

## Miracles & Debacles: In Defense of Trade Openness

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There is no sustained growth without low or declining barriers to trade. And trade is rarely  
behind persistent stagnation or decline.

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A key policy question confronting developing countries today is whether to opt for outward-oriented trade policies or yield to protectionism. Last fifty years of experience overwhelmingly supports the case for choosing freer trade over protectionism. Virtually all growth miracles in the developing world have taken place in the presence of low or declining barriers and there are few growth debacles that can be attributed to sustained import surges. Before I turn to the evidence, however, it is useful to sort out a series of confusions that have plagued the debate on this important subject.

## 1 Non-sequiturs: Criticisms that Won't Do

Free-trade critics often advance arguments that seem superficially plausible but fail to stand up to closer scrutiny. For example:

- Some critics cite countries that opened to trade and failed to achieve higher growth to make a case in favor of protectionism over liberal trade policies. Others argue that the existing econometric evidence fails to persuasively establish a *causal* link between barriers to trade and growth. But such criticisms miss the point that the policy choice must be based not on whether openness by itself leads to higher growth but on whether it is more *conducive* to sustained growth than a protectionist regime. Few serious advocates of free trade argue that openness is by itself sufficient for growth. They fully recognize that in the absence of macroeconomic stability, policy credibility and enforcement of contracts, it is unlikely that a country will be able to register significantly high growth rates for a

- sustained period. But these policies yield the high-growth dividend only in an open trading environment.
- Critics also attack the case for liberal trade policies on the ground that certain successful experiences of sustained growth were actually catalyzed by alternative policies such as government-engineered increase in investment demand or innovation. But these critics fail to distinguish between initial catalysts to growth and policies necessary to *sustain* it. Even if growth is initially stimulated by increased investment demand or innovation, growth is unlikely to be sustained if the trading environment is autarkic and continues to be autarkic. Of course, if openness also serves as a direct stimulus to growth, it is an added advantage. A careful study of the successful cases reveals that whatever the source of the initial stimulus, increased growth often leads to increased trade liberalization and vice versa. The recent successful experiences of China and India graphically illustrate the process of growth and openness feeding on each other.
  - Critics also like to cite examples of countries that managed to register high growth rates behind high walls of protection to conclude that protectionism works. Again, high *initial* trade barriers do not preclude the *onset* of rapid growth, especially in countries such as Brazil, China and India that have large internal markets. Indeed, growth process itself may sometimes be kicked off by gradual liberalization of an initially highly protected regime. But such growth will sustain only if the country responds by undertaking liberalization that accommodates the necessary expansion of trade. Evidence pointing to the fact that a country grew rapidly while still behind high protectionist wall does not

prove the efficacy of protection! The critical question for such an economy is whether it was lowering or further raising the protectionist wall during the period of rapid growth.

- Critics also like to cite examples of countries that managed to register high growth while raising barriers to trade. But pro-free trade economists have often recognized that in an *initial* phase of development and starting with relatively low barriers to trade, increased protection need not preclude fast growth as long as protection remains moderate and short-lived. Late Bela Balassa, one of the early advocates of outward-oriented policies, explicitly recognized the positive role that the *first* stage of import substitution played in the development of South Korea, Taiwan and Singapore. He defined this stage as the period during which imports of non-durable consumer goods such as textiles and apparel and the intermediate inputs used in them are replaced by domestic production. In the present context, this qualification is largely academic since the time for such import substitution is now behind virtually all developing countries.
- Finally, the necessity of trade openness for growth is not inconsistent with the use of industrial policy. Critics sometimes challenge the case for openness by pointing to what they regard as the success of interventionist industrial policies in high-growth economies of the Far East. While the efficacy of industrial policies itself constitutes a separate subject of debate among economists, the success of an activist industrial policy does not prove the failure of outward-oriented policies.

The contrasting experiences of South Korea and India during the first three decades (1950-1980) of their development vividly illustrate these points. Therefore, I

next discuss these experiences. Before I do this, however, let me clarify one definitional issue. The maintenance of a realistic exchange rate is an integral part of an outward-oriented policy regime. If the exchange rate is overvalued, discrimination against the traded goods sector emerges even with low formal trade barriers such as tariffs. Avoiding an overvalued exchange rate is not merely good for macroeconomic stability but is an essential condition for maintaining openness itself.

## **2 A Tale of Two Countries: South Korea and India**

Dani Rodrik (1995), an economist at Harvard university and a leading critic of outward-oriented policies, dismisses the importance of openness in Korea's growth experience during 1960s and 1970s on the ground that the country grew rapidly because its government "managed to engineer a significant increase in the private return to capital" by "subsidizing and coordinating investment decisions." He views the expansion of trade as merely a passive outcome of the process unleashed by this expansion of investment: new investments required machinery imports and the increased need for imports mandated increased exports.

To be sure, one can question the basic premise underlying this simplistic story of Rodrik. During 1961-80, Korea's exports of goods and services grew at an annual rate of 23.7 percent in real terms. Even though Korea began at a relatively low exports-to-GDP ratio of 5.3 percent in 1961, by 1980, the exports-to-GDP ratio had reached 33.1 percent! This dramatic growth in exports, which came in large part after 1965, had to be the outcome of active policy changes rather than a passive response to the growth in government coordinated investment boom. More importantly, the dramatic growth in exports had to be a significant stimulus to the economy at the margin. The efficiency gains that accrue from

competing against the most efficient producers in the world and from accessing the state-of-the-art technology via imports of new products and machinery had to be of primary importance.

