

TRADE AND REGIONALISM: THE LINKS WITH DEVELOPMENT

**Prepared for Inter-American Bank Second Regional
Trade Dialogue
April 2001**

By Sheila Page

**Overseas Development Institute
111 Westminster Bridge Road
London SE1 7JD
UK**

Tel: +44 (0)20 7922 0300

Fax: +44 (0)20 7922 0399

TABLE OF CONTENTS

TRADE AND REGIONALISM: THE LINKS WITH DEVELOPMENT	1
HOW TRADE IS DETERMINED, AND ITS IMPACT ON NATIONAL ECONOMIES	2
Influences on trade	2
Economic determinants of trade	2
Policies toward trade	3
Openness	6
The effects from trade	7
The level of demand and output	8
Growth in income	10
The composition of demand and output	10
Technology and investment	11
Distribution of income	12
Trade policy effects on choice of policies	13
TRADE IN THE CONTEXT OF DEVELOPMENT	14
HYPOTHESES AND POLICIES ON TRADE AND DEVELOPMENT	15
Planned domestically based development (in the import substitution phase)	16
Export-led growth	17
Export-led growth, after import substitution	18
National policies with trade as an element	20
Export led growth with good policies	20
Good institutions	21
Strong policies	22
Allocatively efficient policies	22
COMPARISONS AND CONCLUSIONS	23
On trade	23
On trade and development	23
APPENDIX	25

Trade and regionalism: the links with development

Neither regional integration nor trade is a welfare or policy objective in itself. If countries are pursuing policies to promote them, this is as a means to improve their welfare. The ultimate objective need not be under a purely economic definition: there is a long history of seeing integration through trade as a way of preventing conflict among countries. But it is because trade is believed to increase economic welfare that the advantages from economic integration are seen as a 'glue' to hold countries together for non-economic reasons.

How to promote development remains a puzzle. If 'the combination of external openness, low inflation and a controlled public deficit has not been enough to initiate a sustained process of economic growth throughout the region' (Ocampo 2001), how can we 'introduce innovation..and build productive complementarities' (ibid)?

If we do not understand what it is that promotes development, it is hard to answer whether trade provides this unknown factor. The simplest effect expected is an increase in income, associated with an increase in mutual dependence through integration of markets. For economic assessment, the increase in integration is the means to the benefit to income; for the more political or military motives, it is the integration which may be the objective. For developing countries, and particularly for small countries, other economic benefits are also suggested: catching up through integration into the world economy. But if we try to understand the processes by which these aims are achieved, we find that both economic theory and policy discussion put forward a complex of relationships between trade and income or development, with the differences already seen between means and ends reflected in different analyses of the direction of causality. The purpose of this paper is to clarify, not to resolve, these differences; to describe the various stages of the assumed relationships; and then to use this framework to identify what is asserted about which stage by the various views and policies on 'trade and development'.

There may be purely **economic linkages**: economic effects from trade to development and from development to trade.

There are policies which influence trade, and therefore development, or which influence development, and therefore trade, i.e. **policy to economic effect linkages**.

There are linkages among policies: some are intrinsically consistent or inconsistent with each other; others are formally constrained by an existing set of policies (joining a regional or multilateral arrangement means accepting certain legal constraints on both external and internal policies), so there are also **policy to policy linkages**.

Trade policies, general development policies, and economic relationships will affect the development of regions (in the formal sense) and of trading systems more generally. These in turn will affect trade patterns. Both the initial and the 'induced' trade patterns will affect demand and patterns of economic activity within countries, which are themselves the basis for trading patterns.

For each linkage there are possible indirect or second round effects: some of these are mechanistic, economic responses to an initial economic change (if trade changes demand for a particular sector, there will be effects on incomes, and therefore effects on other sectors), but there may also be policy responses: if the initial effect of a trade-induced change in demand on income is not wanted, a country may take appropriate and efficient (or inappropriate or inefficient) policies to mitigate the effect. Except in the most short-term, officially constrained, description, any analysis (particularly if it starts from the premise that policy can be important) should consider the full chain of all the probable effects, not assume absence of policy following the first impulse. It must take account of how policy is made, as well as of how economic and production systems work: what type of policy response can be expected, given not only a technocratic assessment of the 'best' policy (according to current analysis), but the actual interests and power relationships. This means that the final outcomes become very difficult to identify with any certainty. While the direction of effects from individual elements of trade or other forms of international integration or from growth to the component economic variables may be clear, or subject to known influences (even if their magnitude is difficult to calculate without very detailed information about not just the country but its trading partners), the interaction of all the effects, including the policy responses, and the responses to the reactions to the initial responses..., can only be analysed under with full knowledge of the general economic equilibrium of an economy and the nature of that country's policy responses.

The simplest way to organise the description is to look first at effects of policies on trade, and then the effects of trade on development. This will be done in the next section, which will also try to put both trade policies and trade in the context of other possible influences on trade and on development. As an analysis of 'trade and development', this paper must focus on questions such as how trade affects development and how this is modified by international systems and internal economic and political relationships.¹ But for a more general understanding of development, and policies to promote it, we must ask what is needed, and then what trade can contribute to this. A brief section will therefore look at what may be meant by 'development', and the possible roles of policy. These introductory sections will then allow us to classify the various arguments that are made about the direction (and magnitude) of effects from trade and trade policy on development (this is summarised schematically in the appendix), and finally to draw conclusions about areas of agreement, disagreement, and remaining ignorance.

How trade is determined, and its impact on national economies

Influences on trade

Economic determinants of trade

There are two major strands of analysis of the economic determinants of trade. They are not alternatives; both always operate, on the level and the composition of trade, but which is

¹Evans 1989 suggests five questions: the role of trade in economic development, the 'patterns of international exchange' which 'best serve' developing countries, the effects of different policies on trade, the applicability of different theories, and the relationship of trade to 'class relationships and to inequalities of income and power, both within and between developed and developing countries' (p. 1)

emphasised affects policy debate.

Macroeconomic: the balance of trade (and other international transactions) is the inverse of any difference between domestic output and expenditure, and therefore determined by macroeconomic variables such as income or monetary variables. Within this:

If unemployment is possible (and present), the balance of trade can change.

If there is full employment, there will be only temporary fluctuations. Autonomous changes can come from changes in demand in the country, or abroad.

Comparative advantage: the **composition** of imports and exports will be determined by the particular characteristics of a country and its trading partners, and the differences between these. It can change or its outcome may be affected:

changes in technology or tastes change the products which are demanded and traded

the characteristics of a country (or its partners) can change:

training affects the supply of skilled labour;

investment affects the supply of capital relative to labour

population changes (natural or through migration) affect the supply of labour relative to capital

changes in transport or communications costs affect relative advantages the production of the goods² may not conform to the simplest model of declining marginal returns.

the way in which production is organised may affect the efficiency of response to any stimulus.

Developing country special factors: For developing countries (particularly in the past when short-term fluctuations and imbalances were taken for granted (and financing regarded as either an obligation on external funders or not a major problem), macroeconomic balance has not been a major focus of development policy, the types of change which affect the composition of trade are more likely (and are often themselves among the objectives of development policy), so that the focus is normally on the second, but with a shift over time towards the first.

Policies toward trade

Trade policies can be intended either to influence the volume or value of trade directly, i.e. to be a third influence in addition to the two economic (**Direct trade policies**), or to operate on the various factors which determine the economic influences (**Indirect trade policies**). Given our assumption that trade is not itself an objective, all these could also be called non-trade policies and classified under their 'real' objective, but it seems useful to keep the term **Trade** for policies whose immediate target instrument is trade outcomes (with the intention that these have some other effect), and **Non-trade** for policies targeted on other instruments (perhaps an income or sectoral distribution objective), even if operating through the same mechanisms. **Non-trade**

²Goods throughout this paper can usually be interpreted as 'goods and services or other similar international transactions'.

policies in this sense may also have effects on trade or its determinants. In policy, choice between **Direct** and **Indirect Trade policies** could be affected by views about what types of policies are efficient or effective, but also by restrictions imposed by regional or multilateral agreements.

Direct trade policies include quotas, tariffs and subsidies (and domestic price controls with similar effects). They may also include public procurement restrictions, local provider or content rules. Direct policies are those most likely to be governed by agreements, or even implemented at regional level. Tariffs against all countries are limited (bound) by multilateral arrangements; tariffs against some countries are set by free trade areas; tariffs against all countries are set by customs unions. The internal measures suggested here are regulated at both multilateral and regional levels, and in some regions are set by the region. Direct policies therefore include **regional direct policies**. They also include **policies taken by a country's trading partners** which affect its trade: restrictions or subsidies. These can be expected to be as influential as the policies taken by a country on its own trade.

The actual effects observed from either **regional direct** policies or the **policies of trading partners** will be different from those of national **direct policies** because they have different coverage or different direction of effect, but this does not affect the nature of the analysis. As successful regions are normally formed for reasons which are not directly connected to economic motives (because of historical ties or, in some cases, because of historical conflicts), the formation of the region itself does not need to be included in **direct policies**.

