THE DEVELOPING COUNTRIES' HAZARDOUS OBSESSION WITH GLOBAL INTEGRATION[1]

Dani Rodrik
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A senior U.S. Treasury official recently urged Mexico's government to work harder to reduce violent crime because, in his words, "such high levels of crime and violence may drive away foreign investors."[2] This may have been an off-the-cuff remark. But it nicely illustrates how foreign trade and investment have now become the ultimate yardsticks for evaluating government actions. If you want to get a policy maker's attention these days, forget the slum dwellers or *campesinos* who suffer the lion's share of the costs; you need to appeal instead to "investor sentiment" and "competitiveness in world markets."

What lies behind this perversion of priorities is a remarkable consensus on the imperative of global economic integration. Openness to trade and investment flows is no longer viewed simply as a component of a country's development policies; it has mutated into the most potent catalyst for economic growth known to men. This faith has spread in recent years from a handful of proselytizing academic economists to world leaders and policy makers of all political stripes. Senior officials of the WTO, IMF, and other international agencies incessantly repeat the mantra: open trade and investment policies are the surest ways to achieve economic growth and poverty alleviation.

But insertion in the world economy is no longer a matter simply of removing trade and investment barriers. Countries have to comply with a long list of admission requirements,

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[2] WSJ, 7/3/2000, p. A8.

ranging from patent rules to banking standards. The apostles of economic integration prescribe comprehensive institutional reforms that took today's advanced countries generations to accomplish, so that developing countries can, as the cliché goes, maximize the gains and minimize the risks of participation in the world economy. Global integration has become for all practical purposes a substitute for a development strategy.

This is bad news for the world's poor. The new agenda of global integration is built on shaky empirical ground and is seriously distorting policy makers' priorities. Making compliance with it the first order of business diverts human resources, administrative capabilities, and political capital away from more urgent development priorities such as education, public health, industrial capacity, and social cohesion. It undermines nascent democratic institutions by removing the choice of development strategy from public debate.

World markets are a source of technology and capital; it would be silly for the developing world not to exploit these opportunities. But globalization is not a short cut to development. Successful development strategies have always required a judicious blend of imported practices with domestic institutional innovations. Policy makers need to forge a *domestic* growth strategy, relying on domestic investors and domestic institutions. The most costly downside of the integrationist faith is that it is crowding out serious thinking and efforts along such lines.

The Refurbished Washington Consensus

Reality has not been kind to the faith. Countries that have bought wholeheartedly into the orthodoxy are finding out that openness does not live up to the promise. Despite sharply lower barriers to trade and investment, scores of countries in Latin America and Africa are stagnating or growing less rapidly than in the heyday of import substitution. The fastest growing economies

are those of East and Southeast Asia, China, and India. The latter have also espoused trade and investment liberalization, but have typically done so in an unorthodox manner—gradually, sequentially, and only after an initial period of high growth—and as part of a broader package with many unconventional features.

The disappointing outcomes with deep liberalization have been absorbed into the faith with remarkable aplomb. While global integration remains the key prerequisite for economic development, there is now a lot more to it than just throwing the borders open. The catch is that reaping the gains from openness requires a full complement of institutional reforms.

Consider trade liberalization first. Ask a World Bank economist what a successful trade liberalization requires, and she is likely to come up with a laundry list of measures: tax reform to make up for lost tariff revenues; social safety nets to compensate displaced workers; administrative reform to bring trade practices into conformity with WTO rules; credibility enhancing institutional innovations to quell doubts about the permanence of the reforms; labor market reform to enhance labor mobility across industries; technological assistance to upgrade firms adversely affected by import competition; training programs to ensure that export-oriented firms and investors have access to skilled workers; and so on. And as the promise of trade liberalization fails to materialize, the prerequisites keep on expanding. For example, Clare Short, the U.K.'s chief spokesperson on development, recently added universal provision of health and education to the list.[3]

In the financial arena, complementary reforms have been pushed with even greater fanfare and urgency. The prevailing view in Washington and other G7 capitals is that weaknesses in prudential regulation, corporate governance, and bankruptcy procedures were at

