# Recent decades have witnessed an acceleration of economic globalization, in particular international trade. Is trade openness the key strategy to achieve economic development?

# What lessons could you draw for policymaking?

# Support your arguments with economic theory and empirical evidence from developing countries.

## Abstract

Applying the theories of Competitive Advantage and Factor-Proportion, we find that trade openness and liberalization drives positive economic growth and development at large by allowing each country to specialize in the commodity that costs it the least and brings it advantages to trade in that commodity. Key finding of the paper suggest that trade openness has led to poverty alleviation as well as reduction in child labour, both of which are important determinants of economic growth. The findings of the paper are then analyzed to deduce significant lessons for policy making. These primarily include the fact that trade openness is perhaps not the 'only' factor that drives economic growth. There are others, as identified by Apoteker & Crozet (2003), such as non-gender biased education, improved infrastructures, government intervention, and more credible and reliable political institutions, which play a vital role in achieving economic maturity for any given country. However, trade openness remains the key to economic development, given the widespread wave of economic globalization.

## Content

## Section 1: Introduction

Globalization is a phenomenon that basically refers to the ever-increasing speed of telecommunications and transportation links across the planet, because of which information is able to travel within seconds, from one corner of the planet to the other (Waters, 1995: 67). It is therefore defined in terms of increased trade openness and penetration of foreign direct investment (FDI).

"Globalization is not strictly an economic phenomenon: Social, cultural, and political convergence, such as the formation of international institutions (i.e., the World Bank or United Nations), has played an important role in fostering global interdependence." (Gascon, 2007, pp1)

This globalization has directly led to a significant increase in international trade through major boost to the exports activity worldwide, which has its roots engraved in the international trade agreements. After much debate, discussion and reciprocation, international trade increased with the signing of the General Agreement on Trade and Tariffs (GATT) in 1948, because of which trade barriers and tariffs were reduced on a major scale. This was preceded by the World Trade Organization (WTO) in 1995. Currently, WTO has 153 members. Both protectionist and trade liberalization perspectives have their own merits and demerits. With the signing of the WTO, its members agreed that the merits of trade openness weigh more than those of protectionism (Jose, Garcia & Coque, 2003).

"The underlying idea of the WTO is to strengthen the institutional framework of international trade relations. The birth of the WTO is testimony to the commitment of its members to create a more open, regulated and multilateral trading system.' (Jose, Garcia & Coque, 2003, pp 11)

The relationship between trade openness and economic growth has long been a subject of controversy and much debate. Liberal analysts suggest that trade liberalization leads to improved overall economic performance, whereas some economists argue that protectionism may promote faster growth. This paper is an attempt to find theoretical as well as empirical evidence to support the former argument and analyze the premise that trade openness is indeed the key to economic development, given the economic globalization through international trade.

## Section 2: Theories of International Trade

### 2.1 Theory of Competitive Advantage

Trade openness allows countries to trade freely across borders, particularly from where they can reduce their cost of production. According to Ricardo's Theory of Competitive Advantage, a country is said to have comparative advantage over the other if it opportunity cost of manufacturing a given product is lower than the other country. Given this advantage, both the countries can increase their possibilities from consumption by specializing on the commodities they make at a lower cost, and trade them. This means, trade openness allows the world economies to exploit comparative advantage where possible and achieve better economic growth (Jose, Garcia & Coque, 2003).

Thirwall (2000) further elaborates that countries tend to reap welfare gains through specializing in the production of those goods in which they have the lowest opportunity cost, and trading the surplus of production over domestic demand. This premise lies on the basic assumptions of perfect competition and complete utilization of resources.

