

THE POLITICAL ECONOMY OF TRADE- POLICY REFORM: LESSONS FROM DEVELOPING COUNTRIES

*Razeen Sally**

I. THE GLOBAL CLIMATE FOR EXTERNAL LIBERALISATION

There is less appetite for further liberalisation and associated structural reforms now compared with the heyday of the Washington Consensus in the 1980s and 1990s. Reforms have not been reversed, but their forward momentum has slowed. Governments are more sceptical and defensive about further liberalisation; there has been relatively little in the way of “second-generation” reforms (in domestic trade-related regulations and institutions) to underpin external liberalisation and boost competition. The last two years have seen creeping protectionism (rather than major liberalisation-reversal), e.g. FDI restrictions to protect “national champions” in “strategic” sectors, and export controls on agricultural and other commodities to combat food and fuel inflation. It is a matter of speculation whether protectionism will accelerate in response to global financial crisis, but the chances of that happening are increasingly evident.

Liberalisation slowdown applies to the West, and to most developing-country regions. In the developed world, pervasive agricultural protectionism continues, with an admixture of new protectionism directed against China. The West has no *grand project* for liberalisation in the early twenty-first century to compare with the Reagan and Thatcher reforms in the 1980s, or the EU’s Single Market programme in the late 1980s and early 1990s. Eastern-European countries are suffering from “reform fatigue” after their accession to the EU. This is also the state of play in much of Latin

* Director, European Centre for International Political Economy, Brussels, and on the faculty of the London School of Economics. r.sally@lse.ac.uk

America, Africa, south Asia and southeast Asia. It is true of leading developing countries, notably Brazil, Mexico, South Africa and India. All have their real bursts of trade-and-FDI liberalisation behind them. In Russia, liberalisation has been put into reverse gear. This has also happened in other resource-rich countries enjoying a revenue windfall, e.g. Venezuela and Bolivia. Overall, protectionist flare-ups and lack of reform momentum in the West have reinforced liberalisation-slowdown outside the West.

China was the conspicuous exception: liberalisation proceeded apace before and after WTO accession, in what has been the biggest opening of an economy the world has ever seen. However, domestic political conditions for further liberalisation are now more difficult. Market-based reforms have slowed down since about 2006, with a noticeable increase in industrial-policy interventions and FDI restrictions to support favoured national champions, especially in the public sector.

A variety of factors accounts for liberalisation-scepticism today. There is much anxiety about globalisation, despite record growth across the world in the five years ending in 2007. Macroeconomic crises provided windows of opportunity for fast-and-furious liberalisation in the 1980s and 1990s, but that has not happened since the Asian and other financial crises of the late 1990s. Indeed, the latter may have brought about a popular backlash, and certainly induced more caution regarding further liberalisation. Also, further liberalisation entails tackling border and, increasingly, domestic regulatory barriers in politically-sensitive areas such as agriculture and services. Inevitably, this runs up against more powerful interest group opposition than was the case with previous waves of (mainly industrial-goods) liberalisation. Individuals matter too: The new century has not yet brought forth a Cobden, Gladstone, Erhard, Thatcher or Reagan to champion free markets or free trade.

Not least, the climate of ideas has changed, for prevailing weather conditions have become more inclement since the Washington Consensus reached its zenith only a decade ago. There is, now as before, an extreme anti-globalisation critique, a root-and-branch rejection of capitalism, but

this is street theatre on the fringe. Of greater political importance is a more mainstream critique that accepts the reality of the market economy and globalisation, but rejects the comprehensive liberalisation associated (perhaps unfairly) with the Washington Consensus.

Critics point to tenuous links between liberalisation, openness, growth and poverty reduction; wider inequalities within and between countries that result from globalisation; the damaging effects of large and sudden trade liberalisation in developing countries; the renewed emphasis on aid to poorer developing countries, without which trade liberalisation will not work; the need for developed–country liberalisation while retaining developing–country protectionism; and the need for more flexible international rules to allow developing–country governments to pursue selective industrial policies, especially to promote infant industries.¹ Lastly, there is the pervasive fear — in the South as much as in the North — of being run over by an unstoppable Chinese export juggernaut.

It is important to confront these arguments head on: to defend liberalisation to date, while accepting that its record is mixed; to make the case for further liberalisation; and to identify the political conditions that might make it succeed. Protectionism and industrial–policy intervention has mostly failed across the developing world: history, not just theory, should be a warning not to go down this route again.

Firstly, in–depth country studies by the OECD, NBER and World Bank, going back to the 1970s and 1980s, suggest strongly that countries with more liberal trade policies have more open economies and grow faster than those with more protectionist policies. These are much more reliable than superficial cross–country regression analyses. (Bhagwati and Srinivasan, 1999; Lal and Myint, 1996) That said, even most of the latter point to large gains from trade liberalisation.²

¹ See Stiglitz (2002), Chang (2002), Grunberg et al. (1999), Oxfam (2002), Rodrik (2001), Rodrik (1998), Sachs (2005).

² See, for example, Sachs and Warner (1995), Winters (2004a) and Winters (2004b).

Putting together calculations done by the World Bank and Angus Maddison, a snapshot of the developing world in the year 2000 reveals the following. There are about 25 “new-globalising” developing countries (the World Bank’s term) with a total population of about 3 billion. Since 1980, this group registered massive increases in their trade-to-GDP ratios and real per-capita incomes, alongside big cuts in levels of tariff protection. In the same period, over 50 “less-globalised” developing countries, with a combined population of about 1.5 billion, saw stagnant trade-to-GDP ratios, a modest increase in real per-capita incomes, alongside relatively modest cuts in average import tariffs. The — overwhelmingly Asian — new globalizes have also seen dramatic reductions in poverty and improvements in human-welfare indicators (such as adult literacy, infant mortality, life expectancy and nutritional intake). (World Bank, 2002: 34, especially Table 1.1; Maddison, 2003).

Secondly, it is not true that globalisation “excludes” certain developing countries. Rather they support the argument that globalisation provides an enabling environment that some countries have taken advantage of and others have not. Political disorder, macroeconomic instability, insecure property rights, rampant government intervention and high external protection have kept other countries “non-globalised” and thereby retarded growth and development. Most of these countries are cursed with dysfunctional or failed states. None of this is “caused” by globalisation. (Wolf, 2004: ch 9; Henderson, 2004: 52–58)

Thirdly, NGOs and developing-country governments have been clamouring for one-sided liberalisation in the Doha round. Their interpretation of “development” in the Doha Development Agenda is that it behoves developed countries to liberalise in areas that are protected against labour-intensive, developing-country exports. But developing countries should not reciprocate with their own liberalisation. What these critics fail to say is that developing countries’ own protectionist policies harm them even more than developed-country barriers. The World Bank estimates that 80 per cent of the developing-country gain from worldwide agricultural liberalisation would come from developing countries’ liberalisation of their highly

protected agricultural markets. It is unskilled rural labour — the poorest of the poor — who would gain most since such liberalisation would reduce the anti-agricultural bias in domestic economies. (Oxfam, 2002; Ingco and Nash (eds.), 2004)

Fourthly, the historical record is not kind to “hard” industrial policies of the infant–industry variety. Infant–industry success in nineteenth–century USA and Germany is contested. In east Asia, its record is mixed at best in Japan, South Korea and Taiwan; non–existent in free–trade Hong Kong and Singapore; and failed in southeast Asia (e.g. national car policies in Malaysia and Indonesia). In northeast Asia, there is scant evidence to show that protection of infants actually led to higher social rates of return and higher overall productivity growth. (World Bank, 1993; Little, 1999) Southeast Asia’s conspicuous success is in FDI–led electronics exports — a result of drastically lower tariffs and an open door to inward investment. China, like southeast Asia, has grown fast through FDI–led exports, not infant–industry protection. Arguably, other factors — political and macroeconomic stability, competitive exchange rates, private property rights, openness to the world economy, education and infrastructure — were much more important to east–Asian success than “picking winners”. Finally, infant–industry protection in Latin America, south Asia and Africa has been a disaster not dissimilar to industrial planning in ex–command economies.

