BRIEFING PAPER

25 years 1983 2008 CUTS International

TDP 1/2008

Trade Openness: The Only Path to Sustainable Growth

Introduction

On the basis of an empirical study of rates of economic growth as well as that of exports and imports this briefing paper concludes that trade openness is a necessary condition for sustained and rapid economic growth. It is however not a sufficient condition; other favourable accompanying factors are required for sustained and rapid growth. Given the fact that trade openness is only a necessary condition, it is possible that countries which are open might also be associated with stagnation or decline in incomes. However, it is not right to blame policies relating to openness in such cases but it is necessary to look at deficiencies in other aspects of the economic and political system.

Refuting the Myths about Free Trade

Protectionists have often pointed out the cases of countries which have failed to achieve a high growth rate despite employing open economic policies. However, this is not inconsistent with openness being necessary for such growth; it simply points to the absence of other necessary companion factors such as macroeconomic stability, policy credibility and enforcement of contracts. If one or all of these factors are absent, sustained economic growth might not result despite open economic policies. Similarly, the presence of these factors will not yield sustained high growth unless there is an open trading environment.

The empirical exercise in this paper shows that rapid and sustained economic growth is almost always associated with trade openness while stagnation and declining incomes rarely result from sustained import surges. Therefore, a country making a choice between protectionism and open economic policies is likely to achieve rapid sustained economic growth in an open economy but never in a closed economy.

Protectionists also like to cite results from cross-country econometric studies which fail to establish a causal link between openness in trade and growth. It is important to note that it is only when a change in factor *A* is a sufficient condition for a change in another variable *B* that econometric studies show a causal link flowing from A to B. The relationship between trade openness and economic growth may not fall in the category of such relationships.

Moreover, panel regression studies now show results on the relationship between trade openness and economic growth that are strikingly different. A study by David Greenaway *et al.* (2002) uses panel data to conclude that liberalisation has a negative effect on growth in the short run but a positive effect in the long run. Romain Wacziarg and Karen Welch (2003) offer stronger evidence linking trade and growth. For a panel of country experiences for the period, 1950 to 1998, Wacziarg and Welch find on an average that a country grows at a rate which is 1.5 percent per annum higher in the liberalised phase than in the protected phase.

There are some cases of successful economic growth like those of India and China where initially the conditions were rather autarkic. These are again seized upon by opponents of open economic policies and proponents of protectionism. Even in these cases, after some years of growth India and China liberalised their economies, showing that the need for sustained economic growth can only be served by open economic policies.. It is important to note here that countries with large domestic markets can initially support high growth paths in spite of high trade barriers. However, after some time such markets get saturated and therefore open economic policies which permit access to foreign markets are needed.

Further, a closer look into the so-called import substitution experience of Latin America, where the intellectual stimulus for such policy originated, shows that countries like Brazil actually seem to have progressively liberalised during 1960-73 and do not seem to fit the import substituting industrialisation (ISI) model as is claimed. For example, Brazil's imports and exports grew at the rate of 7.9 and 8.9 percent during this period.

It is true that most of Latin American countries failed to grow during the 1980s despite trade liberalisation, as is alleged by its critics. This is because necessary accompanying factors were not present. This debacle was caused by macroeconomic instability resulting from short-term capital mobility. Chile is an exception as it has experienced sustained economic growth starting from the 1980s with GDP growing at an annual average rate of 5.3 and 5.9 percent during the 1980s and 1990s respectively.

With the support of
MINBUZA Ministry of Foreign Affairs, The Netherlands & DFID Department for International Development, UK

During the same periods export growth was at 8.6 and 9 percent per annum respectively. Chile was different from other Latin American economies not in its pursuit of open economic policies but in its better management of macroeconomic affairs. It had a balanced budget in the 1980s and a fiscal surplus during the 1990s.

The experiences of India and China are also instructive in this regard. China began to liberalise its economy in the late 1970s with regard to both trade and foreign investment. Imports of goods and services grew at the rate of 10.3 and 16.3 percent during 1980s and 1990s respectively. The corresponding growth rates of exports were 12.9 and 15.2 percent. The results were very encouraging with China's per capita income quadrupling over the 1980s and 1990s at an average annual growth rate of 7.1 percent per annum.

