Trade and the Developing World: A New Agenda

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JOSEPH F. STIGLITZ

The gap between the developed and the less developed countries is widening, a gap the international community is doing too little to narrow. Even as the ability of developing countries to use aid effectively has increased, the level of development assistance has diminished, with aid per capita to the developing world falling by nearly a third in the 1990s. Cuts in aid budgets have been accompanied by the slogan of “Trade, not aid,” together with exhortations for the developing world to participate fully in the global marketplace. At the same time, developing countries have been lectured about how government subsidies and protectionism distort prices and impede growth.

Yet all too often these exhortations ring hollow. As developing countries take steps to open their economies and expand their exports, they find themselves confronting significant trade barriers—leaving them, in effect, with neither aid nor trade. They quickly run up against dumping duties (when no economist would say they are really engaged in dumping), or they face protected or restricted markets in their areas of natural comparative advantage, such as agriculture or textiles.

In these circumstances, it is not surprising that critics of liberalization within the developing world quickly raise cries of hypocrisy. Developing countries often face great pressure to liberalize quickly. When they raise concerns about job loss they receive the doctrinaire reply that markets create jobs, and that the resources released from the protected sector can be redeployed productively elsewhere. Often, however, the jobs do not appear quickly enough for those who have been displaced; and all too often the displaced workers have no resources to buffer themselves, nor is there a public safety net to catch them as they fall. These are genuine concerns. What are developing countries to make of rhetoric in favor of rapid liberalization, when rich countries—countries with full employment and strong safety nets—argue that they must impose protective measures to help those adversely affected by trade? Or when rich countries play down the political pressures within developing countries—insisting that their polities “face up to the hard choices”—but at the same time excuse their own trade barriers and agricultural subsidies by citing “political pressures”?

I do not doubt that trade liberalization will be of benefit to the developing countries, and to the world more generally. But trade liberalization must be balanced in its agenda, process and outcomes, and it must reflect the concerns of the developing world. It must take in not only those sectors in which developed countries have a comparative advantage, like finan-

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1. Aid per developing country resident in 1990 was $32.27; in 1997 it was only $22.41.
cial services, but also those in which developing countries have a special interest, like agriculture and construction services. It must not only include intellectual property protections of interest to the developed countries, but also address issues of current or potential concern for developing countries, such as property rights for knowledge embedded in traditional medicines, or the pricing of pharmaceuticals in developing country markets.²

Success in trade liberalization requires understanding the sources of opposition, and assessing the legitimacy of that opposition and whether and how these concerns can be addressed. Standard economic analysis argues that trade liberalization—even unilateral opening of markets—benefits a country. In this view, job loss in one sector will be offset by job creation in another, and the new jobs will generate higher productivity than the old. This movement from low- to high-productivity jobs represents the gain from the national perspective, and explains why, in principle, everyone can become better off as a result of liberalization. This economic logic requires markets to be working well, however, and in many countries, underdevelopment is an inherent reflection of poorly functioning markets. Thus new jobs are not created, or not created automatically (moving workers from a low-productivity sector to unemployment does not increase output). A variety of factors contribute to the failure of jobs to be created, from government regulations, to rigidities in labor markets, to lack of access to capital. But whatever the causes, they must be addressed simultaneously with trade liberalization if a convincing case is to be made for that liberalization.

The case for trade liberalization is undermined both when developed countries act hypocritically and when market imperfections that are not dealt with result in trade liberalization policy to lower output and wages and increase unemployment. There are some sectors where these markets are particularly important, where the standard competitive paradigm does not work well even in developed countries, let alone developing countries. A stark lesson of the recent East Asia crisis is that weak financial institutions can wreak havoc on an economy, and that strong financial institutions require strong government regulation. But the increased frequency and depth of financial crises in recent years—with close to 100 countries suffering through such crises over the past quarter-century—have shown how hard it is to establish strong financial institutions, even in developed countries. It also has shown that liberalization—both capital market and financial sector liberalization—without the requisite accompanying improvements in regulation and supervision can contribute to financial-sector instability. That instability in turn has exacted great costs in terms of growth, deepening poverty in the crisis countries.

