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### Trade Liberalisation and the Poverty of Nations: A Review Article

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Crawford School of Economics and Government  
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# Trade Liberalisation and The Poverty of Nations: A Review Article

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*Abstract:* This paper aims to contribute to the contemporary policy debate on the role of trade policy reforms in economic development and poverty reduction in developing countries through a review of *Trade Liberalisation and The Poverty of Nations* by A.P. Thirlwall and Penelope Pacheco-Lopez (Cheltenham, UK: Edward Elgar). It begins with a chapter-by-chapter summary of the book while emphasising the main strengths and novel contributions. This is followed by an evaluation of the key inferences in the context of an interpretative survey of the related literature.

*JEL Classification:* O19, O24, O50.

*Key words:* trade policy, globalisation, poverty

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## Trade Liberalisation and The Poverty of Nations: A Review Article\*

The role of trade policy reforms in economic development and poverty reduction in developing countries has long been a subject of controversy. In the 1950s and 1960s there was a broad consensus that the basic strategy for development should be based on import substitution– the promotion of industries oriented toward the domestic market by using import restrictions to encourage the replacement of imported manufactures. The period from about the late 1960s witnessed a decisive shift in development thinking and policy away from import substitution and in favour of outward-orientated (or export-promotion) strategy. This policy advocacy soon became an integral part of aid conditionality of the World Bank and the International Monetary Fund (IMF) and the major bilateral donors. Reflecting this new ideological orientation (popularly known as ‘the Washington Consensus’), coupled with the influence of aid conditionality, trade liberalisation became the linchpin of policy reforms in many countries around the world. The past two decades have, however, seen the emergence of a strong revisionist school of thought in response to the lack-luster outcome of Washington-consensus reforms. The revisionists do accept that the old-style import substitution strategy bordering on autarchy has outlived its usefulness and growth prospects for developing countries can be greatly enhanced through integration into the global economy. But they argue that trade can help achieve self-sustained growth with poverty alleviation only through cautious liberalisation combined with the right kind of government action to make ‘openness work’.

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\* I am grateful to Jonathan Atkins for comments and suggestions.

*Trade Liberalisation and The Poverty of Nations* (henceforth TLPN) by A.P. Thirlwall and Penelope Pacheco-Lopez (Cheltenham, UK: Edward Elgar) is a welcome addition to the literature dealing with this debate. Based on a meticulous survey of the vast literature on the theory and practice of trade liberalisation, it makes a compelling call for a development-centred approach to trade, rather than a trade-centred approach to development. The key message of the book is that, from a development perspective, ‘the policy choice is not between autarchy and free trade but the sensible management of trade: to achieve a balance between growth of exports and imports so as to avoid balance of payments deficits; to allow economic space ... to identify and encourage new areas of comparative advantage; to enable the State to intervene to promote ‘self-discovery’; and to allow a judicious mix of tariffs and subsidies to infant industry protection’ (p. xiv).

The purpose of this article is to assess the contribution of TLPN to the debate on policy reforms in developing countries by examining its key inferences in the light of the mainstream counter arguments. It is organized as follows. Section 2 provides a chapter-by-chapter summary of the book while emphasising the main strengths and novel contributions. Section 3, which is the core of the article, offers a critique. The final section provides some concluding comments.

## **The Book**

TLPN is structured in five chapters. Chapter 1 sets out the context for the ensuing analysis. It begins with a succinct discussion of the meaning and process of economic development. The subsequent sections deal with the orthodox case for trade liberalisation,

the history of trade policy and infant industry protection, and finally the central question of how to define and measure trade liberalization (openness). A strong case is made for defining economic development in broader terms encompassing life sustenance, self esteem and freedom for the purpose of analyzing the role of trade liberalisation in growth and poverty reduction. The survey of theory and history of trade protection yields the preliminary inference (to be explored in the subsequent chapters) that, by placing unrealistic demands on developing countries with regard to their industrial policies and institutional design, the now-developed countries have been systematically making it more difficult for them to catch-up in the growth process. The comprehensive and well-balanced discussion on the measurement of trade liberalisation drives home the important point that *trade liberalisation* (policy openness) is not the same as *trade openness* which is commonly measured by the 'trade coefficient' (the share of export (or imports, or trade) to GDP).