The Indian experience is slightly more complicated. There were some liberalising steps in the 1980s which allowed for a greater inflow of raw material as well as machinery from foreign countries. Expanded borrowing facilitated such inflows. Fiscal stimuli supported by large deficits were also used to expand domestic demand. The country achieved a growth rate of 5.5 percent during the 1980s but the foreign and domestic debt accumulated was unsustainable. Thus, there was a macroeconomic crisis in 1991 which led to a more systematic liberalisation of trade. Import licensing which covered 80 percent of the tariff lines was abolished and the highest tariff rate was brought down from 355 percent to 30 percent. This systematic reform led to a decline in the ratio of foreign debt to GDP and a growth rate of over six percent which has persisted till date. The experiences of China and India demonstrate the usefulness of open policies in bringing about sustained economic growth.

Other important empirical studies show a close link between openness and economic growth. J A Frankel and D Romer (1999) found that an increase of one percentage point in the openness ratio (the ratio of the sum of exports and imports to GDP) increases the level of income as well as subsequent growth by 0.5 percent. Similarly, Levine and Renelt (1992) identified a robust positive correlation between the share of investment in GDP and the growth rate of GDP as well as that between the former and the ratio of trade to GDP. In other words, trade affects GDP through investment. For low income countries export orientation helps them to overcome the barrier presented by low purchasing power in the domestic market. Moreover, there is a compulsion to maintain efficiency in the exporting sector which discourages distortionary rent seeking activities.

Critics of openness also cite examples of economies which registered high economic growth while raising barriers to trade. But even pro-free trade economists recognise that countries in an initial phase of development with low trade barriers can raise these without precluding fast growth as long as such protection remains short lived. For example, consider the positive role played by import substitution in the initial stages of development in East Asian economies such as South Korea, Taiwan and Singapore. In this stage, the imports of non-durable goods such as textiles and apparel as well as the intermediate goods used in producing them were replaced by domestic production.

Some critics also point to the role of industrial policies in the development experiences of some countries as if such a role negates the contribution of trade openness to sustained economic growth. However, they forget the complementarity between these industrial policies and policies of trade openness.

The Box given below demonstrates how openness is essential for economic growth and is crucial for building upon import substitution.

Box: Case study: South Korea and India

Rodrik challenged the importance of openness in Korea's experience during the 1960s and 1970s. According to him, the government brought about an increase in the rate of return to capital by subsidising and coordinating investment decisions. The resulting imports of new machinery led to a rise in exports. Thus, high investment facilitated high exports rather than *vice-versa.* During 1961-80, exports grew rapidly in Korea at 23.7 percent per annum. The export-to-GDP ratio climbed from 5.3 percent in 1961 to 33.1 percent in 1980. Such a dramatic growth in exports which was a departure from the previous trend rate of growth could have only been brought about by an active policy change. Irrespective of whether investment policies or those relating to openness were the prime movers behind the substantial economic growth in South Korea, it has to be accepted that such dramatic export growth must have had a positive impact on the economy at the margin because of efficiency gains from competition with efficient producers from other countries and the need to access state of the art technology in facilitating such exports.

Larry Westphal and Kwang (1982) contradict Rodrik's view and attribute a central role to export promotion policies in accelerating growth. For them export expansion was directly responsible for one quarter of the growth in manufacturing and a higher proportion of the growth in manufacturing employment.

A review of the development policy followed by India shows that India began with explicit investment planning and was able to bring about a 3-4 percent growth rate during 1950-80. But its highly protectionist policy prevented it from achieving the dramatic growth rates attained by South Korea. Both the Indian and Korean experiences corresponded to stimulation of investment by the government. The large differences in rates of economic growth between the two countries can only be attributed to the differences in their trade policies. The trade policies of these two countries reveal that after following a policy of import substitution till 1960 South Korea embarked on an export-oriented strategy which was institutionalised further after 1966. India on the other hand also followed an import substitution policy from 1957 to 1966 but shifted over only temporarily to a liberal export-oriented policy in 1966 before reverting back to an import substitution policy in 1969-70.