Three provisos:

Conventionally it is assumed that measures influencing prices are less distorting (have fewer unintended side effects) than those affecting quantities, and that general measures are less distorting than measures directed at particular goods or activities. But if (as discussed below) there are different effects from different types of trade, achieving the direct effects may be more efficient through quantitative or specific measures, so that it is not possible to make a general judgement at this stage.³

We cannot assume that policies will have the intended effect (this requires normal analysis of the conditions for policies to be effective, including external conditions, competence, correct identification and modelling of responses).

We cannot assume that the trade (or changes in trade) which result from policy intervention will have the same effect as trade induced by the economic conditions identified above (Rodriguez, Rodrik 2000 pp. 3-4). Policies are inherently both changeable and influenceable in a way in which in economic conditions and changes in them are not, so responses at later links in the chain may be different.

³ If we assume that governments are behaving rationally, then we must assume that they are choosing their objectives after balancing the direct advantages and indirect costs, not that the indirect costs are unexpected and therefore a new piece of information and reason to reject a policy.

Indirect trade policies: these include tax incentives, marketing assistance or other official assistance to some types of production. If they are general, these can affect the level of demand (macroeconomic influences); if more specific, they can affect the level of investment or advantages of particular sectors (composition influences). Credit policies (general and targeted) affect capital costs. Training, migration, or population policies can affect the supply of total labour and of particular types.

How far should we take the caution about 'effects of policy-induced effects'? If policies operate on the determinants of comparative advantage, will the resulting changes in trade have the 'normal' or different effects? must also be an empirical question

Non-trade policies: many of the same policies which can be **Indirect** or even **Direct trade policies** may alternatively be for non-trade purposes: the most obvious in the context of this paper is the formation of a region, but other policies closely related to trade include local provider rules for financial or health security reasons; subsidies to promote types or location of production; tax incentives to encourage types or locations of production considered desirable for the national economy (or non-economic reasons). Other policies such as provision of infrastructure, whether physical, institutional, or social affect the conditions within which both aggregate demand and comparative advantage are determined. Promotion of education or health, or direct interventions to protect labour conditions, for reasons of non-economic priority have clear effects on labour supply. But, if the assumption that trade is not the principal objective of a country is correct, most policies (at least weighted by effect, if not by numbers) must be treated as by intention **non-trade policies**. Regardless of their immediate motive, however, they may still affect trade or the influences on it. Some may be taken to reduce or reinforce the effects from trade on income, distribution, industrial structure..

While this distinction is clear in theory, using it to analyse historical cases is not straightforward. The Asian NICs placed a heavy weight on increasing education and training as part of their development programmes; it has been much less important in some Latin American countries. It is difficult without political, historical, and social analysis to analyse how much this difference was because of different assessments of the contribution of education to development, of its rate of return, and how much was because spending more on it out of increasing income reflected different national attitudes towards education.

The examples of education and labour conditions also demonstrate that there are potentially different second and third stage effects from the same policies. Increased spending on education or a shift (because of trade opening) to higher returns to unskilled labour both tend to reduce the economic return to education, and thus would reduce spending on it if it is purely economically determined. If it is the result of political choice, on the other hand, increased income will increase spending on education. Economic decision-makers may have greater confidence in responding to what appear to be permanent national policies, where an increase in income may increase the demand for education, and therefore the supply of skilled labour, than to those taken for specific trade purposes, where it is necessary to estimate the net effects of increased total demand for labour, but lower relative demand for skilled labour. Labour standards which are improved because of distribution policy, rather than to meet regulatory demand, may have an

effect on national acceptance of the effects of trade or of economic development more generally.

Developing country special factors: For policies to be effective, the policy-makers must understand the economy sufficiently to predict the response correctly. Data on and analysis of developing countries may be weak, but the greater emphasis on policy interventions may mean that policy effects are relatively better understood. Policies should have competent implementation. Countries with fewer trained people are at a disadvantage, but experience with a policy may offset initial disadvantage. In any particular case the disadvantages of inefficient implementation must be compared to the alternative, possibly also inefficient for the same reasons. Where the exogenous factors (available factors of production, composition of demand) are changing relatively quickly, policy must also be able to adjust relatively quickly. Whether policy will be more or less likely to be effective in developing countries than developed, or when compared to non-intervention is not determined, and requires empirical testing.

Openness

Some analysis of the effects of trade on development attempts to define and use as a variable the 'openness' of an economy. It has, however, various meanings, as well as different definitions within these, in particular the emphasis can be on **policy-openness** or **outcome-openness**. If it is policy, direct measurements can include various combinations of the **Trade policies** cited here, and perhaps some of the **Indirect Trade policies**. If it is an outcome, actual trade flows are the direct quantification. There are considerable technical and theoretical difficulties with either type of measurement. These have found to be sufficiently great for the policy ones that **outcome** measures are sometimes used as indirect measures of **policy openness**. There are also intermediate measures (price differences, estimates of exchange rate distortion from 'equilibrium') which are used to measure **policy openness** by identifying the strength of one of its presumed effects (e.g Dollar 1992).

The difficulties of measuring the restrictiveness of tariffs or the effects of taxes or subsidies are well known; quotas share these problems, with the additional one of lack of agreed definitions or databases. Full analysis would require parallel calculations for all a country's trading partners.

Actual trade flows, as indicated above, are the result not only (often, not principally) of trade policy, but of natural conditions and costs, absolute and relative to trading partners, and macroeconomic and industrial conditions. **Policy-openness** depends also how the **trade measures (direct and indirect)** are applied in practice and on the effects of **non-trade policies**: even if trade is not their target, these effects should be, and probably are in countries which are interested in trade and development relations, taken into account in determining the total trade policy. **Outcome openness** must be measured against some standard, of what is normal for a country of particular economic, institutional, and historical characteristics.

Openness measures are conventionally used to make cross-country or time series analysis of its effects on development (or growth or some other definition of the welfare target), but these difficulties of definition, interpretation, and country and circumstance-specificity suggest that it is better regarded as an analytic conclusion than a mechanical outcome of quantifiable characteristics. Cross-section analyses allow the use of small amounts of data for individual countries, while time series permit holding at least some of the 'other' variables which affect trade

and development constant (if they remain constant for a country) (see Ram 1987 and Edwards 1998 for some comparisons).

Some of the literature⁴ does combine subjective with quantitative measures: the 'socialist' orientation of an economy, various measures of political freedom (some of which have been analysed and quantified) in political science literature (e.g. Sachs, Warner 1995). The problem is that if the non-economic components are mechanically calculated, they become subject to the same reservations about how they are actually applied that are characteristic of the tariff and quota measures but if they are determined with deep knowledge and familiarity with the economy, the analysts' interpretation of the 'openness' of the economy will influence what is entered for their value.

The interpretation of **regional openness** (where a country is more open to a region than to the rest of the world) has all the same problems of measurement and weighting as multilateral openness, with the additional difficulty of weighting the potential distortion (trade diversion). This implies that actual openness to the rest of the world is less than the aggregate measures would imply. As with measuring tariff level by weighting tariff-controlled trade shares, using shares of trade to weight this risks underestimation, and the nature of the 'openness' is different.

These difficulties suggest that not only are there important differences in the definitions of what different analysts call **openness** (a problem, but not an unusual one for economic theory, and not an insoluble one), but that neither of the basic definitions, **policy** or **outcome openness**, can be used to define a continuous variable. Rather they are clusters of non-additive characteristics. It may not be useful to try to aggregate the various influences on trade in this way, and better to analyse the impact of each on development (and other objectives) separately.

The effects from trade

In the last 50 years: trade policy has been liberalised; trade has grown; output has grown. But many other policies have changed; attitudes to policy and to intervention in economies have changed; technology has changed; the non-trade, non-economic contacts among countries have changed. It is not difficult to find simple correlations among all these variables, but before attempting to identifying causation, it is necessary to analyse what type of effects could be explained by generally accepted economic relationships. Without this, it is difficult to distinguish directions of causation (expansion in output may lead to expansion in output of tradable goods and therefore in trade) or to discard correlations which merely reflect variables which have both moved because of an omitted variable, for which trade or some measure of **openness** may be acting as a proxy.

Econometric techniques can supplement theory in identifying relationships, and can draw attention to potential relationships, but it should not be used without theory. Cross-country and time series analysis have different advantages for this, and both are used.

⁴ See Edwards 1998 for a survey which concludes 'there has not been too much progress in this area', p. 386: although he finds evidence of positive correlation between a variety of measures of 'openness' and productivity, other variables like initial GDP and human capital are also important.