Indeed, economists Larry Westphal and Kwang Suk Kim (1982), who have diligently studied the Korean experience during the first three decades of its development and strongly believe in the efficacy of industrial policy, assign the central role to activist trade policy in stimulating growth in Korea. Thus, consider the following statement from the concluding section of their long and careful study (p. 271):

“The growth of manufactured exports over the fifteen years from 1960 to 1975 contributed to Korea’s industrial development in various ways. Export expansion was directly responsible for more than one quarter of the growth of manufactured output and for an even larger fraction of the increase in manufactured employment. In turn, the manufacturing sector has accounted for almost 40 percent of the growth in both GNP and employment. These figures understate the contribution of export growth. They do not reflect the backward linkages to domestically produced intermediate inputs, the multiplier effect resulting from increased consumption and investment resulting from additional income earned, or the increase in economic efficiency that results from exporting in accordance with a country’s comparative advantage.”

Thus, Westphal and Kim turn the Rodrik story almost on its head attributing partially the growth in investment itself to export growth and the income increase accompanying it. In a subsequent article, Westphal (1990) notes, “Korea’s industrial performance owes a great deal to the government’s promotional policies toward exports and

to its initiatives in targeting industries for development. If nothing else, policies towards exports have created an atmosphere--rare in the Third World--in which businessmen could be certain that the economic system would respond to and subsequently reward their efforts aimed at expanding and upgrading exports.” Exports were not a passive response to the import demand generated by investment boom but one of the “propellers” of the investment activity itself.

But suppose we grant Rodrik the point that it was the successful coordination of the investment decisions by the government that triggered Korea’s growth. Does this fact diminish the importance of outward-oriented trade policies that Korea pursued? In other words, what would have happened if Korea had chosen to continue raising trade barriers and moved beyond the first stage of import substitution by attempting to produce its own durable goods, raw materials used in them and machinery? After all, if import substitution works at all stages of development, as Rodrik seems to believe, domestic machinery production was an option that could have been exercised.

This is not idle speculation. During the period under consideration, India also tried to solve the investment-coordination problem through explicit investment planning. By the standards applied by Rodrik to Korea, public interventions in India were surely successful with total investment as a proportion of GDP rising from 15.7 percent in 1960-61 (India’s financial year begins April 1 and end March 31 the following year) to 22.7 percent in 1980-81. Public investment consistently accounted for more than a third of this investment. Through macroeconomic stability, policy credibility and legal institutions capable of enforcing contracts, India was successful in pushing its GDP growth rate from less than 1 percent during the first half of the 20<sup>th</sup> century to the 3-4 percent range during 1950-80. But



it came nowhere near the ultra-high growth rates experienced by Korea during the sixties and seventies principally because it opted for an increasingly protectionist trade policy regime with nearly all imports coming under strict licensing by early 1970s. By the mid-1970s, India's trade regime had become so repressive that imports (other than oil and cereals) had fallen from the already low level of 7 percent of GDP in 1957-58 to 3 percent in 1975-76. Whereas Korea recognized the importance of competing against the world's most efficient producers and the need for importing the state-of-the-art machinery from abroad, India chose to hide behind a steel wall of protection, manufacturing its own machinery (and steel!). The result was an annual *per-capita* GDP growth of 6.3 percent in Korea and 1.1 percent in India during 1961-80. Thus, Rodrik's conclusion that outward orientation of the Korean economy was merely "the result of the increase in the demand for imported capital goods" misses the important point that ultimately such openness was the result of a conscious policy choice made by the country.

Differences between the experiences of Korea and India during the first three decades of development are to be seen not just in terms of the outcome variables such as growth in trade and GDP but also policies and policy changes. Whereas Korea consciously moved away from import-substitution to outward-oriented trade regime relatively early in the game, India became progressively protectionist.

Until 1960, Korea pursued the policy of import substitution of non-durable consumer goods and their intermediate inputs. During this phase, the real exchange rate was overvalued, foreign-exchange controls were widely practiced, finished consumer goods were subject to high tariffs and the government relied progressively on quantitative import controls. In early 1960s, Korea had to choose between extending the import substitution to

intermediate and durable goods and an outward-looking strategy. It consciously opted for the latter. Korean won was devalued first in 1961 to 130 won per dollar and then in 1964 to 256 won per dollar. During 1961-65, measures such as preferential export credit for exporters, tariff and indirect domestic tax exemptions on inputs used in exports, direct tax reductions on income earned on exports, and accelerated depreciation allowances for the fixed assets of major export industries were introduced. In 1962, even an export targeting system was set up.

During 1966-78, Korea institutionalized the export-oriented strategy, complementing it with some import liberalization. The government gradually relaxed the quantitative restrictions on imports and reduced tariffs through several reforms. Moreover, it roughly maintained the real exchange rate at the 1965 level through periodic adjustments of the nominal exchange rate and/or adjustment in export subsidies.

The history of trade policy in India, documented systematically in Bhagwati and Desai (1970) and Bhagwati and Srinivasan (1975), bears a sharp contrast to that of Korea. Years 1950-56 saw some phased liberalization but a foreign exchange crisis in early 1957 put an end to it. Quantitative restrictions on imports, industrial licensing and foreign exchange controls were progressively tightened and expanded. This process continued till 1966 though some export subsidization schemes were introduced in 1962 and expanded subsequently to partially offset the discrimination against exports. Bhagwati and Srinivasan (1975) describe the regime during 1957-66 thus: “The import and exchange policy regime, throughout this period, aimed at comprehensive, direct control over foreign exchange utilization. Thus administrative decisions had to be made over the allocation of foreign

exchange for practically all uses in the economy...Reliance on the direct allocative mechanism was thus almost complete during this period.”