Finally, we must recognize that while enormous progress has been made in trade liberalization over the past 50 years under the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), today real threats exist to that progress. It is not just that future progress may be slow, but there may be, in effect, backsliding, as nontariff barriers replace tariff barriers, with the former far less transparent than the latter. Per-

²The marked disadvantage that developing countries have in participating meaningfully in negotiations should be noted. For example, as the new World Development Report points out, 19 of the 42 African World Trade Organization members do not have a trade representative at WTO headquarters in Geneva. In contrast, the average number of trade officials from 0-0 countries is just under seven.

WHY TRADE LIBERALIZATION MATTERS

For both the developed and developing worlds, the stakes are high. First, the developing countries represent a substantial share of international trade—nearly a third of exports of goods, and nearly a quarter of exports of services. It therefore should be obvious that any meaningful world trading system must take into full account the interests and concerns of these countries. Second, as was mentioned earlier, unless we continue to move forward, there is a real danger of backsliding, as non-tariff barriers replace tariff barriers as impediments to the free movement of goods and services across national boundaries. Third, even to stay still we must move forward: the changing composition of national output, and in particular the increasing role of services, mean that we must broaden the scope of international trade agreements. Fourth, for developing countries, more is at stake than just the efficiency gains from exploitation of comparative advantage; there are also long-term dynamic gains to openness. Trade liberalization, thus, is an essential element of an effective development strategy. But if developing countries believe that the playing field of international trade is not level but sloped against them, their resulting suspicion and lack of commitment to liberalization will set back not only the trade liberalization agenda, but also the broader reform agenda. Fifth, for the developed countries more is at risk than just a sense of fair play and a humanitarian concern for the nearly 1.5 billion individuals who live in absolute poverty. An open and vibrant international trade and investment regime benefits the entire world.

I have argued that trade liberalization is essential for successful development, and that progress in that area depends on a new round of truly balanced and inclusive trade talks. The inverse is also true: if the new round of trade talks is seen as unbalanced and support for liberalization in the developing world falters, then we are likely to see the emergence of even greater inequalities between rich and poor countries, and even more people in poverty. The end of the cold war and the seeming passing of the threat of Communism should not lull us into a sense of contentment. The implications for global economic and political security of an increasing gap between the haves and the have-nots should be obvious. Terrorism and political chaos take their toll no less than does the clash of competing superpowers.

THE POLITICS OF LIBERALIZATION

While the costs associated with liberalization animate much of
the support for restrictive trade practices, the benefits of trade liberalization far outweigh these costs. But this does not grant us license to ignore them. Developed countries have recognized the costs, including the political costs, within their own borders and have introduced provisions in trade agreements to begin to address them. But there has yet to develop a widespread understanding of: (1) the real costs of these protective measures; (2) the even greater political and economic costs facing developing countries; or (3) the need to develop a framework that responds effectively to the differentiated needs of developed and developing countries.

Indeed, the perceived costs of liberalizing may well be higher in developing than in more developed countries. But the costs of not liberalizing loom even larger: poor countries simply cannot afford either the costs associated with inefficient resource allocation that result from protection or the costs that protection incurs when it results in reduced outside flows of investment and ideas.

Let me elaborate this point briefly. I have argued elsewhere that true development entails a transformation of society.3 For poorer countries especially, excessive protection shields local residents from a key transformative mechanism. Trade and investment can bring knowledge. Openness to trade not only makes it possible for consumers to consume at lower cost, as suggested by standard models of trade, it also forces firms to innovate, and it offers firms new inputs and intermediate goods, many of which embody new knowledge. Foreign direct investment can bring with it investment capital and scarce human capital, new ways of organizing production, and access to international marketing channels and knowledge networks.

In this view then, the costs of protectionism are potentially very high for poorer countries. Yet in democratic developing countries, governments must persuade their citizens of the virtues of liberalization, and demagogues always are ready to exploit worries about liberalization—just as in more developed countries. As I have noted, when unemployment rates are high and job opportunities are limited, as is so often the case in developing countries, worries about job losses will be far greater. And more developed countries—through both their rhetoric and their actions—too often have failed to be helpful to those genuinely committed to the cause of liberalization in developing countries.