Chapter 2 surveys the literature on the impact of trade liberalisation on trade performance and economic growth. It begins with a succinct analytical account of trade performance encompassing exports, imports and the balance of payments, not just exports which is the conventional focus. The second section surveys the empirical work on the impact of trade liberalisation on export growth, import growth, and the balance of payments. The third section probes the trade liberalisation-growth nexus.

A noteworthy contribution of this chapter is the discussion on the importance of the trade-off between growth and the balance of payments constraints in determining the sustainability and outcome of trade liberalisation (p. 68). The authors forcefully argue that export performance should receive especial emphasis in analysing trade liberalisation



outcomes because exports contribute to growth not only through various supply-side channels stipulated in the orthodox theory but also, and perhaps more importantly, by relaxing the balance of payments constraint on demand and allowing all other components of demand to grow faster without running into balance of payments difficulties.

The analysis of trade performance yields the inference that there is no conclusive evidence in support of the view that trade liberalisation has significantly improved the overall economic performance and the average standard of living: 'the promises of the pro-trade liberalizers look hollow when compared to the evidence' (p, 87). The findings from a cross-country regression analysis of the trade-off between growth and the balance of payments constraint (using data for 17 Latin American countries) suggest that trade liberalisation, on average, worsened the trade-off between growth and trade balance (pp. 103-4).

Chapter 3 examines the implications of trade liberalisation and increased globalization for the distribution of income among countries and across people in the world. The chapter begins with a broad-brush picture of the distribution of world income between nations and people and a survey of relevant orthodox and un-orthodox models of the implications of trade for world income distribution. It then examines inter-country (international) inequality (both un-weighted and population-weighted) and global inequality which take the individual person (not the country) as the unit of focus. The standard Gini coefficient is used as the standard measure of inequality (and the chapter contains an excellent non-technical discussion of this measure and its uses and shortcomings). However, mindful of the fact that the Gini ratio camouflages what is

happening at the extremes of the income distribution, the analysis is supplemented by information on variability of income (using the coefficient of variation) and changes in income shares of the lowest and the highest deciles in the income distribution. The evidence suggests that, from about the early 1980s, as liberalisation continued apace, rich countries plus India, China and a few other countries, have been growing ahead while the vast bulk of poorer countries languish in their wake. These patterns 'more closely mirror the predictions of non-orthodox trade and growth theory than the orthodox model of trade and growth which predicts convergence.'(p 142).

Chapter 4 examines the link between trade liberalisation and poverty, wage inequality and personal distribution of income using national household survey data. The chapter is in three sections. The first section begins with a succinct discussion of various channels through which trade liberalisation impacts on the level of poverty. Then the findings from two selected studies (Chen and Ravallion 2004 and Ravallion 2006)<sup>1</sup> on the aggregate indirect effect of liberalisation on poverty operating through income growth are synthesised and analysed. The next section examines the impact of trade liberalisation on wages and income inequality within countries through a comprehensive survey of cross-country studies. It also contains an impressive discussion of the various competing hypothesis that have been advanced to explain rising wage inequality in poor countries (pp 160-165). The final section examines the impact of trade liberalisation on income inequality.

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<sup>1</sup> Edwards (2006) is mentioned as a third study but it is not covered in the discussion presumably because its findings are basically similar to those of the other two.

Relating to the poverty impact of liberalisation, the evidence surveyed in the chapter suggests that ‘in the greatest era of trade liberalisation since the early 1980s, the absolute number of poor people in the world, outside of China, has actually *increased*’ (p 150). On wage inequality, ‘reduction in barriers to trade and foreign direct investment increase the relative demand for skilled labour either by shifting the structure of production towards more skill-intensive sectors or by increasing the use of foreign, skilled biased, technologies by individual firms and enterprises’ (p 158). There is however ‘some evidence to support orthodox theory in a small number of countries in South East Asia’ (p 158). In sum, the key inference of the chapter is that trade liberalisation has made no obvious dent on world poverty; nor has it contributed to wage or income equality across the world.

