DRAFT PRESENTATION

# Trade, Growth, Poverty Reduction and Human Development: Some Linkages and Policy Implications*

## The Relationship and Linkages

Conventional wisdom holds that the link between trade, poverty reduction and human development is through economic growth. Trade can be a powerful source of economic growth and trade liberalization is the common policy prescription for increasing trade flows. The voluminous literature on the positive relationship between trade liberalization and economic growth forms the basis for often-heard claims about the benefits of trade openness. But that literature is far from unequivocal. There is no convincing evidence that trade liberalization is automatically or always associated with economic growth, let alone poverty reduction or human development.

Indeed, a close study of the empirical literature shows no compelling evidence that trade liberalization is systematically associated with higher economic growth. So what does the evidence reveal about the links between trade liberalization and economic growth? The best known literature that claims trade liberalization promotes higher growth has important flaws and the problems are many and widespread. In a review of the best-known literature (Dollar, 1992; Ben-David, 1993; Edwards, 1998; Frankel and Romer, 1999; Sachs and Warner, 1995), Rodriguez and Rodrik (2001) found major gaps between the policy conclusions drawn and what the research actually showed. A common shortcoming is the misattribution of macroeconomic phenomena (overvalued currencies or macroeconomic instability) or geographic location (in the tropical zone) to trade policies. The classification of countries as ‘open’ or ‘closed’ in the Sachs-Warner study, for example, is not based on actual trade policies but largely on indicators related to exchange rate policy and location in Sub-Saharan Africa. The authors’ classification of countries conflates macroeconomics, geography and institutions with trade policy. The classification is so correlated with plausible alternative explanatory variables—macroeconomic instability, poor institutions, location in Africa—that one cannot draw any strong inferences about the effects of openness on growth from the empirical analysis (Rodriguez and Rodrik, 2001). Once these problems are corrected, any meaningful cross country relationship between trade barriers and economic growth evaporates.

Moreover, cross-national comparisons reveal no systematic relationship between countries’ average levels of tariffs and non-tariff barriers and their subsequent economic growth. If anything, evidence for the 1990s indicates a positive (but statistically insignificant) relationship between tariffs and economic growth.

The experience of Vietnam can be contrasted with a number of sub-Saharan African and Latin American countries that have either closely or literally followed the economic orthodoxy to

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illustrate this. Since the mid-1980s Viet Nam has taken a gradual approach to economic reform, following a two-track programme. It engages in state trading, maintains import monopolies, retains quantitative restrictions and high tariffs (30–50 per cent in a number of areas) on agricultural and industrial imports and is not yet a member of the World Trade Organization (WTO). Yet it has been phenomenally successful, achieving average GDP growth of more than 6 per cent a year since its declaration of 'doi moi' (economic renovation) in the mid- 1980s, sharply reducing poverty, expanding trade at double-digit rates and attracting considerable foreign investment. And despite high trade barriers, it has rapidly integrated with the global economy.

Meanwhile, a number of sub-Saharan Africa or Latin American WTO members undertook comprehensive trade liberalization in the early to mid-1990s, slashed import tariffs to very low levels and removed all quantitative restrictions. Yet their economies have gone nowhere, their social indicators are deteriorating, and many of these countries have made little progress in integrating with the global economy.

These contrasting experiences highlight two points. First, leadership committed to development and supporting a coherent growth strategy counts for a lot more than trade liberalization—even when such a national strategy departs sharply from the current standard view on reform (ie. even the "enlightened" post-Washington Consensus). Second, integration with the world economy is an outcome, not a prerequisite, of a successful growth strategy. Relatively protected Viet Nam is integrating with the global economy much faster than many sub-Saharan African and Latin American countries because Viet Nam is growing and they are not.

Vietnam, PR China and India are all recent examples that empirically demonstrate this while the history of almost all the current industrial countries also confirms this. With few exceptions, they also demonstrate the empirical finding that trade liberalization most often follows rather than precedes sustained periods of national economic growth. For example, a rarely discussed fact is that PR China and India both implemented their main trade reforms about a decade after the onset of higher economic growth.

