

CAN INTEGRATION INTO THE WORLD ECONOMY
SUBSTITUTE FOR A DEVELOPMENT STRATEGY?¹

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According to *The Wall Street Journal*, a senior U.S. Treasury official recently "urged Mexico's government to work harder to reduce violent crime, saying the country's high crime rate could frighten away foreign investors" (May 15, 2000, p. A25). This may have been an off-the-cuff remark. But it serves as a perfect illustration of how foreign trade and investment are increasingly viewed as the ultimate yardstick for evaluating government policies. An observer less bowled over by the zeitgeist of the times might have thought that the primary targets of violent crime are the local population, and that it is the latter's welfare that should be paramount in guiding policy. It is revealing that making statements of this kind is not only acceptable, it is often the only way to get policy makers to take you seriously.

The quote from the Treasury official highlights a tendency to view development--and the institutional reforms needed to spark and sustain it--almost exclusively from the perspective of integration into the world economy. This tendency is in turn founded on the widely shared belief that openness to trade is the most potent force for economic growth known to man. In the words of Stanley Fischer (2000), "[i]ntegration into the world economy is the best way for countries to grow." Or as the WTO's Mike Moore (2000) puts it, "the surest way to do more to help the poor is to continue to open markets." Few economists and policy makers would answer the question posed in this paper's title affirmatively. But in practice development strategy is becoming increasingly synonymous with global integration.

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It is now well understood that integration into the world economy has highly demanding institutional prerequisites. I shall argue that investing in these prerequisites as the first order of business for development not only closes off alternative development paths, it also crowds out possibly more urgent priorities by diverting human resources, administrative capabilities, and political capital away from other tasks. That would not be bad news if the payoffs to international economic integration were significant--if openness were indeed the key to growth. Alas, the evidence we have is that the link between a country's trade barriers and its rate of economic growth is weak at best (at least for levels of trade restrictions observed during the last couple of decades). There is simply no credible evidence that should lead us to place a very high probability on the likelihood that a sustained, significant growth boost will follow from the lowering of barriers to trade and investment. All of this leads me to the conclusion that openness is not an adequate substitute for a development strategy. Policy makers have to evaluate globalization in terms of developmental needs, not vice versa.

Integration is costly

Membership in the international economic community, at least as it is organized currently, is a costly proposition. Consider some of the WTO obligations. Michael Finger has calculated that it would cost a typical developing country \$150 million to implement requirements under the WTO agreements on customs valuation, sanitary and phytosanitary measures (SPS), and intellectual property rights (TRIPs)--a sum equal to a year's development budget for many of the least-developed countries. Would this be money well spent? Finger argues that the answer is no for the vast majority of developing countries. While these countries would benefit from the strengthening of their institutions in the relevant areas, the reality is that

"WTO obligations reflect little awareness of development problems." "Other alternatives, e.g., basic education for women and girls, would have much more attractive rate-of-return numbers" (Finger 1999).

These specific WTO agreements are just the tip of the iceberg. As global integration proceeds, its institutional requirements are increasingly laid bare. In the trade arena, the WTO already imposes a formidable range of obligations on developing countries, and it is a safe bet that any new round will shorten the leash further (even if pressure in the controversial areas of environment and labor can be fended off). In international finance, the Asian crisis has spawned (or, in some cases, reinforced) an ambitious effort to establish international codes and standards. These cover fiscal transparency, monetary and financial policy, banking supervision, data dissemination, corporate governance and structure, and accounting standards. While these codes are being designed for application in all countries, they are targeted especially on developing countries with fragile legal and financial systems. To my knowledge, these codes and standards have never been costed out, to see if they survive a reasonable cost-benefit analysis (of the type implicitly carried out by Michael Finger in the case of WTO agreements).

Integration has other, more subtle institutional requirements as well. Openness implies heightened exposure to external risk, and consequently greater demand for social insurance.² Greater provision of social insurance seems to be a key factor behind the empirical regularity that governments tend to be bigger in economies where trade is a higher share of GDP (Rodrik 1998). Openness increases the premium on institutions of conflict management more broadly (Rodrik 1999).

² In principle, reduced exposure to domestic sources of risk can compensate, but empirically it does not appear to do so. See Rodrik (1998).

So in the real world opening up is not simply a matter of letting your barriers down. You need to ensure that you abide by the international rules of propriety, that you cover the domestic sources of weaknesses thereby exposed, and that you know how to protect yourself from the elements.

It is often overlooked that the most successful "globalizers" of an earlier era--the East Asian tigers--had to abide by few international constraints and pay few of the costs of integration during their formative growth experience (the 1960s and 1970s). Global trade rules essentially gave them a free ride, and capital mobility was hardly an issue. This is why these countries can hardly be considered poster children for today's globalization (the claims of globalization advocates notwithstanding). South Korea, Taiwan, and the other East Asian countries had the freedom to do their own thing, and they used it abundantly. They combined their reliance on trade with unorthodox policies--export subsidies, domestic-content requirements, import-export linkages, patent and copyright infringements, restrictions on capital flows (including on DFI), directed credit, and so on--that are either precluded by today's rules or highly frowned upon. The environment for today's globalizers is quite different.

