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## DYNAMICS OF TRADE POLICY REFORM

Rachel McCulloch

Graduate School of International Economics and Finance  
Brandeis University

Throughout the world, the goal of liberalized trade has become the norm rather than the exception. In country after country, successful policy reforms of the 1980s and 1990s have added weight to the evidence linking outward orientation and economic growth. China's emergence as a major exporter has demonstrated beyond a doubt that the benefits from integration into global markets apply to large countries as well as small ones. In the 1990s even such notable laggards as Brazil and India have begun to dismantle policies that for decades insulated their economies from foreign competition. Today the key question for policy makers is less *whether* to pursue an outward-oriented policy than *how* to achieve and sustain the required policy environment.

This paper identifies obstacles to trade liberalization and looks at ways successful liberalizers are able to overcome them. The focus is on trade reform as an ongoing process, including the packaging of reform measures, their timing and sequencing, and the political-economy issues central to the viability of reforms in progress. The basic theme of the paper is that implementation of outward-looking policies can help to establish a "virtuous cycle" of liberalization through economic and political changes brought about by the initial policy reforms and market responses to them. One dynamic issue of particular current interest is the potential role of regional trading arrangements (RTAs) in facilitating multilateral liberalization.

Section I of the paper reviews the elements of the trade reform process and the necessary conditions for its success. Section II considers potential obstacles to successful liberalization.

Section III discusses strategies for maintaining a virtuous cycle. Section IV makes some recommendations concerning further study of the trade reform process.

### I. Elements of the Trade Reform Process

Economic theory predicts that trade liberalization will result in an improved allocation of resources along lines of international comparative advantage. A simpler and more transparent policy regime will also reduce the amount of resources diverted into administration and rent-seeking. Finally, the “new” growth theory incorporating public-good aspects of knowledge predicts that by integrating into the global economy a country can enjoy a higher rate of economic growth over the longer term. Experience from successful liberalizers has confirmed the general validity of these propositions.<sup>1</sup>

#### The East Asian paradigm

In reviewing the dramatic shift in the conventional wisdom regarding policies to promote development and growth, the importance of the East Asian example can hardly be overstated, even if there remains considerable debate concerning its precise lessons for other nations. The cases of Hong Kong, Singapore, Taiwan, and Korea<sup>2</sup> constituted irrefutable proof that export expansion could be a powerful vehicle to promote rapid industrial development and growth. By looking to external markets, these four economies achieved scale efficiencies in production potentially available to few if any nations relying on an import-substituting development strategy. Moreover, their experience demonstrated that production for export conveys a number

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<sup>1</sup> In fact, the new growth theory was itself motivated partly by the puzzling (at least to those schooled in traditional growth theory) empirical evidence linking openness with higher long-run growth rates.

<sup>2</sup> Some would begin this list with Japan, the twentieth century’s first example of successful export-oriented growth and an inspiration for development policies throughout East Asia and elsewhere. But Japan’s postwar growth experience, while undoubtedly impressive, reflects the recovery from devastating wartime setbacks of a country already advanced in terms of per capita income and physical and human capital stocks by the mid-1930s.

of benefits previously unappreciated by analysts.<sup>3</sup> Finally, these cases showed that there is no single recipe for successful export-oriented growth. While the economies shared high rates of saving, emphasis on basic education, and a stable domestic environment, the specific policies they employed were surprisingly diverse. When the second wave of East Asian export-led success stories, i.e., Malaysia, Thailand, and Indonesia, is considered, the range of effective policy prescriptions is even broader. Summing up his analysis of the East Asian “miracle,” Stiglitz (1996) concludes, “No single policy ensured success, nor did the absence of any single ingredient ensure failure.”

With the sole exception of Hong Kong, actual policies bore little resemblance to the textbook model of laissez-faire and free trade. Hence, some critics (Amsden 1989, Rodrik 1995) argue that these were far from cases of simply “getting prices right” for exporting. But government activism, while pervasive, was almost universally applied so as to strengthen markets and improve their performance rather than to replace them: “Governments created an environment in which markets could thrive. Governments promoted exports, education, and technology, encouraged cooperation between government and industry and between firms and their workers; and at the same time encouraged competition” (Stiglitz 1996).<sup>4</sup>

### Is East Asia unique?

The record of East Asia is so striking that some have doubted that it can be replicated elsewhere. However, recent evidence suggests that the same economic forces can work in other regions also. In a study to determine whether there is a tendency for poorer countries to grow more rapidly than richer ones, Sachs and Warner (1995) found that “convergent growth can be achieved by virtually all countries that follow a reasonable set of political and economics

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<sup>3</sup> As discussed below, such benefits are significant even for advanced nations (Richardson and Rindal 1996). However, they appear to be critical for economies at an earlier stage of development.