The level of demand and output

The first effect, **allocation efficiency**, is that trade raises a country's potential income (or welfare) by permitting it to change the composition of its output to a more efficient structure, that is, permitting it to specialise according to comparative advantage. A country which is producing efficiently in a closed economy can move to a higher level in the open (or at least less closed) situation, although there is no change in the macroeconomic balance. The increase is only potential, however, not inevitable. If it is not producing efficiently at the initial stage, then whatever prevents it from doing so may also prevent it from benefiting, in full or indeed at all, from the new opportunity. If the problem in the initial situation is unemployment of some resource, for example labour, which cannot be transferred from one type of production to another, and opening to trade allows the country instead to export more of that good, importing the alternative, then the gain from trade may be greater than the static efficiency gain. Or it may be impossible to raise other, domestic, sources of demand because of a balance of payments constraint is binding (imperfections in the international capital market). But if the failure arises from more structural reasons: lack of sufficient incentive in the market to improve efficiency (see below), deliberate (or unintentional) distortion of prices because of other policies, or lack of information or infrastructure linkages which permit efficient transmission of price and demand information to producers, it may prevent any response to trade. Under this effect, therefore:

Trade may raise total income by more than or by less than the **allocation effect**;
it will not lower it, although it may have no effect;
the direct effect is one-off.

The effect of a **regional** opening is potentially the same, with the same qualifications (trade creation), but may be less favourable: If the regional trading partner is not the most efficient producer, the country may adjust its composition of production, but will gain less by exchanging its efficient production (trade diversion).⁵ In contrast, liberalisation by a **trading partner** is likely to reduce distortion, and therefore allow a more efficient allocation of production.

The **X-efficiency effect** holds if what is holding output below potential output before trade is opened is lack of sufficient stimulus to adopt new methods or technologies because of lack of competition and if trade provides that stimulus. Introducing trade therefore not only increases potential output, but moves all output nearer to its potential. How does competition work? For all countries (and economic decision-makers) if losses are weighted more heavily than (equal) gains, the incentive from the risk of losing profits (to competitors) is greater than that from potentially gaining more. (This contradicts the equally prevalent view that carrots work better than sticks.)

There are two reasons suggested for this being a particular problem in developing countries, which can impede the effect from competition. If the problem is inefficient transmission of stimuli (prices are not available to producers; the infrastructure makes mobility among sectors

⁵In multilateral liberalisation, the gains from trade more than offset any losses to national income from loss of tariff revenue; in regional, they may not.

or regions difficult; failures in credit markets impede investment), then the country is at its current potential output; to raise this, it requires appropriate investment in physical and perhaps social infrastructure. If it is the response to stimuli which seems weak, it is difficult to know whether economic or policy changes can tackle it: does it need appropriate education, or training, or does it require particularly strong stimuli? If so, should these be through technology, industrial strategy, demand (macroeconomic policy), or trade policy? The lack of analysis of this is reflected in old concepts like 'take off' or new ones like openness or readiness. If there is a problem of response, then the allocation effect may not work, because it depends on response to same impulses. It assumes that sectors and firms are operating efficiently in their own terms within the closed economy. It is this efficiency which allows them then to respond efficiently to the new signals, and obtain the allocative gains. If they cannot respond efficiently to market incentives, they will not be able to respond to the new trade environment.

Under **efficiency** effects, trade raises total income: eventually by more than the allocation effect, but the process is unclear.

The direct effect is one-off.

As well as stimulating its application, trading is one way of obtaining **access to technology**: through observing traded goods, through the stimulus to efficiency (increasing the application of, not the access to technology), or even simply through greater contact between economies.

Through **technology**, trade can raise income, and, in a relatively technology-poor country, this can be a continuing stimulus.

Regional trade can provide both **efficiency** and **technology** effects and well as **allocation**. They may be more limited than from multilateral liberalisation if the region is small or relatively technologically backward. Econometric analysis whether using time series analysis or CGE modelling (e.g. Vamvakidis 1999, Page et al 1999) normally finds that multilateral opening is significantly preferable to regional. If they are alternatives (for reasons of policy), this is a disadvantage; if they are used together, the effects can be combined.⁶ For all regions except the EU, the share of regional trade, and therefore *a fortiori* the share of the increase in regional trade, in total trade is small (a quarter for MERCOSUR, less for others): Where the share is large for an individual small member, particularly a land-locked one, this is for reasons of geography or historical relationships, not for reasons susceptible to recreation by a region.

Stability has attracted attention for developing countries since the analysis of the effects of commodity price fluctuations. Concern has been intensified by the apparent increase in the frequency and intensity of financial crises. Although the steps in the argument that stability improves income or growth are uncertain theoretically and empirically (Page, Hewitt, 2001), if

⁶The current position in Latin America and the Caribbean is of combination, for most countries at least 3 levels: sub-regional, hemispheric, and global (plus some cross-sub-region: Mexico, MERCOSUR, Chile, and the Caribbean with the EU, for example). The superior ranking of multilateral can therefore be considered an indication of relative priority, to the extent that the motives are economic, but not necessarily of exclusive choice. The Vamvakidis 1999 results are based on relatively small regions (pre-1980s regions) which therefore suffer particularly severely from the disadvantages of regions compared to multinational agreements identified here and the simulation studies consider alternatives.

there is an effect, then any impact from trade to stability becomes important. Liberalising increases the number of potential shocks that could affect an economy, but a large number itself ensures some offsetting effects, including on the shocks that come from within the economy (trade plus capital movements allow 'transfer' of production from one year to another). If, however, a country has become more specialised because of trade, and if trade is a high share of total output, the whole economy may be more concentrated and therefore more exposed to specific risks.

Trade may increase or reduce instability, which may have a harmful effect on growth.⁷

Regional integration may be significantly less able to serve this shock-offsetting role if the region's shocks are more likely to be correlated.

Growth in income

Any increase in income may (under a conventional model) stimulate increased **investment**, so that all these initially 'one-off' effects can have second round effects, and if a country is very closed and pursues a policy of continuous opening, then the observed growth rate will increase, although it could be decomposed into the same trend plus a series of shocks. Therefore under any of these effects:

Trade may lead to a continuing higher growth over an adjustment period.

If exports are an important source of demand and/or technology, then the more rapidly growing are a countries' trading partners, the more it will grow. If, therefore, a **region** is growing relatively slowly, and if integration changes the direction of trade towards the region, a country may face a choice between the benefits to growth from greater integration and those from faster-growing trading partners.

The composition of demand and output

The results of increased specialisation make the characteristics of the sectors in which the country has a comparative advantage a particularly important determinant of the direct impact of trade on the economy. If a country's advantage is in an export with high elasticity of demand and potential for new investment, the efficiency and growth effects of trade will reinforce each other.

But a country may remain specialised in a low-skill, or high resource- intensive export. If this is one for which the growth of demand is likely to be relatively slow, this will limit the growth effects from trade (the traditional argument for policy measures to diversify out of commodity exports, either to import substitution or to manufactured export promotion). The rapidly growing NICs, like most of the OECD countries are specialised in manufactures, and in particular in the more technologically advanced products, with the next level in more traditional manufactures (clothing, leather, some chemicals), and the lowest in primary commodities.

⁷Instability could have a positive effect if increasing the strength of price or other signals offsets any blunting from lack of linkages in the economy.

The efficiency effect of trade may impede the growth effects through the composition of demand, although long-run forces could offset this.

In terms of the analysis of trade above, the mix of exports could be altered by altering **trade directly** or by acting **indirectly**, on one of the elements affecting **comparative advantage**. Such a change could come from either an economic change or a policy change. For example, the increase in income will increase the demand for skilled labour, and therefore the return to education, and the future supply of skilled labour. It may allow families to reduce child labour, also increasing education and future skills.

If a country's comparative advantage in its **region** is different from its advantage in the world as a whole, regional opening will stimulate different specialisation. In Latin America (and in Africa), regional exports have traditionally had a higher share of manufactures than total exports, especially for the leading producers, while in Asia (where the countries' supplies of cheap, skilled labour are large relative to developed countries, but not relative to each other) the reverse has been true (Page 1991). This remains true in the regions formed, or re-formed in the 1990s (Page 2000), with industries like cars and car parts a major vehicle of integration in NAFTA, MERCOSUR, and the Andean Group. Their high and rapidly growing shares are partly the nature of the industry: highly integrated across borders. This is also, however, the industry which for economic and policy reasons has a greater advantage in the regions than in the rest of the world.

If this stimulus to manufactures has a long run effect of raising the country's productivity in the sector, the **region** can be an **indirect trade measure**, altering comparative advantage (by changing the industrial structure of the country and by making the manufactures industries more efficient relative to the rest of the world: even regional exporting may have an **X-efficiency** effect). In a situation of almost-simultaneous regional and multilateral liberalisation, both the advantages and the risks of this difference in regional and multilateral trade patterns may be relatively small.

Regional **comparative advantage** can alter the efficiency-growth effect trade off, but regions also alter what growth effect is available.

Where there are discriminatory trade barriers against manufactures in a country's trading partner, for example against clothing in many developed countries, the effects of **trading partner** liberalisation will be distorted: countries may be able to move to new areas of comparative advantage, including manufactures, from which they were barred. But protection tends to be concentrated in industries which are declining in the developed countries, and if this is because they are industries with low expectations of demand, removing distortions which discourage exports in them may be more damaging compared to neutral trade liberalisation.

Trading partner liberalisation could have favourable composition effects, but may have unfavourable ones, depending on the composition of previous protection.