II. TRADE AND FDI LIBERALISATION: RECENT EXPERIENCE AND UNFINISHED BUSINESS

There has been a policy revolution and a strong liberalisation trend in developing countries and countries in transition since the early 1980s.³ Cross–border trade and capital flows — though not of people — have

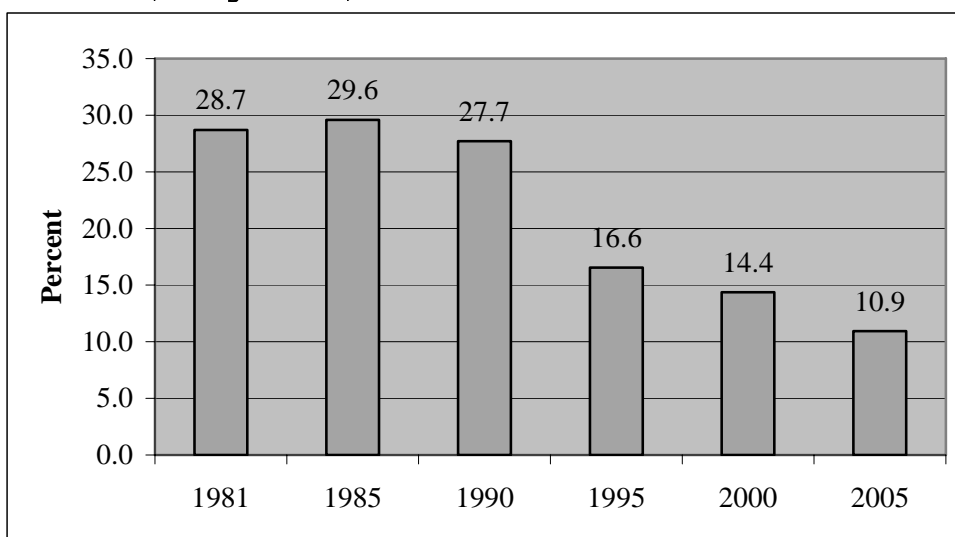
³ On the record of trade and FDI liberalisation as part of larger packages of market–based reforms in developing countries and countries in transition, see Williamson ed. (1993), Kuczynski and Williamson eds. (2004), Lal and Myint (1996), Dean (1995), Drabek and Laird (1998), Henderson (1998), Michalopoulos (2001). On trade–policy trends in Asia, see Sally (2007), Sally (2006a: 181–233), Sally and Sen (2005: 92–115). Special Issue ‘Revisiting trade policies in southeast Asia’, Sally and Sen (eds.).

become freer. There is less discrimination between domestic and international transactions. Domestic prices of tradable goods and services are closer to world prices (though less the case in services than in goods). In terms of measures undertaken, import and export quotas, licenses, state trading monopolies and other non-tariff barriers (NTBs) have been drastically reduced. Tariffs have been simplified and reduced. (See Figure 1 and Table 1 on the reduction of tariffs and core NTBs respectively.) So have foreign exchange controls, with unified exchange rates and much greater currency convertibility, especially on current account transactions. FDI has been liberalised, with fewer restrictions on entry, ownership, establishment and operation in the domestic economy (Table 2). And the services sectors have been opened to international competition through FDI liberalisation, privatisation and domestic deregulation. Overall, trade and FDI in manufactured goods has been liberalised most; trade and FDI in services was liberalised later, and to a much lesser extent; and trade liberalisation in agriculture has lagged behind. Lastly, trade and FDI liberalisation has taken place in the context of wide-ranging macro — and microeconomic market-based reforms — roughly the “stabilisation and liberalisation” package of the Washington Consensus, as described by John Williamson.

This still leaves fairly high levels of protection around the world. There are pockets of developed-country protection — agricultural subsidies, peak tariffs and tariff escalation in agriculture and manufactures, anti-dumping (AD) duties, assorted regulatory barriers such as onerous product standards, and high restrictions on the cross-border movement of workers that continue to damage developing-country growth prospects. But developing countries' own protection on almost all these counts is much higher. Average applied tariffs in developing countries are more than double those in developed countries, with much higher bound rates in the WTO (Table 3). Developing countries have become bigger users of anti-dumping actions than developed countries (Figure 2). Developing countries, with the exception of countries in transition and those that have recently acceded to the WTO, have far fewer multilateral commitments in services than developed countries (Figure 3). There has been a general increase in

the use of technical, food–safety and other standards that affect trade, as indicated by the number of measures notified under the WTO’s TBT and SPS agreements (Figures 4 and 5).

Figure 1. Average Applied Tariff Rates In Developing Countries, 1981–2005 (Unweighted in %)



Source: World Bank trade databases:

<http://siteresources.worldbank.org/INTRES/Resources/tar2005.xls>

Table 1. Frequency of NTBs in Developing Countries 1989–2000 (in percent)

Region	1989–1994	1995–1998	2000
East Asia and the Pacific	30.1	16.3	5.5
Latin America and the Caribbean	18.3	8.0	15.3
Middle East and North Africa	43.8	16.6	8.5
South Asia	57.0	58.3	13.3
Sub-Saharan Africa	26.0	10.4	2.3

Source: For 1989–94 and 1995–98: IMF, <<http://www.imf.org/external/np/pp/eng/2005/021505.pdf>>, citing Hoekman B, ‘Economic development and the WTO After Doha’, World Bank Policy Research Working Paper No. 2851. Washington, DC: World Bank, June 2002; for 2000: Cordell Institute, <[http://www.cordellhullinstitute.org/TPA/Volume%207%20\(2005\)/Vol%207,%20No.%202%20-%20Thomas%20Dalsgaard%20on%20Trade%20Reform%20&%20](http://www.cordellhullinstitute.org/TPA/Volume%207%20(2005)/Vol%207,%20No.%202%20-%20Thomas%20Dalsgaard%20on%20Trade%20Reform%20&%20)

Revenue%20Loss.pdf>, citing World Bank, Global Monitoring Report 2004. Washington, DC: World Bank, 2004, Table 4.6.

Note: Figures are regional averages of percentage of tariff lines subject to core NTBs, including all types of quantity restrictions and price administration or control as well as monopolistic trading channels.

Table 2. National Regulatory Changes on FDI, 1992–2005, by region

		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
World	More favourable	77	99	108	106	98	134	136	130	147	193	234	218	234	164
	Less favourable	-	1	2	6	16	16	9	9	3	14	12	24	36	41
Developed countries	More favourable	11	24	17	22	25	36	20	27	29	38	54	45	54	40
	Less favourable	-	-	1	2	3	6	4	5	-	3	2	3	6	4
Developing economies	More favourable	49	63	79	62	58	87	109	78	105	127	144	139	144	92
	Less favourable	-	1	1	3	10	5	3	2	2	10	9	20	27	30
Africa	More favourable	9	12	22	12	15	14	23	16	13	25	21	43	46	42
	Less favourable	-	-	-	-	2	-	1	-	-	3	6	2	11	11
Latin America and the Caribbean	More favourable	9	17	14	18	14	30	13	17	29	18	15	16	26	7
	Less favourable	-	-	-	2	1	4	2	2	-	3	2	11	9	14
West Asia	More favourable	3	8	4	4	4	5	18	7	24	26	34	35	34	15
	Less favourable	-	-	-	-	-	-	-	-	1	2	1	4	1	1
South, East and South-east Asia	More favourable	27	26	39	28	25	33	52	37	38	58	74	44	37	28
	Less favourable	-	1	1	1	7	1	-	-	1	2	-	3	6	4
Oceania	More favourable	1	-	-	-	-	5	3	1	1	-	-	1	1	-
	Less favourable	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Source: UNCTAD, Reference Thomas Pollan (Economic Affairs Officer)

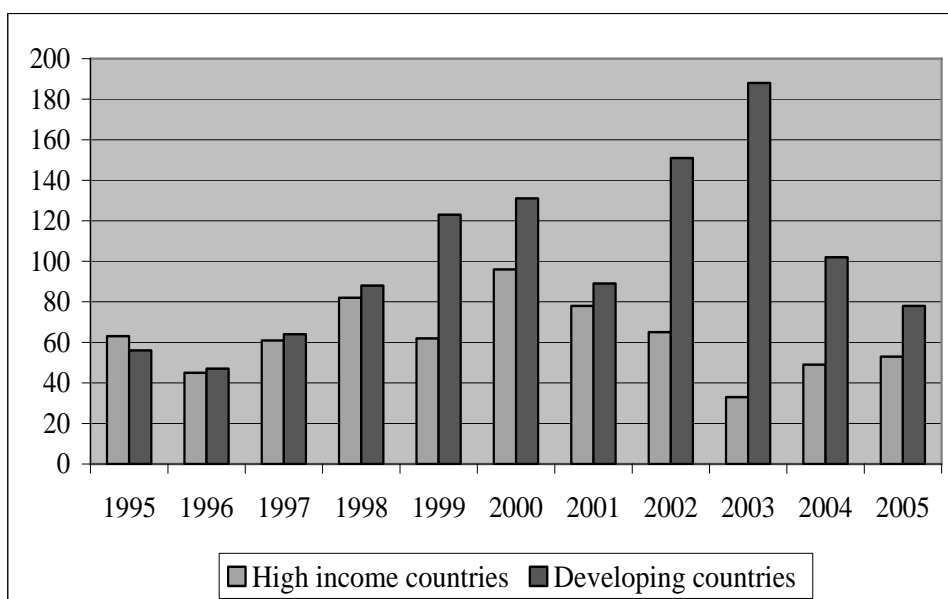
Table 3. Bound and Applied Tariff Rates

	Bound		Applied	
	Developed economies	Developing economies	Developed economies	Developing economies
All goods	17.8	43.6	5.5	11.8
Agriculture	24.3	60.6	9.5	16.3
Manufactures	16.7	32.5	4.8	11.0

Source: World Bank Trade Databases: <http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/tar2005a.xls>

Note: Developed and developing economies by World Bank definitions. Developed economies: category 3–4 (2002–2004) and developing economies: category 1–2 (1998–2004).