<sup>4</sup> As discussed below, these market-strengthening measures also tended to enhance the domestic political acceptability of export-oriented policy initiatives.

policies, including civil peace, basic adherence to political and civil rights, and (most decisively) an open economy, through the absence of trade quotas, export monopolies, or inconvertible currencies.” Sachs and Warner found that *all* developing countries with these characteristics achieved per capita income growth of at least two percent per year between 1970 and 1989.

While impressive, this finding leaves unanswered a more fundamental question: *why* some countries were able to achieve and sustain an open economy while many others, often guided by the same received wisdom and perhaps even the same advice from foreign experts, failed to do so. To a great degree, the answer lies in the complex interplay of economics and politics that is essential to the process of liberalization. Ultimately any trade policy is endogenous, shaped by underlying political forces. Moreover, the economic results of implementing each new policy will alter the political balance within a country, thus strengthening or weakening the position of reformers. This ongoing process gives rise to what Krueger (1993) calls virtuous and vicious circles of political-economic evolution.

#### Liberalization as a sequential process

To consider the underpinnings of successful trade reform, it is helpful to divide the process of liberalization into four sequential components: the design of a policy package; its acceptance and endorsement by top policy makers; its implementation in specific policy measures and their administration; and the economy’s response to changed incentives. The last component in turn influences the degree of support from the policy elite and the public, completing the political-economic cycle. Accordingly, a reform package may fail because the policies themselves are poorly conceived or inappropriate to the circumstances; because the package does not gain the support of a country’s leadership and is therefore not successfully implemented, or is implemented but later reversed; or because elements in the policy environment prevent markets from responding appropriately to the changed incentives.

### Getting started

In most countries, the fundamental ideas for reform are likely to be imports, assembled and put forward by foreign experts or domestic policy makers trained abroad. But to have even a chance of being implemented, a reform initiative requires support from *some* of a country's top policy makers. From four decades of experience advising Latin American governments, Harberger (1993) concludes that successful economic policies "would in all likelihood have failed (or never got started) but for the efforts of a key group of individuals, and within that group, one or two outstanding leaders." Williamson and Haggard (1994), summarizing views of several development experts, likewise cite the need for visionary leadership and a "sense of history." They note, however, that great vision is not always required. In a crisis situation, any sensible leader will see the immediate political benefit of a major change in policy direction. Empirically, crisis conditions do often provide the spur needed for major reforms (e.g., Turkey, Chile, Poland), but other liberalizers have proceeded without waiting for a crisis to materialize under old policies (Australia, Portugal, Colombia).

Successful reform also requires support from legislators and administrators to ensure its effective implementation. To create the desired changes in economic behavior, the vision of a leader must first be translated into practical policies. However, some governments lack the necessary technical expertise to implement new policies. While help is often available from aid agencies in the OECD countries and from multilateral organizations such as the World Bank and International Monetary Fund, excessive reliance on outside assistance may exact a high price. A key role for foreign experts may alienate local officials and erode their sense of ownership of the new policies. Moreover, critics of reform may take advantage of any prominent foreign role to marshal domestic support for their opposition.

### Maintaining broad popular support

Support at the top is necessary but not always sufficient for political sustainability. The importance of broad political support depends, especially in the short term, on the form of government. Because a repressive regime may be able to force its population to accept unpopular policies, some development specialists have raised the controversial notion that “too-early” introduction of democratic institutions may doom the prospects for needed economic reforms. Authoritarian regimes have launched most of the successful reform efforts in both Latin America and East Asia. But any new government, whether authoritarian or democratic, may enjoy a kind of honeymoon period during which leaders benefit from greater freedom of maneuver as well as the luxury of blaming unsatisfactory economic conditions on the previous regime. Poland and New Zealand are examples of honeymoon reform initiatives undertaken by democratic governments (Williamson and Haggard 1994).