Technology and investment

The question of which sector is stimulated also affects how strong will be the **technology** transfer effects. If the sector which expands is itself research or technology intensive, it is more likely

to gain from technology transfer from a trading partner, and the same processes which lead to transfer between traders may also benefit those sectors within a country which are linked to the exporter to others.⁸

The **investment** effect from growth may also be stronger in a capital intensive and technology intensive exporter, intensifying the growth effects from trade.⁹ This can be altered by economic changes in the relative endowment of the country in capital and/or skilled labour compared to unskilled labour or by policies to alter this.

Within a **region**, unless it is large or there is a large technology difference, the effects are likely to be small.

For a country with technology or capital intensive trade, the investment and technology effects will supplement the efficiency effects.

Distribution of income

Trade does not raise all incomes, and may lower some. The first round effects of a sectorally-variable increase in income will have income distribution effects according to the labour, capital, and natural resources employed in the sectors which gain and lose. The losers include those in sectors where the comparative advantage is in another country, but also, if a trade policy change is a change from protecting or subsidising a sector, those in the formerly protected sector, and those who depend on it¹⁰ but normally, liberalising trade will increase the return to factors which are less scarce in the country than in the world as a whole (as this is what explains the country's comparative advantage). In a country with abundant labour, this is likely to mean a redistribution towards wages, but for those where natural resources, whether agricultural, mineral or scenic are more important (most Latin American and Caribbean countries), it will be these which gain. It is important not to overemphasise this: if mobility of labour and other factors among different types of work or different sectors is high, then any increase in income will come through more generally and losses from any falls will also be spread, as people shift from losing to rising sectors. Especially in poor households in informal or agricultural activities, many of the separate interests are not separate: land owners and industrial workers, for example, are in the same family, and companies are producing products which gain and lose. All are consumers. Finally governments can redistribute income. If reversing changes is difficult, policies can be used to alter the composition of trade, again directly or on the factors influencing it. Any increase in income can be captured by appropriate taxation. This may be administratively difficult in the poorest countries, but this is not a problem for Latin American and Caribbean

⁸ It appears to be the technology embodied in the inputs to the industry which expands which determines this Coe et al 1997.

⁹ Baldwin, Seghezza 1996 May emphasise this route, but it is likely to be more important for developed countries or small capital intensive developing than for the relatively commodity intensive countries of Latin America and the Caribbean.

¹⁰ Normally it is not the poorest (probably, politically weakest) sectors which are protected, so normally a shift of income away from a protected sector is more likely to improve poverty or income distribution, than to worsen them, but this may not be certain if there are indirect effects. The weak are less likely to be able to demand protection from the indirect effects.

countries.

Trade will alter the distribution of income towards the factor in which a country has an advantage (except where it removes previous distortions), but the first round effects can be altered both by labour market responses and by government action.

Which factor does best from increasing trade may be different within a **region**, or according to the particular circumstances in world markets. When the Asian NICs were entering world markets in the 1960s and 1970s, the other major traders were the developed countries, so that the NICs' advantage was clearly in relatively abundant labour, and labour incomes gained. In the 1980s and 1990s, however, when Latin America liberalised, the NICs were already established, and China and India were entering export markets. Latin America, with lower supplies of labour than the Asian countries, faced a trading community which already had countries with very abundant labour. The first round effects of trade are likely to have been very different from those in Asia. Therefore, if a more equal distribution were desired, the need for intervention either on trade or on the outcomes would be greater. Within a region, the differences, and therefore the effects, are likely to be smaller. Protection by developed trading partners is now concentrated on labour- or labour- and land- intensive sectors (clothing, other light manufactures, agriculture), so that the reductions in these distortions may improve the advantage of labour intensive sectors in developing countries.

Trade policy effects on choice of policies

Trade has been regulated at international level since the establishment of GATT in 1947, converted in 1994 to the World Trade Organization. The most well-discussed effect is from restrictions on countries' own trade policies. The restrictions on certain types of trade policy and the pressure to reduce even 'WTO-compatible' barriers to goods, and now services, remove certain policy tools. Indirectly, they also affect fiscal policy (tariff revenue losses). Regulations have extended to domestic measures with an effect on trade (notably to subsidies or intellectual property rules).

In its moves on standards and intellectual property, the WTO moved into new forms of international regulation requiring particular levels of protection. The requirements impose real costs, not only to users of the technology, but to national income, as many countries have adopted cheap or free transfer of technology as a tool for accelerating technical innovation. There is no direct compensation (although there may be technical assistance in implementing the rules), and only temporary exemption for least developed countries. This is an area where even countries with strict standards have had very different rules, in length of period of protection, in the nature of that protection and in provisions for new producers, so that the advantages of international standardisation for efficiency are not clear-cut. Countries have lost not only a general tool of development, but the ability to vary its application to suit their circumstances and policies.

The increasing complexity of goods traded, and the increase in the share of manufactures, and also in the sophistication within manufactures, have been important forces for the imposition of minimum quality or other standards, reinforced by rising incomes, and therefore rising standards for health and safety. The increase in coverage of national rules also requires international

regulations to avoid conflicts. The WTO rules on areas like sanitary and phytosanitary standards for agricultural products specify general international standards. They also forbid discrimination between imports and domestic production. Again, this was a new type of restriction because it goes beyond the traditional GATT rule of Most Favoured Nation (no discrimination by importers among suppliers) to National Treatment (no discrimination between imports and home production) and even further, with minimum standards, to international limits on national governments' behaviour, a significant extension of international limits on national policy. Of course, the regulation of tariffs which is the oldest part of GATT could be considered an international standard, but extending rules to specifying national regulations greatly strengthened the WTO regime.

The requirements on standards may push countries into putting more resources into setting, administering, and enforcing them, at an earlier stage, than would be strictly efficient on the grounds of their own needs (assuming that developed countries, which did not adopt either the standards or international conformity until recently, made rational decisions), although they offer savings: from being able to move directly to an international standard, rather than having to adopt a national one and then adapt.

While the least developed countries are exempt from most of these restrictions, and developing countries much less regulated than developed, the pressure to conform is a *de facto* restriction even on those technically exempt.

How important the constraints on policy are depends on what policies a country wants to follow (see section on strategy below). They could conflict with **Direct Trade policies**, and some **Indirect**.

Within the more integrated **regions**, the restrictions may be greater, with policies to encourage particular industries or to respond to economic conditions restricted by *de facto* or *de jure* requirements for coordination and consultation.

The results of the multilateral restrictions can be considered **trade policies**: the agreements are made to provide security or growth of trade, and therefore they need to be considered as part of the complex of trade policies adopted by a country. They are within the control of the government (withdrawal from the WTO is permitted). **Regional** restrictions are ultimately accepted for the non-trade purposes of the region, but particular measures may be targeted specifically at trade by all members.

The changes in the composition of production (and most significantly, the changes in the share of tariffs in trade and of trade in output) affect the composition of the revenue base. To keep the same macroeconomic balance, countries must alter the rates and the weighting of different taxes

Trade in the context of development

Development is here interpreted as the desired change in the structure of an economy, combined with growth. The exact objective varies with the country, or, in a sufficiently integrated region, may be set at the regional level, so that there is little to be said at this general level. But it is

essential for a country which is considering the role of trade in development to have its own clear conception of the meaning which it attaches to development. Only then can it ask what contribution the elements identified as potential favourable trade effects can make: increased demand, changes in the composition of output, technology transfer, income distribution. It is also necessary to analyse both the contribution which trade can make in comparison to other possible instruments and how effective the set of policy instruments available to influence trade will be, in comparison to those available for the potential instruments.

The constraints imposed by the rules which must be accepted in exchange for multilateral access are part of this analysis. For some countries, views about the appropriate limits on the role of policy and the types of acceptable policy will also be part of the analysis. For countries with a commitment to a region, the obligations to the region will be part of the analysis. It is not sufficient to show that trade policy can have particular effects on trade and that trade can have particular effects on development without considering other objectives, other policies, and other instruments.

Hypotheses and policies on trade and development

Trade was first considered a central element in a country's development path in the 1950s and 1960s; at the same time, planning was becoming the 'normal' way of development. Both these owed their new significance partly to the experience of the developed countries in the 1930s and then in World War II: the breakdown of the trading system in the 1930s and the further disruption by war had had a serious effect on many of them, and the need to mobilise all national resources in the war had underlined the importance and demonstrated the feasibility of planning. All the countries at war had used active government intervention to direct production sectors to maximise performance during the war. There was also the tradition of public works from the depression of the 1930s. For the developing countries, development was seen as a stage, in which there would be rapid transition to a more stable state of growth, and therefore a stage where different policies from those suitable for equilibrium countries were likely to be appropriate. There were no examples of countries that were still clearly 'developing', but competing against 'industrial countries' in some industries. They thus saw a discontinuity, but also a potentially successful strategy: a planned economy. In contrast, some more recent analysis suggests that given appropriate conditions (which may be institutions or policy rules), countries can develop or grow along a continuous path, that development does not require special policies.