None of the institutional reforms needed for insertion in the world economy is bad in and of themselves, and in fact, many of them can be independently desirable. To take an important example, a government that is forced to protect the rights of foreign investors perhaps becomes more inclined to protect the basic human rights of its own citizens too. This was a potent argument in the recent U.S. debate about China's PNTR status. But one has to recognize this brand of argument for what it is: trickle-down institutional reform. The reforms may or may not

trickle down³; and even when they do, they will rarely constitute the most effective way of targeting the desired ends (whether those ends are legal reform, improved observance of human rights, or reduced corruption).

Institutional change is costly, and requires the expenditure of scarce human resources, administrative capabilities, and political capital. The priorities implied by global insertion will not always coincide with the priorities of a more fully developmental agenda. Consider some illustrative tradeoffs:

- Education. What should the government's priorities be in its education budget? Should it train more bank auditors and accountants, even if it means fewer secondary-school teachers?
- Corruption. How should the government focus its anti-corruption strategy? Should it target the "grand" corruption that foreign investors complain about, or the petty corruption that affects the average person the most?
- Legal reform. Should the government focus its energies on "importing" legal codes and standards, or on improving existing domestic legal institutions? (In Turkey, a weak coalition government spent the better part of last summer gathering political support for a bill that would provide foreign investors the protection of international arbitration. Reforming the existing legal system for the benefit of foreign and domestic investors might have been a better strategy for the long run.)
- Public health. Should the government pursue tough policies on compulsory licensing and/or parallel importation of basic medicines, even if that means running afoul of existing WTO rules?
- Industrial strategy. Should the government simply open up and let the chips drop wherever they might, or emulate East Asian experience of industrial policies through export subsidies, directed credit, and selective protection?
- Social protection and safety nets. How much can the government afford to spend on such programs in view of the fiscal constraints imposed by market "discipline"? (In Peru, the Central Bank holds foreign reserves equal to 15 months of imports to safeguard the economy against sudden capital outflows. The social cost of the excess reserves (beyond

³ See the useful discussion by Stephenson (2000), who calls the American approach towards China a "Trojan Horse strategy" and disputes the view that legal reforms targeted at narrow economic goals will necessarily bring about broader spillovers.

the 3-month benchmark) is about 1-2 % of GDP, which might otherwise have gone to fund a decent-sized anti-poverty program.)

In each of these areas, a strategy of global integration precludes other paths that could be more development-friendly. While the institutional prerequisites of global insertion overlap with those of development, there are also tensions between the two. Policy makers have to be at the very least conscious of the opportunity costs implied by a globalization-above-all strategy.

And the benefits are uncertain

I have argued so far that pursuing a policy of global integration has opportunity costs because of the institutional consequences that such a strategy entails. These costs have to be traded off against the expected benefits.

All economists know that there exist gains from trade. However, the standard gains from trade--the Harberger triangles--tend to be small. The tendency in policy discussions has been to go considerably beyond the standard case for trade and to claim that open trade policies produce significant boosts in economic growth rates. This claim is apparently supported by a large cross-national empirical literature.

Recently, Francisco Rodríguez and I have reviewed the extensive literature on the relationship between trade policy and growth (Rodríguez and Rodrik, forthcoming). We reached the conclusion that there is a significant gap between the message that the consumers of this literature have derived and the "facts" that the literature has actually demonstrated. The gap emerges from a number of factors. In many cases, the indicators of "openness" used by researchers are problematic as measures of trade barriers or are highly correlated with other sources of poor economic performance. In other cases, the empirical strategies used to ascertain the link between trade policy and growth have serious shortcomings, the removal of which

results in significantly weaker findings.⁴ One common problem has been the misattribution of either macroeconomic phenomena (overvalued currencies or macro instability) or geographic determinants (e.g., location in the tropical zone) to trade policies proper. Once simple corrections are made for such problems, one rarely finds a statistically significant relationship between the level of tariff and non-tariff barriers and economic growth across countries.

There are in fact reasons to be skeptical about the existence of a general, unambiguous relationship between trade openness and growth. The relationship is likely to be a contingent one, dependent on a host of country and external characteristics. The fact that practically all of today's advanced countries embarked on their growth behind tariff barriers, and reduced protection only subsequently, surely offers a clue of sorts. Moreover, the modern theory of endogenous growth yields an ambiguous answer to the question of whether trade liberalization promotes growth. The answer varies depending on whether the forces of comparative advantage push the economy's resources in the direction of activities that generate long-run growth (via externalities in research and development, expanding product variety, upgrading product quality, and so on) or divert them from such activities.