The example of Vietnam also illustrates a common misdiagnosis ie. trade outcomes over which governments have little control are often confused with trade policies such as tariff reductions over which governments have control. A conventional exercise consists of classifying developing countries into 'globalizers' and 'nonglobalizers' based on their rates of growth in trade volumes. The analyst asks whether globalizers (those with the highest rates of trade growth) have faster income growth, greater poverty reduction and worsening income distribution (see Dollar and Kraay, 2000). Their answers tend to be yes, yes and no. But as Viet Nam shows, this approach is misleading. Trade volumes are the outcome of many things—including, most importantly, an economy's overall performance. They are not something that governments control directly. What governments control are trade policies: levels of tariff and non-tariff barriers, membership in the WTO, compliance with its agreements and so on. The real question is (or should be) whether open trade policies are a reliable way of generating self-sustaining growth and poverty reduction—evidence for which is far from convincing as just illustrated.

In reality, the relationship between trade openness and growth is likely to be contingent on a host of internal and external factors. That nearly all of today's industrial countries embarked on their growth behind tariff barriers, and reduced protection only subsequently, surely offers a clue. Moreover, the modern theory of endogenous growth yields an ambiguous answer to the question of whether trade liberalization promotes growth—one that depends on whether the forces of comparative advantage push an economy's resources towards activities that generate long-run growth

(eg. conducting research and development, expanding product diversification, upgrading product quality) or divert them from such activities.

No country has developed successfully by turning its back on international trade and long-term capital flows. And few have grown over long periods without experiencing an increase in the share of foreign trade in their national product. But it is also true that no country has developed simply by opening itself to foreign trade and investment. The trick has been to combine the opportunities offered by global markets with strategies for domestic investment and institution building, to stimulate domestic entrepreneurs. Nearly all the cases of successful or positive development in recent decades— East Asia since the 1960s, PR China and India since the early 1980s and Vietnam since the mid-1990s —have this experience in common and have involved partial, gradual opening to imports and foreign investment.

PR China and India are particularly noteworthy. Both countries are huge, have done extremely well economically, and are now often cited as examples of what openness can achieve. But again, the reality is more complicated. PR China and India implemented their main trade reforms about a decade after the onset of higher growth. Moreover, their trade restrictions remain among the highest in the world. The increase in PR China's growth started in the late 1970s. Trade liberalization did not start in earnest until much later, in the second half of the 1980s and especially in the 1990s—once the trend growth rate had already increased substantially.

India's growth rate increased substantially in the early 1980s, while serious trade reform did not start until 1991–93. Tariffs were actually higher in the higher growth period of the 1980s than in the low-growth 1970s.

The real debate is not over whether integration is good or bad, but over policies and priorities. 'It isn't at all obvious either (1) that further external liberalization ('open-ness') is now in every country's interest and in all dimensions or (2) that in the over-arching sweep of global economic history what the world now most requires is a set of global rules that promote or ease the path to greater freedom for global market actors, and are universal in application' (Helleiner, 2000). The relevant questions are about the correct sequence of policies and how much priority deep trade liberalization should receive early in the reform process. PR China and India suggest both the benefits of a gradual, sequenced approach and that import and trade liberalization are not likely to be the highest development priority, at least in the early reform period.

## What Really Matters?

Despite a voluminous literature, very little is known about which kinds of trade policies are conducive to growth. In the least developed countries (LDCs), for example, standard policy prescriptions over the past two decades have advocated trade liberalization as a way out of poverty. But there is little evidence to back that claim.

According to UNCTADs 2002 LDC Report, there is little correlation between trade liberalization and poverty reduction in LDCs: poverty appears to be increasing unambiguously in the least developed countries with the most open and the most closed trade regimes. But between those extremes, poverty is also increasing in countries that have liberalized trade more. While these findings do not prove that trade liberalization increases poverty, they do show that it does not automatically reduce poverty.