This planning policy, however, stopped at the border: they could only use national measures. In spite of the strong emphasis on **trade policies** in the principal strands of development analysis of the last 50 years, more recently extended to analysis of the effect of **regional trade policies**, there has been remarkably little discussion in development analysis (in contrast to the literature on international trade negotiations) of the effect of **trade partners' policies**. While there are occasional estimates of their effects on total outcomes (e.g. World Bank 2000 p. 180), they are not normally considered in assessing policies. These should, according the outline above, be treated in the same way as countries' own policies in assessing the impact of policy on trade flows, but when policies have been 'tested' by looking at trade performance data, it is only policies of the country (where relevant, plus the region) that are compared to the outcome, not

the state of or any changes in policies of trading partners.¹¹

Planned domestically based development (in the import substitution phase)

Much of the literature on the role of trade in the 1960s, which followed the observation of the success of countries which industrialised and increased their income (and growth rates) by means of increasing internal consumption and production, attributed this to import substituting trade policy. Empirical observation, and the history of primary product consumption within countries, had suggested that demand for their primary exports would grow less rapidly than average demand in the developed countries, and much less rapidly than their objectives for their own growth. Therefore, it seemed that the only path open to them was to continue to specialise in primary products for export, but concentrate on increasing production of other goods for home consumption. Because of the constraint from the expected limited growth in demand for their exports, they would have to substitute an increasing proportion of their imports with home production to avoid having foreign exchange as a constraint on their growth. In terms of trade policy, as export promotion was (by assumption) not likely to be successful, this meant a concentration on policies to control imports, not only their quantity but their composition, to concentrate limited resources on the goods least replaceable by local production. Following the policy precedents of the 1940s, they would do this by active intervention on trade and production. The objective was that the country would be 'developed' in the sense of at a comparable income to the North American and European countries, but that did not then imply the high degree of trade dependence seen now.¹²

In terms of the analysis here (see **Appendix** for summaries):

there was a binding **macroeconomic constraint**, and high unemployment

direct policies on exports were not possible: developing countries produced low income elasticity goods and could not shift immediately.

indirect policies, combined with direct policies on imports could eventually shift the comparative advantage to industrial goods.

The **allocative efficiency** effects were considered unimportant compared to the goal of development. Once the transition to 'normal' growth was completed, they would become important, and tariffs would be liberalised to 'normal' levels, following the historical model of development then liberalisation.

X efficiency effects were not considered

Stability was important, and **trade measures** could reduce the risk of external shocks.

¹¹An exception is Vamvakidis 1998 who found a positive correlation with the 'openness' of 'neighbouring economies' (p. 257).

¹²Although Edwards 1998 p. 383 argues that 'some analysts have argued that protectionism may help economic performance', it does not, however, seem to be the case that import protection or absence of imports itself was regarded as having special benefits (in the sense that exports had, as promoting technology or X-efficiency). It was intended to allow the benefits from industrialisation or domestic demand growth or some other factor to operate.

The experience of Japan and Korea suggested that such a strategy had worked in the past, and in Latin America Brazil and Mexico seemed to be confirming it.

There was, at least in Latin America, often a **regional** dimension to the strategy (it originated in a regional institution), and this was particularly marked in the Andean pact from the 1960s, suggesting that some efficiency constraints were perceived on smaller countries.

For small countries not in regions, it did not offer a solution.

Export-led growth

The literature of the 1980s and early 1990s observed the success of the Asian NICs, and attributed the association between high and rapidly growing exports and rapid growth of manufacturing and total output to a policy of 'export-led growth'. What are the steps in this argument? Three possible cases where exports can be exceptionally useful to development have been considered: that there is unemployed capacity, X-inefficiency, or a technology gap. The step from this to advocating exports as the best strategy is to assume that, for each of these, exports are the only solution: to providing demand, to stimulating efficiency, or to acquiring technology, rather than one possible means, to be considered along with others.

The importance of the experience of the NICs was that they showed that it was not necessary for a country to develop an integrated national industry before competing with developed countries in manufactures. It was possible to specialise in exports of one or a few manufactured goods, and therefore secure a better export market prospect than from primary goods. There seemed to be an alternative strategy, and a very successful one. Their exports grew substantially faster than those of the industrial countries; while this seemed 'normal' by the 1980s, it had not been true before the early 1970s (and has started to cease to be true again in the 1990s).

1. Direct policies were possible, combined with **indirect policies** to shift comparative advantage. Some were to the capital, technology and labour elements, but because exporting is itself a skill (or requires an input of the 'technology' of marketing), there was a case for specific help to exporting. and also with

2. direct policies on imports.

(3) Although later interpretation considered that **non trade policies** like the emphasis on education and the nature of the government regimes contributed to their success, these were not adopted for trade reasons, and therefore cannot be considered examples of successful indirect policies.

An individual industry or firm or all the firms and policy-makers in a country must develop skills, perhaps training specific to the sector, also managerial and market skills. This may be associated with economies of scale. For simple export-led analysis, the way to improve this **X-efficiency** is to impose the risk of loss: to increase competition, and rely on companies' survival instinct to force them to make the correct responses.¹³

¹³ The evidence for the effect of competition was not strong: 'firms in an exporting environment are generally

Shocks and competition were positive, not negative, so in contrast to the concern about overdependence on exports seen in domestically based strategy, **stability** was not an objective, and instability not seen as a problem.

This interpretation of the trade led model was thus that the principal effect of trade on the economy was not in the conventional economic forms (higher demand, changes in composition), but partly in the extended economic (technology transfer), and more in the changes in the way in which economic decision-makers responded to incentives. This meant that not merely **trade policies** had to be liberalised, but also some **non-trade policies**, to allow the market incentives starting in the external sector to spread through the economy.

Any strategy which assumes a special advantage or special role for exports, and thus implies that improving access to markets has more than the demand and efficiency returns valued by market prices, suggests that countries should be willing to pay some extra costs (sacrifice some of these gains) to gain the access. This means greater willingness to accept more external commitments, multilateral, bilateral, or regional, even if they have costs such as constraints on policy, standards, etc., if they will increase access for export, than a simple cost-benefit calculation would imply. The peak of advocacy of this strategy and the negotiations in the Uruguay Round coincided.

This emphasis on maximum exposure meant that there was **no direct regional** element to the policy (although non-trade regions were possible).

Export-led growth, after import substitution

Early analysis emphasised the first explanations for export led growth (**direct and indirect policies** on comparative advantage¹⁴, but later analysis has emphasised also the second, that in most cases the successful exporters had first had a period of import substitution. There remains disagreement about whether this is because they were mistaken, and then found the better solution, or because the import substituting period was necessary as a preparation.

Both the export-led strategy and the sequence strategy were implicitly taking a view that it is necessary to develop the efficiency of firms through appropriate stimuli (in other words, through the use of incentives which fall outside economic analysis). This was not through the conventional element of **comparative advantage** analysis, of removing obstacles to appropriate responses, but by changing the sensitivity of economic actors to stimuli (assumed constant in conventional analysis). For the sequence analysis, the argument was that it was necessary to start in a market that was 'easier': the home market offered less competition and was familiar. When a company was ready and when the country needed more complex integration into the world

confronted with international competition and do not face the sheltered domestic markets they face under import substitution ... In a monopolistic setting, for example, it might with fairness be asserted that productivity growth could be slow because of the absence of a competitive spur or because the entrepreneurial skill of management was poor, or for other reasons.' (Krueger 1983, p. 53).

¹⁴ The late 1980s saw a series of studies of the effects of 'openness' on growth which misused correlations and definitions as evidence for 'export led growth', most notably Papageogiou, 1991. There were also attempts to simplify all the elements of a trade regime by classifying the regime as import substituting, neutral, or export promoting in terms of effective exchange rates (Bhagwati 1988).

economy, the protection could be removed, and the opposite incentive, the threat from competition, would be effective.

But this means that there are unspoken assumptions in the theory: The economic size of a country will influence the length of time an import substitution strategy may be viable; for some small countries this may be a negligible period, while large ones can have a long period. A small country may need to move to exporting before its efficiency or responsiveness is 'ready', and therefore may be more likely to need special measures to help exports.

The transition between the strategies is unclear. The short-term costs of domestically based industrialisation, encouraged by tariffs or other import restrictions (even if it is promoted through subsidies, these must be financed and raise the fiscal burden) clearly hinder export performance and reduce incentives to find export markets. Trade controls obviously prevent the competitive forces from having their assumed effect on efficiency. The problem is to assess the moment at which the gains from biasing a country towards exports can offset the gains from a bias towards industrialisation. Even if this is technically possible, and the economy may be more ready to compete following a period of import substitution, the transition will have costs, which will be resisted.

There are some common elements. Choosing which sector should be promoted in either an import or an export strategy requires a competent planning agency (protected from undue influence by private interests), able to assess either the economic viability of a proposal or the likelihood of success of the proposer. A previous import-substituting regime may help to develop this. Administering a system of training or special tax or subsidy incentives or setting up systems to encourage coordination among firms requires a well established fiscal system. Assisting with access to credit or foreign exchange requires good monetary institutions and instruments.

