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## Can free trade guarantee gains from trade?

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Research Paper No. 2008/97

## **Can Free Trade Guarantee Gains from Trade?**

Moritz Cruz\*

October 2008

### **Abstract**

Static and dynamic gains from trade are the reasons why countries embark on the path of free trade, expecting this to promote industrialization and development. There is nothing, however, in the conventional theory of international trade that guarantees that these gains will materialize and even if they do, they may not accelerate industrialization and growth. This is because there are a number of deleterious effects that the same theory omits and/or ignores. They are, *inter alia*, the monetary effects of trade specialization on the balance of payments, loss of policy autonomy, deindustrialization and jobless growth. When the costs of free trade outweigh its benefits, the slowdown of industrialization and development are the likely results. To avoid this, gradual openness and government intervention are necessary. In this paper, these observations are examined by contrasting the experiences of China and Mexico since these economies introduced trade liberalization. The comparison sheds light on the type of policies that both open and still closed developing economies currently need to implement if they want to reap the static and dynamic gains from trade, and thus make real economic progress.

**Keywords:** free trade, trade gains, industrialization, government intervention, China, Mexico

**JEL classification:** F1, F13, F43

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## Acronyms

FDI foreign direct investment

NIEs newly industrialized economies

SOEs state owned enterprises

TNCs transnational corporations

WTO World Trade Organization

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## 1 Introduction

According to the World Trade Organization (WTO 2007), nine out of the ten top economies with the largest share of trade in 2006 are in the developed world. Their shares account for almost 46 per cent and 49.3 per cent of the world's total exports and imports, respectively, while another ten advanced economies, from a sample of fifty, account for 10 per cent and 9.9 per cent, respectively. Thus, developed economies overall enjoy the largest share of global trade. For this selected group of economies, one question is worthy asking: how did they make trade the real engine of growth, industrialization, and development?

The answer to this question can be traced back to a statement posed more than a century ago to the British economist, Alfred Marshall: 'The causes which determine the economic progress of nations belong to the study of international trade' (Thirlwall 2003: 2). In effect, if one wants to understand how international trade promotes growth, industrialization, and development, it is necessary to study the methods used by economies to make trade the engine for achieving these aims; or to be more precise, to study how countries reap the so-called static and dynamic gains from trade.

In general, historical evidence indicates that in making trade an engine of economic progress, countries during the initial stages of their development benefited from static and dynamic gains of trade by applying policies outside the conventional rhetoric of free trade. They used, instead, trade barriers to protect their infant industries from external competition, actively adopting trade and industrial policies that included, among others, infant industry protection and export subsidies (see, for example, Amsden 2001; Chang 2002, 2003, 2004, 2007; Cruz 2007; Lall 2003, 2004). For this reason, 'historically, relatively high tariffs have accompanied major waves of industrialization' (Amsden 2000: 1). Even in today's globalized world, there is not a single developed country that does not apply some sort of industrial policy, or claim to be totally opened. In this sense, to paraphrase Dobb (1975: 25), 'we live in an era of neo-mercantilism'.

If free trade is not the panacea for the industrialization of the major advanced and newly industrialized economies (NIEs), why do developing economies insist on embarking on the path of (unfair) free trade? That is, how can they pretend to benefit from trade if they open their frontiers without being prepared to face fierce competition? They lose not only employment opportunities, but also their autonomy with respect to economic policy and impose additional obstacles on the road to industrialization and growth. In sum, the question to ask is: why do they dogmatically follow the conventional free trade theory? They do so because, contrary to what historical evidence shows, they believe that it is the only way to reap the gains from trade. Today, one leading example in this regard is Mexico, which initiated trade liberalization strategy in the mid-1970s exactly as dictated by conventional trade theory. However, since the implementation of major trade reforms in the mid 1980s, its economic progress has been paltry. Indeed, the case of Mexico can be generalized with those economies and regions that have dogmatically applied (or are applying) a strategy of rapid free trade liberalization.

China started trade liberalization almost at the same time as Mexico. However, contrary to Mexico, China has managed to benefit from trade, thanks to a strategy that consisted of a gradual, careful trade liberalization coupled with industrial, trade, technological, fiscal, and monetary policies implemented and coordinated by the state. China's

development strategy is, in many ways, reminiscent of the strategies of both advanced and new industrialized economies. As a consequence, growth and industrialization in China have been impressive and poverty reduction has been substantial during the last quarter century.

By contrasting Mexico's and China's road to globalization, this paper aims to show that the gains from trade—which, to some extent, explain the process of sustained growth, industrialization and development—cannot be achieved through market forces, namely free trade. Government intervention is necessary. The paper is structured as follows. In section 2, we present the conventional theoretical reasons that motivate an economy to adopt free trade. At the same time, we also highlight some of the deleterious effects that the same theory overlooks. In section 3, we argue, by presenting the experience of Mexico, that the strategy of trade liberalization has not been successful in attaining industrialization, and that the costs of free trade have offset its benefits. In section 4 we examine China's experience of trade liberalization, showing that government intervention has been of paramount importance in making trade the engine of progress. Finally in section 5, we conclude by presenting some policy suggestions that both open and relatively closed developing economies can currently adapt to gain greater benefit from trade.

## **2 Free trade: gains and costs**

The standard recommendations emanating from the conventional rhetoric of international trade imply that once an economy eliminates government distortions, prices should reflect the correct cost of production and resources be allocated optimally in resource-abundant countries. This would mean the economy dismantling quantitative restrictions on imports, reducing import tariffs (and their dispersion), making the currency convertible for current account transactions, eliminating bureaucratic red tape and other impediments to foreign direct investment and improving customs procedures (Rodrik 2006a). This should lead to increased specialization, and the argument goes, eventually to capital accumulation and technological progress (higher productivity) should rise as result of increasing competition. In the interim, the economy should exhibit an income and wage convergence with trade partners and also within the economy (in other words, an improvement in the living standards).

These are the static and dynamic gains of trade, and the desire to take advantage of these opportunities is the main economic motivation of why economies embark on trade, through unilateral trade liberalization and/or free trade agreements. In short, countries expect trade to become the paramount engine of growth, industrialization, and development. The policy recommendation derived from this view is thus clear: the faster the economy removes trade distortions, the sooner it will enjoy the gains from trade, leaving the market forces to accelerate growth, promote industrialization, and improve the living standards of the population.

There are, however, several deleterious caveats (namely costs) with these static and dynamic benefits that must be taken into account when evaluating the opportunities of free-trade strategy. These are the costs that conventional trade theory (as well as the large number of empirical studies aimed at supporting conventional trade liberalization) implicit or explicitly ignore and/or overlook.

First, the static gains, which arise from shifting resources from one sector to another as the country's comparative advantage increases specialization, are an one-time improvement only. That is, once tariff and non-tariff barriers are removed, the static gains of trade are exhausted (Thirlwall 2003). Furthermore, they may not necessarily have a positive impact on the industrialization process. As dictated by comparative advantage (either based on the Ricardian or on the Heckscher-Ohlin model of trade), specialization occurs in goods with lower production costs relative to global costs, usually those in which the country is resource abundant. If an economy happens to be rich in labour and is thus a labour-intensive producer, then it is destined to specialize in primary goods (on which the terms of trade usually deteriorate over time against manufactured goods and whose price and income elasticity of demand are low). Alternatively, the country may specialize in the production of labour-intensive manufactured goods that have very little domestic contribution in total value added. When this occurs, the country becomes a labour-intensive assembler of components.