## II. Obstacles to Successful Liberalization

Trade liberalization is an intensely political subject for two related but distinct reasons. The first is that costs associated with new policies become quickly apparent while the gains lie farther in the future. Adjustment costs along the way can mean a period of lower average living standard, even though some stand to gain immediately from any new policy. This is one reason why visionary leadership can be key to successful reform. A separate problem is that there are always *permanent* losers from any liberalization. While there is no way to avoid transition costs or an uneven distribution of costs and benefits, appropriate policies may reduce their extent and thus preserve the political viability of reforms. Other potential obstacles to successful liberalization are discussed below.

### Adjusting to new policies

Liberalizing countries necessarily experience dislocation costs during the period of adjustment to new policies. These costs are of two main forms: those associated with necessary changes in the composition of durable capital, and those associated with unemployment of labor or other resources.

As long as the change in policy has not been fully anticipated, the economy will begin from a given stock of durable sector-specific human and physical capital that is no longer optimal. In the new situation some types of capital will be worth more than their replacement cost, others will be worth less. With fully flexible factor rewards, these resources can continue to be fully employed as the stock adjusts over time to suit new relative prices. Required changes in the returns to industry-specific factors are largest soon after the new policy comes into force; in the post-liberalization equilibrium following complete adjustment in the stock of sector-specific capital, the market value of any factor must again be equal to its replacement cost.

In the absence of factor-market distortions, the laissez-faire adjustment process will be socially optimal. In particular, there is no efficiency gain from speeding up or slowing down the process through government policy, although there may be political reasons to do so. But factor prices are not usually fully flexible, and other factor-market distortions are likely to be present as well. Some resources will therefore become unemployed during the transition period, necessarily raising the social cost of adjustment and thus undermining political support for the liberalization program. This would seem to bolster the case for some kind of government adjustment assistance program to speed the movement of resources into expanding sectors.

In practice, the economic benefits from adjustment assistance are slim. The main role of adjustment assistance for workers is often to provide a more generous social safety net than the one available to workers displaced for reasons other than increased foreign competition. At worst, adjustment assistance in the form of subsidized loans and technical assistance to trade-impacted firms actually retains resources in declining sectors, thus postponing rather than

facilitating adjustment. In either case, the primary motive for such policies is to defuse political opposition to socially desirable liberalization.<sup>5</sup>

Development economists formerly counseled gradual change in policy as a means of reducing costs of adjustment (e.g., Little, Scitovsky, and Scott 1970). This is another area where the conventional wisdom has changed in the light of experience. In practice, gradual policy changes allow more time for opponents of liberalization to marshal their forces; liberalization delayed is often liberalization cancelled. Because of the resulting uncertainty about full implementation, gradual policies lack credibility. With investors in doubt as to whether the announced program will ever be fully implemented, their response to the new price signals may be weak or absent.

Also undercutting the case for gradualism is recent evidence that the aggregate effect of a successful trade liberalization on employment can be relatively small even in the short run. Although workers will be displaced from firms in contracting sectors, much of the resulting job loss can be offset by employment expansion in export industries (Edwards 1994).

### The real exchange rate

For an economy adopting an outward-oriented strategy, the most important price is the real exchange rate. The single economic factor most likely to sabotage a liberalization attempt is overvaluation of the real exchange rate. A high real exchange rate undercuts the competitiveness of potential exports across the board and makes imports look cheap relative to their domestic counterparts; deterioration of the current account results. If the nominal exchange rate is fixed, the usual policy response is a return to protectionist measures. This reversal is often billed as temporary, justified by the need to protect dwindling international reserves.

Underlying a high or rising real exchange rate is an increase in the nominal rate or a rise in the rate of inflation. Real appreciation often occurs when the fixed rate is used as a nominal

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<sup>5</sup> In the United States, the first trade adjustment assistance program was created by the 1962 Trade Expansion Act, which authorized U.S. participation in the Kennedy Round of multilateral trade negotiations.

anchor in waging a battle against domestic inflation. A flexible rate will rise (temporarily) as a consequence of capital inflows attracted by the new policy initiative. Under a fixed rate increased capital inflows will swell reserves, putting upward pressure on the domestic money supply and the price level. A number of developing countries limit certain capital inflows, especially of short-term liquid capital, to protect exporters from the effects of undesired appreciation of the real exchange rate.