No country has developed successfully by turning its back on international trade and long-term capital flows. Very few countries have grown over long periods of time without experiencing an increase in the share of foreign trade in their national product. In practice, the most compelling mechanism that links trade with growth in developing countries is that imported capital goods are likely to be significantly cheaper than those manufactured at home. Policies that restrict imports of capital equipment, raise the price of capital goods at home, and thereby

⁴ Our detailed analysis covers the five papers that are probably the best known in the field: Dollar (1992), Sachs and Warner (1995), Ben-David (1993), Edwards (1998), and Frankel and Romer (1999).

reduce real investment levels have to be viewed as undesirable *prima facie*. Exports, in turn, are important since that is what one purchases imported capital equipment with.

But it is equally true that no country has developed simply by opening itself up to foreign trade and investment. The trick in the successful cases has been to combine the opportunities offered by world markets with a domestic investment and institution-building strategy to stimulate the animal spirits of domestic entrepreneurs. Almost all of the outstanding cases--East Asia, China, India since the early 1980s--involve partial and gradual opening up to imports and foreign investment.

The appropriate conclusion to draw from the evidence is not that trade protection should be preferred to trade liberalization as a rule. There is no evidence from the last 50 years that trade protection is systematically associated with higher growth. The point is simply that the benefits of trade openness should not be oversold. When other worthwhile policy objectives compete for scarce administrative resources and political capital, deep trade liberalization often does not deserve the high priority it typically receives in development strategies. This is a lesson that is of particular importance to countries (such as those in Africa) that are in the early stages of reform.

The evidence on the benefits of capital-account liberalization is even weaker. On paper, the appeal of capital mobility is obvious. In the absence of market imperfections, freedom to trade enhances efficiency, and that is as true of trade in paper assets as it is of trade in widgets. But financial markets suffer from various syndromes--informational asymmetries, agency problems, self-fulfilling expectations, bubbles (rational and otherwise), and myopia--to an extent that makes their economic analysis inherently a second-best one. No amount of institutional tinkering is likely to make a significant difference to that basic fact of life.

The question of whether developing nations should be pushed to open their capital accounts (in an "orderly and progressive" manner as it is now recommended by the IMF) can ultimately be resolved only on the basis of empirical evidence. While there is plenty of evidence that financial crash often follows financial liberalization (see Williamson and Mahar 1998 for a survey), we have very little evidence that suggests higher rates of economic growth follow capital-account liberalization. Quinn (1997) reports a positive association between capital account liberalization and long-run growth, while Grilli and Milesi-Ferretti (1995), Rodrik (1998), and Kraay (1998)--the last author using Quinn's (1997) own indicator of capital-account restrictions--find no relationship. Klein and Olivei (1999) report a positive relationship, but one largely driven by the experience of the developed countries in their sample. This is a field of inquiry that remains in its infancy, and there is clearly much more to be learned. The least that can be said at present is that convincing evidence on the benefits of capital-account liberalization has yet to be produced.

Among all the arguments in favor of international capital mobility perhaps the most appealing one is that such mobility serves a useful disciplining function on government policy. Governments that have to be responsive to investors cannot squander their society's resources as easily. The idea is attractive, but once again one has to question its empirical relevance. When foreign creditors suffer from the syndromes noted above, a government intent on irresponsible spending finds it easier to finance its expenditures when it (or other domestic residents) can borrow from abroad. In addition, when investor behavior is driven by fundamentals that are not readily observable, the resulting equilibrium can have all kinds of undesirable features. In particular, governments may be forced to adopt undesirable policies so as to "conform" with investor priors/biases (Mukand 1998).

Concluding remarks

Any economist who appears to question the benefits of trade is at risk of being banished from polite company, so let me end by trying to clarify my position further. What I have questioned here is not the standard version of the gains-from-trade, which makes well-trained economists justifiably proud, but its much-bloated distant cousin that is the source of extravagant, unsubstantiated claims about the consequences of openness. The latter in fact endangers broad public acceptance of the real article because it unleashes expectations that are unlikely to be fulfilled.⁵

I have argued that in the real world opening up is not a simple matter of revising tariff codes and removing barriers to foreign investment. It requires a heavy dose of institutional reform, which consumes financial, bureaucratic, and political resources. While many of these institutional reforms are development-friendly, they are so typically in a trickle-down sort of way. They are not directly targeted on key developmental goals--economic growth, improved governance, industrial and technological capability, poverty alleviation--and occasionally divert attention from them. Institutional reforms aimed at maximizing trade and capital flows may produce broader benefits, but they are not necessarily the most effective way of fostering development.

In short, strategic use of international trade and capital flows is part of a development strategy; it does not substitute for it.

⁵ The NAFTA debate some years back in the U.S. provides an apt illustration of the dangers of over-selling trade. The unreasonable predictions made about the positive employment consequences of NAFTA by some pro-trade economists during this debate did much to tarnish the reputation of free trade in the U.S., and came back to haunt those advocates when the Mexican Peso collapsed and the bilateral trade balance turned around.

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