Figure 2. Anti-Dumping Measures

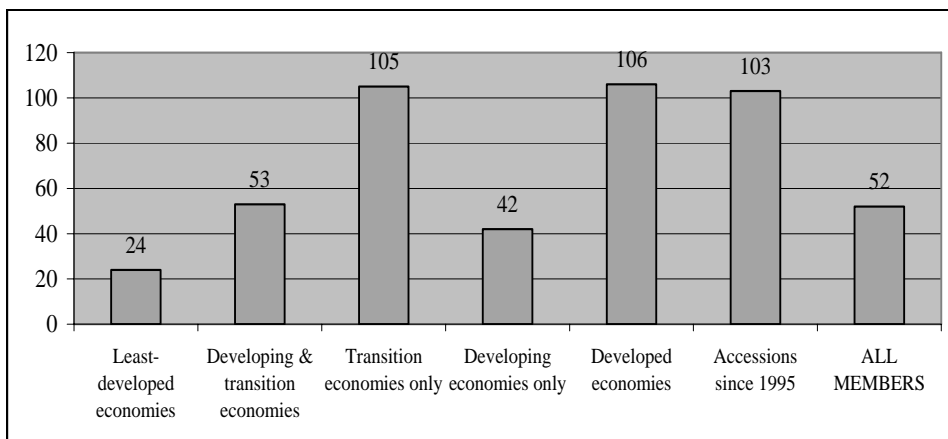


Source: WTO, http://www.wto.org/english/tratop_e/adp_e/adp_stattab7_e.xls

Note: Anti-dumping measures: by reporting Member. Classification of countries by World Bank Definitions

Figure 3. Distribution of GATS Commitments Across Groups of Members, March 2005

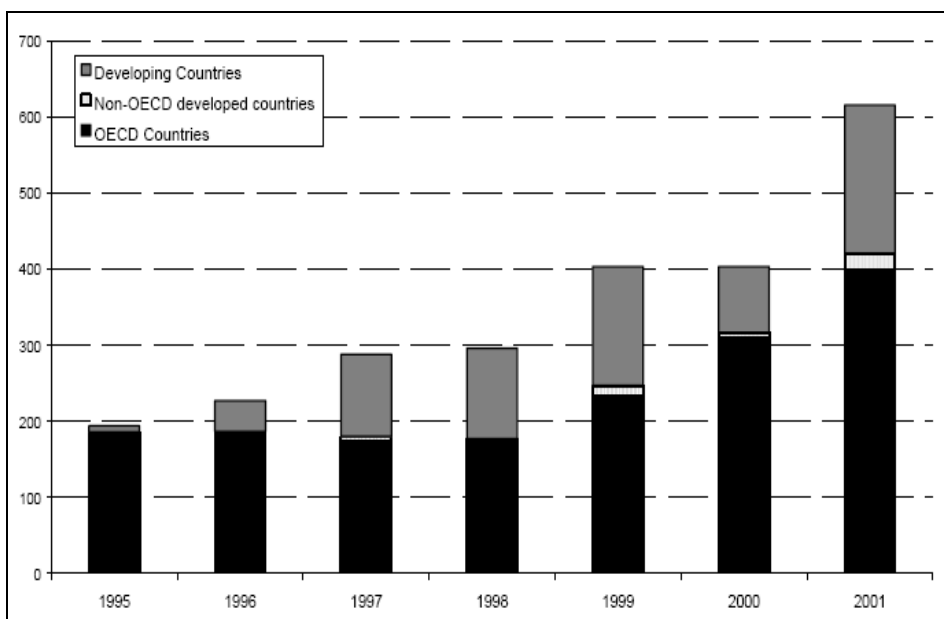
Average number of sub-sectors committed per Member



Source: WTO (Staff Working Paper ERSD-2005-01)

http://www.wto.org/english/res_e/reser_e/ersd200501_e.doc

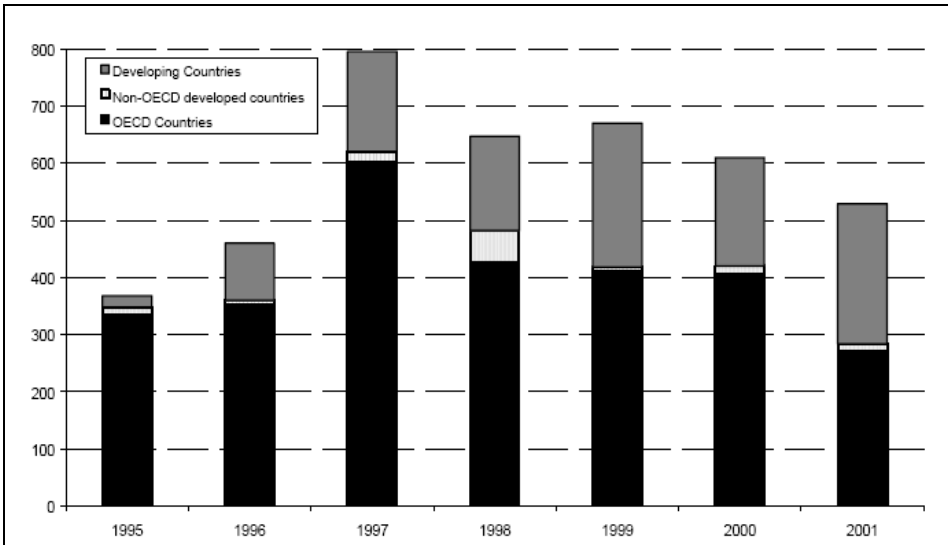
Figure 4. Number of Notified SPS Measures 1995-2001



Source: OECD: COM/TD/AGR/WP(2002)21/FINAL

[http://www.ois.oecd.org/olis/2002doc.nsf/43bb6130e5e86e5fc12569fa005d004c/7b8815fac33fe88ec1256bed002e5cb7/\\$FILE/JT00129244.PDF](http://www.ois.oecd.org/olis/2002doc.nsf/43bb6130e5e86e5fc12569fa005d004c/7b8815fac33fe88ec1256bed002e5cb7/$FILE/JT00129244.PDF)

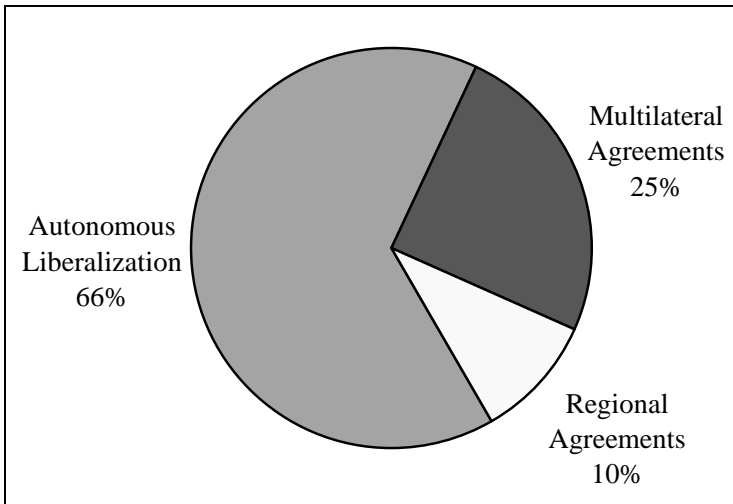
Figure 5. Number of Notified TBT Measures 1995–2001



Source: OECD: COM/TD/AGR/WP(2002)70/FINAL

[http://www.oecd.org/olis/2002doc.nsf/43bb6130e5e86e5fc12569fa005d004c/baacb7d0229000f9c1256cdf00418c0f/\\$FILE/JT00140246.PDF](http://www.oecd.org/olis/2002doc.nsf/43bb6130e5e86e5fc12569fa005d004c/baacb7d0229000f9c1256cdf00418c0f/$FILE/JT00140246.PDF)