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[3] FT, 12/12/2000, p. 8.

the heart of the Asian financial crisis. Hence the ambitious efforts by the G7 to establish international codes and standards covering fiscal transparency, monetary and financial policy, banking supervision, data dissemination, corporate governance, and accounting standards. The Financial Stability Forum (FSF)--an agency with *no* developing country member--has designated twelve of these standards to be key for sound financial systems in developing countries. The full FSF compendium includes an additional 52 standards "considered relevant for sound financial systems," bringing the total number of codes to 64. The primary motive behind these codes is to make the developing countries' integration into global financial markets safe--for themselves and other "emerging markets".

In view of how demanding the prerequisites have become, a cynic might be excused for wondering whether the point of it all is not to provide easy cover for eventual failure. After all, it is far more convenient to blame disappointing growth performance or a financial crisis on "slippages" in the implementation of complementary reforms than on a poorly designed liberalization. So if Bangladesh's trade reform has not produced a large enough spurt in growth, the World Bank concludes that it must have to do with lagging reforms in public administration or with continued political uncertainty. If Argentina gets caught up in a confidence crisis despite significant trade and financial liberalization, the IMF reasons that structural reforms have been inadequate and need to be deepened.

Membership Fees

Most (but not all) of the institutional reforms on the integrationist agenda are perfectly sensible ones, and in a world without financial, administrative, or political constraints, there would be little argument about the need to adopt them. But in the real world, fiscal resources,

administrative capabilities, and political capital are all scarce, and choices need to be made about how to deploy them. In such a world, viewing institutional priorities from the vantage point of insertion in the global economy has real opportunity costs.

Consider some illustrative tradeoffs. It has been estimated that that it costs a typical developing country $150 million to implement requirements under just three of the WTO agreements (those on customs valuation, sanitary and phytosanitary measures (SPS), and intellectual property rights (TRIPs)). As the World Bank's Michael Finger points out, this is a sum equal to a year's development budget for many of the least-developed countries. The budgetary burden of implementing the financial codes and standards has never been fully costed out, but these probably entail an even more serious diversion of fiscal and human resources. Should the government train more bank auditors and accountants, even if it means fewer secondary-school teachers or lower investment in primary education for girls?

In the area of 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 several months gathering political support for a bill that would provide foreign investors the protection of international arbitration. Wouldn’t it have been a better strategy for the long run to reform the existing legal regime for the benefit of foreign *and* domestic investors alike?

In 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? In industrial strategy, should the government simply open up and let the chips drop wherever they might, or should it emulate East Asian experience of industrial policies through export subsidies, directed credit, and selective protection?

How much should the government spend on social protection in view of the fiscal constraints imposed by market "discipline"? In Peru, the Central Bank holds foreign reserves equal to 15 months of imports, as an insurance policy against sudden capital outflows of the type that a financially open economy is prone to. The social cost of this policy amounts to almost 1 percent of GDP annually. That is more than enough to fund a generous anti-poverty program.

How should governments choose their exchange rate regimes? The rules of good behavior under financial openness require that policy makers give up on managing the exchange rate. Yet virtually every growth boom of the last four decades in the developing world has been accompanied by a controlled depreciation of the domestic currency.

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 poor the most? Perhaps, as the proponents of permanent normal trade relations (PNTR) with China argued in the recent U.S. debate, a government that is forced to protect the rights of foreign investors becomes more inclined to protect the human rights of its own citizens too. But isn't this, at best, a trickle-down strategy of institutional reform? Shouldn't institutional reform be targeted on the desired ends directly—whether those ends are the rule of law, improved observance of human rights, or reduced corruption?

The rules for admission into the world economy not only reflect little awareness of development priorities, they are often completely unrelated to sensible economic principles. WTO rules on anti-dumping, subsidies and countervailing measures, agriculture, textiles, TRIMs, and TRIPs are utterly devoid of any economic rationale beyond the mercantilist interests of a narrow set of powerful groups in the advanced industrial countries. The developmental payoff of most of these requirements is hard to see.

