Trading in illusions

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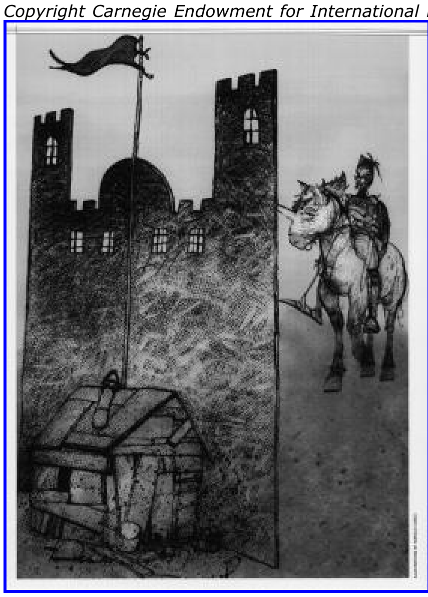
Abstract:
The new agenda of global integration rests on shaky empirical ground and seriously distorts policymakers' priorities. By focusing on international integration, governments in poor nations divert human resources, administrative capabilities, and political capital away from more urgent development priorities such as education, public health, industrial capacity, and social cohesion. This emphasis also undermines nascent democratic institutions by removing the choice of development strategy on public debate. Policymakers need to forge a growth strategy by relying on domestic investors and domestic institutions. The costliest downside of the integrationist faith is that it crowds out serious thinking and efforts along such lines. There is simply no alternative to a home grown business plan.

Full Text:



Advocates of global economic integration hold out utopian visions of the prosperity that developing countries will reap if they open their borders to commerce and capital. This hollow promise diverts poor nations' attention and resources from the key domestic innovations needed to spur economic growth. | By Dani Rodrik A senior U.S. Treasury official recently urged Mexico's government to work harder to reduce violent crime because "such high levels of crime and violence may drive away foreign investors."

This admonition nicely illustrates how foreign trade and investment have become the ultimate yardstick for evaluating the social and economic policies of governments in developing countries. Forget the slum dwellers or campesinos who live amidst crime and poverty throughout the developing world. Just mention "investor sentiment" or "competitiveness in world markets" and policymakers will come to attention in a hurry.

Underlying this perversion of priorities is a remarkable consensus on the imperative of global economic integration. Openness to trade and investment flows is no longer viewed simply as a component of a country's development strategy; it has mutated into the most potent catalyst for economic growth known to humanity. Predictably, senior officials of the World Trade Organization (WTO), International Monetary Fund (IMF), and other international financial agencies incessantly repeat the openness mantra. In recent years, however, faith in integration has spread quickly to political leaders and policymakers around the world [see box on page 57].

Joining the world economy is no longer a matter simply of dismantling barriers to trade and investment. Countries now must also comply with a long list of admission requirements, from new patent rules to more rigorous banking standards. The apostles of economic integration prescribe comprehensive institutional reforms that took today's advanced countries generations to accomplish, so that developing countries can, as the cliche goes, maximize the gains and minimize the risks of participation in the world economy. Global integration has become, for all practical purposes, a substitute for a development strategy.

This trend is bad news for the world's poor. The new agenda of global integration rests on shaky empirical ground and seriously distorts policymakers' priorities. By focusing on international integration, governments in poor nations divert human resources, administrative capabilities, and political capital away from more urgent development priorities such as education, public health, industrial capacity, and social cohesion. This emphasis also undermines nascent democratic institutions by removing the choice of development strategy from public debate.

World markets are a source of technology and capital; it would be silly for the developing world not to exploit these opportunities. But globalization is not a shortcut to development. Successful economic growth strategies have always required a judicious blend of imported practices with domestic institutional innovations. Policymakers need to forge a domestic growth strategy by relying on domestic investors and domestic institutions. The costliest downside of the integrationist faith is that it crowds out serious thinking and efforts along such lines.

