

As stated at the outset, explaining why outer-oriented economies have achieved such high rates of economic growth is subject to considerable debate. Answers range all the way from high productivity growth (which might result from endogenous growth theoretic bases), to getting *all* the policies (not only prices) right, clever government intervention, to laissez-faire policies, to good luck.

That argument cannot be resolved here. But one can, at least, address the difference between simply liberalising the trade regime and moving to an outer-oriented trade policy. Liberalisation is, by definition, the action of making a trade regime less restrictive.

There are always benefits to liberalisation, although their size may depend on many things. But clearly one could not expect to achieve an outer oriented trade regime simply by replacing quotas with tariffs<sup>19</sup> or increasing the size of quotas.

An outer-oriented trade strategy is one in which the development strategy

<sup>18</sup> An example will illustrate. In India in the mid-1980s, an effort was made to liberalise imports by removing licensing requirements under certain circumstances. But producers sometimes found that when they wanted, e.g. state government licenses to operate, they had to show their documents from national investment licensing officials, which in turn were contingent upon approval by the import authorities.

<sup>19</sup> The empirical evidence, however, is that efforts to replace quotas with tariff equivalents seems nonetheless to reduce protection. This was found in several of the countries reported upon in Krueger (1978), including Egypt and the Philippines.

itself is based on the growth of domestic economic activity in response to producer incentives that closely mirror international prices. As such, it is expected that rapid growth of industry will occur (as agricultural productivity rises) as producers find their best alternatives in the global economy. That means that policy makers must focus on delivering adequate transport and communications, permitting imports for exporters at world prices, and going well beyond simply the easing or removal of restrictions on imports. If one ignores the variance across commodities, one can define the bias of a trade regime as the extent to which the ratio of domestic prices of import competing goods to their international prices relative to the ratio of the domestic prices of exportables relative to their international prices deviates from unity. An outer oriented trade regime is one where the deviation is small, while an IS regime is one in which it is larger.

Trade liberalisation clearly implies a reduction in the bias of the regime. Moving to an outer-oriented trade strategy implies moving to a very small, or even zero, deviation. Turkey liberalised the trade regime in 1958-60 and again in 1970. Turkey then moved to an outer-oriented trade strategy in 1980-3.

## 6. Conclusion

There is much still to be learned about trade liberalisation, the best means of achieving an outer-oriented trade regime, and the reasons for the very rapid growth that the outer-oriented economies have achieved. But the reason why trade liberalisation delivers more rapid growth is that IS, over time, becomes a failed strategy. As such, any significant degree of relaxation of restrictiveness can result in gains, unless there are other policies in effect in the economy that thwart their impact.

Trade liberalisation undertaken from a period of declining growth rates or even falling real GDP can normally lead to a period of growth above the rates previously realised. It cannot, however, lead to sustained growth at the sorts of high rates achieved by the truly outer-oriented economies unless policy makers adopt far reaching measures that effectively provide incentives within the tradables sector at world prices and thus an outer oriented trade regime.

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