Bilateral and regional trade agreements are typically far worse, as they impose even tighter prerequisites on developing countries in return for crumbs of enhanced "market access" in the larger partners. The Africa Growth and Opportunity Act signed by President Clinton in May, 2000, contains a long list of eligibility criteria, including the specific requirement that African governments minimize interference in the economy. It provides free market access into the U.S. only if the apparel is made from U.S.-produced fabric and yarns, thereby ensuring that few economic linkages are generated in the African countries themselves. The U.S.-Jordan Free Trade Agreement imposes more restrictive intellectual property rules on Jordan than exist under the WTO.

With regard to financial codes and standards, there are similar questions about their appropriateness and effectiveness. These codes rely heavily on an Anglo-American style of corporate governance and an arms' length model of financial development. They close off alternative paths to financial development, of the sort that have been followed by many of today's rich countries (for example, Germany, Japan, or South Korea). Can we necessarily presume that these codes and standards are good for development? If so, the case has yet to be made.

In each of these areas, a strategy of globalization-above-all crowds out alternatives that may be more development-friendly. Many of the institutional reforms needed for insertion in the world economy can be independently desirable, or produce broader spillovers. But these priorities do not necessarily coincide with the priorities of a more fully developmental agenda.

Asian myths

Even if the institutional reforms needed to join the international economic community are expensive and preclude investments in other crucial areas, pro-globalization advocates argue that these costs will be more than compensated by the vast increases in economic growth that invariably result from insertion into the global marketplace. Take the East Asian tigers or China, the advocates say. Where would they be without trade and foreign investment?

That these countries benefited enormously from their progressive integration into the world economy is undeniable. But look closely at what produced these results, and you will find little that resembles today's rulebook.

Countries like South Korea and Taiwan had to abide by few international constraints and pay few of the costs of integration during their formative growth experience in the 1960s and 1970s. At the time, global trade rules were sparse and economies faced almost none of today's common pressures to open their borders to capital flows. So these countries combined their outward orientation with unorthodox policies: high levels of tariff and non-tariff barriers, public ownership of large segments of banking and industry, export subsidies, domestic-content requirements, import-export linkages, patent and copyright infringements, directed credit, and restrictions on capital flows (including on DFI). Such policies are either precluded by today's trade rules or are highly frowned upon by organizations like the IMF or World Bank.

China also followed a highly unorthodox two-track strategy, violating practically every rule in the guidebook (including, most notably, the requirement of private property rights). India, which significantly raised its economic growth rate in the early 1980s, remains one of the world most highly protected economies.

In all of these countries, trade liberalization was a gradual process, drawn out over a period of decades rather than years. Significant import liberalization did not take place until

after there had been a transition to high growth. And far from wiping the institutional slate clean, all of them managed to eke growth out of the existing institutions, imperfect as they may have been. When some of the successful Asian countries threw caution into the wind and gave in to American pressure to liberalize capital flows rapidly, they were rewarded with the Asian financial crisis.

This is why these countries can hardly be considered poster children for today's global rules. South Korea, China, India, and the other Asian success cases had the freedom to do their own thing, and they used it abundantly. Today's globalizers would be unable to replicate these experiences without running afoul of the IMF or the WTO.

The Asian experience highlights a deeper point: a sound development strategy that produces sustained growth over the medium- to long-term is a far more effective way of achieving integration with the world economy than freeing up trade and investment and waiting for it to work its magic. Protected Vietnam is integrating with the world economy much more rapidly than open Haiti, because Vietnam, unlike Haiti, has a reasonably functional economy and polity.

The frequent incantation that economic salvation lies in greater integration with the world economy is therefore both misleading and hollow. Integration into the world economy, unlike tariffs or capital-account regulations, is not something that policy makers control directly. Telling them that they should increase their “participation in world trade” is as meaningful as telling them that they need to improve technological capabilities—and just as helpful. What policy makers need to know is which policies will produce these results, and whether the specific prescriptions that the current orthodoxy offers are up to the task.