### Increased inequality

Regardless of the political regime, the sustainability of any policy package eventually rests on its ability to raise, or at a minimum to sustain, resources available to meet the needs of the population. It is obviously easier to sell packages that deliver a rising average living standard than packages that require sacrifice. The yardstick most often used to compare economic success across countries is growth in per capita income.<sup>6</sup> But the sustainability of reforms depends not only on aggregate or average gains but also on their distribution.

A previous generation of development economists saw in Simon Kuznetz's "inverted-U" of temporarily increased income inequality the necessary price of future growth; concentration of income and wealth were assumed to promote essential capital formation by raising the aggregate saving rate. Today this rationalization seems less persuasive. The high saving rates of East Asia were achieved largely without increases in equality. Furthermore, in a world of internationally mobile capital, domestic saving and domestic capital formation are no longer required to move in lockstep. Countries that achieve stable, market-oriented institutions are able to rely on private capital inflows from abroad (McCulloch and Petri 1996). Conversely, while international investors are likely to shun countries without such institutions, wealthy local savers are surprisingly resourceful in finding means to move their own financial assets abroad. If, as

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<sup>6</sup> This standard is highly but not perfectly correlated with others that give a better picture of changes in the living conditions of the "typical" member of the population, such as infant mortality, longevity, access to clean water, and literacy. Another recent concern not captured by conventionally measured growth in PCI is degradation of the environment, including inefficiently rapid depletion of natural resources. This is addressed in the recent emphasis on *sustainable development*, i.e., development that doesn't mortgage the welfare of future generations.

anecdotal evidence suggests, concentration of income and thus of savings facilitates capital flight, increased income inequality--whatever its effect on the aggregate saving rate--may actually reduce the amount of domestic savings available to finance domestic capital formation.

### Skilled versus unskilled labor

In earlier decades discussion of the potential for temporary or permanent increases in income inequality resulting from liberalized trade centered on changes in labor earnings versus return to capital, especially foreign-owned capital. Today's concern focuses more on the observed increase in the gap between earnings of skilled and unskilled workers, which some tie to increased openness (e.g., Wood 1997). For a world of two factors, the Stolper-Samuelson theorem predicts exactly this outcome in skilled-labor-abundant countries like the United States. However, the same model also predicts a shift to a lower ratio of unskilled to skilled labor ratio in production, the opposite of what has been observed in most industrial nations. For this reason, Lawrence and Slaughter (1995) argue that skilled-biased technical change rather than trade lies at the heart of this controversial trend. Moreover, the Stolper-Samuelson model predicts a fall in the same differential for unskilled-labor-abundant countries, i.e., less-developed countries, while in fact the skill premium has risen in many such nations.

One explanation for a rising skill premium in developing countries is that the technology transfer associated with growth of nontraditional exports causes a temporary increase in demand for skilled labor. Even though the exports themselves may be unskilled-labor-intensive in production, skilled labor is needed initially to adapt and implement the imported technologies (Pissarides 1997). Also, the Stolper-Samuelson and factor-price-equalization theorems predict changes in *equilibrium* factor rewards with both factors fully mobile between sectors, and then only under other special conditions. Especially for developing countries, it seems unlikely that the current situation can be viewed as such an equilibrium.

A related concern is the perceived increase in the volatility of earnings and/or the increased uncertainty of job tenure associated with participation in international markets (Rodrik

1997). This concern can to some extent be addressed through a social safety net, and indeed Rodrik demonstrates a high correlation between measures of countries' openness and social spending. Furthermore, he points out that increased international mobility of capital implies that such a safety net cannot be financed primarily through taxes on income from capital. However, as long as openness produces *aggregate* gains to a nation's labor force, social insurance for workers can be financed without increased taxes on capital income.

Whatever their causes, increased income inequality and/or volatility can undermine the perceived "fairness" of outward-oriented policies even if they are accompanied by enhanced growth of per capita income. While countries differ widely in the approaches used to make these changes acceptable to their citizens, it is an issue that must be addressed if integration with international markets is to remain politically viable.

### The external environment

The case for import-substituting industrialization, as developed by Prebisch, Singer, and other writers, rests in part on the assumption that global markets offer less-developed countries little opportunity for gains through increased exports. Development along lines of international comparative advantage was interpreted narrowly to mean additional export of raw materials and commodities, since these made up about four-fifths of the value of existing exports from less-developed countries as a group. The authors assumed that the international prices obtained for these exports would decline over time, exacerbating the gap between rich and poor nations (Edwards 1994). Moreover, their narrow view of outward-oriented growth seemed to offer no role for development of a modern manufacturing sector (Krueger 1997).