The rate of growth of external demand, which cannot be controlled, will alter the incentives for either an import substituting or an export promoting strategy. Slow growth increases the pressure on income from traditional exports, making finding an alternative more pressing, but it potentially also reduces the return to new exports. The slower the growth in external demand for traditional exports and the greater the share of essential imports, the greater the incentive to switch towards exporting new products. (On both these, the Latin American countries could be expected to have less incentive to change than the Asian, unless high indebtedness and therefore high interest payments had been seen as a particularly inelastic and unsubstitutable import payment, requiring a transition to an export strategy.)

If there is a sequence of correct policies, and if some policies require specific conditions, whether of size of country, good national characteristics, or good luck in external circumstances, it becomes questionable whether there are general rules about the role of trade in development, or whether the particular characteristics of the country or the nature of the external environment are the dominant influences.

An apparent variant of the import substitute, then export, strategy is *combining export led and domestic production* through export processing zones within an otherwise protected economy. This attempts to target the advantages of each strategy at the sectors of the economy most likely

to benefit (least likely to lose) from them. (The alternative view of 'enclave' development is that it fails to exploit fully the advantages of exports.) It allows a more staged transition and adjustment (Mexico and Mauritius offer examples of spreading the zones around the country).

It also implicitly recognises that there are specific needs of specific sectors in specific sectors, not a general strategy.

At some stages, perhaps between national and multilateral exposure, a **region** may be useful, but the sharp change in strategy makes continuing commitment to a region awkward.

National policies with trade as an element

Although these trade-based views of the policies which have been followed are common, an alternative view of the successful countries, both Latin American and Asian, is that they followed policies with national objectives, in particular of **industrialisation**, and that they used the **trade instruments** as one element, but not the only one, in this. The effects of trade on development are therefore of interest in analysing their success, but not necessarily central to all countries at all times. The productivity arguments of export strategy implicitly assume that it will be based on new, probably manufactured, exports, not simply respond to growth in traditional markets for traditional markets, and the domestically based strategies assumed that countries had to change their composition of production towards industry in order eventually to have appropriate exports.

Development and industrialisation had been regarded as synonymous for the present industrial countries (the most common term for what are now called 'developed' until at least the 1980s).

Industrialisation had traditionally been argued to have the effects of improving efficiency and technology that are attributed to trade in the analysis above. The process requires a shift in production, and therefore productivity gains through reallocation of resources and specialisation.

Industry produces high-income elasticity goods. If industry may have these effects, it has the same claim to be an instrument of development as exports.

The emphasis was thus on **non-trade policies** in the most fundamental sense, of policies with non-trade objectives. Where **Trade policies** were used, these were also *de facto* being used with non-trade objectives. Trade was not regarded as having any special effects.

For countries with a **regional** commitment, it could be the region which was considered the unit for policy, but (with the possible exception of the European Coal and Steel Community) there are no examples of sufficient commitment to renounce national objectives (as was attempted in the original Andean Group, and occasionally in the Caribbean).

Export led growth with good policies

The attempts to apply the original interpretation of the *export led* model (liberalisation: at least external, by extension internal as well) to other countries in the 1980s did not succeed in Latin America or Africa.¹⁵ Simple identifications of countries which liberalised on either policy or

¹⁵Rodrik (April 2001) p. 11 notes 'The disappointing growth performance and increasing economic insecurity in Latin America--the region that went furthest with policies of privatization, liberalization, and openness--the

outcome criteria allowed conflicting interpretation of whether these were the most rapid growth countries or not. Rather than rejecting the measurements¹⁶, there was an effort (in the early to mid-1990s) to find new simple rules. The first response was to increase the number of **indirect trade measures** considered to be desirable or essential. More significant, rather than treating the elements of comparative advantage as independently useful (as suggested here by listing them), this interpretation suggested that some identifiable minimum level of policy was necessary for a wide range of individual inputs to comparative advantage: efficient investment, labour mobility, training. And in addition to the traditional list of elements of economic advantage, there has been increasing emphasis on 'good macroeconomic policy' and 'good governance' (e.g. World Bank 2000, OECD 2001). These do not have formal definitions, so their correlation with improved output growth or development is (at least) as difficult to test as that of 'openness'. They seem to have emerged not, like the analysis of export-led growth from observing success and looking for its explanation, but from observing failure (in particular, the debt crises). This origin makes them more difficult to test. These were still seen as **trade measures**, but perhaps at a step further removed: the non-trade policy would have a non-trade result, which in turn would make a good trade result easier.

This was a much more significant shift in analysis than simply adding a longer list of measures. It was a change to arguing that certain minimum conditions were necessary to export successfully. This is more characteristic of the domestic production strategy than the export-led, with its assumption that exports could stimulate development through their direct and indirect effects. Exports might still have a special role in **efficiency** and **technology**, but other policies within the economy were also necessary to development.

The shift from exports put less weight on **trading partner policies**, whether regional or other, unless regional policies could strengthen the domestic. There was, however, in parallel with the idea that people's responses to stimuli could be changed by some means, a belief that countries' responses could be changed by the simple existence of a regional commitment (the 'lock-in' argument), that binding a change in policy in a regional agreement was more of a commitment than the national policy in itself. Like the assumptions on how to change efficiency, this was not based on theoretical or empirical evidence.

Good institutions

At the same time as this changed interpretation of the role of national policies emphasised the need for a broad range of good policies, rather than the role of individual policies, understanding of international economic policy was increasingly recognising that the role of organisations like the WTO and other international institutions was at least as much to provide regulatory certainty as to 'liberalise'. This led to an emphasis on the need for strong institutions as a tool for development. This must be clearly distinguished from the preceding policy which had emphasised only the withdrawal of interference in markets, to permit them to operate efficiently,

failures in the former Soviet Union, and the Asian financial crisis of 1997-98 all contributed to the refashioning of the Washington Consensus around a number of institutional prerequisites.'

¹⁶Rodrik 2000 Comments accepts 'tariff and non-tariff averages are reasonably accurate in ranking countries in terms of trade policy openness' (p. 3).

not building the necessary conditions for to do so.¹⁷ As with the early interpretations of export-led growth, the first identification of these institutions was of those related to international transactions (trade ministries, financial institutions).¹⁸

This interpretation puts the emphasis on **indirect trade policies**, but at a second stage of indirectness: changing the institutions, which design or implement the policies, which should modify the elements of comparative advantage.

Increased emphasis on the importance of domestic policies and institutions (exports are not enough) means that export access is no longer as clearly superior to discretion in national policies, and therefore suggests a different approach to international commitments. Other countries' policies are still important, but not as central, so that acceptance of high costs in regulatory constraints to obtain market access may be reduced.

Strong policies

The ultimate acceptance that national policies can vary with conditions is the view that it is the strength of commitment to policies (e.g. Rodrik, April 2001) rather than any component of policy which matters. This is effectively putting all the weight on changes in behaviour and responses (on the ability to modify **X efficiency**).

Indirect trade policies were needed to change the final element of **comparative advantage**, the way in which production is organised.

Regional institutions are being seen as a supplement, if not a substitute for good national and multilateral institutions. Perhaps more interestingly, some regions (MERCOSUR is a notable example) have found that the need to clarify and compare their national institutions in the negotiations for integration, or even preliminary fact-finding discussions, has identified national weaknesses. This, however, is more a role for regional negotiations than for regions as such.

Allocatively efficient policies

If a country is at its productive potential, and has the means to stay there, and if it has followed advice on its non-trade policies to remove distortions and improve the transmission of effects, or to put in place the institutions which will achieve this, and if it either has a comparative advantage in what it considers the 'right' products or does not take a view on the appropriate pattern of development, then the traditional recommendations of trade policy come into play: no tariffs, or flat, revenue raising tariffs; no quantitative controls; no discrimination by sector. This is the strategy implied once institutional reform is completed.

¹⁷In contrast IDB 2000 (p. 3) argues that 'the current strategy' of 'opening to world markets, fostering private initiative, the state's withdrawal from direct economic activity, and its enhanced role in oversight, promotion and social 'protection' was 'an integral part of the widespread structural reforms pursued in Latin America since the mid-1980s.' The emphasis on the role of the state in building institutions was a change.

¹⁸If property rights can be considered a good proxy for institutions, Edwards 1998 finds an important role for this in productivity; macroeconomic stability performs less well. The property variable is a policy variable; the macroeconomic an outcome variable.

This assumes that **trade has no special effect** on development, and implicitly that development is not a special stage, different from normal growth. It also assumes that no other policies or instruments have a desirable effect.

There are no past models of completely non-interventionist development. A non-economic **region** is possible, but there is no development role for it.

Comparisons and conclusions

On trade

It is perhaps puzzling that there has been such strong emphasis on trade in the analysis of development, whether as an obstacle or as an advantage. In particular, for each successive 'constraint' on development which has been identified (market demand, investment, technology, efficiency, finance) trade has been identified as the best or only means of supplying it to developing countries. Theory confirms that it is one way of supplying each of these (with the possible exception of **X efficiency** where economics has little to say), but not for any of them that it is the only way. If, however, there is a preference not to use government intervention (whether because of political choice or because of concern about the competence of the government sector in developing countries¹⁹, then the only available exogenous agent may seem to be the external sector. As one of the oldest and best developed branches of economics, international economics is also well placed to find possible development roles for trade. In contrast, analysis of the formulation of government policy is principally outside economics, so that it is not as well understood (and the bias may be against relying on it).²⁰ But in practice, the exogenous agent in some successful countries in the past has been either the government or the emergence of a new type of private sector, so the external sector is not the only possible agent. And there are times or circumstances (of slow growth, high protection, particular structural characteristics) where it may not be able to perform well the various roles assigned to it.