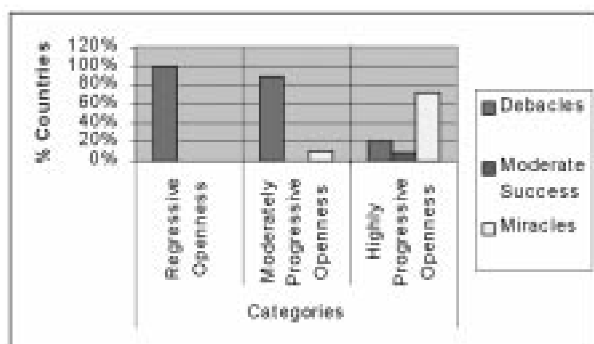
Miracles and Debacles

Panagariya (2004) labels the cases in which there is a sustained growth of over three percent per annum in per capita GDP as *Miracles* whereas others in which growth is negative are labelled as *Debacles*. Systematic evidence based on the Global Development Network (GDN) growth database supports the hypothesis that openness is a necessary condition for fast growth.

This paper pools country experiences for the period 1961-80 and 1980-99 and classifies them according to associated export and import behaviour into three categories (see Figure): a) regressive openness in which both export and import growth rates are negative; b) moderate but progressive openness in which both growth rates are below three percent but at least one is positive; and c) the rest which correspond to the highest degree of openness. For each category, it looks at the proportion of cases corresponding to negative growth rates of per capita GDP (debacles), a positive growth rate of less than three percent (moderate successes) and a rate of growth exceeding three percent (miracles). It is seen (see Figure) that given regressive openness, all the cases experienced negative per capita growth rates of GDP. For the second category - moderate but progressive openness – 90 percent of the cases were debacles and 10 percent were miracles. The last residual category, which corresponds to the greatest degree of openness in a country's economic behaviour was associated with the incidence of miracles in 70 percent of the cases and debacles in 20 percent of the cases. The absence of miracles or even moderate successes in the first category for export/import behaviour and the preponderance of miracles in the last category establish that openness in economic behaviour is important for sustained and rapid economic growth.

For the period 1981-99 there were a significant number of countries, such as tiny African countries and countries which were part of the erstwhile USSR which experienced a decline in per capita GDP. Also, Latin America and East Asian countries suffered through financial crises at the same time though this had little to do with liberal trade policies. Hence, the link between trade and growth is denied by critics on the basis that cross-country regression studies offer weak evidence for it. Though the empirical results do not support the linkage of growth and low or declining trade barriers it is also not sufficient for rejecting outward oriented policies. At best such empirical studies can be considered to be inconclusive.

Figure: Export and Import Behaviour and Economic Growth



Source: Panagariya (2004)

This inconclusiveness is obviously explained by trade not being the only determinant of growth. In many cases its positive influence might not be evident because of the violation of other necessary conditions for sustainable growth.

How Should Open Economic Policies be Used?

Even those who are skeptical about the palliative effects of free trade for the economy, such as the Nobel Laureate Joseph Stiglitz, do not advocate its rejection but call for its more careful use. Moreover, they do recognise the importance of trade for economic development. They however stipulate that liberalisation should be gradual so that dislocation caused by consequent factor reallocation is not crippling for the economy or prescribe adjustment programmes to take care of those who are dislocated. Second, they prescribed reciprocity between the rich and the poor countries in their tariff reductions so that developed and developing countries can take advantage of each other's liberalisation.

A research project on the linkages between trade, development and poverty reduction (TDP) has been undertaken by CUTS International, covering 13 countries in Asia (Bangladesh, Cambodia, China, India, Nepal, Pakistan, Sri Lanka and Vietnam) and sub-Saharan Africa (Kenya, South Africa, Tanzania, Uganda and Zambia). The findings of this project are consistent with those of Panagariya (2004) that trade is necessary but not sufficient for sustainable growth. The conditions, according to Panagariya, that need to accompany trade for it to become an engine of growth in the case of developing countries have been identified by the project. The project study highlights differing degrees of success due to differences in environment and practices associated with liberalisation. All the 13 countries were characterised by an initiation of moderate liberalisation in response to balance of payments difficulties.