The final chapter draws some policy conclusions on trade policy reforms as part of a pro-poor growth strategy. It covers both issues relating to the design of public policy in developing countries and issues relating to how international economic relations should be organized and conducted with a view to providing developing countries with breathing space in their national development endeavour. The key policy advocacy at the national (individual developing-country) levels is for a cautious, gradualist approach to trade liberalisation: ‘[I]n most contexts countries should either wait to liberalise or liberalise very slowly, with the emphasis on exports, until they have a more diversified production structure achieved by means of an integrated industrial and trade strategy, using a judicious mix of tariffs, taxes and subsidies, combined with the use of selective credit (p. 175).

The recommendation for international initiatives include incorporating a detailed analysis of the likely effects of trade liberalisation on poverty in the Poverty Reduction Strategy papers (PRSPs) that must be prepared to qualify for debt relief from the IMF and World Bank; streamlining/expanding Aid for Trade (Aft) for speedy delivery of financial, technical and institutional support for trade- related infrastructure development, skill training and facilitating technology transfer with a view to providing an enabling environment for ‘self-discovery’ in the process of global economic integration; and reforming the rules governing global trade with the aim of providing poor countries with ‘policy space’ to promote non-rational outputs and exports in their own way. Relating to the last point, the authors argue that ‘Poor countries had much more ‘policy space’ under the General Agreement on Tariffs and Trade (GATT) that preceded the World Trade Organization in 1995’ (p. 203). China and Vietnam are cited as example of countries which have achieved export success by breaking the WTO rules.

## **Review**

The stated objective of the book is to ‘question the orthodox doctrine of trade liberalisation’ (p. vii). It is therefore important at the outset to have a clear understanding of what the authors mean by the orthodoxy in order to assess the contribution of the book. I have two major qualifications to their characterization of the mainstream policy posture, which are directly relevant for following assessment of TLPN’s contribution to the policy debate on the role of trade liberalisation.

My first qualification relates to the authors’ claim that mainstream (orthodox) economists recommend trade liberalisation to developing countries as ‘the magic bullet’

(p. vii), ‘*the certain route*’ (emphasis added) (p. 174) to economic development, or ‘as an end in itself, not as a means to an end’ (p. 177). They are right that some of those who make policy recommendations to developing countries have at times placed excessive emphasis on trade liberalization. However, nowhere in the orthodox trade literature have I seen recommendations of trade liberalisation as the *sole* recipe for growth and poverty alleviation. On the contrary, mainstream economists have normally considered trade liberalisation as a *prime part of*, not as a *substitute for*, a coherent development strategy.<sup>2</sup> They have given due attention to the importance of appropriate timing and sequencing of trade opening together with the other required reforms, including measures to cushion groups vulnerable to adjustment shocks in determining the success of liberalisation reforms (Michaely *et al.* 1991, Krueger 1984). The Authors also have overlooked the mainstream argument that trade liberalisation contributes to better economic performance through its positive spillover on other elements of the overall incentive structure, in particular macroeconomic stability and institutional quality. Countries committed to an outward-oriented development strategy have to have macroeconomic stability to ensure sustainability of reforms and thus these countries reap economic advantages that naturally follow from sound macroeconomic management. As regards the institutional quality, the literature on rent-seeking and directly unproductive profit seeking (DUP) (pioneered by Krueger and Bhagwati, respectively) has demonstrated that trade controls implemented during the controlled era were responsible for institutional decay.<sup>3</sup> The mainstream proponents of trade liberalisation also believe that greater exposure to foreign trade acts

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<sup>2</sup> It is important to note here that *trade liberalisation* is the *sixth* among the 10 items of Williamson’s famous ‘Washington Consensus’ reform agenda (Williamson 2003).

<sup>3</sup> Ades and Di Tella (1999) shows a clear cross-country connection between higher rent, stemming from active industrial policy and trade restrictions, and high corruption.

as an effective check on policy errors: under an open trade regime not only the scope of mistakes is less because fewer facets of the economic activity are controlled but also the cost of mistakes become quickly visible, exerting pressure to redress them (Krueger 1978).

Second, qualification relates to the claim that the mainstream advocacy is driven entirely by static resource gains as predicted by the standard trade theory. It is important to note here that the mainstream emphasis on trade liberalisation as a powerful way of poverty alleviation through employment creation is based on the assumption that the typical pre-liberalised developing economy is characterized by surplus labour, not full employment (Kruger 1983). More importantly, dynamic gains emanating from trade opening such as economies of scale that can be exploited when trade expands markets, gains from increased competition, and access to foreign technology through trade and foreign direct investment figure prominently in the orthodox case for trade liberalisation (Kruger 1980; Bhagwati 2006).