Too Good to be True

Do lower trade barriers produce greater economic progress? The cross-national evidence on this issue is easily summarized. The available studies reveal no systematic relationship between a country's average level of tariff and non-tariff restrictions and its subsequent economic growth rate. If anything, the evidence for the 1990s indicates a *positive* relationship between tariffs and economic growth (see accompanying chart). The only systematic relationship is that countries dismantle trade restrictions as they get richer. That accounts for the fact that today's rich countries, with few exceptions, embarked on modern economic growth behind protective barriers, but now have low trade barriers.

The absence of a strong negative relationship between trade restrictions and economic growth may come as a surprise in view of the ubiquitous claim that trade liberalization promotes higher growth. Indeed, the literature is replete with cross-national studies concluding that growth and economic dynamism are strongly linked to more open trade policies. A particularly influential study finds that economies that are open, by the study's own definition, grew 2.4 percentage points faster annually than closed ones—an enormous difference.

Upon closer look, however, these studies turn out to be flawed. The classification of countries as "open" or "closed" in the aforementioned study, for example, is not based on actual trade policies but on indicators related to exchange rate policy and location in Sub-Saharan Africa. In a detailed review of the empirical literature, Francisco Rodriguez and I have found that there is a major gap between the policy conclusions that are typically drawn and what economists have actually shown. A common problem has been the misattribution of either macroeconomic phenomena (overvalued currencies or macroeconomic instability) or geographic determinants (e.g., location in the tropical zone) to trade policies proper. Once these problems

are corrected, any meaningful relationship across countries between the level of trade barriers and economic growth evaporates.

The appropriate conclusion is not that trade protection is inherently preferable to trade liberalization as a rule; certainly, there is scant evidence from the last 50 years that inward-looking economies experience systematically faster economic growth than open ones. But the benefits of trade openness are now greatly oversold. Deep trade liberalization cannot be relied on to deliver high rates of economic growth and therefore does not deserve the high priority it typically receives in the development strategies pushed by leading multilateral organizations.

The evidence on the benefits of liberalizing capital flows is even weaker. In theory, the appeal of capital mobility seems obvious: If capital is free to enter (and leave) markets based on the potential return on investment, the result will be an efficient allocation of global resources. But, the theory notwithstanding, in reality financial markets are inherently unstable, subject to bubbles (rational or otherwise), panics, short-sightedness, and self-fulfilling prophecies. There is plenty of evidence that financial liberalization is often followed by financial crash—just ask Mexico, Thailand, or Turkey. There is practically no evidence to suggest that higher rates of economic growth follow capital-account liberalization.

Perhaps the most disingenuous argument in favor of liberalizing international capital flows is that the threat of massive and sudden capital movements serves to discipline policy makers in developing nations who might otherwise manage their economies irresponsibly. In other words, governments might be less inclined to squander their societies' resources if such actions were to spook foreign lenders. In practice, however, the discipline argument falls apart. Behavior in international capital markets is dominated by mood swings unrelated to

fundamentals. In good times, a government with a chronic fiscal imbalance has an easier time financing its spending when it can borrow funds from investors abroad—witness Russia prior to 1998 or Argentina in the 1990s. And in bad times, governments may be forced to adopt inappropriate policies in order to conform to the biases of foreign investors—witness the excessively restrictive monetary and fiscal policies in much of East Asia in the immediate aftermath of the Asian financial crisis. A key reason why Mahathir's Malaysia was able to recover so quickly after the imposition of capital controls in September 1998 was that the country avoided the high interest rates and tight fiscal policies that Korea, Thailand, and Indonesia succumbed to.

Look not to Washington, but Within Yourself

Well-trained economists are justifiably proud of the standard, textbook argument in favor of free trade. For all its simplicity, it is one of our profession's most significant achievements. However, in their efforts to promote the virtues of trade, the more zealous proponents are proffering exaggerated and unsubstantiated claims about the virtues of economic openness. These claims only endanger broad public acceptance of the real article because they unleash unrealistic expectations about the benefits of free trade.