By the mid-1990s large scale liberalisation was initiated with the governments maintaining their commitments to a more liberal economic regime. The liberalisation programmes in all these countries have resulted in a decline in quantitative restrictions, a diminution of import tariffs and liberalisation of foreign exchange regimes. Also, duty free imports of machinery have been facilitated and export incentive schemes have been initiated to give a boost to exports.

A large number of policy lessons have been learnt from the TDP project; for example countries which undertook reforms through domestic initiative (e.g. China Vietnam and also India where the decision to undertake reforms was influenced by the World Bank and the IMF

but the path taken was determined indigenously) have performed well. However, this has not been the case for all 13 countries. For example, the project study explored how the national priorities of Nepal were sacrificed in order to get foreign aid; the Kenyan experience demonstrates that the lack of a domestic initiative implies that various actors in the liberalisation process – the governments, the citizens and various donors – do not have a common vision for the economy. Reform processes that do not involve any domestic initiative are not only lacklustre but are also characterised by frequent interruptions and slackening of pace.

The role played by institutions towards the success of the liberalisation process is also significant as countries like China, Vietnam and India have clearly done better than other countries because of a network of well resourced institutions to monitor the process of market development. These institutions have devised strategies for investment, liberalisation and export production in addition to overseeing regulatory issues *vis-à-vis* level of competition and functioning of labour markets and customs procedures.

Many poor countries are characterised by export baskets consisting of commodities for which world demand has been inelastic. The lopsidedness of export basket composition towards these items has meant that exports have not grown. These countries need to diversify their baskets away from such primary products.

Different countries have succeeded to different extents in bring about growth through liberalisation programmes even though they have all brought down their tariffs and quantitative restrictions to almost the same level. The primary factor that distinguishes the successes and the failures, according to the TDP project, is the supply-side capacity, which is endogenous and dependant on policies. Productive capacities on the supply-side depend on a large number of factors, e.g development of skills, technological progress, savings for investment, quality of investment etc.

In order to draw the maximum returns from a liberalised regime all countries (TDP project) need to have good physical infrastructure (roads, ports, railways etc) as well as modern institutions (ports and customs procedures, duty drawback systems) as the cost disadvantages suffered due to poor infrastructure erode the comparative advantage of suppliers. Cumbersome bureaucratic procedures which distort comparative advantage should be avoided.

Differences in the strength of governance and in political and social stability are the other factors which explain the differences in the level of success of liberalisation regimes in developing countries.

Conclusion

An extensive study of country experiences shows that an open economic regime is a necessary factor for sustained and high economic growth. It is however not a sufficient factor. Openness in a country's economy needs to be accompanied by several other factors – macroeconomic stability, fiscal balance and a regime for enforcement of contracts – in order for it to result in high economic growth. A review of developing countries also shows that these countries have had very different growth experiences despite undertaking almost similar tariff reductions. The difference obviously lies in whether reforms have been adequately tailored by domestic actors or external actors to needs, the quality of infrastructure, the quality of institutions for supervising the transition to markets and the presence of supply side bottlenecks such as poor human capital and low savings. It is true that certain policies of import substitution have resulted temporarily in high growth; however, the associated countries have had to resort to opening up their economies in order to sustain such growth.

This briefing paper is based on a much longer paper by Arvind Panagariya entitled "Miracles and Debacles: In Defense of Trade Openness" published in World Economy, Blackwell Publishing, Vol. 27(8), pp.1149-1171 and the Linkages between Trade, Development and Poverty Reduction (TDP) study by CUTS. It has been compiled by Siddhartha Mitra and Ravikiran Naik of CUTS International.

© CUTS International 2008. This **Briefing Paper** is published by CUTS Centre for International Trade, Economics & Environment (CUTS CITEE), D-217, Bhaskar Marg, Bani Park, Jaipur 302 016, India. Ph: 91.141.228 2821, Fx: 91.141.228 2485, E-mail: citee@cuts.org, Web Site: www.cuts-international.org/www.cuts-citee.org. CUTS Briefing Papers are to inform, educate and provoke debate on specific issues. Readers are encouraged to quote or reproduce material from this paper for their own use, but CUTS International requests due acknowledgement and a copy of the publication.