### 2.2 Factor- Proportion Theory

The Factor-Proportion Theory, also known as the Hecksche-Ohlin Model, goes a step further than the theory of comparative advantages, primarily counting on the assumption that according to the Ricardian model, comparative advantages only arise due to international differences in labor productivity. However, in the real world, international trade also reflects differences in the countries' resources: these include factors of production other than labour, namely, land, capital, mineral resources, etc. according to this theory, countries tend to export goods that are intensive in the factors that are abundant in those countries. For example, if a country is abundant in land, then the theory implies that it will specialize in agricultural products which use land intensively (Jose, Garcia & Coque, 2003).

According to Manteu (2008), the second proposition emerging from the Hecksche-Ohlin model is the Stolper-Samuelson theorem. This basically illustrates who wins and who loses when a given country opens up to trade. It states that when the relative price of a particular good falls, the real return to the factor used intensively in its production will also fall. Therefore, under the assumptions of trade liberalization, the factor that is relatively abundant tends to gain, and the factor relatively scarce tends to lose.

## 2.3 How Trade Openness leads to Economic Growth

The economic case for an open trading system based on multilaterally agreed rules is simple enough and rests largely on commercial common sense. However, it is also supported by evidence: for example, the experience of world trade and economic growth since the Second World War. "Tariffs on industrial products have fallen steeply and now average less than 5% in industrial countries. During the first 25 years after the war, world economic growth averaged about 5% per year, a high rate that was partly the result of lower trade barriers. World trade grew even faster, averaging about 8% during the period." (Rivera & Oliva, 2004, p.78.) The data show a definite statistical link between freer trade and economic growth. In other words, liberal trade policies – policies that allow the unrestricted flow of goods and services – sharpen competition, motivate innovation and breed success.

There have been economists who advocate that protectionism, and not trade liberalization, is the driver for economic growth. Grossman and Helpman (1991) argue that protection has the ability to enhance the long-run economic growth provided the government intervention in trade encourages domestic investment along the lines of comparative advantage. Similarly, Batra (1992), Batra and Slottje (1993) and Leamer (1995) have gone a step further to suggest that free trade can be a primary source of economic downturn. Their stance is that trade liberalization and trade openness directly reduce tariffs, which makes imports more attractive than domestic production. Hence, the domestic economy may suffer a loss due o trade openness, in the long run, as opposed to economic wellbeing.

On other hand, international trade due to globalization is seen as the engine of growth by many economists. Scitovsky (1954) has studied that exports produce positive externalities whose favourable impact is particularly significant in the economic development. Krueger (1978) argues that openness exposes countries to the most advanced and novel ideas and methods of production dictated by international competitive behaviour which in turn it enhances efficiency and competitiveness. They also suggest that open economies tend to overcome the small size of their domestic market and reap in the process the cost advantage of increasing returns to scale. Hence, the argument in support of trade openness as a key to economic growth remains stable and sound.

According to Apoteker & Crozet (2003), trade openness and liberalization have the potential to put forward a number of key benefits for economic development at large. One, they allow the economy to gain from specialization in the products in which the country has a comparative advantage. Secondly, it increases the competitiveness of the country in terms of innovation and efficient production. Thirdly, greater variety of goods is available to the consumers, which ultimately leads to increasing the consumer surplus as well as consumer satisfaction. Fourth, trade openness makes sure that the country adopts sound economic policies and thus becomes an attractive destination for the investors. All the above factors taken together help foster greater economic growth.

## Section 3: Empirical Evidence from Developing Countries

### 3.1 Trade Openness and Growth

Winters (2000, cited in Edmond, 2003) summarizes field studies on trade liberalization and poverty in Africa (Zambia and Zimbabwe) and South Asia (Bangladesh and India). The Zambian study found that following domestic deregulation of cash crop purchasing, the poor suffered as functioning markets disappeared and private markets did not develop in some areas, while contrasting effects were found in Zimbabwe. (Edmonds, 2003, p.86.) He then elaborates that in the two South Asian countries, labour market segmentation prevented the benefits of

liberalization from spreading widely, and trade liberalization had uneven effects within households. In addition, a study of the first-round effects of trade liberalization in Nicaragua finds that while the fall in the price of agricultural products negatively affects poor producers, this is offset by the income effect of a decline in consumer goods prices (Kruger, 2000, cited in Edmonds, 2003). However, the study advocates that trade liberalization is not the 'only' factor that contributes to economic growth, although it remains a significant one.