Countries that have bought wholeheartedly into the integration orthodoxy are discovering that openness does not deliver on its promise. Despite sharply lowering their barriers to trade and investment since the 1980s, scores of countries in Latin America and Africa are stagnating or growing less rapidly than in the heyday of import substitution during the 1960s and 1970s. By contrast, the fastest growing countries are China, India, and others in East and Southeast Asia. Policymakers in these countries have also espoused trade and investment liberalization, but they have done so in an unorthodox manner-gradually, sequentially, and only after an initial period of high growth-and as part of a broader policy package with many unconventional features.

The disappointing outcomes with deep liberalization have been absorbed into the faith with remarkable aplomb. Those who view global integration as the prerequisite for economic development now simply add the caveat that opening borders is insufficient. Reaping the gains from openness, they argue, also requires a full complement of institutional reforms.

Consider trade liberalization. Asking any World Bank economist what a successful trade-liberalization program requires will likely elicit a laundry list of measures beyond the simple reduction of tariff and nontariff barriers: tax reform to make up for lost tariff revenues; social safety nets to compensate displaced workers; administrative reform to bring trade practices into compliance with WTO rules; labor market reform to enhance worker mobility across industries; technological assistance to upgrade firms hurt by import competition; and training programs to ensure that export-oriented firms and investors have access to skilled workers. As the promise of trade liberalization fails to materialize, the prerequisites keep expanding. For example, Clare Short, Great Britain's secretary of state for international development, recently added universal provision of health and education to the list.

In the financial arena, integrationists have pushed complementary reforms with even greater fanfare and urgency. The prevailing view in Washington and other Group of Seven (G-7) capitals is that weaknesses in banking systems, prudential regulation, and corporate governance were at the heart of the Asian financial crisis of the late 1990s. Hence the ambitious efforts by the G-7 to establish international codes and standards covering fiscal transparency, monetary and financial policy, banking supervision, data dissemination, corporate governance, and accounting standards. The Financial Stability Forum (FSF)-a G-7 organization with minimal representation from developing nations-has designated 12 of these standards as essential for creating sound financial systems in developing countries. The full FSF compendium includes an additional 59 standards the agency considers "relevant for sound financial systems," bringing the total number of codes to 71. To fend off speculative capital movements, the IMF and the G-7 also typically urge developing countries to accumulate foreign reserves and avoid exchange-rate regimes that differ from a "hard peg" (tying the value of one's currency to that of a more stable currency, such as the U.S. dollar) or a "pure float" (letting the market determine the appropriate exchange rate).

A cynic might wonder whether the point of all these prerequisites is merely to provide easy cover for eventual failure. Integrationists can conveniently blame disappointing growth performance or a financial crisis on "slippage" in. the implementation of complementary reforms rather than on a poorly designed liberalization. So if Bangladesh's freer trade policy does not produce a large enough spurt in growth, the World Bank concludes that the problem must involve lagging reforms in public administration or continued "political uncertainty" (always a favorite). And if Argentina gets caught up in a confidence crisis despite significant trade and financial liberalization, the IMF reasons that structural reforms have been inadequate and must be deepened.

FREE TRADE-OFFS

Most (but certainly not all) of the institutional reforms on the integrationist agenda are perfectly sensible, and in a world without financial, administrative, or political constraints, there would be little argument about the need to adopt them. But in the real world, governments face difficult choices over how to deploy their fiscal resources, administrative capabilities, and political capital. Setting institutional priorities to maximize integration into the global economy has real opportunity costs.

Consider some illustrative trade-offs. World Bank trade economist Michael Finger has estimated that a typical developing country must spend $150 million to implement requirements under just three WTo agreements (those on customs valuation, sanitary and phytosanitary measures, and trade-related intellectual property rights). As Finger notes, this sum equals a year's development budget for many least-developed countries. And while the budgetary burden of implementing financial codes and standards has never been fully estimated, it undoubtedly entails a substantial diversion of fiscal and human resources as well. Should governments in developing countries train more bank auditors and accountants, even if those investments mean fewer secondary-school teachers or reduced spending on primary education for girls?