During 1966-68, India went through a brief liberalization episode. In June 1966, the rupee was devalued by 57.5 percent from 4.7 rupees to 7.5 rupees per dollar. The devaluation was accompanied by some liberalization of import licensing, cuts in import tariffs and export subsidies. Because the devaluation turned into a serious political liability (in part due to the widespread impression that the World Bank had forced it), the process of liberalization was quickly reversed. According to Bhagwati and Srinivasan (1975, p. 30), by 1969-70, the liberalization had been largely reversed with the import premium back to 30 to 50 percent. Almost all liberalizing initiatives were reversed and import controls tightened. This regime was consolidated and strengthened in the subsequent years and remained more or less intact until the beginning of a period of phased liberalization in the late 1970s.

### **3 Miracles and Debacles**

The experience of Korea is not unique. We now have considerable systematic evidence supporting the hypothesis that openness is a necessary condition for fast growth. Specifically, the Global Development Network Growth Database provides growth rates for approximately 200 countries over a period of 38 years from 1961 to 1999. Despite missing entries in a number of cases, the database is sufficiently comprehensive to allow a systematic analysis of the issue at hand.

Since the precise division of data over time turns out not to matter, I divide them into two equal periods: 1961-1980 and 1980-1999. For each 19-year period, I identify countries that grew at 3 percent or more in per-capita terms as “miracles” and those that

declined in per-capita terms as “debacles”. I then look at how the growth in per-capita income correlates with growth in exports and imports for miracles and debacles. Since trade is an endogenous variable and is likely to respond positively to GDP growth, this is only the first step toward establishing the necessity of outward oriented policies for sustained rapid growth. I later return to the issue of the link between trade *policies* and growth.

Table 1 shows all non-oil-exporting developing countries that grew at 3 percent or more in per-capita terms during 1961-80 in the declining order of the growth rates. Alongside, third and fourth column show annual growth rates of exports and imports. The last column shows the population of the country at the beginning of the period under consideration. The most remarkable point to note in Table 1 is that even though 1960s and 1970s are commonly identified with the import-substitution phase in developing countries, virtually all countries that grew rapidly did so while rapidly expanding their exports and imports. The countries in this group come from virtually all continents in the South including, especially, Latin America, which is often described as having led the developing world in the pursuit of import substitution. Brazil, which grew at the impressive rate of 4.6 percent, expanded its exports and imports at 8.1 and 7.6 percent, respectively, during the period. Among countries that grew at 3.6 percent or more in per-capita terms, the lowest recorded growth rate of imports was 7.2 percent for Tunisia, which grew at 4 percent in per-capita terms. Even as we go down the growth-rate column, there are only two countries that register relatively low growth rates of imports: Mauritius and Kenya with import growth of 3.8 and 3.6 percent, respectively.

In addition to arguing that openness is not necessary for growth and openness, some critics of free trade go so far as to contend that it is responsible for declining incomes. To examine this contention, Table 2 lists all countries that experienced growth debacle during 1961-80. For the purpose of the table, growth debacle is defined as a reduction in the per-capita income on a sustained basis. It is evident that the weight of evidence is hugely against trade openness being responsible for the debacles. Out of the seven debacle cases in which we have data on both growth rates of per-capita income and trade, only two show significant growth in imports. In the other cases, declines in per-capita incomes are accompanied by import growth of less than 2 percent.

This experience is repeated during the second period under study, 1980-99. Tables 3 and 4 show growth rates of per-capita incomes and trade for the miracle and debacle countries, respectively. As in Table 1, leaving aside a handful of the cases, the miracle countries in Table 3 experience very substantial growth in imports and exports. Two largest countries in the world, China and India, join the club of miracle-growth countries in this period and they both show respectable rates of growth of both exports and imports. In turn, Table 4 provides more substantial evidence that debacles are rarely accompanied by import surges. We now have as many as 65 countries in this category and in no case does the rate of growth of imports reach even 6 percent. And in many cases, it is actually negative and large in absolute terms.

If we go by the *number* of countries that grew at 3 percent or more in per-capita-income terms, performance during 1961-80 is clearly superior to that during 1980-99. As many as 33 non-oil exporting developing countries grew at this high rate during the first period compared with 26 in the second. Yet, if we go by the *population* in the

developing countries experiencing the high growth rates, it is the second period that stands out. Whereas the population of the countries growing at 3 percent or more at the beginning of the period was only 356.5 million during the first period, it was a high of 2.1 billion during the second period. Those who have chosen to characterize the 1980s and 1990s the lost decades of development have often overlooked this crucial fact.

The explanation for why the period 1980-99 has been viewed unfavorably relative to the prior two decades, especially 1960s, is that this period produced a very large number of debacles that also impacted a very substantial population of the world. Thus, during 1961-80, debacles were limited to 14 developing countries with a total population of 68.6 million at the beginning of the period. But during 1981-99, there were as many as 65 debacle countries accounting for 621.4 million people at the beginning of the period. Not only did a large number of tiny countries in Africa do poorly during this latter period, the large majority of the former Soviet republics, some with sizable populations, also joined the ranks of the debacle countries. It is the coincidence of this fact with a series of financial-flow crises in Latin America and East Asia that fueled the anti-globalization movement, victimizing liberal trade policies in the process despite the fact that trade had little to do with either of the phenomena.