First, we must provide some context for current efforts to increase market access in developing countries. Today those appeals are based on sound economic arguments, but it was not so long ago that gunboat diplomacy—or worse, as in the case of the Opium Wars—was used to persuade recalcitrant countries to open their markets. No pretense at reciprocity was made: it was simply that gunboat diplomacy—or worse, as in the case of the Opium Wars—was used to persuade recalcitrant countries to open their markets. The Opium Wars—was used to persuade recalcitrant countries to open their markets. No pretense at reciprocity was made: it was simply that gunboat diplomacy—or worse, as in the case of the Opium Wars—was used to persuade recalcitrant countries to open their markets.

In sum, although real gains are to be had—both for developed and developing countries—from trade liberalization, special interests often triumph over general interests. In a democratic society, the majority must be convinced that they will benefit from—or at least do not face significant risks of being hurt by—liberalization. The special interests, regrettably, often masquerade as general interests, using concerns for the poor to justify sustaining their ill-gotten gains. All too often, more developed countries, both through their actions and their rhetoric, worsen the plight of the honest politician in a developing country who is trying to persuade his or her electorate to support liberalization.

Two principles

Two basic principles should govern the next set of trade negotiations: fairness, especially fairness to the developing countries, and comprehensiveness. By comprehensiveness I refer to the need to include in the round not only issues of central importance to the developed countries, such as financial market liberalization and information technology, but also those, such as construction and maritime services, that are important to developing countries. One might ask how can either principle be opposed? Yet closer examination raises doubts about the extent to which previous rounds have embodied these principles.

For example, the Uruguay Round and previous GATT trade rounds focused heavily on liberalizing tariffs on manufacturing. They did little to reduce protection in agriculture, a sector in which many developing countries have a comparative advantage. The agricultural liberalization that occurred was driven largely by the

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interests of developed exporters such as the United States and Australia, and developing country exporters in the Cairns group.\(^4\) Exporters of tropical products did not play an active role in the design of the agricultural liberalization agenda.

Moving ahead on the agricultural issue in this round would have big payoffs. Abolition of agricultural export subsidies and achievement of sharp cuts in import tariffs would benefit many developing countries. Recent research suggests that a 40 percent reduction in agricultural support policies globally would contribute almost exactly the same amount to global welfare as a 40 percent cut in manufacturing tariffs, despite the fact that manufacturing value added is 2.5 times that of agriculture globally. This reflects the huge size of distortions in agriculture relative to manufacturing. Comprehensiveness is necessary for an equitable agreement, but there are other elements of perceived fairness. Over the years, many developing countries have unilaterally (though often under strong pressure) engaged in a wide variety of trade liberalization measures. As we approach a new round of trade talks, those countries must be given credit for their concessions, in return for making them binding.

Another aspect of fairness entails sensitivity to the special needs of developing countries. This sensitivity has at least three dimensions. First, developed countries should recognize the higher costs of liberalization in developing countries. Allowing longer transition times for liberalization measures, as was done during the Uruguay Round, lowers the cost of adjustment. In addition to this concession, the more developed countries should consider establishing a formal program of trade adjustment assistance. And we should be clear: the costs of implementation can be high (It has been argued that implementation of just a few of the Uruguay Round agreements can swallow up a year’s worth of development assistance for a country).

The World Bank has played an important role in the provision of such support for imand will continue to do so in the future. Never-assistance is clearly needed.

The second point concerns the special problems posed by human needs, such as health. It has been alleged that some developed country drug companies, for example, sell their drugs to some developing countries at prices that exceed those in some developed country markets. That they might be able to do so is not surprising: intellectual property rights give drug firms scope for price discrimination; in particular, the larger developed countries with national health systems can win more favorable pricing from pharmaceutical firms. Yet as reasonable and rational as price discrimination might seem for profit-maximizing enterprises, to those in less developed countries it appears exploitative. Within the United States and other countries, such exercises of monopoly power—that is, price discrimination not justified by differences in costs of serving different customers—is illegal. It might be appropriate to consider a similar provision in the next round of trade negotiations. We must explore various ways to achieve the goal of ensuring that developing countries achieve “most favored pricing” status.