Second, the essence of the dynamic gains of trade is that they shift the frontier of production possibility outwards, especially if trade is associated with greater investment and faster productivity growth based on new technology, particularly through foreign direct investment (FDI).<sup>1</sup> Moreover, if production is subject to increasing returns, export growth is expected to become a continual source of productivity growth. Exports also expand the total market for local producers. At the same time, there is a stimulus to competition which is anticipated to improve productivity even further (Thirlwall 2003: 5-6). The central caveat with these dynamic gains is that there is nothing to guarantee that all of these will occur. Furthermore, even if these do materialize, there is no assurance that the development will have a positive effect or significantly accelerate industrialization. On the one hand, effectively, trade widens the exports markets which, in turn, generate export growth. This could translate into higher output if exports exceed imports<sup>2</sup> (needless to say, growing output does not necessarily imply industrialization, especially when this is not coupled with increments in the sector's value added and employment creation). But the key point to notice here is that in reality, transnational corporations (TNCs) are usually the main agents of export activity and their export dynamics may not necessarily be 'harnessed' to domestic producers. Without a regulatory framework to link the tradable sector with local plants, it is likely that international markets will remain permanently beyond the scope of domestic enterprises.<sup>3</sup>

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<sup>1</sup> If the salient point of the conventional trade theory is to eliminate government distortions, then the same theory assumes that faster productivity through FDI can be attained by adopting a passive FDI-dependent policy approach that would consist of 'opening up to FDI and attracting investors to existing advantages—natural resources or cheap unskilled labour—for exports markets' (Lall 2002: 80). The likely result, however, in adopting this approach is that there will be no incentives for domestic technologies to develop. In other words, technology import is seen as a substitute of capability development.

<sup>2</sup> Recall that higher exports imply more import needs and in a free trade context there may be little incentive to satisfy the domestic demand for inputs. This is certain to occur if there are no domestic local content compulsory requirements on exports, if prices are cheaper abroad (through subsidiaries) and/or if there is a lack of local suppliers. As a result, the income elastic of demand for imports will grow, imposing a constraint on growth (see later explanation on Thirlwall's law).

<sup>3</sup> A regulatory framework can include approval for foreign investment projects, which is often contingent on a technology transfer to domestic partners or the establishment of research centres,

Second, and also equally relevant, is the fact that ‘the expansion of exports does not necessarily indicate the growth in production capacity’ (Shafaeddin 2005: 6). An increase in exports might not be coupled with a corresponding increase in manufacturing value added. Furthermore, ‘the evidence on international specialization suggests that developing countries are becoming increasingly similar to major industrial countries in the structure of their exports but not in the structure of their manufacturing value added’ (UNCTAD 2003: ix). Consequently ‘the presence of export-oriented FDI *per se* does not ensure the continued evolution of dynamic comparative advantage (Lall 2002: 80). Moreover, FDI is neither necessarily good for development nor is it always allocated in the form of *greenfield* investment (i.e., investment in new facilities or the expansion of existing ones).<sup>4</sup> Besides, when domestic conditions for attracting greenfield investment have not been established or improved (namely, a better educated labourforce, good infrastructure, a strong and growing domestic market, a certain level of local service industries and suppliers, political stability, etc.) it is likely that FDI will be allocated in the form of mergers or acquisitions.<sup>5</sup> The key point to note here is that mergers and acquisitions may not add to the production capacity of a country (see Lall 2002).

Third point, which is related to the above, is the fact that free trade, can, in effect, stimulate competition and increase productivity, but only when competition takes place among similarly-prepared companies. When large foreign firms compete with small domestic ones, the small firms will either eventually disappear or be swallowed by the big ones, creating a (new foreign) monopoly. This does not represent a step forward towards competitive structure. As Lall summarizes (2002: 78), ‘where countries have very different structural abilities to cope with free competition, a level playing field is to result in continuing and growing inequities’ (see also Chang 2007). Along the same lines, the technology transfers to domestic firms—that are expected to foster human, technological, and administrative domestic capabilities—may not happen or will have only minimal positive effects due to inadequate technology or poor domestic capabilities. In addition, it is generally not in the TNCs’ economic interest to launch R&D, design and marketing in the host economy: ‘they are reluctant to transfer these to developing host countries because of the difficult learning and institutional linkages involved (Lall 2002: 85). In short, free trade through foreign investment might not generate a more competitive structure or promote increments in productivity.

In sum, as Thirlwall (2003: 6) points out, ‘not all countries ... necessarily share equally in the gains from trade. There is nothing in the doctrine of comparative advantage that guarantees an equal distribution of the gains from trade’.<sup>6</sup>

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controls on the reduction of taxes, managerial autonomy, remittances of profits, external debt and equity finance, interference in supply chain management and product development, requirements to meet a certain degree of local content and complying with the foreign exchange requirements through exporting.

<sup>4</sup> See Chang and Grabel (2004) and Lall (1995) for an interesting review about the complex effects of FDI and TNCs on industrialization.

<sup>5</sup> This is particularly relevant if the economy is launching or is in the midst of a privatization programme (in this context it is likely that FDI flows eventually cease once the scope for more privatization is exhausted).

<sup>6</sup> For an alternative criticism on the static and dynamic gains from trade, see Geske (2000).

But this is not all. In addition to the caveats described above, there is another important deleterious cost that conventional trade theory ignores. By assuming that the balance of payments adjusts itself automatically to equilibrium, the monetary consequences of the pattern of specialization and trade of individual countries are overlooked. This effect is known as the balance of payments constrained growth, or the so-called Thirlwall's law.<sup>7</sup> This law states that if a country suffers a balance-of-payments deficit due to specialization in a range of commodities, and the balance of payments cannot be rectified by relative price or exchange rate adjustment, then income will have to be forced to adjust to preserve equilibrium, implying an underutilization of real resources (Thirlwall 2003: xi).<sup>8</sup> The problem, on the one hand, is that to sustain a growing demand for imports, exports need to grow at the same pace, or the country has to revert to external borrowing. In the long term, this may not be sustainable, and the continuing external deficit poses a constraint to growth. On the other hand, the external deficit is explained precisely by the pattern of specialization and trade, i.e., the import of goods with a high income elasticity of demand and the export of commodities with low elasticity of demand that developing countries trade.

Also, conventional trade theory argues that in the absence of free trade, countries would attempt to exploit their international market power and the resulting equilibrium (trade war) would be inefficient for all the countries involved. Free trade agreements, therefore, can be seen as a way of preventing trade wars (Maggi and Rodriguez-Clare 2005). As a result, according to the theory, economies should embark on *reciprocal* free trade agreements, regardless of their size and level of development. The problem is that with these agreements, developing countries are asked 'to expose their manufacturing industries to competition from more advanced and larger economies, potentially throwing those workers into unemployment, [but also] ... to forgo attempts to promote their own ... industries' (Stiglitz and Charlton 2005). In other words, adopting a free trade strategy leads to a loss of policy manoeuvre to promote growth and industrialization (see Chang 1998). Trade agreements hinder the scope for management demand, because these favour tight monetary and restrained fiscal policies to attain the domestic and external equilibrium that exclusively strives to maintain low inflation and low wage policy. More important, loss of management demand means switching off the main engine of growth, as investment that largely depends on the levels of aggregate demand, can no longer be stimulated by monetary and/or fiscal policy (see Bhaduri 2002). The absence of management demand also diminishes the ability to avert the inherent business cycle fluctuations, creating major exposure to domestic and external volatility (see Stiglitz 2003; Shafaeddin 2005). Finally, by abandoning the management of demand, the scope for allocating resources to productive projects and/or potential industries is dramatically reduced. In sum, 'a trade agreement that would restrict the

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<sup>7</sup> In general, 'this rate of growth can be shown to equal the rate of growth of export volume ( $x$ ) divided by the income elasticity of demand for imports ( $\pi$ ) ...' (Thirlwall 2001: 82). Thus, the directions in which these variables move indicate the success or failure of an economic policy of industrialization.