In addition, the case of Vietnam provides a significant example to study empirical evidence if trade openness does really benefit poverty alleviation. In the 1990s, Vietnam was one of the fast growing economies in the world, and at the same time, the level of institutions and policies in the country was poor compared to other emerging market economies. "These two, apparently discordant facts can be reconciled within the framework of modern growth theory and evidence" (Dollar, 2002, p.15). The key to the apparent anomaly lies in Vietnam's initial conditions in the mid-1980s. The country has a good location and efficient human resources. However, in the mid-1980s, it has very bad economic policies that translated into an extremely low per capita income. Starting from such a base, a modest set of initial reforms had a large impact and generated a very high growth rate. The initial reforms were also quite feasible for a low-income country. They involved macroeconomic policy changes, such as price liberalization, devaluation, trade liberalization, and interest rate increases; this illustrates that trade liberalization is not the 'only' success factor for economic growth. The result was that trade liberalization is estimated to account for an increase in the growth rate of 1.3 percentage points. Similarly, the poverty headcount rate (based on a 2000 calorie poverty line) declined from 75% of the population in 1988, to 58% in 1993, and then to 37% in 1998. Poverty was cut half in a decade.

**E**dwards (1998) used comparative data for 93 countries to study the extent of relationship between trade openness and total factor productivity (TFP) growth. A total of nine indexes of trade policy were used to study the relationship between the two variables for the ten-year period1980-1990. Among these nine indexes, three were related to trade openness, for which a higher value was indicative of a lower degree of policy intervention in international trade. The remaining six indexes were related to trade distortions, for which higher values were indicative

of a higher inclination towards protectionism. The regression results showed that trade openness indexes were positively significant whereas trade distortion indexes were significant with negative signs. This relationship, Edwards (1998) stated, suggested that more open countries will tend to experience faster productivity growth than more protectionist countries. Hence, trade openness turned out to be a driver for economic growth according to his empirical analysis.

## 3.2 Trade Openness and Poverty Alleviation

Bannister and Thugge (2001) mention five important links between trade openness and poverty alleviation. "Trade liberalization can affect the welfare of the poor through a number of channels: by changing the prices of tradable goods (that is, lowering prices of imports for poor consumers and producers, increasing prices of exports for poor producers), and improving access to new products; by changing the relative price of factors (skilled and unskilled labour and capital) used in the production of tradable goods and affecting the income and employment of the poor; by affecting government revenue from trade taxes and thus the government's ability to finance programs for the poor; by changing incentives for investment and innovation and affecting economic growth; and, by affecting the vulnerability of an economy (or subgroups within the economy) to negative external shocks that could affect the poor. Because of their general equilibrium nature, these channels of transmission are interdependent and subject to influence from many other types of policies and economic events. In addition, some of these effects take place immediately and others work only over longer periods. This makes the link between trade liberalization and poverty extremely complex, and thus drawing generalizations about these links very difficult." (Bannister & Thugge, 2001, p.6.)

Viewing trade reform broadly as including any accompanying domestic market liberalization, Winters (2000, cited in Edmond, 2003) suggests that the following factors matter: creation or destruction of markets where the poor participate; intra-household effects; intensity of factors of production in most affected sectors, and their elasticity of supply; the effect on taxes paid by the poor and government revenue; and whether transitional unemployment will be concentrated on the poor. In addition, trade liberalization can affect poverty through incentives

for investment, innovation, and growth, as well as by influencing the economy's vulnerability to negative external shocks that could affect the poor.