Chapter 1 contains an excellent reader-friendly exposition of the classical foundation of trade liberalisation, the case for protection, and the measurement of trade openness and their limitations. However, readability of the book would have greatly improved if this chapter contained an additional section to provide an explicit analytical framework to slot the various pieces of theory and evidence surveyed in the ensuing chapters. The impact of trade liberalisation on growth, income inequality and poverty are discussed in the ensuing chapters in a somewhat disjointed fashion without explicitly linking to the broader definition of development presented at the outset of this chapter. Also the flow of the book could have been improved by an additional unified discussion

on the definition and measurement of poverty, distinguishing between absolute poverty (which is commonly termed 'poverty' in the policy debate) and relative poverty (income distribution).

The discussion on the history of trade policy ('protection in historical perspective', pp. 38-46), which is central to some key policy inferences in the final chapter, is based on three selected studies by economists in the 'revisionist' camp. The mainstream reaction to their critics has been completely overlooked as if the authors had already made up their minds before they started writing the section. It is of course well known that tariff levels were generally higher in most now-developed countries during the period of economic transition through rapid industrialization and that there were also some cases of infant industry protection. But evidence of coincidence of protection with growth is not enough to infer causality running from protection to growth. It could well be that high tariffs were maintained for revenue purposes and had few negative side effects, but indirectly contributed to growth through infrastructure provision (Irvin 2002). As regards selective (infant-industry) protection, such interventionist policies could have nurtured inefficiency and involved resource costs but the economy experienced rapid growth thanks to robust growth of other industries which were not assisted (Irwin 2001). The governments in high-performing economies in East Asia such as South Korea and Taiwan did support some industries/firms through tariff protection and export subsidies. Mainstream economists, however, continue to stress that it was the firm commitment to outward orientation and relatively less reliance (by the developing country standards) on restrictive trade policies (rather than selective intervention) that played the critical role in the industrial transition in these countries. In particular, they argue that the outstanding

success of these two countries in the 1960s and 1970s was based on a phenomenal growth of labour-intensive manufactures (including light electrical and electronics machinery, largely consisting of consumer goods), not the typical 'heavy' sectors (chemicals, non-metallic minerals and base metals) which received favoured treatment (Bhagwati 2000, Little 1994). Even if selective intervention had played an important role in these countries as claimed by the authors, whether these policies can be replicated in other developing countries remains a matter of debate. In fact, the distrust of the capacity of governments to 'pick winners' is a key concern governing the mainstream recommendation against an active industrial policy that targets assistance to particular industries or firms, as opposed to generalized support for training, research, and so forth. The authors have ignored the political-economy arguments against selective intervention.

The analysis in Chapter 2 of the trade-off between the balance of payments constraint and growth in the context of trade liberalisation is an important novel contribution. However, I find making generalizations from the experiences of arbitrary selected 17 Latin American countries rather problematic; balance of payment constraints have never figured prominently in the vast literature on economic performance and trade liberalisation experiences in East Asian countries. Also the model specification (p. 82) suffers from two limitations. First trade balance to GDP ratio is used as the measure of balance of payments condition (dependent variable) ignoring the fact that a properly sequenced and sustained trade liberalisation has the potential to relax the balance of payments constraint by stimulating foreign capital inflows, in particular foreign direct investment. Liberalisation episodes are also usually accompanied by reform-related concessionary capital inflows. Trade balance is therefore not a good indicator of the



balance of payment position in the context of trade liberalisation; a widening current account deficit could well go hand in hand with an overall improvement in the balance of payments position through net capital inflows. Thus, there is a strong case for testing the sensitivity of results to the use of other overall indicators of the balance of payment constraint such as the debt servicing ratio, import-months equivalent of foreign reserves, and short term liabilities as a percentage of total outstanding external debts. Second, there is evidence that import response to trade liberalisation is almost instantaneous (given the large pent-up demand for imports in the typical controlled economy), but export response to the new policy environment following the reforms is essentially time dependent (Michaley *et al.* 1991). The model specification used here does not allow for this possible time lag in trade balance adjustment in the liberalisation context.