<sup>8</sup> This law has been empirically supported for both developed and developing economies, suggesting that countries grow, in effect, at a lower rate than that with external equilibrium. See McCombie and Thirlwall (2004) for a variety of works studying Thirlwall's law; see also Santos-Paulino and Thirlwall (2004) for evidence regarding the negative effects of trade liberalization on the trade balance in a number of developing economies.



policy options of developing countries is not the best to promote long-term industrialization' (Stiglitz and Charlton 2005).<sup>9</sup>

Finally, free trade has been seen as the source of the closely-related phenomena of premature deindustrialization and 'jobless growth'.<sup>10</sup> Premature deindustrialization means that the share of the (valued added) manufacturing sector in GDP and in employment starts to decline more persistently without recovery at lower levels of per capita income than those observed historically in the advanced economies.<sup>11</sup> Deindustrialization is considered to be a normal phenomenon in the economical development process, thus its sources have been associated with differentials in the growth rates of the manufacturing and services sectors as well as in the composition of demand, i.e., demand shifting away from manufactures towards services (see Rowthorn and Ramaswamy 1999). Premature deindustrialization is, however, a more complex phenomenon, resulting from various sources. One of these is the switch of policy regime in both advanced and developing economies from the 'Keynesian interventionist inward' policies to 'trade liberationist outward-oriented' ones (Palma 2005b). As a result of the rapid trade liberalization introduced after the mid-1970s, there has been a re-orientation in the production structure of the economy, particularly in the case of developing economies, towards sectors that mainly exploit static comparative advantage, either primary goods or low skilled manufactured goods (namely, final labour-intensive assembly). Thus, there have been no incentives for the manufacturing valued added to expand. Deindustrialization may be the normal response to changes in taste and technology, but this is not the case when it is the result of dramatic policy changes. Finally, it is worthy noting that as deindustrialization occurs at low levels of income per capita, it could imply that much of the excess labour in agriculture will either remain in that sector or will inevitably end up in low-productivity informal manufacturing and informal services. This may be reflected in the phenomenon of 'jobless growth' (Dasgupta and Singh 2006).

As is obvious from the foregoing, free trade, as recommended by conventional theory, is far from being a straightforward road for achieving the objective of a developed economy. Despite being a benevolent force able to promote industrialization, generate growth, and alleviate poverty, free trade also entails harmful costs. These, if left exclusively to market forces, can in fact offset its benefits. In addition, free trade also imposes restrictions on growth and can lead to possible deindustrialization. Free trade should not be seen as a means, but as an end, and for latecomer economies, the question they must ask is not whether to trade, but rather what to trade and how to trade. Countries that have recognized this dilemma have included free trade within a well structured growth and industrialization strategy, where liberalization has been gradual and careful. Gradual liberalization has been introduced in accordance with the maturity of their productivity structure and, more importantly, has been coupled with industrial,

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<sup>9</sup> In a recent study, Egger, Larch and Pfaffermayr (2007) show that bilateral liberalization is preferable mostly for countries with similar capital-to-skilled labour ratios, suggesting that free trade agreements between countries at different levels of development do not promote higher welfare.

<sup>10</sup> As Geske (2000: 1567) highlights, it is important to recall that if industry matters for development, then the issue 'of the impact of trade liberalization on industry is relevant and legitimate'.

<sup>11</sup> This phenomenon has normally taken place when the country has reached a certain level of development in terms of income per capita, usually between US\$10,000 and US\$12,000, but now it is happening at levels of US\$3,000 (see Shafaeddin 2005; Dasgupta and Singh 2006).

fiscal, monetary, and technological policies (designed and coordinated by the state) aimed at developing human and capital structure (namely the domestic technological capabilities) to improve competitiveness in international markets, and to maximize the benefits of trade.

Economies that ignored the above dilemma are today further from industrialization than they were before trade liberalization. Believing in the rhetoric that free trade will be mirrored in reality, these countries liberalized very rapidly, seeing this as the opportunity to correct for past mistakes, namely the use of protectionist policies. In the process, however, they gave up the arsenal of policies that would have allowed their economy to attain the rankings of developed nations, and in general never achieved the pre-reform level of performance in terms of industrialization, growth, and development. One clear example of this is Mexico, which dogmatically adopted the rapid trade liberalization strategy.

If conventional trade theory were to work in real life as it does in textbooks, then Mexico should by now be enjoying static and dynamic gains from trade and joining the ranks of the more advanced countries with solid growth, stability, and prosperity. Nothing is further from this rosy picture, and Mexico today is still far from the ranks of the developed nations. Indeed, it has made little economic progress since trade was liberalized. But why has free trade for Mexico not been the straightforward road to industrialization and development? The answer to this question is the topic of the next section.

### **3 Mexico's trade liberalization strategy: benefits and costs**

Mexico's new strategy of industrialization started in the mid 1970s, when it underwent its first major post-1950s economic crisis. As a result, Mexico's initial (unilateral) steps towards trade liberalization were included in the list of recommendations in stabilization and adjustment programmes advocated by the IMF and the World Bank (see Bazdresch and Levy 1992). Trade liberalization was intensified during the 1980s as a consequence of the frequent and dramatic economic crises<sup>12</sup> that necessitated more conditional assistance from these international institutions. As a result Mexico started to implement major economic reforms in 1985, intensifying trade openness. The country signed a bilateral trade agreement with the US to eliminate subsidies on exports; joined the General Agreement on Tariffs and Trade (GATT) in 1986, and eliminated certain import licences in 1987 (Moreno-Brid et al. 2006). Furthermore, a soft regulatory frame for FDI was approved and in 1993 a new law for foreign investment was enacted. In 1992 Mexico signed the NAFTA trade agreement with the USA and Canada which came into effect in 1994. Mexico joined the WTO (as founding member) in 1995. Between 1993 and 1997, Mexico unilaterally eliminated most-favoured-nation tariffs on over 1,200 products; the number of duty-free products has increased from 414 to 1,658 by 1997. The tariff elimination primarily concerned inputs and machinery used in agricultural, chemical, electrical, electronic, textile and publishing sectors (WTO 1998).

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<sup>12</sup> Mexico underwent two major economic crises during the 1980s. The first one, the so-called debt crisis, was in 1982; the second in 1987 was caused by an international financial market crash, among other factors.

By 1998, it was generally agreed that trade liberalization had been completed in the manufacturing sector.<sup>13</sup> Table 1 illustrates the rapid pace of liberalization.

Today, Mexico is one of the most liberalized developing economies. It has special trade relations with 43 countries around the globe, which translates into 12 free trade

Table 1  
Mexico's imports tariffs, 1985-94 (%)

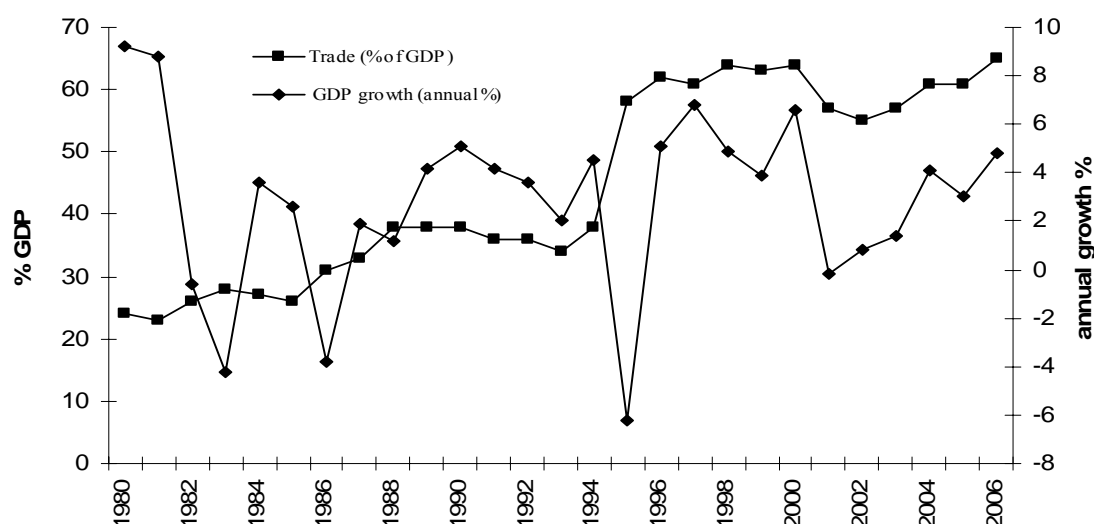
	1985 June	1985 Dec.	1986 Dec.	1987 Dec.	1988 Dec.	1989 Dec.
Domestic production value covered by import licensing	92.2	47.1	39.8	25.4	21.3	19.8
Production-weighted tariff averages	23.5	28.5	24.5	11.8	10.2	12.5
Domestic production value covered by official import prices	18.7	25.4	18.7	0.6	0.0	0.0

NAFTA's tariff elimination schedule

Group A	Duties on goods of this category shall be eliminated entirely and such goods shall be duty-free, effective 1st January 1994.
Group B	Duties on goods of this category shall be removed in 5 equal stages beginning on 1st January 1994, and such goods shall be duty-free, effective 1st January 1998.
Group C1	Duties on goods of this category shall be removed in 10 equal stages beginning on 1st January 1994, and such goods shall be duty-free, effective 1st January 2003.
Group C2	Duties on goods of this category shall be removed in 15 equal stages beginning on 1st January 1994, and such goods shall be duty-free, effective 1st January 2008.
Group D	Goods shall continue to receive duty-free treatment.