The least developed countries that experienced economic growth in the 1990s also became more export oriented. But that does not mean that increased export orientation was associated with growth: GDP per capita declined or stagnated in 8 of the 22 least developed countries with

increasing export orientation between 1987 and 1999. And in 10 of these countries poverty increased. Sustained economic growth was the key to reducing poverty in the least developed countries: 14 with rising GDP per capita saw poverty fall. So, unless accompanied by sustained growth, greater export orientation was not associated with reduced poverty

On the other hand, the East Asian 'tiger' economies are often presented as examples of countries that predominantly relied on export-led growth, where opening to the world economy unleashed the forces for powerful industrial diversification and technological advancement. But this conventional account overlooks the active role played by the governments of the Republic of Korea and Taiwan, province of China, (and Japan before them) in shaping the allocation of resources and the fact that while export-orientation was an important aspect of their overall development strategy, it was only one aspect (not necessarily the most important) while import liberalization was not part of their early development strategy at all. Indeed, neither economy undertook significant import liberalization early in the growth process. Most of their trade liberalization occurred in the 1980s, after high growth was already firmly established.

Key to the success of these and other East Asian economies was a coherent strategy of raising the returns to private investment through a range of policies that included credit subsidies, tax incentives, education promotion, establishment of public enterprises, export inducements, duty-free access to inputs and capital goods and government coordination of investment plans. In the Republic of Korea the main investment subsidy was the extension of credit to large business groups at negative real interest rates. Banks were nationalized after the military coup of 1961, giving the government exclusive control over the allocation of investible funds in the economy. Investment was also subsidized through the socialization of investment risk in selected sectors. This approach emerged because the government implicitly guaranteed that the state would bail out entrepreneurs investing in 'desirable' activities if circumstances later threatened the profitability of those investments. In Taiwan, province of China, investment subsidies took the form of tax incentives.

In both South Korea and Taiwan, public enterprises played important roles in enhancing the profitability of private investment by ensuring that key inputs were available for private producers. Public enterprises accounted for a large share of manufacturing output and investment in both economies, and their importance increased during the critical take-off years of the 1960s. Singapore also heavily subsidized investment, but it differed from South Korea and Taiwan in that its investment incentives focused on foreign investors.

Although trade policies that spurred exports were a part of the arsenal of incentives in all the East Asian tiger economies, their role should be put in proper perspective since many other parts of the arsenal were equally if not more important and investment and its promotion were the primary goals. To that end, the governments of the Republic of Korea and Taiwan resorted to unorthodox strategies: they protected domestic markets to raise profits, provided generous export subsidies, encouraged firms to reverse engineer foreign-patented products and imposed so-called trade related investment measure (TRIM) requirements on foreign investors (when they were allowed in) such as export-import balance requirements and domestic content requirements. Most, if not all of these strategies are now severely restricted under WTO agreements.

## Key Messages and Some Policy Implications

1. The only systematic relationship between countries' economic growth and their average tariffs and non tariff restrictions is that they dismantle trade restrictions as they get richer. With few exceptions, today's rich countries embarked on modern economic growth behind protective trade

barriers but now have low barriers. The experiences of industrial and successful developing countries also provide two other lessons. First, economic integration with the world economy is an outcome of growth and development, not a prerequisite. Second, institutional innovations—many of them unorthodox and requiring considerable domestic policy space and flexibility—have been crucial for successful development strategies and outcomes.

2. As a result, the design of the multilateral trade regime needs to shift from one which over-emphasizes a market access perspective to one which prioritizes enabling (or at least not disabling) the domestic policy space available to developing countries to make a range of diverse, including unorthodox, policy choices and pursue the concomitant strategies. It should also be evaluated not on the basis of whether it maximizes the flow of goods and services but on whether trade arrangements—current and proposed— maximize possibilities for human development, especially in developing countries. A world trade regime friendly to human development would provide domestic policy space and give developing countries flexibility to make institutional and other innovations. Such policy space should take precedence over market access considerations, even as the trade regime continues to recognize that market access can make an important contribution to human development in specific situations and for specific sectors and issues.