#### **4 Trade Volumes versus Trade Barriers**

Before I turn to some additional, country-specific evidence, let me address an important criticism of the link between growth and openness offered by free-trade skeptics (Rodriguez and Rodrik, 1999). Observing that the cross-country-regression studies linking growth and *direct* measures of trade policy such as tariff and non-tariff

barriers offer at best weak evidence, these skeptics also reject the link between growth and openness.

For one thing, the evidence from cross-country regression studies is not as weak as critics would have us believe. Following the Rodriguez-Rodrik critique, Romain Wacziarg and Karen Welch (2002) have offered more compelling evidence linking openness and growth. Interestingly, in the first part of their paper, they themselves begin by rejecting the Sachs-Warner approach that Rodriguez and Rodrik criticize. They then construct a panel data set that allows them to exploit within and between country variations. They base their openness indicators on the date at which individual countries liberalized their import policies. In a panel of countries extending from 1950 to 1998, they find that on average, a country grows at 1.5 percent per annum higher rate in the liberalized phase than in the protected phase, controlling for country and year effects. Because trade reforms sometimes occur during periods of macroeconomic instability, the authors also experiment with excluding the three years surrounding the reform but find the results robust to this modification.

But just for the sake of argument, suppose we grant critics the point that evidence to-date does not conclusively establish a positive link between low or declining trade barriers and growth. But this is hardly sufficient to reject the case for outward-oriented policies. Once we agree that fast growth in per-capita GDP strongly correlates with fast growth in trade, the rejection of a link between low or declining trade barriers and growth in per-capita incomes is equivalent to the rejection of a link between low or declining trade barriers and growth in *trade*. Admittedly, trade barriers are not the only determinant of growth in trade. But they are hardly irrelevant to it. In the extreme case,

we cannot expect trade to grow rapidly if a country adopts autarkic or near-autarkic trade policies. The experience of India until the late 1970s, discussed earlier, is a case in point. It will be a stretch to argue that India's trade failed to grow rapidly because India's GDP failed to grow rapidly. India consciously chose to suppress the growth in trade through draconian trade-policy restrictions. Additionally, if free-trade skeptics truly believe that growth in trade is unrelated to the level of trade barriers, they should be indifferent to them. But their concern with such barriers, which sometimes goes so far as to blame their removal for economic debacles, betrays their faith in a positive correlation between trade barriers and growth in trade.

In large part, the controversy surrounding the evidence in support of the positive link between low or declining trade barriers and growth in per-capita income is the result of our inability to accurately measure the protective effect of a given set of trade barriers. Difficulties in measuring the effects of non-tariff barriers are well known. For example, the effect of import licensing depends crucially on the severity with which it is enforced. Traditionally, developing countries have not explicitly specified the quantities permitted under licensing. Instead, they stipulate conditions under which an import license can be obtained. A license may be issued depending on the desired use of the product, its proposed user, availability of like domestic products and the availability of foreign exchange. Under such a regime, even without any formal change in the policy regime, imports can be permitted in smaller or larger quantities through a more or less strict administration of the existing rules.

Even when restrictions take the form of tariffs, aggregating them into a single measure that is comparable across countries is difficult. A 15 percent uniform tariff has a



very different effect from a two-part tariff such that one half of the imports are subject to 10 percent duty and another half to 20 percent duty. Yet, when aggregated for purposes of regressions, they are both set equal to 15 percent. More dramatically, often a two-part tariff consisting of 20 and 10 percent tariff rates can have a *more* protective effect than a single 20 percent tariff rate. Thus, starting with 20 percent tariff on auto parts as well as automobiles, a reduction in the tariff on the former increases the effective protection to the latter. If domestic output of auto parts is small, this will likely result in increased overall protection in the economy. Not surprisingly, in his provocative paper “Measuring outward orientation in LDCs: Can it be done?” Pritchett (1996) finds that some of the measures of openness used in cross-country growth regressions are actually negatively correlated. This means that if one measure yielded a positive correlation between growth and trade barriers, the other one would do exactly the opposite.

Also important in assessing the impact of openness on growth is the real exchange rate. Even when countries liberalize trade but leave the real exchange rate overvalued, discrimination against traded goods remains. In this respect, the Rodriguez-Rodrik criticism of Sachs and Warner that once the black-market premium is taken out of their index, the link between openness and growth disappears is itself problematic. Black-market premium itself can be a measure of the overvaluation of the exchange rate and the resulting discrimination against traded goods and therefore arguably belongs in the openness index.

## **5 Import Substitution: Is Latin America an Exception?**

Going by the *number* of countries experiencing rapid growth, Rodrik (1999) characterizes the years 1960-73 as the golden period of growth for developing countries. Per-capita incomes in as many as 30 countries grew annually at rates equaling or exceeding

3 percent during this period. In comparison, growth rates plummeted in most developing countries during 1973-84 to 1984-94. Noting that 1960-73 was the period of import-substitution industrialization (ISI) and 1984-94 that of liberalization, Rodrik concludes that this suggests the triumph of ISI.

Much is wrong with this story. To begin with the proposition that 1960-73 defined the golden period of growth for developing countries is itself questionable. For it is based on counting the *number* of countries that grew rapidly. But most of these countries were tiny in terms of population as well as GDP. As already emphasized above, if we choose to count the number of people in the developing countries impacted by high growth, we get a different picture. With East and South Asia growing rapidly during 1980s and 1990s, one can as easily argue that it is these decades that define the golden period of growth. Indeed, if we consider developing countries as a whole, the growth rate is higher in the 1980s and 1990s than during 1960-73.