Source: Pacheco-Lopez and Thirlwall (2004).

Figure 1  
Mexico's trade and GDP evolution, 1980-2006



Source: WDI online.

<sup>13</sup> See also Moreno-Brid et al. (2005) for a more detailed description of Mexico's process of trade liberalization.

agreements. As a result, Mexico, measured by its trade size, is currently within the first 15 economies in the world and its ratio of trade to GDP (a gross measure of trade liberalization) has more than doubled from the mid-1980s to the 2000s (26 per cent in 1986 versus 65 per cent in 2006).<sup>14</sup> Thus the relevance of trade in the economy cannot be exaggerated. But the trade liberalization period in Mexico has been associated with a poor, indeed a very disappointing, economic evolution (see Figure 1).

Two simple macroeconomic indicators provide a very illustrative record of Mexico's poor economic evolution since liberalization. The average economic growth rate during the period 1982-2007 was 2.4 per cent. This is a considerable slowdown from 6.8 per cent, the average growth rate during 1986-81, the era of economic regulation, import substitution, and government participation in the economy. In terms of per capita GDP, the comparison is even more disappointing; during the period 1982-2007 it grew at a pathetic rate of 0.77 per cent, which is in stark contrast to 3.7 per cent achieved in the pre-openness period, when population growth was also much higher than during the last 25 years.<sup>15</sup>

Given this background, we show next that Mexico's free trade strategy has failed because the risks materialized, producing costs that eroded the benefits and imposed additional constraints on growth, industrialization and development.

### **3.1 Trade liberalization benefits**

Two main benefits have evolved in the Mexican economy since trade liberalization was introduced (and are in accordance with the conventional trade theory): (i) export growth, particularly in manufacturing, and (ii) the rising share of FDI in the economy. On the one hand, exports have in effect increased substantially. Not only has the rate of export growth exhibited an outstanding average increase of 10.5 per cent during the period 1981-2007, but also the contribution of exports in total output has been impressive, increasing from around 10 per cent of GDP in 1980 to around 30 per cent since the mid-1990s. Particularly important within this export dynamic is the key role played by manufactured exports. Manufactured exports have expanded at an average rate of 15 per cent (1982-2007) since liberalization, and rose to 13.1 per cent after NAFTA—one of the highest rates among developing economies. Moreover, since the early 1990s manufactured exports have represented more than half of total exports and currently account for around four-fifths. Mexico, in terms of total manufactured exports from the developing economies, accounts for 12 per cent (ranking just behind China, Korea, and Taiwan, but ahead of Singapore) (Palma 2005a). In fact, in 2006 its share of manufacturing exports of total world market was 2.3 per cent, parallel with economies like Canada and Singapore but ahead of Switzerland. At a first glance, then, one could argue that the Mexican economy has shifted from being a primary export producer to

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<sup>14</sup> If the ratio of trade to GDP is taken as a measure of trade openness (i.e., economic success according to the conventional view), then it is interesting to ask how the high-income OCDE members, despite having remained relatively closed (their trade openness ratio never exceeded 44 per cent during the period 1980-2004), have managed to increase their industrialization and development levels.

<sup>15</sup> If the Mexican economy is compared in these terms with other countries (in particular the Asian tigers or India, none of which represents a straightforward tale of export growth achieved through trade openness and free market forces [Rodrick 2006a, 2006b]), the picture is even more bleak. From this it would seem that a quarter of a century has been simply wasted.

one that exports highly value added commodities. This conclusion, however, is deceiving.

The second major positive impact from trade liberalization was the increasing participation of FDI in the economy. This, in turn, was the cause of the high export dynamics highlighted above. Particularly from the early 1990s, FDI grew mainly as a result of the aggressive privatization programme implemented by the government, with FDI rising from around 1.5 per cent of GDP in the decade of the 1990s to 4.4 per cent of GDP in 2001 (when privatization was halted). Mexico, in fact, has been one of the major FDI recipients in the developing world (lagging behind China, India, and Brazil). Importantly, the manufacturing sector absorbed 53 per cent of the total FDI during the 10-year period 1994-2004 and was concentrated in three sub-sectors: metal commodities (48 per cent), chemical commodities (16 per cent) and food, beverages and tobacco stuff (18 per cent) (Moreno-Brid et al. 2006: 105).

With these impressive benefits derived from free trade, which in some cases are similar or even exceed to those attained by some NIEs, one would expect to see Mexico joining the ranks of the developed economies. However, as pointed out earlier, certain costs have eroded the benefits of free trade, and additional restrictions have been imposed on Mexico's economic growth. This is apparent in the development of the balance of payments, particularly the current account, the drop in total factor productivity, the loss of policy autonomy, and the phenomena of premature deindustrialization and 'jobless growth'.

### **3.2 Trade liberalization costs and further restrictions on growth**

Figure 2 shows the current account balance evolution during the period 1980-2006. It clearly exhibits that, with the exception of only four years during the early 1980s, Mexico faced a permanent, and at times, a very large deficit. The continuous external deficit, on the one hand, has mainly been the result of the growth in imports, the development of which has paralleled that of exports (11.1 per cent during 1982-2007). This massive growth in imports has been basically due to satisfying the needs of manufactured exporters (mainly *maquila*) for imported inputs. Policies aimed at safeguarding domestic content requirements on final export goods had been eliminated; the regulatory framework that could have created backward and forward linkages was missing, and there was a lack of local suppliers. Thus, exporters (i.e., TNCs whose share in total exports was at least of two-thirds [UNCTAD 2002])<sup>16</sup> found it more convenient to turn to imports for most of their input needs (Pacheco-Lopez and Thirlwall 2004). Palma (2005a: 951) illustrates this clearly when he points out that in 2001 Mexico produced no less than 30 millions TV sets, 90 per cent of which were exported to the US, but 98 per cent of the related inputs had either been imported directly or indirectly (i.e., inputs supplied by other foreign firms operating in Mexico, who also import most of their input). Today, manufactured imports represent around 95 per cent of total imports, implying a dependence of exports on imported inputs. As a result, the income elasticity of demand for imports has more than doubled during the last 15 years (from

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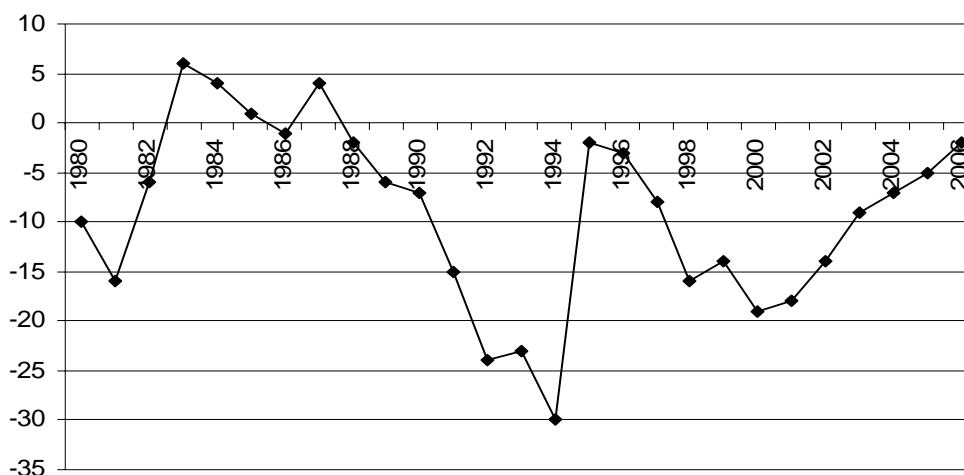
<sup>16</sup> There are only a limited number of Mexican firms exporting to the USA, mainly commodity and low value-added manufacturing products (IMF 2006). According to Dussel (2002) during the period 1993-98, a small proportion of the domestic economy (6.6 per cent) contributed to total exports.

