

***Should developing countries open their economies to foreign trade and investment?
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1. Background

One of the most hotly debated policy questions in development economics is whether developing countries should open their economies to foreign trade and investment. Is this openness likely to stimulate growth of the overall economy? Can firms of developing countries compete with firms from advanced economies? What are the adjustment costs? What are the distributional implications? Will the poor benefit from openness? And are there practical approaches to sequencing of these reforms that are important for realizing benefits?

The debate about openness has been going on for a long time. Most developing countries emerged from World War Two with policy regimes closed to foreign trade and investment. Many new developing countries won their independence in the 1950s and 1960s, and most of these followed the existing pattern of high barriers to foreign trade and investment. These policy choices reflected the notion that “infant industry protection” was the best approach to developing nascent industry in the developing world. It was not at all unusual for developing countries to have industrial tariffs in the 100% range, effectively closing off the local market to global competition. Similarly, prohibitions on direct foreign investment were common. There were a number of exceptions to this pattern, notably the four tiger economies of East Asia (Hong Kong, Singapore, Taiwan province of China, and South Korea).

More recently, as globalization has proceeded, the debate has shifted more toward, which interest groups in developing countries benefit from foreign trade and investment. The anti-globalization movement has championed the idea that, while foreign trade and investment may benefit elites, the poor are made worse off in the process.

2. Methodology

Because of the obvious importance of this topic, the World Bank has devoted considerable effort to researching the effect of foreign trade and investment on growth and poverty. I have been involved in this research at several different points of my career. I think that it is worth distinguishing four different and complementary approaches to researching this issue:

- A. The first approach is simply data collection and dissemination. The Bank has collected a lot of data on trade policies such as tariff rates and non-tariff barriers. The data themselves clear up some debates. The Bank has also sponsored household surveys in many countries. In Vietnam we helped the government conduct a careful, nationally representative household survey in 1992, and then revisit the same households six years later. Similarly, the Bank has sponsored many surveys of firms which can

be used to research the effect of trade policy on firm productivity and dynamics.

- B. There have been many cross-country statistical analyses of the effect of trade and investment on growth. These are useful for showing general patterns in the data, but cannot rigorously establish causality.
- C. Case studies of individual reform efforts are very useful for showing how policy reform in practice is carried out and for estimating the effect of policy changes in specific cases.
- D. Studies at the industry and firm level can also shed light on the effects of trade and investment policy.

For important policy questions, it is useful to use different methodological approaches, as it is unlikely that one approach alone will provide a convincing answer.

3. From research to decision making

My experience has been that case studies are the most convincing way to bring research results to policy-makers. Furthermore, policy-makers are more likely to be convinced when they hear directly from other policy-makers. I worked with the policy-makers in Vietnam during the period 1989-1995. During this time there was very extensive liberalization of the country's policies toward foreign trade and investment. The World Bank used various approaches to bringing research results into the policy discussion. World Bank reports summarized various pieces of research that indicated that trade and investment liberalization was likely to accelerate Vietnam's growth. We included cuts in import tariffs as conditions in the first structural adjustment loan to Vietnam. We also arranged policy seminars that brought senior policy-makers from nearby countries (Indonesia, Malaysia, Singapore, South Korea) to meet with Vietnam's policy team. In my view this last effort was far more effective than any of the others. Officials who had actually carried out reforms discussed how they had done it, what opposition they had faced, and what results they had gotten. This is much more persuasive than research papers can ever be.

I also found that "mere" data collection is one of the most useful things that researchers can contribute. In Vietnam it quickly became clear that opening up to foreign trade and investment was leading to faster growth. But the critics of openness then shifted their position and argued that this growth was leading to higher inequality and not benefiting the poor. The careful second survey in the late 1990s showed conclusively that there was not in fact any large increase in inequality and that the poor had seen very sharp increases in their income and consumption.

4. Politics and policy

Politics and research interact and clash in interesting ways. In general, I think that research can point the broad direction toward needed policy changes (*what* needs to be done). Politics, on the other hand, will determine *how* reform is carried out. A lot has been made about the fact that policy change tended to be rapid ("big bang") in Eastern

Europe and gradual in East Asian countries such as China and Vietnam. In my view, politics dictated these outcomes in both cases. China and Vietnam had relatively stable political regimes. Stable regimes are likely to institute reforms gradually. The regime does not want to suggest that its prior policy was completely wrong. Also, very large changes can be destabilizing. Where there is big political change, as in Eastern Europe, on the other hand, the new regimes do want to suggest that prior policies were completely wrong and have more interest in big changes, quickly.

5. *Lessons learned*

It is impossible to get perfect reconciliation between research and policy-makers because their interests are somewhat different. Researchers continue to put a lot of effort into showing rigorously the causality between policy and outcomes. Policy-makers do not care about this rigor. Once it is clear that a policy such as trade liberalization tends to go hand-in-hand with faster growth, that correlation is convincing to policy-makers. While the academic debate about trade and growth continues, the policy debate is largely settled. Almost all developing countries have liberalized trade and have far more open regimes than they had 20 years ago. But countries now are searching for what complementary policies will increase the benefits of open trade and what kinds of distributional and safety net policies help manage the tension associated with it. Research is a nice business in that success always invites new questions and more business. Twenty years ago, there were so few liberalization experiences that there would have been no empirical basis for studying how complementary policies or differences in safety nets affected outcomes. Now that the policy community is convinced that open trade is good and has instituted this policy broadly, there are a wide range of liberalization experiences that can be studied.

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