But let us set aside this qualification and consider Rodrik's case. How is ISI to be defined? Rodrik offers no definition. Nor does he make the case that the fast growing countries during 1960-73 were import substituting and doing so more vigorously than the slow-growing countries during the same period. Indeed, he does not even look at growth rates of exports and imports or trade policies. The reader must simply take him on faith that the period in question was one of ISI.

But detailed country studies conducted over the last three decades provide substantial evidence that sheds light on this issue. Two large-scale projects, one directed by Little Scitovsky and Scott (1970) at the OECD and the other by Bhagwati and Krueger (1974) at the NBER, offer detailed documentation of the success achieved by countries that

adopted outward-oriented policies and the general failure of those who did not during 1960s and early 1970s. In addition, we have the important study edited by Balassa (1982).

According to Westphal and Kim (1982), Korea's per-capita GNP at 1970 prices grew at rates 0.7, 3.6, 8.8 and 7.5 percent per annum during 1955-60, 1960-65, 1965-70 and 1970-75, respectively. Thus, the performance during the core import-substitution period, 1955-60, was not as spectacular as one might think. By 1961, Korea had already begun to move toward outward-oriented policies. A similar story holds for Singapore, which went through a truly brief import-substitution phase during 1965-67 and with relatively low protection (see Augustine Tan and Ow Chin Hock 1982) and Taiwan, which perhaps had the best performance under import substitution during 1952-60 but even then not nearly as good as under outward orientation (T. H. Lee and Kuo-Shu Liang 1982).

Perhaps *prima facie* one would expect the greatest scope for making a case in favor of import substitution in Latin America. After all, this is where much of the initial intellectual stimulus for the desirability of import-substitution policies had originated. But even here closer examination reveals a different picture than painted by Rodrik. Thus, the case of Brazil, by far the largest country on the continent and the star performer of 1960-73, fails to fit the ISI model. Its exports and imports in constant 1995 dollars grew at the impressive annual rates of 7.8 and 8.9 percent, respectively during this period. With imports rapidly substituting for domestic production and exports accounting for increasingly larger share of the GDP, *prima-facie* Brazil cannot be characterized as succeeding through import substitution.

But this is not all. Even if we consider policies rather than trade outcomes, the Brazilian growth experience during the post 1960 era fails to fit the ISI story. Thus, consider Brazil's growth rates during 1961-68, 1968-1975 and 1975-80. During 1961-68, the average growth rate was 1.6 percent followed by 8.3 and 3.5 percent, respectively, in the subsequent periods. It turns out that thoughtful trade policy specialists on Brazil describe the period 1965-73 as one of "cautious outward-looking trade policy liberalization" and 1974-80 as one of "renewed inward-looking policies." During the former period, Brazil adopted a number of policy measures aimed at integrating itself into the global economy. On the exchange-rate front, it undertook several devaluations to correct the overvaluation of the real exchange rate and later adopted the crawling peg to ensure its stability. It also introduced several export incentives to reduce the anti-export bias. Finally, it lowered the average legal tariff (including surcharges) for manufacturing from 99 to 57 percent and for agriculture from 53 to 34 percent.

This still leaves the question why Latin America failed to grow during 1980s despite substantial trade liberalization. Here we must recall the qualification that trade openness is an important necessary ingredient in the fast-growth recipe but not the only ingredient. Therefore, the debacle of 1980s in Latin America is to be attributed not to sustained import surges trade that did not happen but to macroeconomic instability that resulted from short-term capital mobility, which most Latin American countries had embraced by then. The seventies had been characterized by rising foreign debt in many Latin American countries with debt-service as a proportion of exports rising to 30 percent or more by early 1980s in many cases. On top of that came the Volcker-era interest-rate

increases in the United States, which led capital to flow out of Latin America abruptly and choked all growth potential.

But even the 1980s onward Latin America offers an example that supports the hypothesis that trade openness is necessary for growth. During the past two decades, Chile is perhaps the only major country in Latin American that has registered sustained rapid growth. Its GDP grew at the annual rates of 5.3 and 5.9 percent respectively during 1981-91 and 1991-01. During the same time periods, its exports of goods and services grew annually at 8.6 and 9 percent, respectively with the imports to GDP ratio rising from 26.8 percent in 1981 to 32.7 percent in 2001.

Like many other Latin American countries, Chile opened up its economy to trade by slashing tariffs and undertook the reforms such as privatization. What distinguished it from the former, however, was the management of macroeconomic affairs. For example, on the average, Chile had a balanced budget during 1980s and a fiscal surplus during 1990s. Moreover, this fiscal discipline was accompanied by a reduction in both government spending and taxes. The central government spending dropped to 20 percent of GDP in 1990 from 32 percent in 1985 though it has since crept up to 24 percent. Through prudent management of monetary policy, Chile also brought inflation down to 3 percent in 1999 from 21 percent in 1989. Above all, Chile has avoided financial-capital-flow crises through a credible policy regime in general and judicious use of capital controls in particular.

## **6 Additional Country Evidence: India and China**

The experience of China and India during 1980s and 1990s lends further support to the hypothesis that outward-oriented policies constitute a necessary ingredient into high-

growth performance. Starting in late 1970s, China gradually began to open its economy to both trade and foreign investment side by side with other policy measures. The results were spectacular. China's GDP grew at near double-digit rates during both 1980s and 1990s with per-capita incomes more than quadrupling over the two decades. This was accompanied by the annual growth in imports of goods and services at 10.3 percent during 1980s and 16.3 percent during 1990s. The corresponding growth rates of exports of goods and services were 12.9 and 15.2 percent.