Notwithstanding the past successes of export-led industrialization in East Asia and elsewhere, the question of global market receptivity to nontraditional exports is always lurking in the background, and often with good reason. Apparel exports, the first step on the export-led-industrialization ladder for a host of countries, is also the most protected manufacturing industry

in most industrial nations, including the United States.<sup>7</sup> Of course export-oriented development would work better if the rich countries were more willing to adjust out of sectors that have clearly lost their comparative advantage. But, as Sachs and Warner (1995) conclude, it still works even under less than ideal external conditions: “With the...exception of Haiti, there is not a single developing country that had substantially open trade and yet failed to grow by at least 2 percent per year” between 1970 and 1989.

Studies focusing instead on countries that have remained insulated from global markets tell a similar story. From their research into the causes of sub-Saharan Africa’s declining share in world exports, Yeats, Amjadi, Reincke, and Ng (1996) conclude that OECD trade barriers in potential export markets are not to blame: “Rather, the sub-Saharan African countries’ own trade and transport policies incorporate a substantial anti-export bias, which lessens their ability to be competitive in international markets.” If anything, exports from sub-Saharan Africa should have gained an advantage in the markets of industrial nations from trade preferences under the European Union’s Lome Convention as well as the Generalized System of Preferences, but these preferential arrangements were apparently insufficient to offset the anti-export bias of the policies pursued by these nations.

### III. Elements of the Virtuous Cycle

Commitment to an outward-oriented trade strategy requires complementary supporting policies including transportation and communications infrastructure; improved access to financial capital and to imported capital goods, raw materials, and intermediate inputs; and,

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<sup>7</sup> The Uruguay Round of multilateral trade negotiations resulted in an agreement to phase out the Multifibre Agreement (MFA), the global network of quantitative restrictions on trade in textiles and apparel, over a ten-year period. However, many trade policy experts are pessimistic about a return to open markets for these important developing-country exports. They interpret the long phase-out period as indicating a lack of commitment to liberalization on the part of OECD nations. Moreover, some analysts believe the extent of OECD protection of these import-competing industries may actually be raised temporarily during the phase-out process.

above all, maintenance of an appropriate real exchange rate. To the extent that potential exporters respond to the profit opportunities offered by the new policy environment, their political influence increases while that of import-competing producers wanes. The result is then to strengthen the political viability of liberalization, allowing the reform process to go forward (Krueger 1993). But will potential exporters respond? The key to the cycle lies in the credibility of the new policy, and this in turn rests on the economy's ability to withstand the dislocations of the period of adjustment.

### Sequencing of trade reforms

In the developing world (as well as in centrally planned economies), an import-substitution trade regime has typically been one element in a broad complex of dirigiste policies affecting all domestic economic activity--extensive public ownership, selective subsidies, and government restrictions affecting operation of domestic capital and labor markets as well as the foreign exchange market.<sup>8</sup> Furthermore, many developing countries experienced double- or triple-digit inflation rates during the 1960s and 1970s thanks to over-reliance on money creation to finance government spending. Experience suggests that appropriate sequencing of economic reforms can minimize the period of economic distress following liberalization, and a large literature has addressed this issue (Edwards 1994 summarizes the main findings). However, the sequencing literature typically treats trade liberalization as a single element in a broader reform program. Remaining unanswered questions concern the sequencing of the individual policy changes required to complete a country's successful transformation from import substitution to outward-oriented growth.

Notwithstanding theorists' concentration on the costliness of restrictions on imports, successful liberalizers most often begin the process of integrating into global markets by creating incentives for exporters. Only later, sometimes much later, does attention turn to broad reforms

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<sup>8</sup> Krueger (1993) points out that the perceived need for these policies may arise from the negative consequences of import substitution--a vicious policy cycle.

on the import side. Indeed, the initial impetus for import liberalization frequently comes from the needs of potential exporters who must look to world markets for capital goods, raw materials, or intermediate inputs. Early reforms often include rebates of import duties on capital equipment and/or intermediate inputs used to produce exports; establishment of export-processing zones; favorable access to licensed foreign exchange and restricted imports; and other incentives intended to raise the profitability of all or selected export-oriented activities. Subsequent reforms may include broader measures such as elimination of import licensing, tariffication of quantitative import restrictions, rationalization of the tariff structure, and elimination of multiple exchange rates used to discourage “nonessential” imports. At this later stage, the goal is less to spur exports than to move domestic relative prices closer to international prices and to eliminate large discrepancies in domestic effective protection rates.

