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PREFERENTIAL TRADING ARRANGEMENTS, TRADE, AND GROWTH

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Resumen
El punto natural de partida para estudiar la relación entre acuerdos comerciales preferentes, comercio y crecimiento es el vínculo entre crecimiento y comercio. Si esta relación es débil, es improbable que se pueda establecer un nexo sólido entre estos acuerdos y el crecimiento, puesto que dicho nexo debe operar principalmente a través del comercio. Hasta hace poco, los economistas especializados en comercio internacional pensaban que sus estudios sistemáticos de los setenta y ochenta habían establecido en forma concluyente la relación positiva entre comercio y crecimiento. Pero las críticas a la evidencia de parte de opositores al libre comercio, tales como Joseph Stiglitz y Dani Rodrik, así como el ataque continuo a la lógica de la liberalización del comercio por parte de otros como algunas organizaciones no gubernamentales influyentes, han hecho esencial replantear y defender explícitamente este vínculo. Una vez hecho esto, podremos dedicarnos a evaluar si los acuerdos comerciales preferentes, que son una forma específica de liberalización comercial, promueven el comercio en formas que estimulan el crecimiento. ¿O es que alguna peculiaridad de este instrumento hace ineficaces los efectos beneficiosos de la liberalización comercial?

Abstract
The natural starting point in the study of the relationship among PTAs, trade, and growth is the link between growth and trade. If this relationship itself is weak, it is unlikely that we can establish a strong link between PTAs and growth since such link must work principally through trade. Until recently, trade economists had thought that their systematic research during the 1970s and 1980s had conclusively established the positive relationship between trade and growth. But the criticisms of the evidence by free-trade critics such as Joseph Stiglitz and Dani Rodrik and continued attack on the wisdom of trade liberalization by others including influential NGOs have made it essential to restate and defend this link explicitly. Once this is done, we can turn to an assessment of whether PTAs, which form a specific form of trade liberalization, promote trade in ways that is conducive to growth. Or, is there something peculiar about this instrument that renders the beneficial effects of trade liberalization ineffective?

This paper has been prepared for presentation at the joint World Bank-Central Bank of Chile Conference "The Future of Trade Liberalization in the Americas" on March 22 and 23, 2004 in Santiago, Chile.
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1 Trade Openness and Growth: Criticisms that Won't Do

Many of the criticisms offered by free-trade critics sound superficially plausible but fail to stand up to careful scrutiny. Let me offer a brief dissection of five such arguments.

- First, some critics cite countries that opened to trade and failed to achieve higher growth to make a case in favor of protectionism over liberal trade policies. They also argue that the existing econometric evidence fails to persuasively establish a *causal* link between barriers to trade and growth. But such criticisms miss the point that the trade-policy choice must be based not on whether openness by itself leads to higher growth but on whether it is more *conducive* to sustained growth than a protectionist regime. Few serious advocates of free trade argue that openness by itself is sufficient for growth. They fully recognize that in the absence of macroeconomic stability, policy credibility and enforcement of contracts, it is unlikely that a country will be able to register significantly high growth rates for a sustained period. What they do argue is that these policies yield the high-growth dividend only in an open trading environment.
- Second, critics also attack the case for liberal trade polices on the ground that certain successful experiences of sustained growth were actually catalyzed by alternative policies such as government-engineered increase in investment demand or innovation. But these critics fail to distinguish between initial catalysts to growth and policies necessary to *sustain* it. Even if growth is initially stimulated by increased investment demand or innovation, growth is unlikely to be sustained if the trading environment is autarkic and continues to be autarkic. Of course, if openness also serves as a direct stimulus to growth, it is an added advantage. A careful study of the successful cases reveals that whatever the source of the initial stimulus, increased growth often leads to increased trade liberalization and vice versa. The recent successful experiences of China and India graphically illustrate the process of growth and openness feeding on each other.
- Third, critics like to cite the examples of countries that managed to register high growth rates behind high walls of protection to conclude that protectionism works. Again, high *initial* trade barriers do not preclude the *onset* of rapid growth, especially in countries such as Brazil, China and India that have large internal markets. Indeed, growth process

itself may sometimes be kicked off by gradual liberalization of an initially highly protected regime. But such growth will sustain only if the country responds by undertaking liberalization that accommodates the necessary expansion of trade. Evidence pointing to the fact that a country grew rapidly while still behind high protectionist wall does not prove the efficacy of protection! The critical question for such an economy is whether it was lowering or further raising the protectionist barriers during the period of rapid growth.