In the area of legal reform, should governments focus their energies on "importing" legal codes and standards or on improving existing domestic legal institutions? In Turkey, a weak coalition government spent several months during 1999 gathering political support for a bill providing foreign investors the protection of international arbitration. But wouldn't a better long-run strategy have involved reforming the existing legal regime for the benefit of foreign and domestic investors alike?

In public health, should governments promote the reverse engineering of patented basic medicines and the importation of low-cost generic drugs from "unauthorized" suppliers, even if doing so means violating WTO rules against such practices? When South Africa passed legislation in 1997 allowing imports of patented AIDS drugs from cheaper sources, the country came under severe pressure from Western governments, which argued that the South African policy conflicted with WTo rules on intellectual property.

How much should politicians spend on social protection policies in view of the fiscal constraints imposed by market "discipline"? Peru's central bank holds foreign reserves equal to 15 months of imports as an insurance policy against the sudden capital outflows that financially open economies often experience. The opportunity cost of this policy amounts to almost 1 percent of gross domestic product annually-more than enough to fund a generous antipoverty program.

How should governments choose their exchangerate regimes? During the last four decades, virtually every growth boom in the developing world has been accompanied by a controlled depreciation of the domestic currency. Yet financial openness makes it all but impossible to manage the exchange rate.

How should policymakers focus their anticorruption strategies? Should they target the high-level corruption that foreign investors often decry or the petty corruption that affects the poor the most? Perhaps, as the proponents of permanent normal trade relations with China argued in the recent U.S. debate, a government that is forced to protect the rights of foreign investors will become more inclined to protect the rights of its own citizens as well. But this is, at best, a trickledown strategy of institutional reform. Shouldn't reforms target the desired ends directly-- whether those ends are the rule of law, improved observance of human rights, or reduced corruption?

The rules for admission into the world economy not only reflect little awareness of development priorities, they are often completely unrelated to sensible economic principles. For instance, WTO agreements on anti-dumping, subsidies and countervailing measures, agriculture, textiles, and trade-related intellectual property rights lack any economic rationale beyond the mercantilist interests of a narrow set of powerful groups in advanced industrial countries. Bilateral and regional trade agreements are typically far worse, as they impose even tighter prerequisites on developing countries in return for crumbs of enhanced "market access." For example, the African Growth and Opportunity Act signed by U.S. President Clinton in May 2000 provides increased access to the U.S. market only if African apparel manufacturers use U.S.-produced fabric and yarns. This restriction severely limits the potential economic spillovers in African countries.

There are similar questions about the appropriateness of financial codes and standards. These codes rely heavily on an Anglo-American style of corporate governance and an arm's-length model of financial development. They close off alternative paths to financial development of the sort that have been followed by many of today's rich countries (for example, Germany, Japan, or South Korea).

In each of these areas, a strategy of "globalization above all" crowds out alternatives that are potentially more development-friendly. Many of the institutional reforms needed for insertion into the world economy can be independently desirable or produce broader economic benefits. But these priorities do not necessarily coincide with

...enda.

...international economic community are expensive and preclude investments in other crucial areas, pro-globalization ...ic growth that invariably result from insertion into the global marketplace will more than compensate for those costs. ...s say. Where would they be without international trade and foreign capital flows?

...m their progressive integration into the world economy is undeniable. But look closely at what policies produced those ...y's rule book.

...ide by few international constraints and pay few of the modern costs of integration during their formative growth ...global trade rules were sparse and economies faced almost none of today's common pressures to open their borders to ...utward orientation with unorthodox policies: high levels of tariff and nontariff barriers, public ownership of large segments of banking and industry, export subsidies, domestic-content requirements, patent and copyright infringements, and restrictions on capital flows (including on foreign direct investment). Such policies are either precluded by today's trade rules or are highly frowned upon by organizations like the IMF and the World Bank.