## 3.3 Trade Openness and Reduction in Child Labour

According to Neumayer and de Soysa (2005), if the less developed countries are abundant in unskilled labour, then trade openness is likely to increase the relative return to this unskilled labour, which consequently reduces the incentive to invest in education and skills. Hence the returns to child labour increases and so does the supply of child labour. However, they further study that trade openness will have both a substitution and income effect; given the basic assumption that trade openness increases the relative return of the unskilled labour. According to the income effect, trade openness will lead to increased income which will in turn increase the incentive of parents to send children to school and hence decreased child labour. According to the substitution effect: such economies will substitute away from unskilled toward higher skilled labour in the long run, which will again increase the incentive to invest in education and thereby reduce the incidence of child labour. Neumayer and de Soyosa (2005) also conclude that more open economies are more likely to observe two basic trends: one, they have lower interest rates and better access to credit, which lowers the cost of education. Secondly, they are less likely to preserve social norms and/or traditions which promote child labour. Both the trends again support the negative relationship between trade openness and incidence of child labour.

Their empirical analysis comprises of cross-sectional data for developing countries for the year 1995. The Labour force participation rate of children aged 10-14 years old was taken as the dependant variable, whereas the independent variables included factors such as GDP per capita, incidence of child labour in rural and urban areas taken separately, sum of imports and exports to GDP (as a measure of trade openness) and FDI to GDP ratio, etc. The empirical results showed that GDP per capita, FDI to GDP ratio, and trade openness had significantly negative effect on child labour. The conclusion to be drawn from the study conducted by Neumayer and de Soysa (2005) suggests that more open to trade economies and countries hosting more FDI have lower incidence of child labour.

## Section 4: Factors that Impair the Effects of Trade Openness

Apoteker & Crozet (2003) discuss that trade openness can be harmful for the economic development at times. According to their findings, there are primarily five reasons why this can happen. Firstly, since all products do have the same fluidity and there are hindrances such as distance, transportation cost and home country bias, all of which make trade liberalization a failure. Secondly, since many countries with similar resources participate in international trade, they simultaneously bring in their same comparative advantage on the market. This tends to create an excess supply of that product and its world price will decrease, thus harming all the providers. Thirdly, instability as per regards financial volatility is another glaring concern of trade openness. This means that in a country which lacks political credibility or monetary strength, capital mobility due to trade liberalization can result in economic policies backlash, which in turn will render the fiscal or monetary tools of the country useless, thereby creating domestic economic problems.

On the other extreme, there are empirical studies conducted on the strength of relationship between trade barriers and economic growth. Yanikkaya (2003) studies that one of the possible explanations for this positive relationship is that if trade barriers' cause a reallocation of productive resources to the goods in which a country has comparative advantage from the goods in which a country has no advantage, then tariffs are likely to affect growth positively' (Yanikkaya, 2003, pp 77). Furthermore, he studies that if higher trade barrier, in the form of tariff, cause a shift of resources towards sectors that have relatively higher positive externalities, then this can also trigger positive growth effects for the economy. Using statistical evidence to illustrate this premise, take the example of East Asian, African and Latin American countries. The trade shares in GDP from 1970 through 1997 for these countries were 93%, 63%, and 61%, respectively. However, average tariffs for the same period, average tariff rates for them were 11%, 18%, and 10%, respectively. Furthermore, East Asian economies are as protective as Latin American economies that have actually supported import substitution policies for majority of the period examined in this study.

## Section 5: Lessons for Policy Making

"Liberalization is supposed to move resources- labour in particular- from low productivity uses into higher productivity uses. But if markets are not working well- perhaps because interest rates are so high that investment does not occur – then resources idled because of competition from imports simply move from low productivity uses into unemployment." (Stiglitz, 2005, pp 244-245)

The above premise states an important point: if markets fail, then there is the need for government intervention so as to not hamper economic growth of a given country. Stiglitz (2005) discusses the case of India, who witnessed robust economic growth since 1991, since it began liberalizing, with an average growth rate of 6% per year. However, the critics argue that, one, India did not liberalize fully; two, its growth actually began way before its strategy for liberalization was implemented; and three, the hub of economic and technological growth, the Silicon Valley in Bangalore, was not related to its liberalization strategy.