1.2 per cent to around 3 per cent). This has clearly restricted the speed and rate of Mexico's growth: every percentage point increase in the economy means that the demand for imports triples (Moreno-Brid et al. 2006). To satisfy foreign exchange requirements, exports must either grow at the same rate as imports or the economy must face an increasing foreign debt that is usually unsustainable in the long term (Pacheco-Lopez and Thirlwall 2004).

Moreover, the continuous deficit on the external balance is also due to a leak of foreign exchange through royalties, management fees, interest, and overseas repatriation of profits. Again, due to the lack of controls for preventing the outflow, it has been easier and profitable for TNCs to simply send their money back home.

As was mentioned earlier, it was expected that trade liberalization, through competition, increasing returns to scale and FDI technology transfer, would increase productivity. However, in the experience of Mexico, this variable—essential for growth and successful export-led growth strategy—has decreased in the post-liberalization period. According to the IMF (2006) and ECLAC (2004), total factor productivity has dropped 0.5 per cent during the period 1980-2003, indicating a negative contribution to growth (see Table 2).<sup>17</sup> So, despite the high manufactured export growth that generally implies the production of high valued commodities, practically none of the country's exports are produced with domestic technology. In fact, Mexico's total value added contribution on most of the manufactured export industries is negligible (Palma 2005a). Moreover, Mexico's manufacturing value added, as a share of GDP, has dramatically declined since 1988. Despite the fact that the structure of Mexico's exports replicates those of the industrial countries, the structure of its manufacturing value added, which is relevant for

Figure 2  
Mexico's current account balance, 1980-2006, US\$ billions



Source: WDI online.

<sup>17</sup> Furthermore, according to Romero, Puyana, and Dieck (2005) the rate of growth of Mexico's labour productivity has been -0.3 per cent during the same period. The same study also concludes that some manufacturing sectors, such as the automotive, that enjoyed a certain degree of protection and the benefits of an industrial policy, were the only ones to report increases in productivity. See Karacaovali (2006) for a study regarding why protected sectors in the economy might end up with higher productivity than sectors that have not enjoyed protection.

Table 2  
Mexico's sources of growth, (annual % change)

	Contribution of:					
	Output	Output per worker	Physical capital per worker	Factor productivity	Factor productivity	Physical capital per worker
	In percentage points			In % of total		
1965-79	6.5	2.9	0.8	2.1	72	28
1980-2003	2.6	-0.4	0.1	-0.5	125	-25
1996-2003	3.5	1.1	0.4	0.7	64	36

Source: IMF (2006)

industrialization, remains at the level of a developing economy. This suggests the following: technological transfers to local partners have not evolved as conventional trade theory holds, nor has there been an even level playing field that could promote competition and create more efficient companies. Furthermore, according to Moreno-Brid et al. (2006) and Dussel (2006), the productivity increases observed in some industries of the manufacturing sector have been the result of reductions in employment. In this sense, Mexico has simply focused on the assembly of components and has over time increased its technological dependence,<sup>18</sup> with its comparative advantage based exclusively on cheap unskilled labour.

Paradoxically, the WTO (1998) proudly states that 'Mexico's trade policy is closely associated with the promotion of foreign investment flows'. The WTO, however, fails to point out that Mexico has used a passive FDI-dependant approach (exploiting mainly cheap unskilled labour) to attract foreign investors. As previously stated, this approach does not encourage the development of a dynamic export advantage, that is, productivity increments.

With regard to the issue of whether the Mexican economy has experienced premature deindustrialization, the empirical evidence indicates that the share of manufactured value added in GDP has declined steadily since 1988, when it fell around 3 per cent compared to the previous year. At the same time, although complete information for the whole period 1980-2006 is not available, there is evidence to suggest that in the most optimistic case, the share of manufacturing employment in the sector has remained steady, albeit with a sharp decline during 2000-05, when it fell from 22.5 per cent to 18.5 per cent, all in a situation where the per capita income is still less than US\$10,000. At the same time, the number of workers in the informal sector has soared, climbing from 4.7 million in the 1980s to 11.7 million a decade later, to 15.7 million in 2000 (Godinez 2004). Moreover, even if one were to attribute the (poor) economic growth to the impressive export growth during the period 1982-2007, it is worthy noting that it has been accompanied with growing unemployment. Unemployment in the midst of trade reforms (1992) was 2.8 per cent but 15 years later, in 2007, when trade liberalization was a reality, rate was one percentage point higher, 3.8 per cent. More important, had the average 400,000 Mexicans per year since 2000 not emigrated (mainly to the US), the unemployment rate would be much higher. Thus, even with the outstanding dynamics of the trade sector, not enough jobs have been generated to satisfy the

<sup>18</sup> For example, every year around 6,000 patents are registered in Mexico, but only 5 per cent of these are from Mexicans.

growing demand, as it is the big companies (TNCs) that mainly account for 90 per cent of total exports. This means that a large portion of the medium- and small companies, employing around 70 per cent of the labourforce, have no access to international markets. Trade liberalization has not had a major effect on employment creation. During the period 1993-98, the activities and firms that were associated with approximately 93 per cent of total exports absorbed only 5.6 per cent of the labourforce and created only 13.5 per cent of total employment (see Dussel 2002).<sup>19</sup> As the evidence shows, and Palma (2005a) stresses, market forces have missed out in ‘harnessing’ the trade sector to the domestic economy, suggesting the existence of both premature deindustrialization and ‘jobless growth’.

Last but no less important is the fact that the embracement of free trade has reduced the country’s scope and autonomy in pursuing growth and developmental goals. Industrial and trade policies were subordinated to narrow macroeconomic priorities, such as fiscal budget and low inflation (in this sense, monetary and fiscal policy was distanced from its pro-growth and countercyclical objectives, with capital accumulation, in consequence, growing at very low levels [see Table 2]). Second, industrial policy was implemented in a horizontal manner, so that the (low) existing resources were distributed without any priority with regard to sectors (Dussel 2002). Third, tariff and non-tariff barriers were dramatically reduced, eliminating the options for trade policies. And finally, the elimination of controls on capital flows has led to exchange rate instability, and being unable to use monetary policy or the financial system to support and promote domestic investors.

It is clear from the evidence that the conventional rapid trade liberalization and market forces have been unable to guarantee gains from free trade for Mexico. Instead, the adopted approach of minimalist state-intervention has led to counter-productive results.

Today’s developed countries and the NIEs have benefited from trade by liberalizing gradually and with their governments deploying at the same time policies to correspond to their infant industry promotion (see Chang 2002, 2007). For the most recent example of this, we briefly illustrate in the next section how China profited from trade gains. Indeed, China has followed a trade liberalization strategy that somewhat resembles the strategy applied in today’s advanced and new industrialized economies.