The Lerner Symmetry Theorem implies that removing barriers to imports is equivalent to removing barriers to exports. Nonetheless, there may be dynamic advantages in pursuing export promotion prior to general liberalization on the import side. The most controversial aspect of trade liberalization is not the configuration in the new equilibrium versus the old one, but the path by which the economy moves from one to the other. In the new outward-oriented equilibrium both imports and exports will be much larger. However, the extent of overall economic losses and income redistribution, and hence the difficulty of maintaining adequate political support for needed reforms, all depend critically on whether imports grow sooner or later than exports, i.e., whether the current account improves or deteriorates during the period of adjustment. Deterioration of the current account is likely to spur a return to protection.

### The role of reciprocity

The stimulus for and context of the reforms implemented by successful liberalizers have been as varied as the shape and extent of the reforms themselves. However, one common theme running through many otherwise dissimilar cases is external reinforcement via some type of

reciprocity. A few countries have eliminated trade distortions in a purely unilateral fashion as part of a broad reform package (Chile, New Zealand), but much liberalization has been undertaken as an element of a regional trade initiative (AFTA, CACM, NAFTA, Mercosur, APEC).<sup>9</sup>

Arguments for reciprocal over unilateral liberalization can be made on several related but distinct grounds that correspond to different stages in the sequential process described above in Section I. Some are economic advantages, others political.

(1) Whether carried out regionally or on a multilateral basis, reciprocal liberalization is likely to produce a superior final outcome for an individual country. The logic of the optimum tariff argument implies that unilateral cuts in protection by any sizeable economy may benefit the world at the expense of the liberalizer. Although the unilateral liberalizer may gain also, as a result of reducing domestic distortions, but these gains will necessarily be offset by an adverse movement of the terms of trade. With reciprocal liberalization, the terms-of-trade effect will be smaller and may even be favorable.

(2) By promoting action on the part of countries that might otherwise choose to free-ride, reciprocal liberalization may result in more liberalization and thus greater global as well as national gains. A reciprocal process, whether regional or multilateral, also enhances public acceptance of liberalization. It undercuts the public sense that the country is giving something away (market access) with no quid pro quo.

(3) Reciprocity typically eases the economic problems associated with adjustment to trade reform. In a unilateral liberalization, lower domestic prices of imports put pressure on import-competing producers to cut their own prices and production. Eventually the resources displaced from import-competing production are absorbed by a growing export sector, but the process may be a painful one, as exporters search for new market opportunities. Reciprocal liberalization means that new export opportunities begin to appear just as import-competing

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<sup>9</sup> In other cases reluctant reformers have been prodded by strong external incentives from the U.S. government (e.g., CBI), World Bank, International Monetary Fund, GATT/WTO.

firms are forced to contract. Reciprocal liberalization thereby *pulls* resources into the expanding export sector, while with unilateral liberalization the same resources must *push* their way in.

### Benefits from expanded exports

At the level of traditional theory, import-substituting and export-promoting industrialization strategies are close relatives, the former less advantageous only to the extent that a small domestic market may not allow producers to enjoy the full advantages of scale and scope economies. The case for a temporary government role to enhance industrial production for either the domestic or export market is grounded in the belief that modern industrial activities produce important positive externalities. Yet the record suggests that, even for large industrial countries like the United States, exporting has special benefits over production of import substitutes. The key is that buyers in global markets have broad choices. Production for export thus sets a higher standard (of design, quality, price, etc.) than production for a domestic market where access to imports is restricted. This means that “good” export firms are rewarded with higher profits, but also that the pressure of global competition forces export companies to make constant improvements in their productivity, technology, and the skills of their workers (Richardson and Rindal 1996).