Third, the negotiations should pay special attention to the long-term growth aspirations of the less developed countries. This has several dimensions. Poorly designed financial services liberalization, for example, can lead to greater instability and perhaps even starve small and medium-sized enterprises of needed capital. Similarly, definitions of intellectual property rights must take into account the interests of users of knowledge as well as producers of knowledge. Within the developed countries, political debates have striven to achieve a balance, with both users’ and producers’ voices being heard. At the international level, a similar balance is necessary.

More problematic in this vein are issues related to promotion of infant industries, which has justified so much protectionism in the past. Certain types of technology subsidies were given the green light under the Uruguay Round, developed countries use a variety of other, hidden under the rubric of “defense.” This point was illustrated the recent debates about dual-use technologies an to aircraft manufacturers. The technology issues facing developing countries are different, but no less important. These countries must absorb new technologies; to do so, they must have the space to engage in a process of learning-by-doing, during which costs fall. With imperfect capital markets, firms cannot simply borrow against future profits, and governments may need to intervene. We must find some way of accommodating these very real concerns of developing countries.\(^5\)

[see box, LIBERALIZING FINANCIAL MARKETS, next page.]

THE BROADER AGENDA

Trade liberalization, while necessary, is not sufficient for developing countries to reap the full benefits from with the world economy. Much of the trade agenda now penetrates into areas such as domestic regulation, intellectual property rights, the efficiency of customs administration, and conformity with standards. Further, the ability of a country, and particularly of the more isolated communities within a country, to participate in trade depends upon the quality of the transport and communications infrastructure that allows them to access the world trading system.

The new, broader agenda for international trade involves many issues much more difficult to implement than trade liberalization, which, after all, can be implemented at the stroke of a pen once the necessary agreement has been obtained. Efficient infrastructure requires years of investment both in the regulatory framework under which it is supplied, and in the infrastructure itself. Similarly, improving the efficiency of customs is likely to require strengthening of the customs administration in many countries. Establishing a strong financial regulatory structure – so that opening up markets for financial services strengthens economic performance rather than contributing to economic instability – is no easy task, even for more developed countries.

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\(^4\) The Cairns Group was formed by Australia in 1986 and consists of 15 “fair trading” agricultural producing countries: Argentina, Australia, Brazil, Canada, Chile, Colombia, Fiji, Hungary, Indonesia, Malaysia, New Zealand, Paraguay, Philippines, Thailand, and Uruguay. These countries account for about 20 percent of world agricultural exports.

\(^5\) Article XVIII, Section A of the GATT does provide an explicit mechanism for infant industry protection, but that provision has been little used, presumably because of the requirement for compensation of trading partners, as well as the backlash in recent years against abuse of infant-industry arguments. But going forward, it will be important to ensure that the legitimate development concerns of poorer countries are reflected in the international trade rules – even while guarding against the development-impeding types of protectionism that have so often been justified using infant-industry arguments. Part of the task will be to preserve and raise awareness of provisions already available within the trade rules that may serve some development needs. One example is the article XIX safeguard provisions, which permit transparent protection of limited duration without requiring compensation.
LIBERALIZING FINANCIAL MARKETS

M odern financial markets are clearly important for economic efficiency and international financial institutions play an important role in promoting global economic integration, including trade expansion. But financial markets are different from ordinary markets in that our standard theorems about the gains from trade liberalization in the presence of competitive markets may not apply. The central functions of financial markets are related to the provision of information and markets for information function differently from markets for ordinary goods and services.

This fundamental difference explains why countries accept a need for financial regulation that all agree would be totally inappropriate for the typical manufacturing sector. Indeed, the recent and ongoing global financial crisis should have sensitized us to the downside risks of rapid liberalization of financial markets in countries that lack the appropriate regulatory structure. If domestic banks in the liberalizing country are weak then providing an easy avenue for depositors to switch funds to a safer foreign-owned bank could spark a run on the domestic banking system. Even short of that, the additional competition may erode franchise value of the bank, and that itself may lead to more risk taking, or more broadly imprudent behavior on the part of domestic banks. Thus even countries with reasonably good systems of bank regulation will need to tighten and improve their financial sector regulations even as they liberalize the market more broadly.