- Fourth, critics also like to cite examples of countries that managed to register high growth while raising barriers to trade. But pro-free trade economists have often recognized that in an *initial* phase of development and starting with relatively low barriers to trade, increased protection need not preclude fast growth as long as protection remains moderate and short-lived. Late Bela Balassa, one of the early advocates of outward-oriented policies, explicitly recognized the positive role that the *first* stage of import substitution played in the development of South Korea, Taiwan and Singapore. He defined this stage as the period during which imports of non-durable consumer goods such as textiles and apparel and the intermediate inputs used in them are replaced by domestic production. In the present context, this qualification is largely academic since the time for such import substitution is now behind virtually all developing countries.
- Finally, the necessity of trade openness for growth is not inconsistent with the use of industrial policy. Critics sometimes challenge the case for openness by pointing to what they regard as the success of interventionist industrial policies in high-growth economies of the Far East. While the efficacy of industrial policies itself constitutes a separate subject of debate among economists, the success of an activist industrial policy does not prove the failure of outward-oriented policies.

The contrasting experiences of South Korea and India during the first three decades (1950-1980) of their development vividly illustrate these points. Time constraints do not permit me to spell out these experiences in detail but let me just note that the governments in both these countries tried to solve the investment coordination problem through activist interventions. The main difference was that Korea did this in an outward-oriented trade-

policy framework and India in an autarkic one. Korea grew at growth rates of 6% plus and India 1% in per capita terms during this period.

2 Miracles and Debacles

In Panagariya (2004), I offer systematic evidence demonstrating that the experience of Korea is not unique. Defining sustained growth in the per-capita income at rates 3.5 percent or more as "miracle" and sustained decline in the per-capita income as "debacle," I demonstrate that virtually all miracles during the past four decades have taken place in the presence of low or declining barriers to trade and almost no debacles have been accompanied by sustained surges in imports.

Rodrik paints a contrasting picture of the experience in his 1999 book. Noting that Per-capita incomes in as many as 30 countries grew annually at rates equaling or exceeding 3 percent during 196-73, he characterizes these years as the golden period of growth for developing countries this period. He finds that in comparison, growth rates plummeted in a very large number of developing countries during 1973-84 to 1984-94. Noting that 1960-73 was the period of import-substitution industrialization (ISI) and 1984-94 that of liberalization, Rodrik concludes that this suggests the triumph of ISI.

Much is wrong with this story. To begin with, one can question the characterization of the years 1960-73 as the Golden Age and 1984-94 as failure. Per-capita incomes in the developing countries taken as a whole grew more slowly during 1960-73 than 1984-94. This is because the star performers of the former period, though many more in number, were relatively small while those of the latter period included such large countries as India and China. Many more people were lifted out of poverty during the second period than the first.

Bust even granting Rodrik the point that 1960-73 defined the golden age of development, we must ask how the star performers got where they got. In precisely what sense is the period to be defined as one of ISI? According to the evidence from Panagariya (2004) to which I alluded earlier, virtually all growth miracles have taken place side by side with very rapid growth in trade. It is simply not true that the countries that grew rapidly were actually substituting domestic production for imports. On the contrary, they were

taking considerably greater advantage of the world markets than their poorly performing counterparts.

This is surely known to be true of the Far eastern countries of Korea, Taiwan, Hong Kong and Singapore. Therefore, *prima facie* one would expect the greatest scope for making a case in favor of import substitution in Latin America. After all, this is where much of the initial intellectual stimulus for the desirability of import-substitution policies had originated. But even here closer examination reveals a different picture than painted by Rodrik. Thus, the case of Brazil, by far the largest country on the continent and the star performer of 1960-73, fails to fit the ISI model. Its exports and imports in constant 1995 dollars grew at the impressive annual rates of 7.8 and 8.9 percent, respectively during this period. With imports rapidly substituting for domestic production and exports accounting for increasingly larger share of the GDP, *prima-facie* Brazil cannot be characterized as succeeding through import substitution.

