



Lessons from the Literature

The literature generated by the debate on the effect of trade and related policies on country economic performance concludes that although trade offers long-term benefits for developing countries, trade liberalization alone is not sufficient for economic growth.

Rather, it has become clear that maximizing trade and welfare outcomes depends on the underlying macroeconomic environment, policies for export development, the design and sequencing of trade policies, external constraints and opportunities, and complementary policies that contribute to the overall investment climate. These factors in the outcome of trade liberalization, together with a summary of the lessons from previous IEG assessments, are the subject of this chapter. The objective is to provide context for the evaluation of the Bank's approach to trade.¹ The chapter partly draws on Oyejide (2004) and the literature survey in Appendix B1.

Trade Policy Reform and Economic Growth

The first multi-country studies of developing countries' trade regimes (Little, Scitovsky, and Scott 1970; Balassa and Associates 1982; and an influential study done by the NBER and summarized in Bhagwati 1978 and Krueger 1978) systematically detailed the inefficiencies of the import-substituting development strategies that prevailed throughout the developing

world. The studies were influential in promoting export orientation as a path to more rapid economic growth.²

Despite the potential benefits from trade, policies related to trade liberalization remain controversial in some circles.³ First, critics assert that these policies led to instances of liberalization that proceeded too rapidly, resulting in severe transitional costs of adjustment reflected in increased poverty, deindustrialization, and job loss.

A second criticism revolves around design issues. Critics argue that the Bank recommends the same programs for all countries, taking too little account of differing country circumstances. They also assert that the Bank emphasizes "import liberalization" at the expense of "export promotion," despite evidence from the East Asian countries that promoted export growth before general import

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Despite the expected benefits, trade liberalization is often controversial.

Process may differ from textbook theory. liberalization by using duty drawbacks and preferential exchange rate schemes.

Third, in contrast to the “first best” world that underpins trade theory, the “real” world has several deviations that are likely to influence the outcome of unilateral trade liberalization. Protectionism in industrial and other developing countries, the rise of regionalism, and unanticipated political events are just three factors that can result in unanticipated outcomes. Therefore, some observers have criticized the Bank for not taking these factors into account.

The expected benefits from trade may not be fully realized in the short run for several reasons:

- Inappropriate macroeconomic policies, such as incomplete stabilization, resulting in contractionary fiscal or monetary policies that squeeze out credit from the private sector and reduce the entry of new firms, or lead to appreciation of the real exchange rate, thereby reducing competitiveness
- Missing complementary (so-called “behind-the-border”) policies and institutions to support faster export growth, such as customs, rule of law, quality and standards, and trade logistics⁴
- Insufficient or inadequate skills and capital to take advantage of emerging opportunities that arise from the liberalization
- External constraints such as market access.

Beyond these points on imperfect trade liberalizations, there are questions about the link between trade reform and economic growth. The econometric evidence on the links between trade reform, economic growth, and trade performance remains mixed.⁵ It has proven difficult to use the cross-sectional approach to establish causality and to identify the role of

The econometric links between trade reform and growth are often inconclusive. other intervening factors such as geography and institutional elements. In particular, the verdict is still out on the relative importance of each factor.

Researchers continue to extend existing methodologies to explore the links between trade reform and growth. They have focused on refining the measurement of “openness” and on incorporating additional economic variables that influence whether trade liberalization results in accelerated economic growth, and, if so, the extent of this influence. By identifying the years when non-reversed trade liberalization programs were launched and using panel regression techniques, Wacziarg and Welch (2003) find that, on average, growth, investment, and openness increase after trade liberalization.

Others have focused on the role of additional country-specific factors, such as institutions (Rodrik, Subramanian, and Trebbi 2004; Freund and Bolaky 2004) and complementary factors (Chang, Kaltani, and Loayza 2005).

The new growth theory predicts that openness to trade (and investment) increases access to new technology; enhances efficiency by making market structures more competitive, allowing the exploitation of economies of scale; and by spurring innovation. In a study of 93 countries, Edwards (1998) finds that total factor productivity growth is faster in more open economies. Subsequent work in this area has supported this finding (Tybout 2003; Choi and Harrigan 2003; Amiti and Konings 2005). De Melo (2005) documents how the Bank’s research in this area has contributed to establishing the microeconomic channels at the firm and sector levels through which trade openness contributes to economic growth.

Building on enterprise and census surveys in manufacturing, Bank research contributed to establishing the beneficial impact of “import discipline” on pricing and productivity gains. More recently, De Melo notes that Bank industry studies have complemented firm-level studies by establishing the links among a variety of factors (research and development embodied in trade, foreign direct investment [FDI], and product variety) and productivity growth.

Despite differences of opinion among econometricians on the causal relationship between trade reform and economic growth,

there are areas of common ground. Few, if any, countries have grown rapidly and reduced poverty by following a long-term autarkic approach. As noted in Panagariya (2004), neither Rodrik (1999) nor Stiglitz (2002), critics of the Bank's approach to trade liberalization, dispute the benefits countries can gain by opening up their economies. Researchers on both sides of the issue also increasingly agree on the importance of country specificity and of institutions in disentangling the policies that affect trade and growth.