#### **4 China and trade openness: a non-conventional story**

China’s insertion into global markets started in 1978 when it began trade liberalization reforms, virtually at the same time as Mexico. But the progress of trade reforms was neither simple nor straightforward (see Branstetter and Lardy 2006: 4), as ‘significant reforms lagged behind growth ... by at least a decade or more’ (Rodrik 2006a: 3). More importantly, China’s trade reforms were not introduced at the insistence of IMF or the

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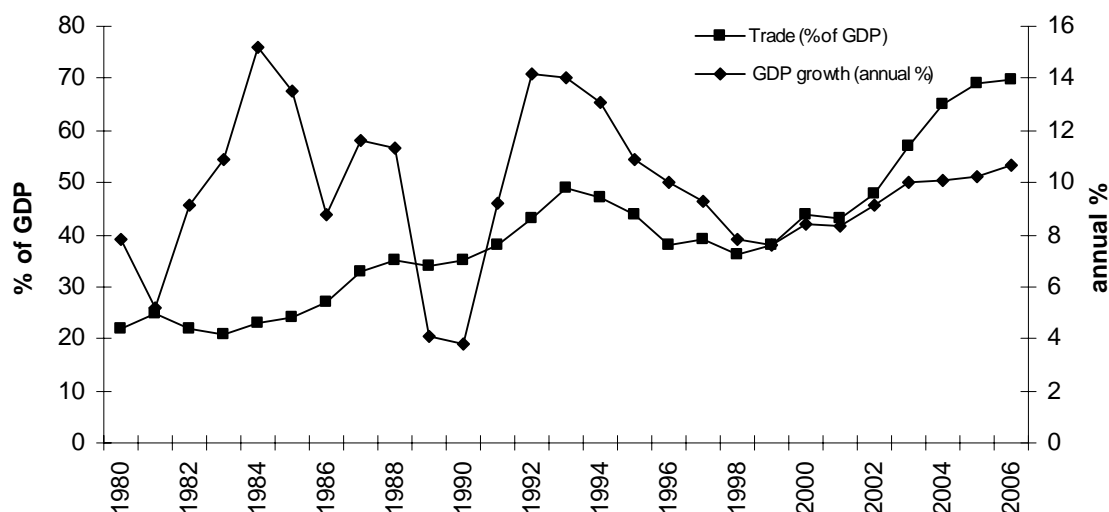
<sup>19</sup> But not only has the quantity of employment been below the needs of the country, but also their quality has not increased. The wage per hour measured in US dollars in the manufacturing sector has risen just US\$0.60 in 12 years (US\$2.1 in 1993 to US\$2.7 in 2005). Furthermore, the minimum real wage has fallen a dramatic 70 per cent since 1980. It is ironic, as Palma (2005a: 953) states, that ‘Mexican wages are trying to equalize them to those of its competitor (China [and Brazil]) rather with those of its trading partner (USA)’. See also Mesquita Moreira (2007: 361).



World Bank but because of a change in the presidency of the Communist party (see Meza Lora 2006). The view and pragmatism of Deng Xiaoping, the new Chinese leader, regarding the aim of the reforms can be summarized in his famous remark: ‘It does not matter whether the cat is white or black as long as it catches mice’ (quoted in Chang 2007: 121). As a result, trade became the real source of economic progress (Figure 3), and the economy grew at an impressive average rate of almost 10 per cent from 1979 to 2007. Coupled with this, the per capita income growth rate has been very high, 8.1 per cent, supporting poverty alleviation at the same time. The economic evolution in the post-trade liberalization period is in contrast to China’s pre-reform performance. During the years 1961-78, for example, GDP grew at an average rate of 5.1 per cent whereas the rate for income per capita was 3 per cent. These figures, although not disappointing, were well below the country’s needs.

But how exactly did China exactly manage to make trade the engine of economic progress? In other words, how was the country able to maximize the gains from trade? To begin with, according to a consensus in the literature, China’s path to growth and development as achieved through trade openness and free market forces was not straightforward. Rather it is the story of a country that, as Rodrik (2006a: 1) states, applied ‘its own brand of experimental gradualism’. The gradual process of trade openness is well illustrated by China’s pattern of import tariffs (Table 3). As can be seen, average rates prevailing from the early 1980s through the next decade, though decreasing, were clearly indicative of a highly protected economy.<sup>20</sup> Furthermore, it was in 1999, prior to its accession into WTO and in the midst of the US trade agreement talks that China agreed to reduce average tariff levels on industrial products to 8.9 per cent. This gradual process was taken to its ultimate end when in 2005 China eliminated

Figure 3  
China’s trade and GDP evolution, 1980-2006



Source: WDI online.

<sup>20</sup> China’s average rate, well above 40 per cent, is similar to what the US maintained in the manufacturing sector for more than a century (1820-1931), when the country was in its development phase (see Chang 2002: 17). At the time, even other advanced economies (France, Germany, or Italy) had by 1913 maintained tariff imports as high as 25 per cent; the corresponding figure for the US was 33 per cent (see Bairoch and Kozul-Wright 1998: 44).

Table 3  
China's import tariffs (%)

	Unweighted average	Weighted average	Dispersion (SD)	Max
1982	55.6	–	–	–
1985	43.3	–	–	–
1988	43.7	–	–	–
1991	44.1	–	–	–
1992	42.9	40.6	–	220.0
1993	39.9	38.4	29.9	220.0
1994	36.2	35.5	27.9	–
1995	35.2	26.8	–	220.0
1996	23.6	22.6	17.4	121.6
1997	17.6	16.0	13.0	121.6
1998	17.5	15.7	13.0	121.6
2000	16.4	–	–	–
2001	15.3	9.1	12.1	121.6
2002	12.3	6.4	9.1	71.0

Source: Prasad (2004: 10).

all quotas, licenses, tendering requirements and other non-tariff barriers with regard to the import of manufactured goods (Branstetter and Lardy 2006). In sum, what had taken place in China was a ‘complex and highly restrictive set of tariffs, non-tariffs barriers and licenses’ (Rodrik 2006a: 3).

What is important to notice within China’s growth, industrialization, and development strategy is the fact that it did not rely exclusively on tariff protection and gradualism to avoid the once-and-for-all static gains from trade and to sidestep the restrictions on growth. In order to guarantee that dynamic benefits were achieved, and that policy autonomy maintained for rapid growth, China applied (and continues to apply) an arsenal of measures. These are related to industrial policy, exchange rate, technological, fiscal, and monetary measures aimed at creating the infrastructure (human and capital) that allows trade to become the real engine of growth and industrialization. That is, China promoted its infant industries in a manner similar to what is being adopted in today’s developed economies. Moreover, the government was (and still is) the main and most active agent of industrialization and growth. Only in this way has it been possible to benefit from the gains of trade (i.e., to maximize the benefits and reduce its costs).

#### 4.1 A déjà vu strategy of reaping the trade rewards

To guarantee technological transfers and increases in productivity, and to promote a competitive structure, China’s policy stance towards FDI was gradual and maintained important restrictions for a number of years. Within these restrictions, certain foreign investment projects were approved. Approval was often contingent on a regulatory framework that included technology transfers to domestic partners or the establishment of research centres, tax reduction controls, managerial autonomy, profit remittances, external debt and equity finance, involvement in the supply chain management and product development, requirements regarding a certain degree of local content and complying with foreign exchange requirements through exporting. Many of the foreign firms targeting the domestic market were forced to form joint ventures with local

Chinese companies (in mobile phones and computers, for example), particularly with state owned enterprises (SOEs). In this context, both the size and potential growth of the domestic market were extensively used as the ‘carrot’ to attract TNCs.<sup>21</sup> Eventually major leading companies emerged from the joint venture efforts of foreign and domestic firms. In 1986 there was a major regulatory change in FDI, dubbed as the ‘22 Regulations’ (Branstetter and Lardy 2006), that introduced an important relaxing of earlier restrictions. FDI subsequently increased in 1988 to around 1 per cent of GDP. This tendency continued for the rest of the decade, until 1993 when it reached the record level of 6.2 per cent of GDP. The growing inflows of FDI suggest that regulation did not deter China from accumulating large FDI stocks. Furthermore, government-imposed measures explicitly represented its bargaining-power capacity and implicitly the safeguard of its policy autonomy for achieving the industrialization objectives. In this regard, bargaining power was always used to pursue a clear objective: to foster domestic capability by ensuring the transfer of technology to local firms (Lall 2003). In promoting domestic capability, the ‘weak enforcement of intellectual protection laws [that] enabled domestic producers to reverse engineering and imitate foreign technologies with little fear of prosecution’ (Rodrik 2006a: 18) was also important. In this sense, China applied FDI-dependant policy approach that involved ‘strong and targeted interventions by the host government, both to direct FDI into higher value activities and to raise the quality of domestic factors, suppliers and institutions’ (Lall 2002: 81).