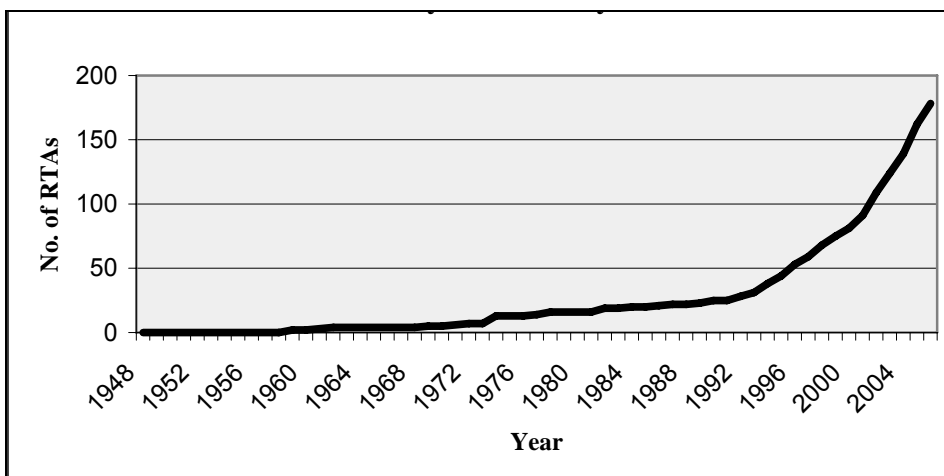
Figure 6. Share of Total Tariff Reduction, by Type of Liberalization, 1983–2003



Source: World Bank

http://siteresources.worldbank.org/INTGEP2005/Resources/GEP107053_Ch02.pdf

Figure 7. RTAs in Force by Date of Entry Into Force



Source: WTO, http://www.wto.org/english/tratop_e/region_e/summary_e.xls

Political economy and trade-policy reforms

The politics of economic policy reform is as much about distribution as it is about wealth generation. This is true of international politics; it is even truer of domestic politics. Shifts in trade policy — from protection to openness or vice versa — trigger redistribution of gains and losses between regions (especially between rural and urban areas), sectors of the economy (agriculture, industry, services), classes (owners of capital, educated and skilled workers, semi- and unskilled workers), and even between ethnic groups. Such disruption, especially in the short term, can be particularly unsettling in developing countries with political instability, corrupt elites, wide disparities in wealth and influence, meagre safety nets, ethnic divides and generally brittle institutions. Hence trade and other forms of liberalisation take place in a snake pit of messy and sometimes poisonous politics.

What are the determinants of trade-policy reform, especially in the direction of liberalisation? What follows is a simple taxonomy of relevant factors: a) circumstances, especially crises; b) country size; c) interests;

d) ideas; e) institutions; f) factor endowments; g) foreign policy and international politics.

a. Circumstances/Crises

Events, dear boy, events.

Harold Macmillan

When a man knows he is going to be hanged in a fortnight, it concentrates the mind wonderfully.

Dr. Johnson

The practical politician, official or businessman knows that choices are dictated by responses to often unanticipated events. In reality, major episodes of economic policy reform have mostly taken place in response to political and/or economic crises. A macroeconomic crisis, with symptoms such as extreme internal or external indebtedness, hyperinflation, a terms-of-trade shock, or a severe payments imbalance leading to a plummeting currency, provides the classic backdrop. Sometimes this is combined with a political crisis, whose most dramatic expression is a change of political system (from authoritarianism or totalitarianism to democracy or vice versa).

An economic crisis, with or without political system-change, is when “normal politics” is suspended, and when a period of “extraordinary politics” can provide a window of opportunity for thoroughgoing reforms (that would not be possible in “normal” political circumstances). (Haggard and Williamson, 1993: 527–596; Balcerowicz, 1995) Examples are legion: Chile in 1973–74; Mexico in 1986; Brazil and Argentina in the early 1990s; South Africa in the mid-1990s; Sri Lanka in 1977; India in 1991; eastern Europe and the ex-Soviet Union in the early 1990s; Australia and New Zealand in 1983–84.

But the crisis explanation cannot be taken too far. Firstly, a crisis can precipitate swings both ways: sometimes towards liberalisation;

sometimes the other way, as happened during the Depression in the 1930s, and, to a lesser extent, in the 1970s after the first oil-price shock. Secondly, different governments act in different ways in response to similar external shocks. Thirdly, a crisis might trigger some reforms, but it is no guarantee of the sustainability of those reforms, nor of further reforms down the line. That is one key difference between east-central Europe and the Baltic states, on the one hand, and Russia and other parts of the ex-Soviet Union, on the other. Lastly, there are counter-examples of gradual, but cumulatively substantial, reforms without a sudden crisis as a triggering mechanism. That is, roughly, the east-Asian record.

Why have some countries sustained reforms while others have not? Why have some gone farther than others? What happens to a reform programme post-crisis, when “normal” political and economic conditions return? These questions demand supplementary explanations.

It may not seem urgent to pursue liberalising reforms in “normal” conditions, especially after so much reform heavy-lifting has been done. But complacency is dangerous. It means that the economy continues to live off reforms accomplished some time ago. Reforms needed to make the economy flexible and adaptable to changing global conditions, and resilient to unanticipated shocks, are neglected. Meanwhile, distortions and rigidities build up. A future crisis is then the trigger for long overdue reforms. These come at a much higher political, economic and social cost than would otherwise be the case (OECD, 2007).

Depending on a crisis for reform is myopic, and ultimately crazy, policy. It is far better to nurture a culture of permanent, incremental and mutually reinforcing reforms. But that is terribly difficult in practice. Still, star reformers such as Chile, Australia and New Zealand show that it can be done. All three have followed up crisis-induced first-generation reforms with deeper second-generation reforms rolled out over almost two decades (Bowen, 2007; Sandrey, 2007; Herreros, 2007). These,

however, are small open economies where the reform imperative is stronger than in medium–sized and large economies.

b. Country Size

Generally, small countries reliant on the world economy have liberalised farther and faster than bigger countries. This is the case in the OECD and the developing world. Ireland, Chile, Australia, New Zealand and Estonia (among other East–Central European and Baltic countries) stand out as very strong reformers. So do Hong Kong and Singapore, with long traditions as free–port city–states. Sri Lanka pioneered liberalising reforms in south Asia, before ethnic conflict compromised economic prospects from 1983. Mauritius and Botswana stand out in Africa.

It is generally believed that the economics and politics of reform in small countries are easier. Larger countries have more differentiated economies. They are less reliant on the world economy and have more inward–looking, protectionist–inclined interests. That translates into more complicated politics. But big countries are not preprogrammed to avoid reforms or do them sluggishly. China is the most populous country on Earth, but it is the strongest reformer among large developing countries. Others in the latter category — Brazil, India, Indonesia, South Africa, Nigeria, Egypt, Russia — have mixed or unfavourable records compared with some smaller countries in their respective regions.

c. Interests

A good cause seldom triumphs without someone's interest behind it.

John Stuart Mill

Mainstream economists, following Adam Smith, tend to rely on an interest–group explanation of trade politics. Free trade is the optimal policy in most circumstances (they say), but protection more often is the result, because organised rent–seeking interests demand protection that

politicians and officials then supply. The benefits of free trade are diffused over the broad majority of consumers, but its costs bear down disproportionately on minority producer interests. The latter, not the former, have the incentive to organise for collective action. (Olson, 1971; Krueger, 1974: 291–303) In reality, “iron quadrangles” of politicians, bureaucrats, employers and unions imposed a straightjacket of protection in developing countries from the 1930s to the 1970s. Mostly this benefited capital-intensive, unionised, urban manufacturing industries producing for the domestic market, at the expense of agriculture and tradable sectors. India’s license raj was its most notorious incarnation. In many countries, a crisis was used to overcome interest-group opposition and push through liberalising reforms (as happened in India in 1991).

But what role do interest groups play after an initial burst of external liberalisation and in post-crisis conditions when “normal” politics returns? Here the picture differs across countries and regions. In some parts of the world, protectionist coalitions have halted or slowed down liberalisation. This is the case with “nomenklatura” coalitions in Russia, Ukraine and other parts of the ex-Soviet Union. Elsewhere, radical opening has triggered major economic shifts in favour of sectors exposed to the world economy. Traditional protectionist interests have been weakened, and countervailing coalitions have emerged. The latter comprise exporters, users of imported inputs, multinationals with global production networks, and cities and regions seeking to be magnets for trade and FDI. These interests lobby for the maintenance and extension of open trade and FDI regimes.⁴ This has happened in strong-liberalising countries in east Asia, eastern Europe and Latin America. It happened in Australia and New Zealand from the early 1980s. It is also evident in India after the 1991 reforms.