But this is not all. Even if we consider trade *policies* rather than trade *outcomes*, the Brazilian growth experience during the post 1960 era fails to fit the ISI story. Thus, Brazil grew 1.6 percent per-capita during 1961-68, 8.3 percent during 1968-1975 and 3.5 percent during 1975-80. It turns out that thoughtful trade policy specialists on Brazil describe the period 1965-73 as one of "cautious outward-looking trade policy liberalization" and 1974-80 as one of "renewed inward-looking policies." During the former period, Brazil adopted a number of policy measures aimed at integrating itself into the global economy. On the exchange-rate front, it undertook several devaluations to correct the overvaluation of the real exchange rate and later adopted the crawling peg to ensure its stability. It also introduced several export incentives to reduce the anti-export bias. Finally, it lowered the average legal tariff (including surcharges) for manufacturing from 99 to 57 percent and for agriculture from 53 to 34 percent.

This still leaves the question why Latin America failed to grow during 1980s despite substantial trade liberalization. Here we must recall the qualification that trade openness is an important necessary ingredient in the fast-growth recipe but not the only ingredient. Therefore, the debacle of 1980s in Latin America is to be attributed not to sustained import surges that did not happen but to macroeconomic instability that resulted from short-term capital mobility, which most Latin American countries had embraced by then. The

seventies had been characterized by rising foreign debt in many Latin American countries with debt-service as a proportion of exports rising to 30 percent or more by early 1980s in many cases. On top of that came the Volcker-era interest-rate increases in the United States, which led capital to flow out of Latin America abruptly and choked all growth potential.

But even the 1980s onward Latin America offers an example that supports the hypothesis that trade openness is necessary for growth. During the past two decades, Chile is perhaps the only major country in Latin American that has registered sustained rapid growth. Its GDP grew at the annual rates of 5.3 and 5.9 percent respectively during 1981-91 and 1991-01. During the same time periods, its exports of goods and services grew annually at 8.6 and 9 percent, respectively with the imports to GDP ratio rising from 26.8 percent in 1981 to 32.7 percent in 2001.

Like many other Latin American countries, Chile opened up its economy to trade by slashing tariffs and undertook the reforms such as privatization. What distinguished it from the former, however, was the management of macroeconomic affairs. For example, on the average, Chile had a balanced budget during 1980s and a fiscal surplus during 1990s. Moreover, this fiscal discipline was accompanied by a reduction in both government spending and taxes. The central government spending dropped to 20 percent of GDP in 1990 from 32 percent in 1985 though it has since crept up to 24 percent. Through prudent management of monetary policy, Chile also brought inflation down to 3 percent in 1999 from 21 percent in 1989. Above all, Chile has avoided financial-capital- flow crises through a credible policy regime in general and judicious use of capital controls in particular.

3 PTAs, Trade and Growth

Having argued that trade openness is empirically a necessary condition for rapid growth, the critical question facing us today is whether this openness can be satisfactorily achieved through PTAs. Or, more directly, can we link PTAs to growth. I fear here the evidence is much weaker and logic less than compelling.

To be sure, we are hard pressed to find examples of growth miracle attributable to PTAs. The closest we come is Mexico but the post-NAFTA Mexican performance fails to

qualify as a miracle.[1] There is no doubt that the Mexican trade has grown at miracle rates--a fact the NAFTA devotees like to cite tirelessly--but the same cannot be said of its per-capita incomes. This is particularly puzzling since Mexico seems to satisfy other conditions of growth such as macroeconomic stability and policy credibility. One is tempted to speculate whether trade diversion, which most surely happened, contributed to the slowdown in growth. But not having a detailed knowledge of Mexico, I will hold that temptation.

On the other hand, as I have already noted, Chile, which did not hang its growth strategy on a PTA peg, has been able to sustain rapid growth for two decades. Likewise, India and China have both grown at miracle rates during the last two decades while opening up their economies but on a nondiscriminatory basis. In the same vein, despite the 1997-98 financial crises, the majority of the East and Southeast Asian economies have resumed growth at miracle rates but without PTAs playing significant role.