Table 2.1 (and Appendix B1) summarizes the main lessons from the literature on the impact of the underlying macroeconomic environment, policies for export development, the design and sequencing of trade policies, external constraints and opportunities, and complementary policies on trade outcomes.

Lessons from Past IEG Evaluations

Previous IEG trade-related evaluations focused on agriculture (IEG 1996a), industrial sector and policies (IEG 1991b, 1995), aspects of trade adjustment lending (IEG 1991a, 1992a), social impact of lending (IEG 1997, 1999), and trade infrastructure (IEG 1996b).⁶ These are summarized in Appendix B2.

The main trade-related conclusions and recommendations of those studies were:

- The Bank paid inadequate attention to the

role of selective promotion in export development. It would be useful to increase support for technology development, improved information about market opportunities for exports, and labor training.

- Reduce trade conditionality to a few key variables that would be easy to monitor.
- Achieve macroeconomic stabilization before trade liberalization and better coordinate tax and trade reforms (stronger conclusion than the literature).
- Greater internal competition is needed to prevent deregulation from becoming anti-competitive.
- Identify population groups negatively affected by trade reforms and use well-targeted relief measures for losers.
- Strengthen the links between poverty and macroeconomic policies, such as trade and exchange rate policy, in poverty assessments.

With respect to design, there is consensus on the role of macro, exchange rate, and complementary policies, but less agreement on the role of selective and industrial policies.

Findings from previous OED ratings of trade-related activities are largely consistent with the literature, but place stronger emphasis on macro stabilization as a prerequisite.

Table 2.1: Summary of Policy Design Issues

Policy / issue	Literature
Macroeconomic Environment and Trade Policy Reform	
Macro stabilization	Necessary to have significant effects on resource allocation. Literature less clear on whether trade policy reform should be implemented after macroeconomic stability has been achieved or whether it should proceed simultaneously (Dean, Desai, and Riedel 1994).
Real exchange rate	Strong consensus on relevance; perhaps single most important variable (Williamson 1997). Considerable empirical evidence shows real exchange rate misalignment detrimental to export growth, and that real exchange rate variability and uncertainty associated with negative effects on export performance (Diaz-Alejandro 1984; Paredes 1988; Caballero and Corbo 1989).
Timing of foreign exchange liberalization	For countries with overvalued currencies, the first step in the adjustment process has typically been a sustained real devaluation, which enables the real exchange rate to be held stable before implementing any trade liberalization.
Policies for Export Development	
Compensatory measures designed to offset any inherent anti-export bias in a trade regime	Effectiveness of these incentives—and other industrial policy measures—continues to be debated (Pack 2000). Successes noted in East Asia; export processing zones have been effective in Madagascar, Mauritius, and Mexico; temporary subsidies stimulated the growth of nontraditional exports in Chile.
Additional incentives meant to address specific problems that exports face	Changes in the economic environment and in the international “rules of the game” mean more constraints using these compensatory measures (Lall 2004). These constraints not necessarily overwhelming (Amsden and Hikino 2000; Chang 2004).
Design, Sequence, and Duration of Trade Policy Reform	
Components of the trade reform package and the sequence in which the various elements should be reformed	The literature is relatively clear on the components and sequence of actions on the import and export sides. Imports: eliminate quantitative restrictions first. Exports: Remove export licensing and bans at the same time as restrictions on imported inputs used by exporters. Next, export taxes and other export incentives.
How long it should take to complete trade reform?	Evidence on the intensity of reform (strong or moderated) and its speed (sudden or gradual) is less conclusive, with more recent literature discounting political economy benefits of speed (credibility, signaling) in favor of gradualism to reduce adjustment costs (Winters 2000), from competing interest groups (Collier, Greenaway, and Gunning 1997).
External Constraints and Opportunities	
Role of multilateral negotiations/system	Mixed; in theory more equal playing field but empirical evidence scant and mixed (Rose 2004; Subramanian and Wei 2003) and rising bilateralism poses a challenge.
Market access in Organisation for Economic Co-operation and Development countries	External market constraints may cause problems for developing countries that adopt outward-oriented trade strategies (Cline 1989; Ghosh 1992). Preferential market access has helped some developing countries to take advantage of export opportunities in preference-giving countries. But the schemes have not fully eliminated the trade barriers faced. Remedies include duty-free and quota-free market access to all exports of low-income and small countries (Hoekman and others 2003). Poorest countries must first be assisted to address their export supply capacity constraints through increased investment in infrastructure and skills (Helleiner 2002a).
Complementary and mitigating measures	Limited empirical evidence is inconclusive and it is difficult to make broad generalizations. Papageorgiou and others (1991) and Matusz and Tarr (1999) suggest that the costs of trade policy reforms are small, even in the short term. More recent studies that focus on least-developed countries (such as Oyejide, Ndulu, and Gunning 1999) show that short-term costs constitute realistic concerns. Winters (2000) concludes: More protected sectors likely to have greater transitional costs, may also offer the largest long-run returns to reform; if labor market is exposed to large shocks emanating from policy reforms that render it dysfunctional, transitional unemployment may be larger in volume and longer in duration; and rapid or concentrated reforms more likely to generate transitional losses through unemployment than more diffuse reforms.

Source: Appendix B1.