But countries liberalizing their financial systems have not taken these precautions. Typically these countries not only have failed to recognize the need to do so but instead have moved in the opposite direction, loosening their regulatory frameworks in the euphoria of liberalization. In retrospect, it should be clear that in many countries the objective should not have been deregulation but the establishment of a suitable regulatory framework. Even with the appropriate objectives, however, policymakers and regulators would have found the going tough. In country after country, the new foreign entrants into the financial system have recruited away the best and most talented individuals from the government regulating agencies. Unable to compete on salaries, agencies have found themselves much weaker just at the time they need to be strengthened.

Nor should we ignore the longer-run development problems that can arise when foreign banks displace domestic banks; these foreign banks may focus their lending efforts on providing finance to multinationals or large national firms, but may show little interest in small and medium-sized enterprises, which are often the engines of growth.

To be sure, if countries manage to strengthen their financial sector regulation as they liberalize, and if they manage to ensure that funds reach small and medium-sized enterprises and other underserved groups, then financial sector liberalization has the potential for improving the performance of this vital part of the economy. The induced competition can be an important spur to efficiency of the sector. But there are clear examples (Kenya, for one) where foreign entry, even in the presence of financial sector liberalization, has failed not only in that objective, but also in the broader goal of reducing interest-rate spreads and bringing down the rates at which funds are available to borrowers. Thus, the liberalization of financial services in developing countries approached with some caution.
The broader agenda raises the prospect that trade liberalization may yield even more benefits than it has in the past. But I should quickly add that from the perspective of the developing country, access to markets abroad, especially in the developed countries, is crucial for growth. The East Asia miracle was based on export-oriented policies that took advantage of increasing access. Such policies play a critical role in raising quality within the developing countries, in promoting the transfer of technology, and in enforcing the discipline of competition. I have previously described the development process as a transformation of society, and have argued that openness to the outside in general, and trade in particular, can play a central role in that transformation. In short, for developing countries more is at stake than simply the exploitation of the gains from comparative advantages, as important as those gains are for static economic efficiency. Trade is vital to the dynamics of successful development.

FAIRNESS, COMPREHENSIVENESS, AND THE MILLENNIUM ROUND

The two principles of fairness and comprehensiveness are strongly linked. A comprehensive approach to trade will not only be more effective in attaining the objectives of trade liberalization, but it will also be perceived as fairer. This perception will not only enhance the chances of trade liberalization within developing countries, but also increase their enthusiasm for a broader range of market reforms. A comprehensive round of trade talks that adequately represents the interests of developing countries will deflate the sentiment that market economics is a theory invoked only in the pursuit of developed country interests, and it will increase awareness that vigorous market competition benefits any economy.

Both the political and economic stakes are high. If we fail—if the developed countries allow their special interests to prevail over their national interests, both in terms of their offers of market access and their demands on the developing world for market access—then our failure will undermine confidence in democratic processes everywhere. Clearly, the developed countries have much to gain from a more integrated global economy, and they have much to gain from reducing their distortionary policies. But they can afford the luxury of the inefficiencies of the existing distortions, and they have demonstrated an impressive capacity to dismiss or overlook the intellectual inconsistencies—to use a mild term—in some of their positions.

The developing countries cannot afford such economic distortions; the evidence of the last three decades strongly supports the conclusion that market-oriented policies, including outward-oriented policies, provide their best hope for sustained growth. Such growth is absolutely necessary if poverty within these countries is to be eradicated.

The Millennium Round of trade talks that begins November 30 in Seattle provides a great opportunity. It can reinforce the movement toward true market economies, enhancing competition and promoting economic and societal transformation. At the same time, by reducing trade barriers, and thereby eliminating some of the major sources of corruption and lack of transparency, the round can strengthen democratic processes.

But the round also poses great risks. If negotiations follow historical patterns—hard bargaining motivated by special interests within developed countries, with too little attention paid to the interests of the developing countries—the Millennium Round could strengthen the hand of those in the developing world who resist market reforms and an outward orientation. It could give confirmation and ammunition to those who see relations between the third world and the developed countries through the prism of conflict and exploitation, rather than recognizing the potential for cooperation and mutual gain. Outward-oriented policies will succeed only to the extent that there are markets in which developing countries can sell their products, as well as international rules that allow developing countries to make good use of their current areas of comparative advantage and to develop new areas of economic strength.