



**POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
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**COMMENTS ON
“TRADE POLICY OPENNESS AND
ECONOMIC PERFORMANCE: CROSS-
COUNTRY EVIDENCE”
BY DR. P. N. WEERASINGHE**

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Comments on
“Trade Policy Openness and Economic Performance: Cross-country Evidence”
by Dr. P. N. Weerasinghe

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Let me congratulate the author, Dr. Weerasinghe, for producing and presenting this interesting paper on the relationships between trade policy openness and growth performance. As this conference is a venue for discussion of challenges and policy options for developing Asia, focusing on the region's low income countries, my comments will be divided into two parts. First, a summary of findings from a reader's point of view and comments on technicality and conclusions of the paper will be provided. And second, comments on issues pertaining to Trade and Development in general will be presented.

Summary of Findings

The paper, by acknowledging often inconsistent results obtained from many cross-country empirical studies on the relationships between trade policy openness and economic performance, tries to provide more robust findings by utilizing a more direct measurement of trade policy openness, i.e., Trade Bias Index (TBI). TBI accounts for distortions/restrictions both on export and import fronts at an aggregate level, and therefore is expected to perform better compared to those of indirect measurements that only represent import tariffs and QRs. The impact of trade policy openness on economic performance (per capita income growth) is broken into three categories, namely, TFP growth, capital deepening, and improvements in human capital (represented in years of formal education in this study). The paper also quantifies these relationships in short-, medium-, and long-term regressions. The main findings of this paper are:

- 1) Empirical findings on the relationship between trade policy openness and economic performance largely depend on two factors: a) the measurement of trade openness, and b) the estimates of TFP growth rates.
- 2) If trade openness is measured by a more direct and comprehensive index of trade bias (TBI), robustness of the empirical findings of a positive and significant relationship between openness and TFP growth can be obtained.
- 3) If indirect measurements of trade policy openness such as the levels of tariffs and QRs are used, they produce generally insignificant and often counter-intuitive results. Black market (exchange rate) premium (BMP) and the so-called Sachs Warner Index (SWI) (constructed from four elements: BMP, export marketing index, coverage of import quotas, and socialist or not) are the only indirect measures that are consistently significant both in TFP growth and capital deepening regressions.
- 4) More than half of the positive impacts of trade policy openness on economic performance operate through TFP growth. Trade openness also affects economic performance positively through promoting capital deepening. No significant impacts through improvements in human capital are detected.
- 5) Those findings are consistent across time frameworks: S-T, M-T, and L-T.

Comments on the Paper

My comments on the paper are composed of those regarding technicality, and those regarding interpretations and policy implications.

- 1) The way in which the quality of human capital was measured is crucial in two ways. First, it defines measurements of TFP growth. Second, it should represent the channels through which the effects of trade engagement appear. Years of formal education (H in the paper) are often institutionally fixed and therefore do not respond to changes in trade environment. But for example, export-oriented firms traditionally engaged their workers more in OJT activities in Japan.
- 2) Directional changes in policy stance may be of some importance, in addition to the average level of policy openness, as found in some of the studies of the relationship between governance and development performance.
- 3) Why does TBI turn out to be (statistically) less significant in the TFPG regression as compared to BMP and SWI (Table 1), or insignificant in the capital deepening regression (Table 4)? It might behoove the author to explore further the real stories behind these numbers. Trade openness can in fact affect the process of capital deepening significantly as it may change a) the rates of return on investment (capital), b) the relative cost of capital due to imported capital goods, and c) FDI flows.
- 4) In an anti-trade-bias indicator, export subsidies (negative export taxes) reduce the level of bias. Therefore they are expected to enhance economic performance. However, export subsidies for agricultural products, for instance, are not pro-poor because subsistence farmers (the real poor sector) are net purchasers of food. Should we choose pro-growth policies even if they are not pro-poor, or even anti-poor?
- 5) Estimates obtained from the annual time series regressions should be interpreted with great caution. Depending on how the initial growth accounting was conducted, cyclical factors may remain. If the agricultural sector is included, weather volatility may be a concern. External shocks affect the rates of factor utilization, and therefore affect measured productivity growth and capital deepening.