In less-developed countries with many market distortions, a focus on exports can help to guide resources toward their most productive uses.<sup>10</sup> Stiglitz (1996) suggests that export success is a better measure of performance than profits because profits may simply reflect distortions in the domestic market such as a local monopoly; export markets are usually more competitive. Moreover, exporting firms benefit from spillovers of marketing and production knowhow. For example, OECD firms that buy intermediate inputs or consumer products from suppliers in developing countries have a vested interest in working with these suppliers to insure that goods

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<sup>10</sup> These considerations are reinforced when industrial production is carried out by local subsidiaries of multinational firms.

are produced to appropriate standards. This interaction is a fruitful channel for transfer of knowledge about “world class” production techniques, product standards, and testing methods.

### Regional trade agreements

The recent proliferation of regional trade agreements (RTAs) has raised concerns about their compatibility with further progress toward multilateral liberalization. The key issue is the way RTAs evolve over time and the associated effects on the political viability of future regional or multilateral liberalization. Theory has demonstrated that formation of RTAs can have either positive or negative effects on the success of subsequent multilateral liberalization (Haveman 1996, Levy 1994, Richardson 1993). But in comparison with their theoretical counterparts, real-world RTAs seem decidedly benign in their effects. In fact, the evidence suggests considerable complementarity between regional and multilateral liberalization. Regional blocs not only appear to facilitate their members’ shift from inward-oriented to open trade regimes but their formation is sometimes motivated primarily by this goal.

Critics of RTAs worry that these arrangements will be dominated in their effects by costly trade diversion<sup>11</sup> and will cause their members to lose enthusiasm for further multilateral negotiations. Yet much of the evidence from actual RTA behavior suggests that policy makers do not typically choose this strategy *over* participation in multilateral liberalization but, rather, see the two as types of liberalization as complementary ways of pursuing gains from integration into international markets. Often the anticipated gains from an RTA are exactly the efficiency-boosting effects of a larger market that are most difficult to model: scale and scope economies, increased competition, technology transfer. Nor do members of actual RTAs show much sign of exploiting their collective market power by raising their protection toward nonmembers, perhaps

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<sup>11</sup> The traditional literature, following Viner’s lead in assuming constant opportunity cost in production probably overemphasized the costliness of trade diversion. Benefits associated with creation of a larger integrated market can transform a high-cost trading partner into a globally competitive one (Wonnacott 1996; McCulloch and Petri 1997). Also, apparent diversion can include welfare-increasing reversal of previous diversion, as in the expansion of U.S. imports from Mexico at the expense of higher-cost goods already afforded preferential access under the Caribbean Basin Initiative.

because nations interact over many issues other than trade, rendering adherence to an exploitive external trade policy short-sighted.

Theory suggests that an RTA may help to overcome political obstacles to multilateral liberalization to the extent that trade creation shrinks the size and political power of the region's least competitive firms (McCulloch and Petri 1997). Conversely, trade diversion under an RTA can strengthen resistance to any future enlargement or multilateral liberalization. But in practice, it appears that RTAs dominated by trade diversion are ones that never get off the ground because potential members are reluctant to accept the associated losses.

Once successfully established, RTAs show a decided propensity to grow over time. In the case of Europe, the Six became Nine in 1973. Greece joined in 1981 and Spain and Portugal in 1986. These last three, with economies quite different from the original Six, brought with them opportunities for trade flows along stronger lines of comparative advantage. The U.S.-Canada agreement, similarly, led to the inclusion of Mexico and possibly other Latin American countries. The Association of South East Asian Nations (ASEAN) grew in size and economic diversity with the accession of Vietnam in 1995. The Asia Pacific Economic Cooperation (APEC) forum absorbed three Chinas, Mexico, and Chile soon after its formation. These examples suggest that the dynamics of blocs favor increasingly diverse membership; the development of a trading bloc appears to change the balance of producer interests in ways that promote the eventual admission of members who were previously "too competitive" to be admitted.

In their external policies, blocs may worry about sensitive industries--often ones that benefit from trade diversion. But they do not usually oppose multilateral liberalization. In fact, they sometimes develop initiatives that favor new types of internal and even multilateral liberalization. The battle over agriculture that delayed completion of the Uruguay Round obscured the European record of support for several GATT rounds and European innovations in extending liberalization to include "deep" regulatory and financial issues (Lawrence 1991).

Canada-U.S. bilateral negotiations on issues such as foreign direct investment and services may have paved the way for later progress on similar issues in the Uruguay Round.