India's experience is slightly more complicated. As I document in Panagariya (2004), the country undertook several liberalizing steps during 1980s, especially in the latter half of the decade, which allowed a more liberal flow of foreign raw materials and machinery. Expanded borrowing abroad added further to the expansion of imports and investment. The country also expanded domestic demand through fiscal stimulus supported by large deficits. This strategy allowed the country to achieve a growth rate of nearly 5.5 percent during 1980s, though it also increased foreign and domestic debt at an unsustainable rate. The result was a macroeconomic crisis in 1991 that stimulated more genuine reforms including more systematic liberalization of trade. In approximately a decade, import licensing, which had covered approximately 80 percent of the tariff lines, was entirely abolished and the highest tariff rate was brought down from 355 percent to 30 percent. The result was a growth rate of nearly 6 percent during 1990s with a rapidly declining ratio of foreign debt to GDP. Reforms being more systematic during 1990s, there appear to be no signs of a macroeconomic crisis this time around.

## 7 What do Free-trade Skeptics Recommend?

As a final point, let me note that despite their *apparent* difference of opinion, the bottom line drawn by free-trade skeptics is so close to the position taken by many pro-free-trade economists as to be virtually indistinguishable from it. Thus, in public perception, foremost among skeptical economists today is the Nobel Laureate Joseph Stiglitz. Yet a careful pro-free-trade economist finds very little in his widely publicized book *Globalization and its Discontents* (Stiglitz 2002) with which to disagree. When it comes down to putting down their ideas on the paper, skeptics end up singing the free-trade economist's song!

In his book, Stiglitz never questions the importance of liberal trade policies for development. On the contrary, he explicitly recognizes their role in all successful cases of sustained growth. His beef with free trade hovers around two propositions: trade liberalization must be gradual and rich countries need to do their part by removing trade barriers on products of interest to developing countries, especially agriculture where domestic and export subsidies further undermine the interests of developing countries.

Pro-free-trade economists have written extensively and affirmatively on both issues. Indeed, since the Kennedy Round of negotiations, gradualism has been an integral part of all liberalization under the GATT/WTO auspices. As regards liberalization in agriculture and industrial products of interest to developing countries, the problem has been recognized for decades. The lack of progress, however, has much to do with the absence of developing countries from the negotiating table until the Uruguay Round. This absence has meant that developed countries negotiated principally on products that they traded with one another. In fact, when developing countries did at last

join the negotiations in the Uruguay Round, agreement to end the import quotas in developed countries on textiles and apparel was actually reached and agriculture appeared on the liberalization agenda.

But let us return to what Stiglitz has to say about the role of liberal trade policies themselves in the process of development. On the second page of first chapter of his book appears the following statement (Stiglitz 2002, p. 4):

“Opening up to international trade has helped many countries grow far more quickly than they would otherwise have done. International trade helps economic development when a country’s exports drive its economic growth. Export-led growth was the centerpiece of the industrial policy that enriched much of Asia and left millions of people there far better off.”

This assertion is not only consistent with what the present author has said earlier in this paper but actually stronger. Stiglitz sees a causal link between growth and low or declining trade barriers and, contrary to Rodrik (1995), assigns the *central* role to the latter for the success of Asia. Later in the chapter (p. 6), he turns to one of his two central criticisms of free trade:

“The critics of globalization accuse Western countries of hypocrisy, and the critics are right. The Western countries have pushed poor countries to eliminate trade barriers, but kept up their own barriers, preventing developing countries from exporting their agricultural products and so depriving them of desperately needed export income.”

In so far as Stiglitz implies here that developing countries have now liberalized their markets and developed countries have not or that developing countries have



liberalized more than the latter, he is factually incorrect. In Bhagwati and Panagariya (2002), we have documented this fallacy systematically. But in so far as Stiglitz makes a case for more, not less, liberalization by developed countries and argues that such liberalization is beneficial to developing countries, few trade economists would have a reason to disagree with him. Where free trade economists will part company with him is if he implies here that developing countries should have chosen to keep higher trade barriers because of continuing agricultural protectionism in the rich countries. For, as Stiglitz himself concedes in the previous quotation, the countries in East Asia could successfully penetrate rich country markets despite agricultural protection because they themselves chose to be more outward oriented.

Subsequently, in Chapter 3, Stiglitz complains about the unemployment caused by trade liberalization and cites East Asian economies as having been successful because they liberalized “slowly and in a sequenced way.” Again, most trade economists recognize that trade liberalization, like any other effective policy change, leads to reallocation of resources and in the process may cause dislocation in the short run. There are generally two solutions to this problem: creation of adjustment programs and gradualism in policy change. Often developing countries lack resources for adjustment programs so that gradualism is the main option. Recent experiences of China and India suggest that gradualism can indeed allow countries to accomplish substantial liberalization relatively painlessly.

Stiglitz reiterates the gradualism theme in Chapter 7, entitled “Better Roads to the Market,” of his book. The title of this chapter is itself revealing: in so far as the ultimate destination is concerned, Stiglitz is in agreement with the mainstream economists that

countries must eventually reach a market based economy. Citing the successful cases of China and Poland, he once again makes a pitch for gradualism. Here, in so far as Poland is concerned, he is wrong to assert that the country moved gradually in the area of trade. Soon after it broke away from the Soviet Union, Poland quickly adopted a very liberal trade policy regime and proceeded in quick succession to sign a free trade area agreement with the European Union. Most developing countries have been in the business of trade liberalization much longer and have substantially more protected trade regimes than Poland today. Thus, if Poland passes the test of gradualism in trade policy, most other developing countries pass it as well.