On trade and development

The traditional agreed view was that there were special needs of economic development as a phase or of developing countries, although whether these could be best met by industrial, export-led, or other strategies was in dispute. Some policy designers have now shifted to a focus on the

¹⁹It is the relative competence of the government and private sectors which should be the consideration, if they are alternatives, not judgement about the absolute level, but (Dasgupta 1994, p. 16) current theory 'holds a poor view of the political leaders of the LDCs, and would prefer them to leave economic issues in the hands of private agents operating in a market without barriers.'

²⁰It is clear that any policy that has instruments, indirect or direct, intended to promote particular sectors, has opportunities for 'rent-seeking', but the analysis of how policy is actually formulated and the role and influence of pressure groups goes beyond identifying the opportunity and assuming that it will be taken and be successful. (And beyond the competence of economists, so it will not be pursued here.) The alternative, of depending on private sector self-interest, has well-established conditions within economics for this to produce an efficient result, but the size of markets, the often limited number of participants, and the nature of some of the products make it difficult to assume that these conditions will always be fulfilled in developing countries.

special changes needed to get policies and/or institutions in place, which will then lead to the desired economic development. The domestic production, export led, and industrialisation strategies implied specific special policies, although without proving their effectiveness. Institutional analysis and emphasis on efficiency are much more indirect strategies. The first strategies have a common disadvantage of lacking a clear analysis of how or when (or even why, if rapid growth remains an aim) there is a transition from 'development' to 'normal growth'. All, but particularly the second group, suffer the disadvantage of not allowing for the possible difference in effect on development between policy-induced changes and existing influences. This must be seen as a major weakness of almost all analysis of policy.

The conceptual impossibility of finding a satisfactory, universal, definition of 'openness' and the use of *sui generis* variants of the general strategies by some of the most successful countries suggest that general, aggregate regression, attempts to define general rules are unlikely to be successful, and it is puzzling that even some of those who reject most strongly the attempts by others persist in attempting this. We have some theoretical understanding and some empirical evidence on some of the specific relationships: between trade and changes in the structure of production; between technology and trade; between demand from trade and total demand. We have some, although more limited, understanding within economics of what policy can do; on how tax or subsidy-type incentives work; on improving the productivity of labour or capital. There is evidence from other disciplines on how what determines behavioural responses which economics assumes that are constant, although, there is more evidence on the difficulty of changing them. There is evidence on how institutions work in particular circumstances, although this is also not amenable to general rules.

It would be possible to apply these insights to the circumstances of a particular country, at a particular period in its development, given a particular external environment and its political views on acceptable or desirable types of policy or outcome. Effectively this is what the most successful countries have attempted to do for themselves. The problem for them, as for analysts, is that the 'right' answer will change whenever either our understanding or the conditions of the country change, and the problem specifically for analysts is that the 'right' answer varies across countries at a particular time, and is the answer to a question which is political as well as technical.

It is not possible to say with conviction whether the countries which succeeded and had rapid growth of exports did so because of the special effects from trade or because they already had the efficient responses to be able, using policies and market responses, to alter their economies to respond to and create opportunities, and in that period (but perhaps not before or since) those opportunities were most available from trade. They had rapid growth, and internal transformation, and rapid exports. A pessimistic conclusion from this type of analysis: that trade is not sufficient, that domestic policies and institutions matter, and that policy changes cannot be assumed to change comparative advantage, is that there may be no formula which can produce rapid growth in a particular country in its particular circumstances.

Appendix

Domestically based development or import substitution and: National policies with trade as an element

Trying to alter

Macroeconomic:

there was a binding macroeconomic constraint, and high unemployment

Comparative advantage

Characteristics of country (capital, labour, technology), specifically in direction of industrialisation

By means of

Direct trade policies;

direct policies on exports were not possible: developing countries produced low income elasticity goods and could not shift immediately.

direct policies on imports are possible and desirable

Indirect trade policies

tax, subsidy,

indirect policies, combined with direct policies on imports could eventually shift the comparative advantage to industrial goods.

Non-trade policies:

not central

The allocative efficiency effects were considered unimportant compared to the goal of development

The X efficiency effects were not considered

Technology could be obtained directly, not through trade, and depends on industrialisation

Concern about instability

Trade effect? Development and autonomous technology transfer were required in order to increase trade and alter it to the most beneficial composition, not the reverse.

Acceptance of constraints to obtain export access? Not relevant

Small countries: not directly suitable, unless in region.

Regional? by implication: policy assumed to require sufficiently large home market

Other countries' policies: liberalising during this period; not allowed for

How assessed: countries' growth rates were the objective and their measure of success: some grew rapidly. (Developing country exports, which were not part of the strategy, did not grow more rapidly than average world trade in 1950s and 1960s.)

Seen as a temporary policy

Comment: a direct policy for development, with trade as one of the instruments.

Export led growth (and export-led growth after import substitution)

Trying to alter

Macroeconomic:

there was a binding macroeconomic constraint, and high unemployment

Comparative advantage

Characteristics of country (capital, labour, technology. behaviour of economic actors.), normally to change towards manufactured exports

By means of

Direct trade policies

It is possible to identify and promote specific exports (subsidies, promotion)

Controls are undesirable on imports (they can raise costs for exports), but may be used, as a preliminary or for special sectors; specific targets can be identified

Indirect trade policies

tax, subsidy

Improving characteristics through low cost credit, training for labour infrastructure

non-trade policies

infrastructure for non-trade reasons

education spending

Allocative efficiency was important, but only for goods not directly targeted as exports

X-efficiency was important, but could be targeted directly by policies to encourage or discourage particular sectors, not only through markets

Technology would be induced by trade and investment

Stability: shocks were beneficial

Trade effect on economy: principally from the efficiency and technology effects, and transformation of the production structure of the economy.

Acceptance of constraints on policy: because exports have additional effects, some extra costs can be accepted

Other countries' policies: liberalising strongly during the peak period for export led strategy, with rapid growth of trade.

Regional: no special advantages, and possibly some disadvantages from less competition, lower technology

How assessed: both countries' output growth rates and their export growth rates were targets.

The analysis followed and depended on the evidence that some countries' exports had grown rapidly at an early stage in their development. This was at a period when total world trade was also growing rapidly, but it also saw the first example of developing country exports growing more rapidly than the average.

Comment: the objective was development, with exports believed to be the only/best way of achieving it

Export led growth with good policies

Trying to alter

Macroeconomic:

there was a binding macroeconomic constraint, and high unemployment

Comparative advantage

Characteristics of country (capital, labour, technology. behaviour of economic actors) to allow faster growth

By means of

Direct trade policies

It was possible to identify and promote specific exports (subsidies, promotion), but this should be done sparingly

Controls were undesirable on imports (they can raise costs for exports), but might be used, as a preliminary or for special sectors; specific targets can be identified

Indirect trade policies

tax, subsidy

Improving characteristics through market cost credit, training for labour and encouraging labour mobility

infrastructure, but with industry contribution to costs

non-trade policies

infrastructure for non-trade reasons

education spending

good macroeconomic balance, good labour policies to promote mobility, good governance

Allocative efficiency was important,

X-efficiency was important, and should be targeted principally through markets

Technology would be induced by trade and investment

Stability: shocks were beneficial

Trade effect on economy: principally from the efficiency and technology effects, and transformation of the production structure of the economy, but for these to work, an efficient market structure was required.

Acceptance of constraints on policy: because exports have additional effects, some extra costs can be accepted

Other countries' policies: less favourable growth in rest of world during this period, so could not depend as strongly on export policies

Regional: no special advantages; some disadvantages from less competition, lower technology, risks of allocative inefficiency from trade diversion

How assessed: both countries' growth rates and their export growth rates were targets. In more difficult conditions, exports did not grow as rapidly

Comment: the objective was development, with exports believed to be a necessary, but not sufficient condition for achieving it.

Good institutions

Trying to alter

Comparative advantage

Characteristics of country (institutions governing markets and economic actors, behaviour of economic actors) to allow faster growth

By means of

Direct trade policies

no

Indirect trade policies

creating appropriate institutions which would induce changes in labour, capital, technology, and structure of economy

non-trade policies

infrastructure for non-trade reasons

education spending

good macroeconomic balance, good labour policies to promote mobility, good governance

Allocative efficiency was essential

X-efficiency was important, and should be targeted through markets, which would be made efficient through institutions

Technology would be induced by trade and investment

Stability: no role.

Trade effect on economy: principally from the efficiency and technology effects, and transformation of the production structure of the economy, but for these to work, an efficient market structure was required, and this can be created by good institutions

Acceptance of constraints on policy: exports have no special, non-market valued, effects

Other countries' policies: less favourable growth in rest of world during this period, so could not depend as strongly on export policies

Regional: no special advantages; some disadvantages from risks of allocative inefficiency from trade diversion

How assessed: countries' growth rates were targets.