### Promoting favorable dynamics with RTAs

The recent prominence of RTAs has raised interest in a revision of WTO/GATT rules to increase the likelihood that such arrangements will make positive contributions to multilateral liberalization. One possible approach is suggested by Kemp and Wan's (1976) theoretical demonstration that the external barriers of a bloc can always be adjusted to leave trade with third countries unchanged--i.e., to rule out trade diversion--while allowing net gains for members. Variants of a no-trade-diversion rule have been proposed as alternatives or supplements to Article XXIV of the GATT, which currently restricts RTAs principally through the requirement that countries must fully eliminate internal barriers (Bhagwati 1992). However, minimizing diversion does not necessarily produce the most favorable dynamics. Trade diversion may be critical to the political viability of a particular RTA, and if the RTA represents an essential step in the transformation of a country's industrial structure, then a no-trade-diversion constraint can actually have the effect of retarding subsequent multilateral liberalization.

A second approach focuses on establishing mechanisms for the long-term liberalization of an RTA from its beginning. Conditional MFN proposals that arose in APEC illustrate several such options. Membership in an RTA can be made contingent on the member's own concessions, or it can be offered on an MFN basis initially, under the threat that partners' concessions will be withdrawn if reciprocal concessions aren't forthcoming by a specified time. The latter alternative may encourage an eventual MFN outcome if the member's adjustment costs of returning to a pre-concession industrial structure are high.

A third approach is "open regionalism"--a strategy for integrating economies through coordinated MFN agreements rather than formal RTAs or customs unions (see World Bank 1994 for East Asia). In some contexts, MFN concessions may be almost as beneficial as a preferential agreement. The APEC trading area, for example, has nearly 70 percent intra-regional trade. The

share of benefits accruing to regional partners can be increased further by focusing concessions on products in which the region has a competitive advantage (Elek 1994; Martin, Petri, and Yanagashima 1994).

The "open regionalism" strategy offers many of the advantages of a preferential approach without its inherent drawbacks. MFN agreements can achieve partial reductions of regional barriers without violating WTO/GATT rules, leading to a richer menu of liberalization solutions. Regional targeting of MFN liberalization offsets leakage of benefits to non-regional free riders, yet the likelihood of welfare-reducing trade diversion is less than with a formal RTA.

#### IV. Improving the Dynamics of Trade Reform

Recent decades have produced strong evidence linking growth rates and open trade regimes for countries on every continent and at every stage of economic development. However, domestic political forces continue to pose an important obstacle to trade reform. The theme of this paper is that reforms once initiated may create favorable momentum by strengthening the political power of export-oriented sectors, thus allowing the liberalization process to go forward: the virtuous cycle. But the cycle can only begin once outward-oriented policies take hold. Above I have suggested that regional trade agreements may provide a way to take that first step. Yet the theory of RTAs has delivered a decidedly mixed message as to whether this will be a step in the right direction.

Because predictions from theoretical models of RTA behavior are so much at odds with the generally benign role RTAs actually seem to play in the global economy, the dynamics of these regional agreements is a timely and important area for future empirical research. If the role of RTAs is to facilitate members' integration into global markets, this needs to be documented. The now-established superiority of export-led over import-substituting development strategies could not be deduced from theoretical modeling alone. Likewise, the conventional wisdom on

RTAs needs to be informed by closer study of their effects. As suggested earlier, one immediate benefit of improved information on the dynamic effects of such agreements is guidance in revising WTO/GATT rules governing the formation and policies of RTAs.

A second area for further research also deals with facilitating the difficult first step. The overall record on the effectiveness of multilateral and bilateral development aid in helping countries move toward reform has been unimpressive, and empirical studies show little if any evidence that foreign aid conveys measurable benefits in terms of long-run growth. On the other hand, properly applied, external resources and assistance may be key to helping countries weather the inevitable difficulties during the transition period. The important issue here is how to ensure that resources are used to help countries “stay the course” rather than allowing them to return to the old status quo.

A final area for investigation concerns the interaction between politics and economics that lies at the heart of the reform process and its success or failure. Rodrik (1993) observes that “economists have always been better at telling policymakers what do do than at explaining why policymakers do what they do.” In recent years the political economy of trade policy has become an important area for theorizing, but little serious empirical study has been carried out by economists. As Rodrik comments, “this is simply too interesting to leave to political scientists.” It is also too important.

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