⁴ The Ricardo–Viner and Hecksher–Ohlin models of comparative advantage are used to explain interest-group activity pro and contra free trade in different countries with different factor endowments. See Frieden and Rogowski (1996) and Rogowski (1990).

Now the biggest challenge is to harness open–economy interests to the wagon of further liberalisation, and especially to domestic regulatory reforms. Their stakes in structural, microeconomic reforms are becoming ever clearer. Previous liberalisation has spurred firm–level restructuring, export orientation and overseas expansion. But firms remain hamstrung by high–cost domestic business environments, which they feel puts them at a disadvantage compared to foreign competitors with more salubrious business climates in their home markets. That also translates into defensiveness in trade negotiations. Structural reforms at home would lower business costs, boost the international competitiveness of local firms, make them less resistant to opening domestic markets to foreign competition, and translate into less defensive positions in trade negotiations.

Starting this virtuous cycle begins with reforms at home, not in the WTO or FTAs. In terms of interest–group activity, it implies a new and different political economy to that of hitching exporting interests to tariff concessions in trade negotiations.

d. Ideas

It is the word in season that does much to decide the result.

John Stuart Mill

Madmen who hear voices in the air are distilling their frenzy from the academic scribblings of some defunct economist or political philosopher. Indeed the world is ruled by little else.

John Maynard Keynes

It is always difficult to gauge the influence of ideas (or ideology) in policy.⁵ But practical observation teaches us that the prevailing climate of ideas, interacting with interests and events, can entrench or sway this–or–that set of policies. A policy consensus on import substitution, state planning and

⁵ On “ideational” approaches, see Goldstein (1994).

foreign aid was strongly embedded in developing-country governments and international organisations up until the 1970s. This was buttressed by a post-colonial political ideology of mercantilist state-building, and an interventionist consensus in development economics. (Bauer, 2000 and Lal and Myint, 1996) This set of ideas was overturned by what came to be called the Washington Consensus, which reflected sea changes in political ideology and in development economics. The latter returned to classical and neoclassical foundations, emphasising market-based pricing, “outward orientation”, the prevalence of “government failure” over “market failure”, not to mention a dose of aid scepticism.

The Washington Consensus ideas took stronger hold in countries where reforms were substantial, especially in ministries of finance, central banks and presidential/prime-ministerial offices. These agencies tend to be the cockpits of policy reform, especially in crisis situations. They have been staffed by technocrat-economists (dubbed “technopols” by John Williamson) committed to Washington Consensus prescriptions. Technopols are much less in evidence and less influential outside macroeconomic policy, especially in line ministries and regulatory agencies which control microeconomic policies.

But now the climate of ideas has changed somewhat, not least in reaction to global financial crisis. This does not yet presage a return to full-blown pre-Washington Consensus thinking. The pendulum, however, is swinging towards more attention to market failure and government intervention, e.g. to ease back on further liberalisation, expand “policy space”, promote infant industries, defend “food security” and increase foreign aid. The question is what effect this is having, and is likely to have, on trade policies.

e. Institutions

In the broad sense, institutions are the steel frame of the economy, its “formal rules and informal constraints”, according to Douglas North. The legal framework governing property rights and contracts, production and

consumption, comes to mind. “Formal rules” comprise bankruptcy laws, competition laws, regulations governing financial markets and corporate governance, and much else besides. “Informal constraints” are (often non-legal) traditions and norms influencing the intersecting worlds of business, government and the law.

Evidently, “institutions” are much broader and more difficult to pin down than “policies”; the two are of course intimately connected. Historically-conditioned institutions, domestic and external, set the scene for government action, interest-group lobbying and the influence of ideas. They are the arena for policy choices and their implementation. Making generalisations about institutional constraints on policy choice, and how this might explain differences in national and regional economic performance over time, is notoriously difficult. To what extent must “good” institutions be in place before “good” policies can take hold and work their magic? Conversely, to what extent are institutions the result, rather than the cause, of policy choices? These are chicken-and-egg questions.

In the narrow sense, institutions are the organisational map of decision making at the junction where politics and public policy meet business and society. On trade policy, this map is much more complicated than it used to be. Trade policy is no longer just about a clutch of border instruments, and the preserve of trade ministries. It is increasingly “trade-related”, a matter of non-border regulation reaching deep into the domestic economy and its institutions. That is reflected in more complex multilateral, regional and bilateral trade agreements. This brings in agencies across the range of government and many actors outside government as well. Now the management of trade policy involves the division of labour between the executive, legislature and judiciary; the role of the lead ministry; the participation of other ministries and regulatory agencies on trade and trade-related policies; the WTO mission in Geneva; interagency coordination within government; the involvement of non-governmental actors, such as

business and unions, and now including NGOs and think tanks; and the role of donors and international organisations.

In as much as one can make generalisations about institutions and trade policy in developing countries, here are a few. Firstly, it is the more advanced developing countries (in terms of per-capita income and human-welfare indicators) that have liberalised more and plugged themselves better into globalisation than other developing countries. They have lower trade and FDI barriers, higher ratios of trade and FDI to GDP, and better-performing tradable sectors of the economy. They also have stronger institutions in the broad sense: better enforcement of property rights and contracts (i.e. the rule of law), better-functioning judiciaries and public administration, better-regulated financial markets, a stronger competition culture, less corruption and so on. This is the divide that separates Chile and a few other Latin American countries, eastern Europe, the northeast-Asian and southeast-Asian Tigers, and a tiny handful of African countries (Mauritius, Botswana and South Africa), from the rest. Large developing countries such as China, India, Indonesia and Brazil do not fit into this pattern. They still have weak institutions. Institutional improvements have taken place, but these have lagged well behind big policy shifts — not least lower trade and FDI restrictions — and fast-paced global integration.⁶

Writing from the 1990s rightly stresses institutional capacity, within the state and beyond it (World Bank, 1997; Rodrik, 2003). This fills in the institutional vacuum in studies on market-based policy reforms in the 1970s and 1980s. But the later literature sometimes goes too far in setting high institutional preconditions for reformist policies to work. The extreme is “institutions come first”. The reality is a complex

⁶ See the World Bank’s governance and business-climate indicators. They point to large institutional and policy differences among developing countries. They also point to relatively weak institutions, as well as the high “red-tape” costs of doing business, in China, India, Indonesia, Brazil, South Africa, Russia and other large less-developed countries. See World Bank (2008) and World Bank governance indicators, www.worldbank.org.

interplay between market-based policies, including trade and FDI liberalisation, and improving domestic institutions. Often policy reforms provide the stimulus for institutional change. As Adam Smith realised over two centuries ago, opening markets to international trade and investment triggers powerful incentives to improve infrastructure, public administration and the rule of law. Then producers and consumers can reap more gains from international commerce (Myint, 1977). China and Vietnam are shining successes of policy reform. But reforms in both countries, including opening to the world economy, began when institutions were very weak. That is also true of Indonesia in the mid 1960s, and Cambodia and Laos in the 1980s and 1990s.

Secondly, looking at institutions in the narrower organisational sense, strong and sustained trade policy and wider economic policy reforms were driven, more often than not, by powerful presidential or prime-ministerial offices, ministries of finance and central banks, insulated from blocking pressures in other parts of government and outside government. Ministries of finance were particularly important in driving trade liberalisation during crises, often overriding protectionist-inclined ministries of trade and industry. But, post crises, the former have retreated to their core macroeconomic functions, leaving line ministries and regulatory agencies to handle trade policy with much less oversight.

Thirdly, advanced developing countries have stronger capacity, in terms of qualified, experienced manpower and other resources, for formulating and implementing trade policy, whether done unilaterally or through international negotiations and agreements. China and India are exceptional: they are low-income countries with relatively weak institutions (in the broad sense), but with relatively strong trade-policy capacity.

Fourthly, it is very difficult to make generalisations about the link between political systems and economic policy reforms. Across the developing world, liberalisation has taken place under authoritarian and democratic systems. In the short-to-medium term, authoritarian regimes

may find it easier to go further with reforms (China from the early 1990s, Indonesia in the 1980s). But in Russia, increasing authoritarianism under President Putin proceeded alongside partial reform reversal. In the medium-to-long term, a question hangs over authoritarian regimes due to arbitrary and opaque decision-making, and lack of popular legitimacy. That might compromise the durability of policy reforms. In reasonably stable liberal democracies, reforms, however slow and piecemeal, may be more durable due to their sanction in the political marketplace. That is the silver lining for Brazil and India, and perhaps for Indonesia and South Africa.

f. Factor Endowments

Explaining the trajectory of policy reforms is not complete without factoring in the relative mix of land (or natural resources), labour and capital in an economy.⁷ We know from recent economic history that the star developing-country performers are from east Asia. These countries had different starting positions, but, at a certain stage of development, relative abundance of labour allowed them to break into labour-intensive manufactured exports, which became an engine of growth and in turn aided poverty reduction and human-welfare improvement. Of course this was not inevitable: it depended on the right policies and improving institutions. South Asia, with similar factor endowments, remained stuck on a low-growth, high-poverty path because it did not adopt market-based policies.