It is important to mention that the likely adverse effects of high import tariffs, exchange rate controls (see below) and FDI restrictions on export and output growth, were neutralized through measures such tax rebates, duty free import on capital for export processing, incentives for export investment projects as well as credit allocated by the government to support export growth. These measures did indeed boost export growth, particularly during the 1990s, when exports soared from less than 10 per cent of GDP in the mid-1980s to more than 30 per cent as of 2003. Unlike the experience of Mexico, China’s export boom has been ‘harnessed’ to economic growth, even though the TNCs were the force behind this export performance (accounting in 2003 for 55 per cent of exports and 19 per cent of industrial value added, with local firms contributing to nearly half of total exports and nearly 80 per cent of industrial value added [Mesquita Moreira 2007]). Furthermore, the export boom and economic growth have been accompanied with job creation. Unemployment fell from 5 per cent in the late 1970s to about 3 per cent in the mid-1980s, albeit since then gradually and steadily increasing but without yet reaching the late-1970s level.<sup>22</sup>

In order to stabilize foreign exchange and alleviate foreign exchange pressures, crucial for subsidizing capital imports and for controlling the FDI flows, China applied capital controls. These included a 100 per cent foreign exchange surrender requirement for exporters, tight limitations on holding foreign currency and controls on the outflow of

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<sup>21</sup> Naturally fiscal incentives were also offered (i.e., zero taxes for a number of years). However, it is a fact that local firms also benefited from this regime, thanks to the so-called ‘round-tripping’, in which ‘local capital that goes abroad and then returns disguised as foreign investment (Mesquita Moreira 2007: 364).

<sup>22</sup> According to Giles, Park and Zhang (2005), these official rates are widely believed to underestimate the true rate of unemployment, indicating, for instance that the urban unemployment rate was 14 per cent in 2002.

capital (Branstetter and Lardy 2006: 9). Moreover, authorities relaxed these restrictions when it was convenient. Gradual adjustments in the exchange rate were possible so that the renminbi (RMB) yuan fluctuated from 1.5 to the US dollar in 1985 to Y8.7 in 1994 and to Y8.3 in 1995, where it has stabilized until 2005. Since then, it has been moving gradually.

Another important fact was the autonomy of management demand during the whole reform period. Fiscal and monetary measures supported the country's policy of infant industry promotion. Fiscal policy has been countercyclical and widely used to foster investment. A clear indication of this occurred during the 1997 Southeast Asian financial crisis when the government sought to boost domestic demand with a sizable fiscal stimulus. Moreover, during the decades of the 1980s and 1990s the government registered a somewhat increasing deficit. With respect to monetary policy, authorities sliced interest rates several times and expanded lending by state banks. This is indicative of the role of monetary authorities as the promoters of growth rather than the narrow inflationary view that prevails in most of today's central banks (Epstein 2007). Finally, according to Branstetter and Lardy (2006), capital investment (Table 4) and private consumption—both stimulated rather than constrained by the government—can also be ascribed to explain much of China's recent success. In sum, the central part of China's strategy was focused on strengthening and expanding the domestic market.<sup>23</sup>

What is more important, the level of sophisticated commodities that China started to produce and eventually to export is justification for the series of measures introduced by China that regulated FDI and other complementary policies. As Rodrik (2006a: 4) points out, China has somehow managed to latch on the advanced, high-productivity products that one would not normally expect a poor, labour abundant country like China to produce, let alone export. This is particularly true for consumer electronics. In this context, the share of China's manufactured exports in the total world market is impressive, peaking at 10 per cent in 2006, or just behind the European Union but at a similar level as the USA. In fact, according to Adams, Gangbes and Schchmurove (2006) China's expansion of manufactured export products continues to increase rapidly in line with world market growth, and its high-tech exports are increasing even faster. In 2001 these accounted for 43 per cent of total east Asian high-tech exports, irrespective of the reality that China is not yet as technologically advanced as Korea or Singapore (see also Schott 2006).

Also, as a result of these strategies, China has registered a trade balance with minimum deficit or surplus from the early the 1980s until the mid-1990s, thus being able to avoid possible growth constraints from external accounts. This, in turn, has been the outcome of a decreasing elasticity of imports (as gauged by the ratio of average growth of imports to the average growth of output) that went from 3.3 per cent during the 1970s decade to 0.8 per cent during the 1990s (see UNCTAD 2003: 142). Evaluated in these terms, the strategy of China has, therefore, been successful, as the country has been able to relax the balance-of-payments constraint and at the same time, to accelerate

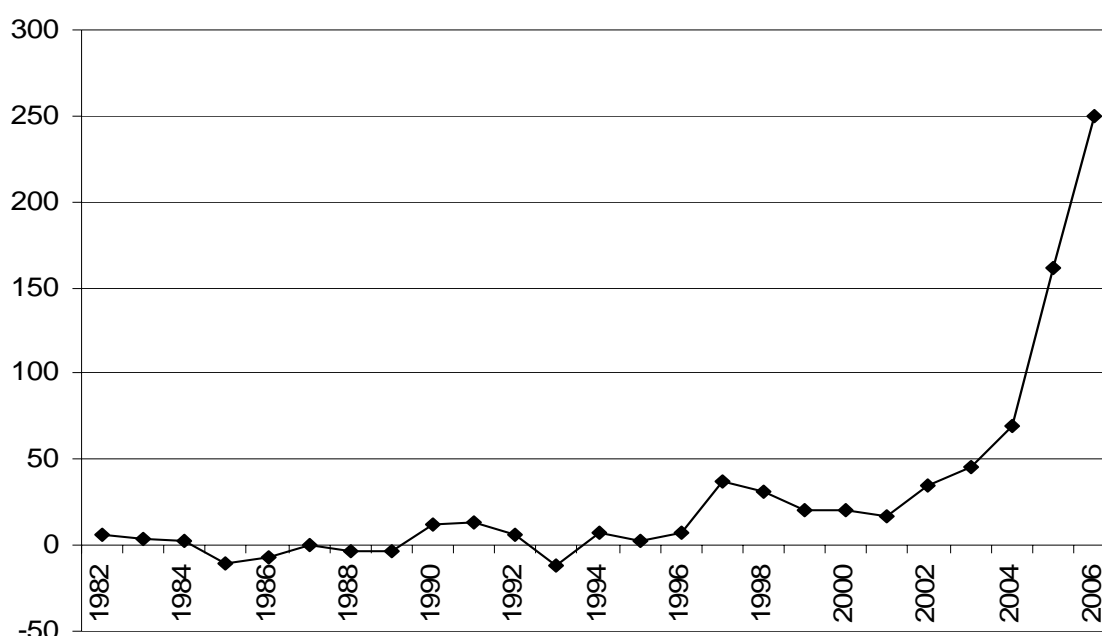
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<sup>23</sup> In this setting, *The Economist* (27 September 2007) points out that 'the popular notion that China is dependent on export-led growth is a myth; domestic demand is much more important. This year the increase in China's net exports (i.e., less imports) is likely to account for about one-quarter of its growth—a record amount. But even without this external boost, GDP growth would still have been a respectable 9 per cent'.

industrialization and growth. Finally, it is important to notice that the trade surplus has soared since 1994, increasing from US\$7 billion to US\$161 billion in 2006 (Figure 4). This development has provided room for further manoeuvre in terms of exchange rate policy management.

The outstanding increase in China's exports as a share of the total world—lagging after Germany and the USA only—has been the result of the country's improved competitiveness. This, in turn, has been based not only on the exchange rate policy that maintained a stable exchange rate against the US dollar and/or made adjustments (devaluations) as necessary, but also on the increased total factor productivity, particularly in labour productivity (Table 3). In fact, according to Rodrik (2006a: 15), there was a process of productivity diffusion within the economy: productivity gains associated with the production of sophisticated exportables were spread around the economy as labour moved across industries. In addition, low wages and available

Figure 4  
China's current account balance, 1982-2006, US\$ billion



Source: WDI online.

Table 4  
China's sources of growth, (annual % change)

	Contribution of:					
	Output	Output per worker	Physical capital per worker	Factor productivity	Physical capital per worker	
		In percentage points			In % of total	
1960-80	4.04	1.83	0.76	0.64	35	41
1980-99	9.75	7.85	2.63	4.71	60	33
1960-99	6.78	4.72	1.66	2.6	55	35

Source: Bosworth and Collins (2003).

Supply of unskilled labour as well as reduced costs of communication and transportation, and FDI have been the factors promoting China's competitiveness (see Adams, Gangnes, and Shachmurove 2006; Branstetter and Lardy 2006).