China also followed a highly unorthodox twotrack strategy, violating practically every rule in the guidebook (including, most notably, the requirement of private property rights). India, which significantly raised its economic growth rate in the early 1980s, remains one of the world's most highly protected economies.

All of these countries liberalized trade gradually, over a period of decades, not years. Significant import liberalization did not occur until after a transition to high economic growth had taken place. And far from wiping the institutional slate clean, all of these nations managed to eke growth out of their existing institutions, imperfect as they may have been. Indeed, when some of the more successful Asian economies gave in to Western pressure to liberalize capital flows rapidly, they were rewarded with the Asian financial crisis.

That is why these countries can hardly be considered poster children for today's global rules. South Korea, China, India, and the other Asian success cases had the freedom to do their own thing, and they used that freedom abundantly. Today's globalizers would be unable to replicate these experiences without running afoul of the IMF or the WTO.

The Asian experience highlights a deeper point: A sound overall development strategy that produces high economic growth is far more effective in achieving integration with the world economy than a purely integrationist strategy that relies on openness to work its magic. In other words, the globalizers have it exactly backwards. Integration is the result, not the cause, of economic and social development. A relatively protected economy like Vietnam is integrating with the world economy much more rapidly than an open economy like Haiti because Vietnam, unlike Haiti, has a reasonably functional economy and polity.

Integration into the global economy, unlike tariff rates or capital-account regulations, is not something that policymakers control directly. Telling finance ministers in developing nations that they should increase their "participation in world trade" is as meaningful as telling them that they need to improve technological capabilities-and just as helpful. Policymakers need to know which strategies will produce these results, and whether the specific prescriptions that the current orthodoxy offers are up to the task.

TOO GOOD TO BE TRUE

Do lower trade barriers spur greater economic progress? The available studies reveal no systematic relationship between a country's average level of tariff and nontariff barriers and its subsequent economic growth rate. If anything, the evidence for the 1990s indicates a positive relationship between import tariffs and economic growth [see chart on opposite page]. The only clear pattern is that countries dismantle their trade restrictions as they grow richer. This finding explains why today's rich countries, with few exceptions, embarked on modern economic growth behind protective barriers but now display low trade barriers.

The absence of a strong negative relationship between trade restrictions and economic growth may seem surprising in view of the ubiquitous claim that trade liberalization promotes higher growth. Indeed, the economics literature is replete with crossnational studies concluding that growth and economic dynamism are strongly linked to more open trade policies. A particularly influential study finds that economies that are "open," by the study's own definition, grew 2.45 percentage points faster annually than closed ones-an enormous difference.

Upon closer look, however, such studies turn out to be unreliable. In a detailed review of the empirical literature, University of Maryland economist Francisco Rodriguez and I have found a major gap between the results that economists have actually obtained and the policy conclusions they have typically drawn. For example, in many cases economists blame poor growth on the government's failure to liberalize trade policies, when the true culprits are ineffective institutions, geographic determinants (such as location in a tropical region), or inappropriate macroeconomic policies (such as an overvalued exchange rate). Once these misdiagnoses are corrected, any meaningful relationship across countries between the level of trade barriers and economic growth evaporates.

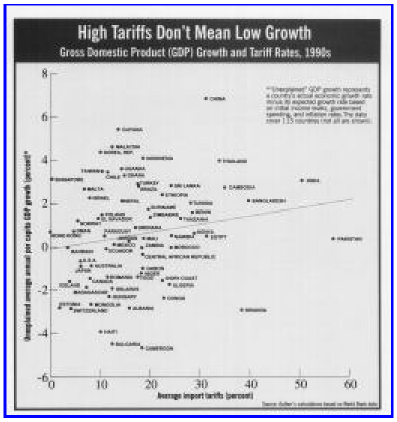
The evidence on the benefits of liberalizing capital flows is even weaker. In theory, the appeal of capital mobility seems obvious: If capital is free to enter (and leave) markets based on the potential return on investment, the result will be an efficient allocation of global resources. But in reality, financial markets are inherently unstable, subject to bubbles (rational or otherwise), panics, shortsightedness, and self-fulfilling prophecies. There is plenty of evidence that financial liberalization is often followed by financial crash-just ask Mexico, Thailand, or Turkey-while there is little convincing evidence to suggest that higher rates of economic growth follow capital-account liberalization.