The discussion on the implications of trade liberalisation for trade performance and structural adjustment (in Chapter 2, and also in the final chapter) is couched within the conventional North-South framework in which the Southern (developing) countries are assumed to remain locked in the production of structurally-weak primary products. This characterization is not consistent with dramatic changes that have taken place in world trade patterns in the past four decades or so. The share of developing countries in world manufacturing trade increased from around 19 percent in the late 1960s to 40 percent by the middle of the first decade in the New Millennium. Changes over time in the ranking of individual countries in the geographic profile of manufacturing exports reveals notable changes in the relative position of many countries, and these shifts can be meaningfully related to effective domestic policy reforms (Athukorala and Hill 2010).

African countries have generally performed poorly, but even there one can notice some recent success cases.

The treatment of the poverty impact of trade reforms in the book (Chapter 3, pp. 145-153) is rather short, when considered against the prominence attached to this subject in the contemporary policy debate and the disparate amount of space allocated in the book to global and national income inequality and wage inequality. The sole focus here is on the overall impact of trade liberalisation on poverty operating through economic growth. Various channels through which the impact of liberalisation is transmitted to the poor are briefly discussed, but these channels are not specifically investigated. A glaring gap here is the absence of any discussion on poverty impact operating through employment creation which is the central effect of trade liberalisation predicted in the mainstream policy advocacy. Trade in labour intensive products, including both agriculture and manufacturing products, has the potential to create substantial employment opportunities for low skilled workers, precisely those living below or near the poverty line. A number of studies have come up with evidence in support of this mainstream prediction (Athukorala and Menon, 1999; Krueger *et al.*, 1983; Fei *et al.*, 1979; Fields, 1980; Harrison, 2006; Manning, 1998).

The key inference of this section that globalization and its associated rise in per capita incomes has not alleviated poverty is based on the findings of two World Bank studies which used data from national household surveys (Chen and Ravallion' 2004; Ravallion, 2006). The influential studies of Bhalla (2002) and Sala-i-Martin (2006) which have world income inequality declining using national income data have been overlooked in the discussion. Bhalla finds that the proportion of people in the developing

world living below \$1 a day in terms of 1993 purchasing power declined from 30 percent in 1987 to 13.1 percent in 2000, a much steeper decline than the reduction from 28.7 percent to 22.7 percent estimated by the World Bank, and outside the former Soviet empire, Africa – which has not integrated into the world economy, and faces serious problems of governance – is the only region where poverty has risen. Bhalla's inferences are consistent with those of Sala-i-Martin for the same data (with a slightly larger country coverage) using a more sophisticated methodology. Of course, the superiority of the national account data over household survey data remains an issue of debate, but Lal (2006, pp. 128-129) argues (based on his first-hand experience in working with the Indian National Sample Survey data) that in a post-reform context household survey data are likely to understate income gains by poor households compared to national account data.

Most, if not all, of the empirical evidence used in Chapters 2, 3 and 4 is derived from aggregate multi-country (cross-section or pooled time series) regression analyses. The authors have used these results at face value, but there are serious shortcomings with the cross-country regression approach, both because of the implicit assumption of a common underlying structure across countries, unequal quality of data and problems of comparability of concepts across countries, and the related econometric problems (Levine and Renelt, 1992; Rodriguez and Rodrik, 2001). Comparison of results from various studies is also complicated by the absence of a unique measure of trade openness as the authors have discussed in detail in Chapter 1. Given these limitations, we need to go beyond cross-country results and look closely at the findings of in-depth country studies, which typically involve deeper examination of specific episodes to identify direct and

indirect effects of liberalisation measures, that would be more enlightening. The authors do mention some detailed country studies, but their results have not been incorporated in the authors' analysis. In addition to the works cited, the relevant country-level studies include Lal and Mynt (1993), Harrison (2006), Michaely et al. (1991), Tsai and Huang (2007).