Finally, it is important to highlight the fact that despite its accession to the WTO, China has not forfeited its autonomy regarding policy to pursue growth and developmental goals. Chinese authorities, for example, enforce certain controls on the TNCs, such as technology transfers to local partners, permissible within the trade-related investment measures. China retains state monopoly in some key import commodities such as crude oil, refined petroleum products, fertilizer, cotton, grain and vegetable oil, and key exports such as tea, tungsten, silk, cotton products, and fossil fuels. The country also plans to eliminate tax preferences to foreign firms within 6-8 years, but in addition will maintain average statutory import tariff rates for agricultural products. In the service sector, China agreed to deregulate the banking and insurance sector five years after WTO accession but liberalization of the securities and fund management has become more restricted since foreign ownership restrictions were tightened. Furthermore, joint venture security firms cannot trade in A shares (Branstetter and Lardy 2006).

#### **4.2 Trade liberalization costs**

Of course, it is not reasonable to argue that China's strategy has been perfect: there were costs to government intervention. However, government intervention so far has produced higher rewards than costs, and has put the economy on the right trajectory for industrialization and growth. Nevertheless, for now, the Achilles' heel of China's trade liberalization policy is wages. These are still fairly low, especially in comparison to those of its trade partners. In other words, there has been no convergence of wages, and because of China's current infinite supply of excess labour, it seems unlikely that wages will increase in the short or medium term, despite growing productivity. On the contrary, it seems clear that China will keep the competitive advantage of cheap labour until the supply starts to run out and/or most of the labourforce shifts to the secondary and/or tertiary sectors.

### **5 Concluding remarks: are there current policy alternatives for reaping the gains from trade?**

The empirical evidence of Mexico and China presented in this study indicates that in order to benefit from the rewards of trade and thus promote industrialization, growth and development, trade liberalization must be gradual and accompanied with a pervasive governmental presence. In other words, we illustrated that 'trade helps economic development only when the country employs a mixture of protection and open trade, constantly adjusting it according to its changing needs and capabilities' (Chang 2007: 83). Free trade and market forces have serious limitations and leaving them to work on their own is likely to lead to a situation in which the costs from trade offset its gains and impose further restrictions on growth, retarding industrialization. These costs and restrictions are enormous, and are always omitted or ignored by conventional trade theory. This has been the experience of Mexico. Thus, state intervention is necessary for eliminating/minimizing these costs. China proceeded accordingly, and industrialization, high growth, and development are the norm in the

country. The experience of China confirms the success of the general strategy utilized by the advanced and new industrialized economies to make international trade gains the engine of economic progress.

Ironically, free trade advocates insist that when policymakers attempt to implement alternative policies for promoting industrialization (e.g., import substitution strategy), the economy risks forgoing the gains from trade (Chang and Rowthorn 1995). In today's context, however, it is needs to be mentioned that the advanced countries and NIEs (even China) introduced their development strategies in circumstances that have substantially changed due, *inter alia*, to the current new trade regulations (namely, the WTO). In view of the current levels of trade openness (and their irreversibility), it may not be feasible for many developing economies like Mexico to replicate the process used by the advanced countries and NIEs to climb the ladder of industrialization. But for other less developed, yet not totally open, economies, the opportunity is still there, albeit with certain limitations. In either case, it seems clear that 'trade is simply too important for economic development to be left to free trade' (Chang 2007: 83). Thus, the state should not be perceived as an intruder but rather as the means of promoting industrialization, growth, and development.

In this sense, perhaps, the real question is not whether the presence of the state is necessary but whether the mistakes of the past can be avoided—that is, whether the benefits of government intervention can offset its costs. Only in this way, can policy recommendations such as 'overcoming excruciating credit constraints on local producers ... and boosting the frail local technological capabilities' represent feasible and attainable goals (Mesquita Moreira 2007: 373). According to Stiglitz (2003: 9), 'each country must choose the [political economy] alternative that is appropriate for its conditions and its people'. Based on this, a relevant concern for the developing economies is to recognize that policy alternatives for industrialization and accelerated growth and development are still there. More specifically, they need to identify the alternative policies that can be applied to replace low-productivity activities, and move towards the production of high valued added goods and services. Based on what has been presented in this study, we offer the following brief guideline.

First, all developing economies must petition for clauses that encourage industrialization within the predominant WTO regime. Countries can, for example, apply the balance of payments clause, use temporary safeguards, or impose anti-dumping duties as protection against the foreign competition that is distorting their balance of payments or their industries. These measures have the advantage of being discretionary, so that the commodities to be considered are at the discretion of the country. Also, safeguards can be used to protect infant industries for eight years, and developing countries have the option of maintaining or even strengthening local content requirement. Furthermore, subsidies are available for relative application so that exports subsidies, for example, are permitted for the least developed economies. Also, subsidies for agriculture, regional development, basic R&D and environment-related technology upgrading are still possible, as are certain other subsidies as long as trade-related policies are not dismantled (Amsden 2000; Chang 2004). Instigating these measures could avoid the once-and-for-all effects of initial trade openness.<sup>24</sup> Developing

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<sup>24</sup> More important, Rodrik (2006b) suggests that an economy, during the initial stages, must be diversified in producing a range of goods, becoming over time specialized in some of them rather than specializing in single commodity of trade, as advocated by conventional theory.

countries also need to explore and exploit grey areas in the current trade regime, as was done by Korea and other countries under the old GATT regime.

Second, all developing countries, but particularly those where trade openness is quite advanced, should discard the narrow aims of fiscal balance and inflation targeting, to reinstall management demand among their priorities. This can be easily done, as no international rules prohibit the establishment of a pro-industrialization and growth management demand, but needs to be implemented within a well-designed strategy. Management demand means supporting employment creation and the development of domestic industries through a strong, growing domestic market.<sup>25</sup> It also implies being able to counter-balance domestic and external shocks that could affect local producers. Furthermore, it grants the policy autonomy for allocating resources to strategic industries as needed, to channel credits, support R&D, promote science and technology, upgrade the labourforce through education, invest in infrastructure, and so on. All of these are necessary in order to develop domestic technological capabilities. In this context, it is essential to expand public investment and to maintain as many SOEs as necessary in strategic and/or potential sectors and industries, particularly if private investment is unlikely to be forthcoming due to nonexistent private returns.

Third, foreign exchange stability is a necessity for subsidizing imports, especially capital imports, which are vital for continuing the development process. A well-proven strategy for achieving this goal consists of measures to adopt capital controls and/or impose exchange rate convertibility. These provide not only exchange rate stability, but also grant autonomy (with regard to monetary policy, in particular) and reduce the scope for speculative attacks. Moreover, capital controls promote development by attracting favourable forms of foreign investment. For these reasons, developing economies must adopt (or maintain) some capital control. It is important to mention that according to the IMF Articles of Agreement (Article 8), selective exchange rate convertibility is possible.

Finally, Chang (2007: 127) points out, ‘economic development is all about absorbing advanced foreign technologies’ and Wilkins (1998: 95) notes, ‘economic development (whether in industrial or less developed economies) requires a combination of imitation and innovation, emulation and diversification, copying and surpassing’. It is, therefore, of paramount importance to establish a strategy to develop and upgrade technology in order to be able to compete in international markets. Successful countries have followed either a targeted FDI-dependant strategy or an autonomous system (that ‘minimized or selectively reduced reliance on FDI as a means of technological transfer. [Thus] entitl[ing] pervasive interventions...’ [Lall 2002: 81]). In either case, a high degree of government intervention has been necessary ‘to create the skill and technological capabilities if they are to result in sustainable development’ (ibid.: 84). Thus, in following any of these strategies, economies must strive to set up the infrastructure for innovating, developing, and upgrading their technology. In this respect, it is important to recall that within the current Trade-Related Aspects of Intellectual Property Rights, enforcement of technological transfers from TNCs to local partners has been sanctioned.

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<sup>25</sup> Recall that specialization is limited by market size which, in turn, is contingent on the level of domestic demand and, in the same vein, only through an increasing domestic demand can the interest of private investors be tapped and kept alive, to foster capital accumulation.



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