3. An implication is that multilateral trade rules will need to seek peaceful co-existence among national practices, not harmonization, especially if this takes the form of a 'one-size-fits-all' that only fits a few powerful members.

4. There are other obvious implications for the framework of global trade governance, not least the need to permit asymmetric rules in favour of the weakest members, especially the least developed countries. In the long run, such rules will be beneficial for both developed and developing countries.

**A vision for the future should start with four simple principles of international trade:**

- Trade is a means to an end, not an end in itself.
- Trade rules have to allow for diversity in national institutions and standards.
- Countries should have the right to protect their own institutions and development priorities.
- No country has the right to impose its institutional preferences on others.

**A trade regime friendly to poverty reduction and human development is possible if these four principles are genuinely and consistently implemented**. Such a trade regime must give governments the space to design appropriate policies and it will need to include the following elements if it were to seriously take such a development perspective:

*Human development assessments:* There should be research and analysis on the human development implications of each of the WTO agreements in different country settings and for countries at different levels of development. Estimating the costs of implementing each agreement, current and proposed, for all member nations should be part of such assessments. Such assessments should be conducted by a credible and independent research program established with the consent of all WTO members. It should present the implications of current and proposed agreements for human development under different scenarios of technical assistance, phased implementation and other important variables. While not binding, the results of such a research program should inform the agenda for future negotiations.

*Diversity in development strategies***.** The trade regime is a means of serving larger national goals and should therefore focus mainly on facilitating international trade within the development context. All members of the multilateral trading regime are confronted with both costs and benefits; a development friendly regime should not systematically benefit or harm any one set of countries or interests over others. This will be possible only if it facilitates the development agendas of different countries and provides the maximum policy space to enable them to design appropriate development strategies. This will require a trade regime that primarily manages diversity rather than one that unifies and harmonizes national policies.

*Market access.* The multilateral regime was established to facilitate a greater flow of goods and services between countries in a predictable, fair and rules-based manner. The trade regime needs to ensure participation by as many countries as possible. To this end, the participation of developing countries, including LDCs, through their access to developed markets will be important if these countries are to realize the gains from trade in the immediate term.

*Asymmetric rules.* "One-size-fits-all" does not work. Extending identical rules to inherently unequal members locks weaker countries into existing unsatisfactory relationships which fail to address their developmental problems. Given economic and capacity disparities, asymmetry needs to be more systematically built into the regime as a starting point for the rules. The principles of reciprocity and non-discrimination should be linked to the economic capacity of countries and restricted to groups of countries at similar levels of human development.

*Reconciling asymmetric rules with market access.* Market access is important for developing countries to enable them to reach a level of development where they can compete on an equal basis. But it is not enough. Developing countries gain relatively less from trade, partly because of their specialization in relatively low value added export activities and declining commodity prices. They also lack the capacity to compensate those adversely affected by greater trade liberalization. Developed countries, by contrast, gain significantly more from trade overall, and also have more evolved internal mechanisms to cope with the vulnerabilities of opening up. WTO rules should reflect these differences in capacity by allowing developing countries more flexibility in compliance.

*A sustainable regime*. An asymmetric trade regime will benefit all its members if its short-term cost to particular sectors in developed countries (in lost markets and increased competition from imports) are less than the general efficiency and substantive gains it produces in both the short and long run. Many of the costs, both in the short and long run, can be mitigated through carefully designed economic policy packages at the national level in both developed and developing countries. By balancing costs and benefits, an efficient and effective multilateral regime will provide enough incentives for countries to enjoy its fruits, while reflecting the inherent and current inequalities and different stages of development of countries in the policy options it offers.