The inferences drawn in these chapters on growth, equity and poverty implications of trade liberalisation also seem to have an undue 'African and Latin American' bias resulting from the excessive reliance on studies which cover liberalisation episodes in the 1980s and 1990s. The experiences of the early liberalisers in Asia are given only scant attention. Moreover, as already discussed, throughout the book the authors have shown a tendency to downplay the Asian reform experience as special cases and/or as reflecting the outcome of selective trade protection based primarily on the revisionist interpretations, while ignoring the mainstream counter arguments. In particular, I find it difficult to understand the justification for treating India and China (the two largest developing countries where more than half of the world's poor live), which have been able to reduce poverty significantly only after shifting to an outward-oriented development strategy from an earlier inward-orientation, as special cases in world income equality and poverty (Chapters 3 and 4). Poverty has remained stubbornly high in Sub-Saharan Africa and most countries in Latin America, notwithstanding liberalisation reforms. But this may have little to do with trade policy (or globalization), and more to do with unstable or failed political regimes, and wars and civil conflicts that have afflicted several countries in the region. If anything, such instability only reduces

their extent of globalization, because it scared off many foreign investors and traders (Bardhan 2006, Reid 2007).

Some sections of chapter 5 are repetitive. It also contains new material which belongs in the previous chapters. A short concluding chapter summarizing the key inferences of the previous chapters followed by an itemized discussion of policy recommendations would have improved the quality and readability of the book.

Among the policy recommendations made in the chapter, the case for giving priority to export expansion at the initial stage of the process of trade opening is consistent with the mainstream policy advocacy for timing and sequencing of liberalisation reforms (Krueger 1978, Michaely 1991). The same is true with their criticism of the WTO agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) (Bhagwati, 2006, p. 182-3).

The case for the promotion of ‘self discovery’ (encouraging and promote ‘learning what one is good at producing’) (p. 183-4) through a ‘carrot and stick’ approach does not seem to go well with the available evidence. The emergence of new entrepreneurs/firms and new product lines has been a well-known characteristic of the export-led growth process in East Asian countries. However, there is evidence that this was propelled by market forces unleashed by liberalisation and, in particular, interaction with foreign firms and international buyers, rather than by direct government support setting the stage for this process (Hone 1974, Riedel 1988). The stage for the emergence of a competitive export-oriented garment industry in Bangladesh through the collaboration of domestic entrepreneurs and Daewoo Corporation in Korea (who provided market channels) was set by the process of trade-cum-investment liberalisation

initiated in the late 1980s. In Sri Lanka dynamic new exporters emerged *de novo* in clothing, and in a number of other labour-intensive industries following the liberalisation reforms initiated in the late 1970s. Interestingly, most of the export-oriented firms set up during the control regime benefiting from selective incentives disappeared in the aftermath of the liberalisation reforms (Athukorala and Rajapatirana 2000).

The criticism of world trade rule of the World Trade Organization (pp. 201-4) ignores the fact that only a few countries benefited from the ample policy space provided under earlier GATT regimes. There is ample evidence that many developing countries made use of the policy space to protect inefficient domestic industries rather than to create winners in export trade. The author's claim that some countries, in particular China and Vietnam, succeeded spectacularly by breaking WTO rules is not consistent with the facts. These two countries worked hard to achieve WTO accession (that was their own choice!) and there is evidence that the effort has paid dividends. In China, export expansion accelerated dramatically following the WTO accession in 2001; policy certainty and broadened access to developed markets associated with WTO membership triggered massive relocation of production activities in China within globally integrated high-tech industries. Similarly, there has been a surge of export oriented investment in Vietnam following the WTO accession in 2007.

## **Concluding Comments**

This is a meticulously research and well written book on a subject of immense contemporary academic and policy interest. In spite of the somewhat radical tone of writing, it is not an 'anti-trade (or anti-globalization) manifesto'; the authors do emphasize that there are real economic gains from trade while questioning whether the

developing countries can be helped by ‘big-bang trade liberalization’. The reader may not agree with every interpretation and policy recommendation in the book, but will depart feeling challenged, invigorated and questioning after reading this book. The book will be useful to students in a wide range of social sciences, not just development economics, who would like to get a feel for the ‘big picture’ of the contemporary debate on economic development and public policy. It will also be a valuable addition to bookshelves of development practitioners. The publisher deserves to be praised for bringing out an affordable paperback version of the book in addition to the expensive hardbound edition.

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