Perhaps the most disingenuous argument in favor of liberalizing international financial flows is that the threat of massive and sudden capital movements serves to discipline policymakers in developing nations who might otherwise manage their economies irresponsibly. In other words, governments might be less inclined to squander their societies' resources if such actions would spook foreign lenders. In practice, however the discipline argument falls apart. Behavior in international capital markets is dominated by mood swings unrelated to fundamentals. In good times, a government with a chronic fiscal deficit has an easier time financing its spending when it can borrow funds from investors abroad; witness Russia prior to 1998 or Argentina in the 1990s. And in bad times, governments may be forced to adopt inappropriate policies in order to conform to the biases of foreign investors; witness the excessively restrictive monetary and fiscal policies in much of East Asia in the immediate aftermath of the Asian financial crisis. A key reason why Malaysia was able to recover so quickly after the imposition of capital controls in September 1998 was that Prime Minister Mahathir Mohamad resisted the high interest rates and tight fiscal policies that South Korea, Thailand, and Indonesia adopted at the behest of the International Monetary Fund.

GROWTH BEGINS AT HOME

Well-trained economists are justifiably proud of the textbook case in favor of free trade. For all the theory's simplicity, it is one of our profession's most significant achievements. However, in their zeal to promote the virtues of trade, the most ardent proponents are peddling a cartoon version of the argument, vastly overstating the effectiveness of economic openness as a tool for fostering development. Such claims only endanger broad public acceptance of the real article because they unleash unrealistic expectations about the benefits of free trade. Neither economic theory nor empirical evidence guarantees that deep trade liberalization will deliver higher economic growth. Economic openness and all its accouterments do not deserve the priority they typically receive in the development strategies pushed by leading multilateral organizations.

Countries that have achieved long-term economic growth have usually combined the opportunities offered by world markets with a growth strategy that mobilizes the capabilities of domestic institutions and investors. Designing such a growth strategy is both harder and easier than implementing typical integration policies. It is harder because the binding constraints on growth are usually country specific and do not respond well to standardized recipes. But it is easier because once those constraints are targeted, relatively simple policy changes can yield enormous economic payoffs and start a virtuous cycle of growth and additional reform.



High Tariffs Don't Mean Low Growth

Unorthodox innovations that depart from the integration rule book are typically part and parcel of such strategies. Public enterprises during the Meiji restoration in Japan; township and village enterprises in China; an export processing zone in Mauritius; generous tax incentives for priority investments in Taiwan; extensive credit subsidies in South Korea; infant-industry protection in Brazil during the 1960s and 1970s-these are some of the innovations that have been instrumental in kickstarting investment and growth in the past. None came out of a Washington economist's tool kit.

Few of these experiments have worked as well when transplanted to other settings, only underscoring the decisive importance of local conditions. To be effective, development strategies need to be tailored to prevailing domestic institutional strengths. There is simply no alternative to a homegrown business plan. Policymakers who look to Washington and financial markets for the answers are condemning themselves to mimicking the conventional wisdom du jour, and to eventual disillusionment.