The evidence coming cross-country growth regressions is at best mixed. My own early work in 1992 with Jaime de Melo and Claudio Montenegro produced negative results on balance. And subsequent studies have generally failed to produce more reassuring results as well. To my knowledge, the main exception that deserves close attention and scrutiny is the study by my student Matias Berthelon to be presented later in this conference. Rather than rely on the dummy variable to represent PTAs in the regressions, as is conventional, he defines a new variable that takes into account the share of the PTA partner in the world GDP to represent the participation of a country in PTAs. This variable captures the idea that a PTA with the United States is not the same thing as that with Ecuador. Berthelon then finds that PTAs do contribute positively to growth.

But I fear cross-country regressions have never settled a policy debate and much more will be needed to persuade the PTA skeptics among whom I include myself. Underlying these regressions is the assumption that the diverse countries ranging from the United

[1] I do not include here the European Union (EU) since it has always been much more than a PTA and has been gradually working its way toward a single state. Moreover, in the days that the EU grew rapidly, it was progressively lowering its external trade barriers. In contrast, the countries participating in PTAs today appear to have sworn against lowering their external trade barriers. I return to this issue below.

States to United Arab Emirates operate on the same aggregate production function and that they are all in a steady-state equilibrium. These are rather heroic assumptions.

4 PTAs and Trade Liberalization

Before I conclude, let me mention a few downsides of the PTA route to liberalization. First, in countries with high tariffs, the risk of trade diversion remains. Unless countries have brought all their tariffs down to the 8-10 percent range, they should not take this risk lightly. Sectoral exceptions and the rules of origin tend to operate with vengeance in precisely those sectors where the potential for trade creation exists.

Second, PTAs have had a definitely adverse effect on unilateral or autonomous liberalization. This is most visible in Latin America where unilateral trade liberalization has come to a standstill. Only countries in Asia such as China and India have been continuing their unilateral liberalization. But even India appears to be now moving rapidly into the PTA game and that will diminish the prospects of its continued unilateral liberalization.

Third, agricultural export and domestic subsidies can simply not be dealt with in the PTA context. And in so far as PTAs distract countries from multilateral liberalization, agricultural liberalization will suffer.

Fourth, PTAs have already fragmented the trading system as never before. The "Spaghetti Bowl" has become a reality today. The cornerstone of the GATT and WTO was the Most Favored Nation (MFN) principle. This principle made eminently good sense from the viewpoint of both administrative order and efficiency. Both objectives have now fallen victims to the so-called liberalization. Some may simply dismiss this as water under the bridge. But we can do something about it by agreeing in the Doha Round to eliminate all industrial tariffs by a certain date such as 2015 for the rich and 2020 for the poor countries.

Finally, the greatest downside of PTAs is the proliferation of trade-unrelated issues in PTAs. Increasingly, these arrangements are less about trade liberalization and more about non-trade issues. The trend began with the inclusion in the NAFTA of WTO plus IPP provisions and side agreements on labor and environment. The process later moved forward to the inclusion of the WTO plus IPP and labor and environmental standard becoming into the core FAT agreement in the U.S.-Jordan FTA. More recently, tough restrictions have

also been introduced on the use of capital controls in the U.S> agreements with Chile and Singapore. While the promotion of labor and environmental standards itself is a good cause, some economists object to the use of trade agreements to pursue it. Making market access contingent on such standards promises to further fragment the trading system. Worse still, the acceptance of this PTA template by a large number of WTO members will itself become justification for the inclusion of these standards into the WTO.

5 Conclusions

The proliferation of PTAs is at best a mixed blessing. While liberalizing trade between union partners, they have undermined the MFN principle and created a spaghetti bowl of tariffs. They also hurt non-member nations located principally in Asia. The most effective instrument to combat this is to complete multilateral liberalization. The United States has on the table a proposal to bring all industrial tariffs down to 8 percent by 2010 and zero by 2015. The merits of this proposal should be explained to other nations. If this proposal, modified to address developing country concerns by giving them longer phase out period, can be turned into an agreement under the Doha negotiations, the need for PTAs will itself vanish. The critical question, however, is whether the current passion to forge new PTAs and maintain the existing preferences will not undercut the desire of to achieve full multilateral liberalization.

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