I understand that this commentator is asking a lot given the existing limitations in data. However, when the findings of this wonderful study are to be translated into policy implications/initiatives, say in today's Bangladeshi context, they have to be supported with real-life stories.

More General Comments on Trade Issues

If we look back over the history of development discourse or the evolution of development paradigms, we see it has been a process of finding an ever increasing number of so-called 'necessary conditions' for growth and poverty reduction, such as price reforms (market-orientation), policy reforms, institutional reforms, governance reforms, social capital reforms, and so on. As Professor Panagariya says, 'although trade openness is not by itself sufficient to trigger growth, it is clearly necessary.' And thus, we add one more necessary condition for growth.

Now, if trade is good for growth and growth is necessary for poverty reduction, what are the sufficient conditions that have to be met for us to make trade openness good for *both* growth and poverty reduction? Last year, the Independent Evaluation Group (IEG) at the World Bank issued an evaluation of the Bank's support for trade from 1987 to 2004. Two of the report's main findings are as follows:

- 1) If developing countries are to reap larger gains from trade liberalization, the reforms need to be combined better with investments, measures to mitigate adverse effects, and institution building (i.e. cultivating competition, reducing labor market rigidities, and improving the regulatory environment).

- 2) The IEG evaluation found little evidence that more recent trade-related operations are doing significantly better in identifying potential winners and losers of trade policies and recommending specific policies to facilitate adjustment.

Although trade, like FDI, is a positive-sum game both nationally and globally, it does create winners and losers. The distribution of benefits and allocation of compensation are the issues of political-economy.

The paper may imply that no economy has grown at a sustained high rate behind the cover of high trade restrictions in the history of post-WWII development. Wrong! There have been notable exceptions in Brazil, Mexico, India, China, and Japan among others. However, these economies had sufficiently large domestic markets to create a certain level of scale economy. In Japan's case, emerging industrial sectors were well protected from imports until the mid 1960s. 'First product imported, second product produced with improved engineering' was a slogan for import substitution and induction of technology. However, success in foreign markets (via exports) was considered necessary for firms to succeed in the protected domestic market. The success stories of SONY, Matsushita Panasonic, Hitachi, and so on stand out in this regard. The creation of a kind of 'contestable market' and competition in foreign markets promoted productivity growth in Japanese industry despite the protected nature of the domestic market.

Recently, I had a student from Kyrgyzstan in class. He is an economist and now a director for industry promotion in the Central Bank of Kyrgyzstan. He used to complain that the big-bang liberalization of trade and investment (following IMF-WB policy guidelines) almost completely wiped out Kyrgyzstan's domestic industries. He wanted to learn about 'strategic' liberalization from Japan's experience.

Regarding big-bang vs. gradual opening (strategic trade liberalization), many main-stream economists say that trade distortions continue to create welfare losses (and gains only for vested-interest groups), and argue that if anything, it should be dismantled ASAP. However, in the longer run, low income countries in Asia should create competitive industries of their own. 'Smart' utilization of strategic liberalization (coupled with industrial policies) may need to be considered as an option.

Doha Round negotiations are not going anywhere due to the gridlock in negotiations in the liberalization of 'trade in Agriculture.' The current share of Agriculture in global GDP is only 3 percent (6 percent with food processing), and the share of trade in Agriculture (and processed food) is only 7 percent of the total trade in goods and services. However, Agriculture employs more than half of the (employed) labor force in developing countries. As a recent study by Anderson, Martin, and van der Mensbrugghe (World Bank, 2006) pointed out, many CGE-based global trade models have shown that more than two-thirds of the welfare gains from full global trade liberalization come from Agricultural trade liberalization. They have also shown that Agricultural liberalization in developing countries is just as important as that in developed economies in terms of producing welfare gains. Agriculture is where we still have monstrous and grotesque protections.

Similarly, in Japan, where the ODA budget faces continuing cuts, policy makers in the Japanese government would do well to realize that Agricultural trade liberalization benefits Asia's low income countries much more than ODA projects.

Hence, as we add more items in our list of necessary conditions for growth and poverty reduction such as that of trade openness presented by this paper, we continue to be confronted with lingering questions as well as encounter new ones.