[Sidebar]
Spreading the Faith

[Sidebar]
"We have an enormous job to do to convince the sincere and well-motivated opponents of the WTO agenda that the WTO can be, indeed is, a friend of development, and that far from impoverishing the world's poorer countries, trade liberalisation is the only sure route to the kind of economic growth needed to bring their prosperity closer to that of the major developed economies."
-British Prime Minister Tony Blair January 18, 2000

[Sidebar]
"[I]n every case where a poor nation has significantly overcome its poverty, this has been achieved while engaging in production for export markets and opening itself to the influx of foreign goods, investment and technology; that is by participating in globalization."
-Mexican President Ernesto Zedillo January 28, 2000

[Sidebar]
"[A]ny serious reflection on the future of the world economy and therefore the living standards of the billions who inhabit our world, will show that a strategic shift towards a significantly larger world economy can only be achieved as a result of raising living standards in the countries of the South, and therefore the radical expansion of the world markets for capital, goods and services."
-South African President Thabo Mbeki April 4, 2000

[Sidebar]
"Korea will continue to strive toward fully integrating itself into the global economy and adapting to the digital revolution for truly sustainable growth in the coming decades."
-South Korean Minister of Finance Lee Hun-Jai May 11, 2000

[Sidebar]
"The economic case for NAFTA is strong and the moral case is just as powerful. As barriers fall and markets open, people in Mexico are finding good jobs in their own country. Thousands are able to start businesses for the first time. Standards for conducting businesses become more regular. Standards for education rise to meet the demands of the economy, and that economy demands literacy, skilled labor, expertise in accounting and engineering and technology. It's a gradual change and not always easy but it can uplift a country and uplift lives."
-U.S. presidential candidate George W. Bush August 25, 2000

[Sidebar]
[Want to Know More?]

[Sidebar]
Thomas L. Friedman provides the canonical celebratory account of global economic integration in The Lexus and the Olive Tree: Understanding Globalization (New York: Farrar, Straus & Giroux, 1999). The World Trade Organization's (WTO) Director General Mike Moore presents the global trading system as the best hope for developing countries in "The WTO Is a Friend of the Poor" (Financial Times, June 19, 2000). Dani Rodrik challenges Friedman's view of a seamlessly connected world economy in "How Far Will International Economic Integration Go?" (Journal of Economic Perspectives, Winter 2000).

[Sidebar]
Two of the better-known academic studies arguing that trade promotes economic growth are Jeffrey Sachs and Andrew Warner's "Economic Reform and the Process of Global Integration" (Brookings Papers on Economic Activity, No. 1, 1995) and Jeffrey Frankel and David Romer's "Does Trade Cause Growth?" (American Economic Review, Vol. 89, No. 3, June 1999). Francisco Rodriguez and Dani Rodrik provide a detailed critique of these and other academic works in "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence" in Ben Bernanke and Kenneth S. Rogoff, eds. NBER Macroeconomics Annual 2ooo (Cambridge: MIT Press, forthcoming).

[Sidebar]
On the costs of implementing WTO rules, see Michael J. Finger and Philip Schuler's "Implementation of Uruguay Round Commitments: The Development Challenge" (Washington: World Bank Policy Research Working Paper No. 2215, October 1999). Katharina Pistor discusses the difficulties of importing financial codes and standards in "The Standardization of Law and Its Effect on Developing Economies" (New York: G-24 Discussion Paper No. 4, June 2000).

[Sidebar]
For an account of the postwar development record that emphasizes the role of successful deviations from the prevailing economic orthodoxy, see Dani Rodrik's The New Global Economy and the Developing Countries: Making Openness Work (Washington: Overseas Development Council, 1999). Jose Antonio Ocampo's "Rethinking the Development Agenda" (Santiago: Economic Commission on Latin America and the Caribbean, December 2000) provides a parallel account from a Latin American perspective. Yingyi Qian summarizes China's institutional innovations in "The Institutional Foundations of China's Market Transition" (unpublished paper, Stanford University, April 1999). See also Moises Naim's "Washington Consensus or Washington Confusion?" (FOREIGN POLICY, Spring 2000).

[Sidebar]
For links to relevant Web sites, as well as a comprehensive index articles, access www.forelgnpolicy.com.

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