Latin American and African countries, on the other hand, are largely land- or resource-abundant and labour-scarce. Absent import-substitution policies, they are better able to exploit comparative advantage in land and resources — as Brazil, Argentina, Chile, Australia and New Zealand have done in agriculture since they liberalised, and as

⁷ Lal and Myint (1996) provide perhaps the best analysis of how factor endowments have influenced the political economy of post-colonial policy reforms in developing countries.

all the latter and many other countries besides have been doing in the present China-driven commodities boom.

Thus a simple story based on an early 21st-century comparative advantage would point to all-around gains from trade: for technologically-advanced and capital-abundant countries in the West; the labour-abundant countries of east and south Asia; and land and resource-abundant countries elsewhere.

But the political economy of factor endowments reveals a different and more problematic story. Arguably, land- and resource-abundant countries are at a structural disadvantage compared with labour-abundant countries. By plugging into global markets for manufacturing, and now labour-intensive services too, the latter seem to be on sustainable growth paths. Labour-intensive exports attract FDI (and the technology and skills that come with it), feed quickly into poverty-reducing, welfare-improving employment, and, more gradually, into better infrastructure and institutions. This creates and strengthens a constellation of interests to support open trade and FDI policies.

On the other hand, land- and resource-abundant countries, given their relatively high price of labour, seem to be crowded out of global manufacturing markets by east-Asian (especially Chinese) competition (Wolf, 2004). This leaves them dependent on cyclical and volatile commodities markets. FDI in resource-abundant countries tends to be capital-intensive and generate big rents in not-so-competitive market segments. Often the result is an FDI enclave, without an employment, technology or wealth spillover to the rest of the economy, but with big profits to distribute among a corrupt local business and political elite.

Thus most research-dependant countries have the interest-group constellation to squander rents from resource booms, but not to spread wealth and improve governance and institutions. A retreat to protectionism, however, would repeat past mistakes and make matters worse. This is the dilemma inherent in the present “China-in-Africa”

phenomenon. It is an acute dilemma for Russia, Nigeria, Saudi Arabia and other overwhelmingly resource-abundant countries. But there are notable exceptions to the “resource-curse” rule: Chile has successfully exploited comparative advantage in agriculture and resources (mainly copper) through liberal trade policies, while diversifying the economic base and improving institutions (Herreros, 2007). That is also true of Australia and New Zealand (Sandrey, 2007; Bowen, 2007).

g. Foreign Policy and International Politics

Unhampered trade dovetails with peace; high tariffs, trade barriers and unfair economic competition with war.... I will maintain faith in my belief that the security, peace and welfare of nations are indissolubly connected with friendship, fairness, equality and the maximum practicable degree of freedom in international trade.

Cordell Hull

Trade policy links down to national economic policies and institutions. But it also links up to foreign policy and international politics. A reasonably stable international political order is the categorical imperative for economic development. Without the global Pax — an orderly framework for international relations — there can be no security for international commerce.

The end of the Cold War and the collapse of the Soviet Union reshaped international politics. It was the catalyst for the twin political and economic transitions in eastern Europe and the former Soviet Union. But it also reverberated elsewhere. It brought on a foreign-policy transformation in India. It looked west to a *rapprochement* and closer relations with the USA, and in the second instance with Europe. It also looked east, first to southeast Asia and then to China. Stronger security relations with the USA and other countries have proceeded in tandem with stronger commercial relations with the same countries. Arguably,

India's foreign policy shift is an important factor influencing its belated embrace of the world economy (Narayan, 2007; Baru, 2006).

China's foreign policy transformation began in the 1980s and accelerated in the 1990s. Its emphasis is on “constructive engagement” with the USA, Europe and emerging developing-country powers. China's “soft power” has been very effective in its east-Asian neighbourhood, although less so with Japan (not to mention Taiwan). Its self-advertised “peaceful rise” is geared to regional political stability and steady integration into the world economy. Trade diplomacy, in the WTO and FTAs, is perhaps the most visible sign of China's foreign-policy transformation.

Russia's trade policy has also followed the swings of its foreign policy. The opening of the economy in the 1990s occurred alongside closer relations with the USA and western Europe. This seemed to be reinforced during President Putin's first term but his second term has seen a distancing of relations with the West, and a more aggressive stance towards Russia's “near abroad”, particularly through energy politics. It is part of Russia's assertion of “big-power” status. This is the context for more statist energy policies and ambivalence about further external liberalisation.

– Preliminary summary

In many strong-liberalising countries, an economic crisis, sometimes combined with a political crisis, has led to a big opening of the economy. New open-economy interest-group constellations have emerged to counter traditional protectionist interests. Washington Consensus ideas have spread through technopols (although more influential in macroeconomic than microeconomic policy), leadership focus on growth (much more so in east Asia than in other regions), and pragmatic emulation of successful policies elsewhere. In some democracies, a party-political and wider public consensus, however partial and patchy,

has gradually formed around reforms. Gradually improving institutions are better able to support and manage open-market policies, although they remain relatively weak in most developing countries. Shifts in foreign policy have also encouraged external opening and closer relations with major trading partners. Russia is a major exception to these trends, given partial reform reversal.

Labour-abundant countries in east Asia, and now in south Asia, have the most promising political economy to support external liberalisation and global integration — China and India prominent among them. Resource-abundant countries in Latin America, Africa, the Middle East, Russia and other parts of the ex-Soviet Union, have been doing well in the China-driven commodities boom. But their political economy is problematic: their predatory governments and interest groups are geared more to squandering rents than to creating and spreading wealth sustainably.

– Multi-track trade policy

Another way of cutting into trade-policy reform is to look at it on several levels. Some reforms are carried out unilaterally; others reciprocally through (bilateral, regional, multilateral) trade negotiations, or in agreements with donors. Most developing countries now do trade policy on all these level concurrently, although the relative balance differs from country to country. What follows is a brief summary of the main features of “multitrack” trade policy in developing countries.

– Unilateral liberalisation

This is the Nike strategy (“Just Do It!”). Governments “liberalise first and negotiate later”, as Mart Laar, the former prime minister of Estonia, puts it. In theory, this makes good economic sense. The gain from liberalisation comes from imports, which release domestic resources for more productive uses, including exports, and help to open the door to

inward investment.⁸ Why, therefore, delay the gain by waiting for cumbersome, bureaucratic trade negotiations to deliver the goods? Unilateral liberalisation can make political sense too, since it can be tailored to local conditions rather than being dictated by “one–size–fits–all” donor conditionality and international trade agreements.

The British led the way with unilateral free trade in the nineteenth century. The first half of the twentieth century witnessed unilateral protectionism by country after country. Since 1945, most developed countries have liberalised reciprocally, through the GATT and bilateral/regional trade agreements. But most developing–country trade and FDI liberalisation has been done unilaterally, not through trade negotiations. The World Bank estimates that two–thirds of developing–country tariff liberalisation since the early 1980s has been done unilaterally (Figure 6) (World Bank, 2004). The strongest liberalisers have been unilateral liberalisers: the east–Asian countries, now led by China; Chile and Mexico; the east–European countries; Australia and New Zealand. Nearly all of India’s post–1991 liberalisation has been done unilaterally.

China’s external liberalisation now matters most, for it is the biggest the world has ever seen, with the biggest spillover effect in Asia. China’s opening not only spurred southeast–Asian liberalisation pre–Asian crisis; it probably helped to prevent liberalisation reversal post–Asian crisis. It has also encouraged east–Asian countries to further liberalise at the margin of the post–Asian crisis — for fear of losing trade and FDI to China. Not least, China has probably had a knock–on effect on the Indian opening to the world economy. India has recently accelerated its

⁸ There is the theoretical possibility of (usually large) countries being able to exercise long–run market power in international demand for certain goods. This enables them to shift the terms of trade in their favour by means of an “optimal tariff”. The corollary is that these countries should only lower tariffs if others reciprocate, in order to avoid worsening terms of trade. In reality, very few countries have such long–run market power. And retaliatory tariffs by other countries could nullify terms–of–trade gains. Thus — not for the first time — a neat theory turns out to have limited practical relevance. See Irwin (1996: 106–115).

liberalisation of tariffs, and eased FDI restrictions in some services sectors. This has occurred outside trade negotiations, as was the case with previous Indian trade-and-investment liberalisation since 1991. Would this have happened, or happened as fast, if China had not concentrated minds? Probably not.