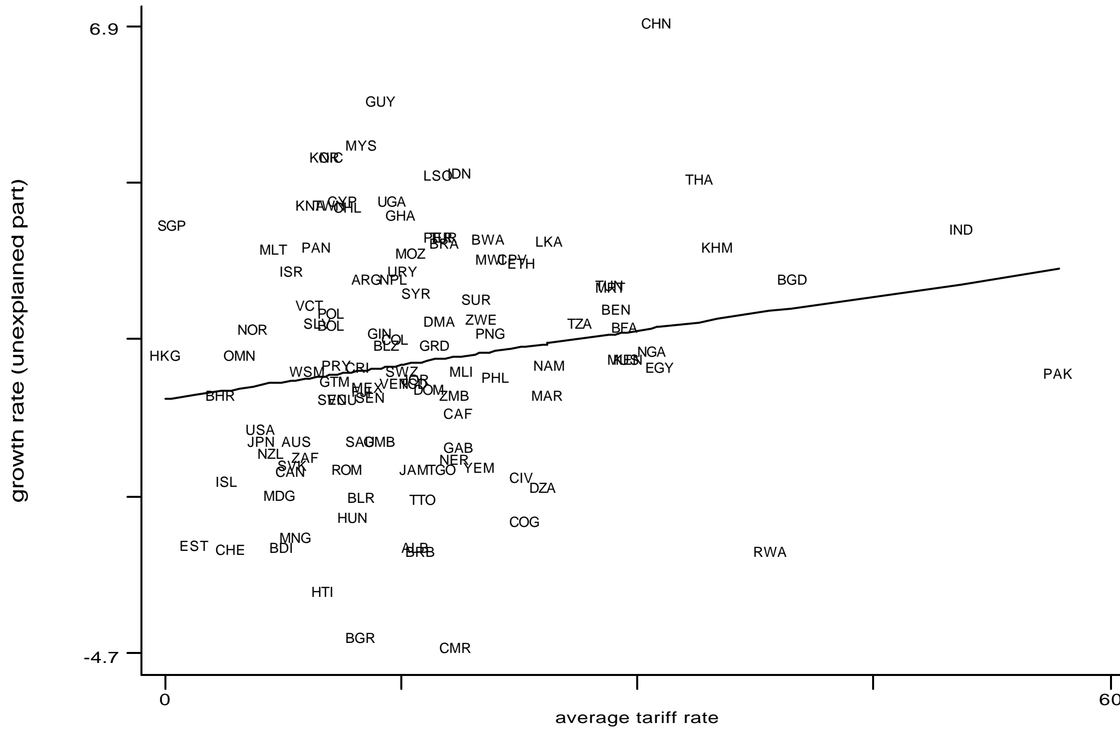
Countries that have succeeded in fostering long-term economic growth have usually combined the opportunities offered by world markets with a growth strategy that mobilizes the capabilities of domestic institutions and investors. Designing such a growth strategy is both harder and easier than what the integrationists believe. It is harder because the binding constraints to growth are typically specific to individual countries and do not respond well to standardized recipes. It is easier because once those constraints are targeted, relatively simple

policy changes can yield enormous economic payoffs and set off a virtuous cycle of growth and further reforms.

Unorthodox innovations that depart from the rulebook are typically part and parcel of such strategies. Public enterprises in Meiji Japan; township and village enterprises in China; an export processing zone in Mauritius; generous tax incentives for priority investments in Taiwan; extensive credit subsidies in South Korea; infant-industry protection in Brazil during the 1960s and 1970s—these are some of the innovations that have been instrumental in kick-starting investment and growth in the past. None came out of a Washington economist's tool kit.

If few of these experiments have worked as well when transplanted in other settings, the fact only underscores the decisive importance of local conditions. To be effective, development strategies need to be tailored to prevailing domestic institutional strengths. There is simply no alternative to a home-grown "business plan." Policy makers that look to Washington and financial markets for the answers are condemning themselves to mimicking the conventional wisdom *du jour*, and to eventual disillusionment.

Low import tariffs are good for growth? Think again



<u>Notes</u>: All data are averages for the 1990s, and come from the World Bank. Initial income, government consumption/GDP, and inflation rate are separately controlled for.