Taking the discussion forward from the above point, government intervention is perhaps a sensible bailout strategy when markets fail. An impressive example of trade openness translating into economic growth is perhaps China. Since 1990, China's trade in goods and services as a percentage of GDP has increased from 32% to 66% while its Human Development index (HDI) has increased from 0.627 to 0.755 (Rodrik, 2006). However, this growth is not entirely attributable to trade openness alone. Instead there are other factors which play a crucial role in the economic growth and development of China, namely, the country's industrial strategy and government intervention. According to Stiglitz (2005), when there is a market externality such as contagion, then government intervention is an ideal policy to tackle this financial crisis and improve matters. For example, if short-term capital flows are a glaring cause of the contagion, then government can perhaps regulate these flows and help solve the problem.

A research project on the relationships between trade openness, economic development and poverty reduction (TDP) was undertaken by CUTS International, covering 13 countries in Asia and sub-Saharan Africa: Bangladesh, Cambodia, China, India, Nepal, Pakistan, Sri Lanka,

Vietnam, Kenya, South Africa, Tanzania, Uganda and Zambia. The findings of this research were evidently consistent with those of Panagariya (2004), advocating in the favour of free trade which is necessary but not sufficient for sustainable growth (CUTS, 2008). The liberalization programmers in all the countries mentioned above "resulted in a decline in quantitative restrictions, a diminution of import tariffs and liberalization 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" (CUTS, 2008).

A number of policy lessons can be drawn from this study by CUTS International and the findings of Panagariya (2004). Firstly, the primary factor that distinguishes the successes and the failures amongst the economies studied, according to the TDP project, is the "supply-side capacity, which is endogenous and dependant on trade 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" (CUTS, 2008). Secondly, TDP Project's results indicate that in order to reap the maximum returns from trade openness, all countries need to have good physical infrastructure as well as modern institutions. This is important because the cost disadvantages suffered due to poor infrastructure erode the comparative advantage of suppliers. Hence, bureaucratic procedures which somehow distort comparative advantage should be avoided while devising trade policies (CUTS, 2008).

Thirdly, Stiglitz (2005) discusses that when tariffs and quotas are cut down, the world price for a given commodity becomes equal to the domestic price. This means that the home suppliers become more competitive and the buyers will ultimately benefit from lower prices. As a result of both prices being equal, the room for quality improvements is increased. This implies that the domestic producers will tend to improve their quality since they are now competing in an international market. Coupling both the above mentioned ideas, due to reduced government support through subsidies, the 'holding' phenomenon will tend to reduce which means less of economic crises. Hence trade openness becomes the key to economic development.

## Section 6: Conclusion

With the signing of the WTO, its members agreed that the merits of trade openness weigh more than those of protectionism. Closed economies obviously need safety nets as well, since households are subject to shocks from business cycles, technological change, weather and disease. To the extent that trade openness raises national income, it strengthens the fiscal ability of a society to provide these safety nets.

Trade openness increases imports for a given country which increases efficiency and reduces costs. Exposure to international competition forces the domestic industries to become more efficient and competitive. This in turn reduces the costs for consumers as well.

The fact the increased trade generally goes hand-in-hand with more rapid growth and no systematic change in household income distribution, means that increased trade generally goes hand-in-hand with improvements in well-being of the poor. While trade openness is not the only factor accredited to promote economic growth and development, it indeed is a prominent one. There are others, as identified by Apoteker & Crozet (2003), such as non-gender biased education, improved infrastructures, and more credible and reliable political institutions, which play a vital role in achieving economic maturity for any given country. However, trade openness remains an important, however not the only factor, to economic development, given the widespread wave of economic globalization.

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