The Stiglitz view on trade policy that emerges from a careful reading of his book is essentially applicable to other prominent free-trade skeptics. Generally speaking, serious economists critical of globalization rarely take a firm stand against free trade. Much of the discomfort of these economists with globalization derives from the injury inflicted by financial crises that followed the embrace of short-term capital mobility by Latin America and East Asia. Free trade has simply turned into an innocent victim of that discomfort.

Thus, consider a recent paper by the Harvard University economist Richard Freeman (2002) on why and how to raise labor standards around the world. In the early part of this paper, Freeman expresses deep admiration of anti-globalization demonstrators and mercilessly attacks various forms of globalization including trade liberalization. To quote him, "While orthodox policies have a certain logic inside simple Macro and Trade models, whether they are right for real economies is less clear. Cross-country evidence

shows that policy measures relating to openness such as tariffs and trade barriers have little link to growth.”

Yet, in the later part of the paper when Freeman draws up his own list of steps that may be taken to promote labor standards in the poor countries, liberal trade policies occupy a place of pride on it. “Elimination of tariffs and other barriers to LDCs, particularly in agriculture, and reduction of huge debt burdens almost certainly can create more good for more people than improved labor standards for workers in the export sector or even more broadly,” he writes.

One might still argue that skeptics do not advocate liberalization by the poor countries themselves. Instead, their recommendations are limited to the removal of trade barriers imposed against their products by rich countries. But such a position would be logically inconsistent. If skeptics believe that the removal of rich country barriers stimulates poor country exports by making the latter more profitable, they cannot simultaneously argue that poor country liberalization, which also makes their exports more profitable by lowering the relative price of import-competing goods, does not accomplish the same objective.

Indeed, if the poor country barriers are high, they are likely to fail to take advantage of even the rich country liberalization. For example, during 1960s and 1970s, while the more open Far Eastern economies took advantage of the progressive opening and expansion of the rich country markets and managed to register spectacular export growth, autarkic India failed to register rapid growth of exports as well as GDP. Symmetrically, the poor country liberalization will fail to bear fruit if their rich country

counterparts are autarkic. The poor country door must be open to let the goods out and the rich country door to let them in.

Rodrik seems to recognize at least some of the logic behind a country's own liberalization more explicitly when confronted with the choice between liberal and protectionist trade policies. Thus, in his famous critique of econometric studies linking growth and trade, written jointly with Francisco Rodriguez, he states in the last to first paragraph, "We do not want to leave the reader with the impression that we think trade protection is good for economic growth. We know of no credible evidence--at least for the post-1945 period--that suggests that trade restrictions are systematically associated with higher growth rates."

The paper goes on to conclude, "The effects of trade liberalization may be on balance beneficial on standard comparative-advantage grounds; the evidence provides no strong reason to dispute this. What we dispute is the view, increasingly common, that integration into the world economy is such a potent force for economic growth that it can effectively substitute for a development strategy." But few thoughtful trade economists consider free trade as sufficient for fast growth. On the contrary, many of them also happen to be serious development economists. As an example, the early advocacy of freer trade policy in India by Bhagwati and Desai (1970) carried many more chapters on domestic policy and institutional reforms than on the advocacy of liberal trade policies.

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Table 1: Miracles of 1961-80\*

Growth Rates				
Country	GDP per capita	Exports	Imports	Population in Million (1961)
Botswana	8.5			0.5
Malta	7.3			0.3
Singapore	7.2			1.5
Hong Kong, China	6.9	10.8	10.6	3.2
Gabon	6.6	10.6	12.1	0.5
Taiwan, China	6.4			11.0
Korea, Rep.	6.3	23.7	18.0	25.7
Lesotho	4.8	7.6	11.8	0.9
Trinidad and	4.7	3.8	9.1	0.9
Thailand	4.6	9.3	9.6	27.2
Brazil	4.6	8.1	7.6	75.0
Malaysia	4.4	6.9	7.2	8.4
Barbados	4.4			0.2
Israel	4.2	10.8	8.1	2.2
Georgia	4.1			4.2
Cote d'Ivoire	4.1	7.6	7.9	3.9
Seychelles	4.0			0.0
Tunisia	4.0	8.3	7.2	4.3
Bermuda	4.0			0.0
Ecuador	3.7	8.2	8.0	4.6
Dominican	3.6	5.6	10.6	3.3
Ireland	3.6	8.0	7.8	2.8
Egypt, Arab Rep.	3.5	5.4	8.1	26.5
Indonesia	3.5	6.5	10.2	95.9



Paraguay	3.5	3.0	10.6	1.9
Mauritius	3.5	2.4	3.8	0.7
Mexico	3.4	8.6	7.8	38.1
Panama	3.4			1.2
Belize	3.4			0.1
Togo	3.2	9.9	8.8	1.5
Fiji	3.0	7.6	7.7	0.4
Mauritania	3.0	11.3	7.7	1.0
Kenya	3.0	3.3	3.6	8.6

\*Non-oil-exporting developing countries with per-capita GDP growth rate of 3 percent or more (33 countries with a combined population of 356.5 million people in 1961).

Source: Author's calculations based on the World Bank GDN database.

Table 2: Debacles of 1961-80\*

Growth Rates					
Country		GDP per capita	Exports	Imports	Population in Million (1961)
Central African		-0.1			1.6
Zambia		-0.3	1.0	0.4	3.2
Somalia		-0.4			2.9
Madagascar		-0.4	1.2	1.8	5.5
Dominica		-0.4			0.1
Ghana		-0.4	-2.7	-3.0	7.1
Guinea-Bissau		-0.5			0.5
Niger		-0.5	3.5	7.8	3.1
Senegal		-0.6	-0.1	1.2	3.3
Iran, Islamic Rep.		-0.7			22.1
Congo, Dem. Rep.		-0.9	2.8	5.7	15.7
United Arab Emirates		-1.0			0.1
Chad		-1.9	1.4	0.8	3.1
Kuwait		-3.6			0.3

\*All developing countries with negative growth rates (14 countries with a total population of 68.6 million). Exports and imports include goods and services and are measured at constant prices.