That is not to say that China-induced unilateral liberalisation is a total solution. It is unlikely to induce further external liberalisation in the developed world, and least of all in the USA, EU and Japan. In the developing world, its results will inevitably be patchy and messy. Unilateral liberalisation has been more successful in manufacturing than in services and agriculture; it has tackled border barriers much better than non-border regulatory barriers. More generally, unilateral measures do not lock in liberalisation against future backtracking. They do not provide fair, stable and predictable rules for international commerce. Finally, unilateral liberalisation has slowed down across the developing world, now including China.

On its own, therefore, unilateral liberalisation cannot slay protectionist dragons and solve international commercial conflicts. That leaves room for reciprocal negotiations and international agreements, i.e. for the WTO and FTAs.

– Multilateral liberalisation

The rationale for liberalisation through “multilateral reciprocity” is that unilateral liberalisation is politically difficult in the 20th/21st-century conditions of democratic politics and strong interest-group activity. The GATT/WTO negotiations help to contain protectionist interests and mobilise exporting interests; multilateral agreements provide fair, non-discriminatory rules for all.

Multilateral liberalisation was successful during the GATT when the latter had a relatively slim agenda, club-like decision-making dominated by a

handful of developed countries (especially the USA and EU), and the glue of Cold War alliance politics. It has proved spectacularly unsuccessful in the WTO, given its large, unwieldy agenda, chaotic UN–style decision–making in a vastly expanded membership, and without the glue of military alliances after the Cold War. The deadlock in the Doha Round probably shows that future multilateral liberalisation will be elusive, and modest, at best.

Arguably, the best the WTO can hope for is to lock in pre–existing unilateral liberalisation through binding commitments, and gradually improve the functioning of non–discriminatory multilateral rules.⁹ That implies scaling back ambitions and expectations. Market–access negotiations (to deliver extra liberalisation) should be more modest and incremental; maybe trade rounds should become a thing of the past. There should be a shift of focus to safeguarding and improving trade rules.

Finally, to get business done, WTO decision–making should fall in line with the political and economic realities outside of Geneva. About 30 countries (counting the EU as one) account for about 90 per cent of international trade and FDI. That includes 20–25 developing countries. They should gather in plurilateral “coalitions of the willing” to make key market–access and rule–making decisions, and correspondingly take on stronger commitments than the rest of the WTO membership. Within this outer core there is an inner core of “big beasts”, including China, India and Brazil. They should exercise co–leadership alongside the USA, EU and perhaps Japan (if the latter can get its act together). In other words, the WTO needs “variable geometry” in order to function effectively.

Moving in this direction will be difficult, given the parlous state of the WTO. There is every prospect that multilateral trade rules will be undermined by major players seeking to evade them, with extra pressure coming from proliferating, discriminatory bilateral and regional trade

⁹ The following argument draws on Sally, 2006b.

agreements. Weaker multilateral rules will be a much bigger cost for developing countries than the extra multilateral liberalisation forgone as a result of the failure of the Doha Round.

– Bilateral and regional liberalisation

Negotiations for new preferential trade agreements — overwhelmingly FTAs, but also some customs unions and partial-scope agreements — have occurred at an increased pace since 1999/2000, and even more so since the launch of the Doha Round (Figure 7) (Crawford and Fiorentino, 2005). Eastern Europe, Africa and Latin America have long been involved in PTA activity. East Asia, which previously relied on non-discriminatory unilateral and multilateral liberalisation, is now playing PTA catch-up, as is south Asia. All the major regional powers — China, India and Japan — are involved in Asian PTAs, as are the USA, EU, Korea, Australia, New Zealand, Hong Kong, other south-Asian countries and the ASEAN countries.

Proponents argue that small clubs of like-minded members can take liberalisation and rules faster, wider and deeper than in the WTO, and act as “building blocks” to further multilateral liberalisation and rule-making. Sceptics say they are “stumbling blocks”, diverting attention from the WTO, creating “spaghetti bowls” of discriminatory trade restrictions, and generally favouring powerful players at the expense of the weak.

The reality is mixed. Non-discriminatory unilateral and multilateral liberalisation blunt the damaging effects of discriminatory trade agreements. There is little prospect of the world economy retreating to the warring trade blocs of the 1930s. Strong, “WTO-plus” FTAs can also make sense in certain circumstances but the record in developing-country regions is not encouraging.

With few exceptions, FTAs and customs unions are weak, often falling short of WTO provisions. This is particularly true of South–South PTAs (i.e. between developing countries), but also holds for many North–South PTAs. These tend to be driven by foreign–policy aspirations, but with justifications that are all too often vague, muddled and trivial, having little relevance to commercial realities and the economic nuts and bolts of trade agreements. This can amount to little more than symbolic copycatting of other countries’ PTA activity and otherwise empty gesture politics. In such cases economic strategy is conspicuous by its absence. In short, such PTAs are “trade–light”.

The predictable results of foreign–policy–driven PTA negotiations light on economic strategy are bitty, quick–fix sectoral deals. Politically sensitive sectors in goods and services are carved out, as are crucial areas where progress in the WTO is elusive (especially disciplines on anti–dumping duties and agricultural subsidies). Little progress is usually made in tackling domestic regulatory barriers (e.g. relating to investment, competition, government procurement, trade facilitation, cross–border labour movement, and food–safety and technical standards). These PTAs hardly go beyond WTO commitments, deliver little, if any, net liberalisation and pro–competitive regulatory reform, and get tied up in knots of restrictive, overlapping rules of origin (ROOs). Especially for developing countries with limited negotiating capacity, resource–intensive PTA negotiations risk diverting political and bureaucratic attention from the WTO and from necessary domestic reforms. Finally, the sway of power politics can result in highly asymmetrical deals, especially when one of the negotiating parties is a major player.

Latin America and Africa have a messy patchwork of weak FTAs that do not liberalise much trade or improve upon WTO rules, but do create complications, especially through trade–restricting rules of origin, and divert attention both from the WTO and from unilateral reforms. This is also the emerging picture of FTAs in east and south Asia (Sally, 2006c).

– The role of donors¹⁰

Foreign aid, with conditions attached by the IMF, World Bank and other donors, has clearly played a big part in driving Washington Consensus-type reforms in many developing countries. This has gone way beyond developing countries' (relatively weak) liberalising commitments in the WTO and PTAs. Arguably, unilateral liberalisation has not been truly "unilateral" when it has depended on donor policy preferences and aid with strings attached. The record of IMF stabilisation packages and World Bank structural adjustment packages has been mixed at best, and certainly disappointing compared with optimistic expectations in the 1980s (World Bank, 1998a and World Bank, 1998b). Often donor-driven reforms have proceeded in stops and starts, with reversals en route. Projected growth and poverty-alleviation effects have not materialised. The politics of aid are even more dubious than its economics. "Conditionality" is empty rhetoric when self-serving interests at both ends of the pipeline ensure that aid continues to flow, even when promised reforms are not delivered. And the perception that Western donors are imposing reforms on otherwise reluctant countries is hardly sustainable: local "ownership" is lacking (to borrow aid jargon), and it invites a backlash and reform-reversal at home (Bauer, 2000).

The bottom line is that countries that have seen strong, sustained, unilateral liberalising reforms are those whose governments have driven reforms ("from below", as it were) rather than having them imposed by donors ("from above"). Aid at its best has smoothed short-term adjustments, as happened with the IMF package to India in 1991, and Japanese aid to Indonesia in the 1980s. The IMF and World Bank have sometimes been useful sources of policy and technical advice. More than anything else, donor conditionality has provided a "good housekeeping seal of approval" — an international signal of reform credibility — for determined home-driven reforms. In these countries (mostly in east Asia and eastern Europe with a few in Latin America), aid has played a

¹⁰ This section draws on Erixon and Sally (2006: 69–77).

marginal role. Where there has been more reliance on aid and donor conditionality — especially in Africa — reforms have a far worse record.

Hence grand aid blueprints, notably the UN Millennium Project and the Africa Commission Report, are questionable. They are not critical to successful trade–policy reforms, and they may be counterproductive. The WTO's “aid–for–trade” initiative, though more modest, should face the same critical questioning.

– Preliminary summary

Developing countries have relied mostly on unilateral liberalisation to open their economies to the world. But unilateral liberalisation has stalled or slowed down and some countries — notably Russia — have seen partial reform reversal. In some countries, trade negotiations have gained the upper hand over unilateral measures, but led to little or no additional liberalisation.