Comment: the objective was development, with institutions believed to be the necessary, and probably sufficient condition for achieving it.

Strong policies

Trying to alter

Macroeconomic

a binding constraint, and high unemployment

Comparative advantage

Characteristics of country (how production is organised, . behaviour of economic actors)

By means of

Direct trade policies

If desired

Indirect trade policies

to alter production patterns, by any means, applied consistently

Non-trade policies

to alter production patterns, by any means, applied consistently

Allocative efficiency not relevant

X-efficiency in the sense of changed economic behaviour is the essential element

Technology would be induced by trade and investment

Stability: no role.

Trade effect on economy: could help change production patterns

Acceptance of constraints on policy: exports have no special, non-market valued, effects

Other countries' policies: less favourable growth in rest of world during this period, so could not depend as strongly on export policies

Regional: if it supports the clear and consistent policies, it can strengthen them

How assessed: countries' growth rates were targets.

Comment: the objective was development, with changes in productive structure and in behaviour seen as essential

Allocatively efficient policies

Trying to alter

No presumption that change in structure necessary

By means of

Direct trade policies

no

Indirect trade policies

no

Non-trade policies

promotion of efficient markets

Allocative efficiency was essential

X-efficiency may be important, but will be achieved through markets

Technology, to the extent needed, would be induced by trade and investment

Stability: no role.

Trade effect on economy: no special role

Acceptance of constraints on policy: exports have no special, non-market valued, effects

Other countries' policies: no special role

Regional: no special advantages; some disadvantages from risks of allocative inefficiency from trade diversion

How assessed: countries' growth rates were targets.

Comment: the strategy rejects development as a special objective or transition in an economy's history.

Bibliography

- Baldwin, Richard E. and Seghezza, Elena (1996) 'Testing for Trade-Induced Investment-Led Growth'. NBER Working Paper 5416. Cambridge, MA: NBER.
- Baldwin, Richard E. and Seghezza, Elena (1996) *Trade-induced Investment-Led Growth*. NBER Working Paper 5582. Cambridge, MA: NBER.
- Bhagwati, J.N. (1998) 'Export-Promoting Trade Strategy: Issues and Evidence' , *World Bank Research Observer*, 3 (1).
- Coe, David T., Helpman, Elhanan and Hoffmaister, Alexander W. (1997) 'North-South R&D Spillovers', *The Economic Journal* 107 (January): 134-49.
- Dasgupta, Biplab (1998) *Structural Adjustment, Global trade and the New Political Economy of Development*. London: Zed Books.
- Dijkstra, A.Geske (1997) *Trade Liberalization and Industrial Development: Theory and Evidence from Latin America*. Working paper no.255, Institute of Social Studies, The Hague, Netherlands.
- Dollar, David (1992) 'Outward-oriented Developing Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976-1985', *Economic Development and Cultural Change* 40 (3): 523-544.
- Dollar, David and Kraay, Aart (2000) 'Growth IS Good for the Poor'. Paper prepared for the World Bank. Washington, DC: World Bank.
- Edwards, Sebastian (1998) 'Openness, Productivity and Growth: What do we Really Know?', *The Economic Journal* 108 (March): 383-98.
- Edwards, Sebastian (1992) 'Trade Orientation, Distortions and Growth in Developing Countries', *Journal of Development Economics* 39: 31-57.
- Evans, David H. (1989) *Comparative Advantage and Growth: Trade and Development in Theory and Practice*. Hemel Hempstead: Harvester Wheatsheaf.
- Fitzgerald, E.V.K. (1997) *The Theory of Import Substitution*. Luca d'Agliano-Queen Elizabeth House Development Studies Working Paper No.108. Oxford: International Development Centre and Turin, Italy: Centro Studi Luca d'Agliano.
- Garces-Diaz, Daniel (2001) 'Was NAFTA Behind the Mexican Export Boom (1994-2000)?'.
- Helleiner, G.K. (1995) *Trade, Trade Policy and Industrialization Reconsidered*. UNU World Institute for Development Economics Research , World Development Studies No.6. Helsinki, Finland: UNU World Institute for Development Economics Research.

Inter-American Development Bank (2000) *A New Push for Regional Infrastructure Development in South America*. Integration and Regional Programs Department, December.

Inter-American Development Bank (2000) *Integration and Trade in the Americas*. Periodic Note, Integration and Regional Programs Department, December.

Lewis, Jeffrey D. (2001) *Reform and Opportunity: The Changing Patterns of Trade in South Africa and SADC. A Synthesis of World Bank Research..* Africa Region Working Paper Series No. 14.

Lumenga-Neso, Olivier, Olarreaga, Marcelo and Schiff, Maurice (2000) *On 'Indirect' Trade-Related R&D Spillovers*. Working Paper 2580. Washington, DC: World Bank.

Morton, Kathryn and Tulloch, Peter (1977) *Trade and Developing Countries*. London: Crook Helm.

Neary, J. Peter (2001) 'Competition, Trade and Wages'. Discussion Paper No. 2732, Centre for Economic Policy Research.

Ocampo, José Antonio (1986) 'New Developments in Trade Theory and LDCs', *Journal of Development Economics* 22 (1):129-170.

Open Integration (2000) *Open Integration Newsletter*, No. 5, December.

Organisation for Economic Co-operation and Development (2001) 'Trade and Development Issues in Non-OECD Countries'. Document submitted for discussion during brainstorming of the Trade Committee and the Development Assistance Committee, 24 April. TD/TC(2000)14/FINAL.

Page, Sheila (2000) *Regionalism among Developing Countries*. Basingstoke: Macmillan

Page, Sheila (1991) 'The Role of Trade in the New NICs', *Journal of Development Studies* 27 (3): 39-60.

Page, Sheila (1990) *Trade, Finance and Developing Countries*. Savage, MD: Barnes and Noble.

Page, Sheila and Hewitt, Adrian (2001) *World Commodity Prices: Still a Problem for Developing Countries?*. ODI Special Report. London: ODI.

Page, Sheila, Robinson, Peter, Solignac Lecomte, Henri Bernard and Maurizio Bussolo (1999) 'SADC-EU Trade Relations in a Post-Lomé World'. London: ODI.

Papageorgiou, D., Michaely, M., Choksi, A.M. (ed) *Liberalizing Foreign Trade*. Cambridge: Basil Blackwell Inc.

Puga, Diego and Venables, Anthony J. (1997) *Trading Arrangements and Industrial*

Development. Policy Research Working Paper No. 1787. Washington, DC: World Bank.

Ram, Rati. (1987) 'Exports and Economic Growth in Developing Countries: Evidence from Time-series and Cross-section Data', *Economic Development and Cultural Change* 36 (1): 51-72.

Rodríguez, Francisco and Rodrik, Dani (2000) 'Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence'. Department of Economics, University of Maryland and Harvard University.

Rodrik, Dani (2001) 'The Global Governance of Trade. As if Development Really Mattered'. Paper prepared for the UNDP. April.

Rodrik, Dani (2001) 'The Developing Countries' Hazardous Obsession with Global Integration'.

Rodrik, Dani (2000) 'Comments on 'Trade, Growth and Poverty' by D. Dollar and A. Kraay'. Harvard University, October.

Sachs, Jeffrey and Warner, Andrew (1995) 'Economic Reform and the Process of Global Integration' *Brookings Papers on Economic Activity* 1: 1-118.

Singer, H.W. and Gray, P. (1988) 'Trade Policy and Growth of Developing Countries: Some New Data', *World Development* 16 (3): 395-404.

UNECLAC (2001) *Notes*, 15, March.

UK (2000) 'Rights of Exchange: Social, Health, Environment and Trade Policy on the Global Stage'. A Performance and Innovation unit report. Available at <http://www.cabinet-office.gov.uk/innovation/2000/trade/default.htm>

Vamvakidis, Athanasios (1999) 'Regional Trade Agreements or Broad Liberalization: Which Path Leads to Faster Growth?' *IMF Staff Papers* 4 (1), March.

Vamvakidis, Athanasios (1998) 'Regional Integration and Economic Growth', *The World Bank Economic Review* 12 (2): 251-70.

Wood, Adrian (1997) 'Openness and Wage Inequality in Developing Countries: The Latin American Challenge to East Asian Conventional Wisdom', *World Bank economic Review* 11: 33-57.

Wood, Adrian (1994) *North-South Trade, Employment and Inequality: Changing Fortunes in a Skill-Driven World*. Oxford: Clarendon Press.

Wood, Adrian and Mayer, Jörg Mayer (1998) 'Africa's Export Structure in a Comparative Perspective', Study No. 4 for UNCTAD project, African Development in a Comparative Perspective.

World Bank (2000) *World Development Report 2000/2001: Attacking Poverty*. Washington, DC: Oxford University Press for the World Bank.

Yaghmaian, Behzad. (1994) 'An Empirical Investigation of Exports, Development and Growth in Developing Countries: Challenging the Neoclassical Theory of Export-led Growth', *World Development* 22 (12): 1977-1995.