Source: Author's calculations from the World Bank GDN databases.

Table 3: Miracles of 1980-99\*

Country	Growth Rates			Population in Million (1980)
	GDP per capita	Exports	Imports	
China	8.3	10.4	8.0	981.2
Korea, Rep.	6.6	12.9	10.5	38.1
Equatorial Guinea	6.4			0.2
Taiwan, China	6.1			17.6
Singapore	5.9			2.3
St. Kitts and Nevis	5.9	2.9	2.9	0.0
Thailand	5.5	11.9	8.0	46.7
Indonesia	4.7	2.6	3.7	148.3
Botswana	4.7			0.9
Hong Kong, China	4.5	11.0	10.8	5.0
Antigua and Barbuda	4.4	5.4	4.8	0.1
Dominica	4.2	9.1	1.8	0.1
Bhutan	4.1			0.5
Malta	4.1			0.4
Chile	3.9	7.7	5.5	11.1
Malaysia	3.9	11.1	9.6	13.8
India	3.8	8.5	6.5	687.3
St. Vincent and the Grenadines	3.7	4.4	2.6	0.1
St. Lucia	3.7	4.0	3.1	0.1
Mauritius	3.7	7.4	6.8	1.0
Grenada	3.4	6.0	3.8	0.1
Maldives	3.3			0.2
Vietnam	3.2			53.7
Sri Lanka	3.1	6.0	5.6	14.7

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Cape Verde	3.1			0.3
Pakistan	3.0	5.8	1.4	82.7

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\* Non-oil-exporting developing countries with per-capita GDP growth rate of 3 percent or more (26 countries with combined population of 2106.5 million in 1980). Exports and imports include goods and services and are measured at constant prices.

Source: Author's calculations based on the World Bank GDN database.

Table 4: Debacles of 1980-99\*

Country	Growth Rate			Population in Million (1980)
	GDP per capita	Exports	Imports	
Afghanistan	-0.1			16.0
Gambia, The	-0.1	2.7	-1.1	0.6
Estonia	-0.1			1.5
Guatemala	-0.2	1.5	3.4	6.8
Ecuador	-0.2	4.9	-1.7	8.0
Samoa	-0.2			0.2
Namibia	-0.2	2.5	2.6	1.0
El Salvador	-0.3	3.6	5.7	4.6
Latvia	-0.3			2.5
Gabon	-0.3	2.8	0.1	0.7
South Africa	-0.4	2.9	2.5	27.6
Honduras	-0.5	0.8	1.6	3.6
Bolivia	-0.5	2.7	4.3	5.4
Netherlands Antilles	-0.5			0.2
Croatia	-0.5			4.6
Togo	-0.5	-0.8	0.0	2.6
Yemen, Rep.	-0.6			8.5
Sao Tome and	-0.6			0.1
Rwanda	-0.7	-1.0	5.5	5.2
Albania	-0.7			2.7
Algeria	-0.7	3.5	-2.1	18.7
Suriname	-0.7	-5.6	-6.4	0.4
Cameroon	-0.7	4.8	4.0	8.7
Romania	-0.8			22.2

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Mali	-0.9	6.9	4.0	6.6
Somalia	-0.9			5.9
Nigeria	-0.9	0.0	-3.0	71.1
Vanuatu	-0.9			0.1
Comoros	-1.0	11.3	0.1	0.3
Lithuania	-1.0			3.4
Micronesia, Fed. Sts.	-1.0			0.1
Belarus	-1.0			9.6
Russian Federation	-1.1			139.0
Bahrain	-1.1			0.3
Burundi	-1.2	7.7	2.6	4.1
Venezuela, RB	-1.2	3.3	2.1	15.1
Uzbekistan	-1.2			16.0
Central African	-1.3			2.3
Angola	-1.4			7.0
Kuwait	-1.5			1.4
Zambia	-1.6	-0.1	-2.3	5.7
Djibouti	-1.6			0.3
Madagascar	-1.9	0.8	-1.9	8.9
Nicaragua	-1.9	2.7	3.2	2.9
Kyrgyz Republic	-1.9			3.6
Cote d'Ivoire	-1.9	2.9	0.1	8.2
Liberia	-2.0			1.9
Marshall Islands	-2.1			0.0
Armenia	-2.2			3.1
Haiti	-2.2	2.7	5.6	5.4
United Arab Emirates	-2.4			1.0
Kiribati	-2.4			0.1
Kazakhstan	-2.5			14.9

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Saudi Arabia	-2.6			9.4
Niger	-2.6	0.1	-5.1	5.6
Brunei	-2.8			0.2
Sierra Leone	-2.9	-4.8	-5.2	3.2
Moldova	-3.6			4.0
Tajikistan	-4.1			4.0
Ukraine	-4.3			50.0
Libya	-4.5			3.0
Congo, Dem. Rep.	-4.5			27.0
Georgia	-4.7			5.1
Azerbaijan	-5.1			6.2
Iraq	-9.5			13.0

\*Developing and Transition economies with negative growth rates (65 countries with combined population of 621.4 million). Exports and imports include goods and services and are measured at constant prices.

Source: Author's calculations from the World Bank GDN database.