The WTO has been of second–line assistance by providing a framework of multilateral trade rules for unilateral reforms but GATT/WTO commitments have contributed little extra liberalisation in most developing countries. China and other newly–acceded developing countries are exceptions. In China, however, the primary thrust of reforms was domestic and unilateral, coming from national leadership rather than external pressure in trade negotiations.

Developing countries' PTAs are trade–light: they are driven more by foreign policy than commercial strategy; their noodle–bowl discriminatory patchwork causes complications for business and multilateral rules; and they are unlikely to spur regional or global integration. Hence further substantial liberalisation through trade negotiations, whether in the WTO or PTAs, is unlikely. Trade negotiations and resulting agreements are subject to diminishing returns as a vehicle for extra liberalisation, especially on non–border regulatory issues.

Foreign aid has been important in some crisis situations but it has played a marginal role in medium- to long-term trade-policy reforms in countries that have successfully globalised. Generally, aid-induced liberalisation has not really worked: its political economy is dubious. Hence it would be a mistake to rely on aid for further market-based reforms.

Finally, unilateral measures and competitive emulation are likely to be the main vehicle for future trade and FDI liberalisation. Much depends on a Chinese engine. Further unilateral liberalisation in China will probably set imitative reforms in motion, elsewhere in Asia and beyond. A workable post-Doha WTO can help to lock in reforms, but more by strengthening multilateral rules than through market-access negotiations. Much more caution needs to be exercised with PTAs; serious attempts made to minimise the damage from their discriminatory provisions.

What lessons for future reforms?

To recapitulate, the conditions for further liberalisation and associated structural reforms are more difficult today than they were in the heyday of the Washington Consensus. Reform complacency results from a post-crisis environment of buoyant growth and normal interest group politics. There is dissatisfaction with previous reforms in parts of the developing world. Some anti-liberalisation ideas are enjoying a minor revival. This revival might become major in the wake of the global financial crisis. Lastly, the politics of “second-generation” trade-policy reforms is proving to be much more difficult than that of the “first-generation” reforms. The latter involve the reduction and removal of border barriers. This is relatively simple technically and can be done quickly — although politically these measures are rarely easy. The former are all about complex domestic (though trade-related) regulation, such as services regulation, regulation of food-safety and technical standards, intellectual-property protection, public procurement, customs administration and competition rules. These reforms are technically and administratively difficult, and take time to implement. They demand a

minimum of capacity across government, especially for implementation and enforcement. Above all, they are politically very sensitive, since they affect entrenched interests that are extremely difficult to dislodge.

Still, there is a strong case for further market-based reforms in general, and for external liberalisation in particular. Reduction of what are still high barriers to trade, foreign investment and the cross-border movement of people holds out the promise of higher growth, and significant poverty reduction and improvements in human welfare. Stalled reforms and reform reversal threaten to deprive hundreds of millions of people of the life-chances they deserve. These are the stakes. Against this backdrop, the following challenges lie ahead:

– First-division reformers:

These are the 20–25 developing countries — the “new globalisers” — that have already gone far with macroeconomic stabilisation as well as internal and external liberalisation. They have plugged themselves into globalisation. Their task is to go further in dismantling border barriers to trade and opening the door to FDI. But their bigger challenge is to make much more progress on trade-related domestic reforms — the “structural” and “institutional” reforms where progress to date has been too slow. This entails tackling the second-generation issues mentioned above. What is needed is a culture of permanent, incremental reforms, mainly of the second-generation variety, that build on the foundations of first-generation reforms, so that the economy adapts flexibly to changing global conditions. That is easier said than done. The great difficulty lies in doing serious reforms of the conditions of normal interest-group politics. But the alternative is creeping sclerosis in times of plenty, and excessive reliance on a crisis for the next reform wave. (Olson, 1982 and OECD, 2007) That cannot be good for long-term political, social and economic health.

Such are the broad trade-policy priorities for first-division developing countries. In this context, the following points deserve emphasis.

Firstly, there needs to be a clearer link between trade policy, on the one hand, and domestic economic policy and institutional reforms, on the other. Trade policy should be coupled strongly with competition-friendly measures to improve the domestic business climate. It should be better tied to domestic reforms. For example, there should be ways of linking trade and FDI liberalisation, and trade-related regulatory reform, to measures to shorten and simplify regulations that hinder business at home. Such red tape includes procedural hurdles to overcome before starting a business, dealing with various licensing procedures, registering property, getting access to credit, employing workers, paying taxes, protecting investors and bankruptcy procedures. Red tape directly affecting exports and imports include the documentation, time taken and costs of clearing goods through customs. These regulations are documented, classified and ranked in the World Bank's annual *Doing Business* Report. Second-generation trade-policy reforms also depend on the quality of public administration and the rule of law (i.e. the quality of the legal framework governing property rights and contracts, and their enforcement by the judicial system). They also relate, ultimately, to the political system. Most developing countries do badly — some very badly — in the World Bank's business-climate and governance indicators (not to mention similar rankings done by a host of other organisations). That indicates how partial reforms have been to date. They have barely touched highly restrictive labour markets and the bloated, malfunctioning domain of the state. That affects external as well as internal trade, and foreign as well as domestic investment. In essence, such policies continue to restrict economic freedom for individuals and enterprises, consumers and producers. They act as structural, long-term deterrents to productive investment, entrepreneurship and the creation of wealth (Greenspan, 2007). That leaves a vast pro-market reform agenda yet to be tackled.

Secondly, and following directly from the previous point, trade policy should be seen less through the prism of trade negotiations and international organisations, and (as argued above) more through the prism of the domestic economy. Second-generation reforms in particular are bundled up

with domestic politics and economics; initiating and implementing them is overwhelmingly a domestic affair; and the scope for productive international negotiations and solutions is restricted. That is already becoming evident with the regulation of trade in services and trade–related product standards, and of policies towards inward investment. It will become even more evident as global production networks and the movement of people across borders bite ever deeper into domestic institutions. As trade policy becomes ever more entwined with domestic policies and institutions, it follows that there should be more reliance on unilateral measures, including external liberalisation, and correspondingly less reliance on reciprocal liberalisation through the WTO and PTAs. Unilateral reforms should then be locked in through stronger WTO commitments. This should be the foundation for advancing national market–access and rule–making interests in the WTO. Governments should also exercise caution with PTAs.

Thirdly, there should be much more policy transparency. Trade policy–making is usually opaque. Too little is known and understood about the effects of this–or–that set of trade policies. Consequently, public discussion of policy choices is usually uninformed and misguided. It is the Achilles Heel of trade policy–making in developing countries. And one should add that trade policy transparency is not vastly better in most developed countries.

What is lacking is what Patrick Messerlin calls a “culture of evaluation”. (Messerlin, 2006). Independent think tanks and even government bodies should do much more detailed research and analysis on the costs and benefits of trade policies in different sectors of the economy, and then disseminate findings to the public. This would facilitate more informed, intelligent public discussion of policy choices.

One model to examine is that of the Australian Productivity Commission (formerly the Tariff Board). This is a governmental body, but it is independent and has statutory powers. It provides research and analysis on trade–related issues in Australia; and its conclusions do make their way into the public debate. The Tariff Board’s ground–breaking work did much to reveal the costs of protection to the Australian public back in the 1970s, at

a time when Australia was a highly-protected economy. This generated much public discussion at the time, and in many ways prepared the ground for the radical opening of the Australian economy in the 1980s (Bowen, 2007). Such “transparency boards” could be set up at relatively low cost in developing countries. Finally, the WTO's Trade Policy Review Mechanism, while welcome, is stuck within the rarefied bureaucratic confines of far-away Geneva. It has limited effect in terms of *domestic* transparency — which is what matters. Hence it is no substitute for national transparency boards.

Taken together, these reform priorities are as much about simplicity and transparency as they are about liberalisation. The case for transparency has been made above. Simplicity is all about making complex bureaucratic procedures shorter, more predictable, and also more transparent. This would lessen the costs of doing business — for domestic and foreign traders and investors. Hence the importance of linking trade policy to nitty-gritty domestic reforms.

— Lower-division reformers:

These countries, overwhelmingly in the low-income and least-developed bracket, have higher border barriers than first-division reformers, in addition to bigger domestic obstacles to trade and investment. They are less globalised. Their first priority should be to reduce border barriers and simple non-border barriers (such as some red-tape procedures that give them low rankings in the World Bank's *Doing Business* Report). They have less capacity than first-division reformers for implementing more complex second-generation reforms. These could wait until the easier reforms are done. The real dilemma is that countries at the bottom of this pile, especially among the least-developed countries, are mired in political instability and civil strife, with failed and failing states that do not perform the most basic public functions. Such countries do not have the capacity to implement even simple reforms. Aid-driven solutions have failed, but what is the substitute?

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