



SECOND ITEM ON THE AGENDA

Trade liberalization and employment

I. Introduction

1. Trade liberalization, loosely defined as a move towards freer trade through the reduction of tariff and other barriers, is generally perceived as the major driving force behind globalization. Rapidly increasing flows of goods and services across national borders have been the most visible aspect of the increasing integration of the global economy in recent decades. However, this has also been one of the most contentious aspects of globalization. Critics of trade liberalization have blamed it for a host of ills such as rising unemployment and wage inequality in the advanced countries, increased exploitation of workers in developing countries and a “race to the bottom” with respect to employment conditions and labour standards, the de-industrialization and marginalization of low-income countries, increasing poverty and global inequality, and degradation of the environment. These views have spread in spite of the fact that the benefits of freer trade, in terms of improved allocation of resources and consequent gains in productive efficiency and economic growth, is a basic tenet of mainstream economic analysis.
2. This dispute over trade liberalization has wide ramifications for the future path of the global economy and its governance. A basic issue is that of the implications of trade liberalization for economic development and the reduction of inequality between advanced and developing countries. If trade liberalization is, as the critics claim, detrimental to economic growth in developing countries then the current trajectory of the global economy will lead to growing inequalities between advanced and developing countries rather than an eventual convergence. Moreover, if, as claimed, trade liberalization also harms the poor in developing countries it will thwart a basic common objective of the international community, that of the reduction in global poverty. Apart from this, what is also at stake is the viability of the current governance structure of the global economy. If the effects of trade liberalization are those depicted by its critics then the value of the WTO and the multilateral trading system it promotes and upholds is put in serious doubt. Similarly, in the eyes of its critics, the role of the Bretton Woods institutions is also compromised by their strong support for trade liberalization in their policy conditionality at the country level and for continued multilateral trade liberalization.
3. The issue of trade liberalization and employment forms part of a broader array of relationships between globalization and labour, including questions of trade and labour standards, social protection, and the role of social dialogue. It is also closely related to the liberalization of policies towards foreign direct investment and the role of multinational

enterprises.¹ It is clearly beyond the scope of this paper to address this daunting range of issues. Instead, it will, in keeping with the title assigned to the Office by the Working Party, focus on the link between trade liberalization and employment. Given that the level and quality of employment is strongly dependent on the level of economic growth, as well as the fact that it is a key determinant of economic welfare in countries at all levels of development, this focus is by no means too narrow. One cannot discuss the impact on trade liberalization on employment and conditions of work without also addressing the central mediating issue of its impact on economic growth. In addition, the impact of trade liberalization on the level and structure of employment is also an important determinant of its impact on poverty, wage and income distribution, and on the quality of employment. These latter variables are clearly among the central points of contention in the debate over trade liberalization.

II. Overall developments in world trade

4. There has been considerable liberalization of trade in the post Second World War era. This has been particularly pronounced since the 1980s. Over 100 countries across the world have adopted some measure of trade liberalization such as the reduction of tariffs, quantitative restrictions, and other non-tariff barriers to trade. As a result, average levels of tariffs and other barriers to trade have fallen significantly in a majority of countries in the world. These trade liberalization measures have often been accompanied by the liberalization of policies towards foreign direct investment as well as wider liberalization measures such as the removal of controls over domestic investment, deregulation of domestic product and labour markets, privatization and both internal and external financial liberalization.
5. This latter characteristic of trade liberalization in this period is significant because it raises the important methodological problem that it is often difficult to disentangle the effects of trade policies per se from those of other measures of liberalization that occurred contemporaneously. It is also important to note that there were important differences among countries in the initial degree of protection from which liberalization occurred, in the macroeconomic circumstances that surrounded the initiation and the implementation of trade liberalization programmes, in the extent of liberalization that was undertaken, in the pace and sequencing of trade liberalization measures, and in the relationship between trade and other liberalization measures. This makes it inherently difficult to arrive at general conclusions about the effects of trade liberalization.
6. There were three basic factors behind this widespread trade liberalization over this period. One was the manifest failure of the import-substitution policies that many developing countries had adopted as a key element of their development strategies in the 1950s and 1960s. At the same time, the spectacular success of a few East Asian economies that had shifted to more outward-oriented development strategies gave rise to a widespread shift in policy attitudes in favour of liberalization. This led some developing countries to embark unilaterally on programmes of trade liberalization. A more important influence, however, was the debt crisis of the early 1980s which led a large number of developing countries, particularly in Africa and Latin America, to adopt stabilization and structural adjustment programmes with the World Bank and the IMF. These programmes typically included the requirement to undertake substantial and rapid trade liberalization measures as part of their

¹ As foreshadowed in the Chair's summary of the discussion in the March 2001 meeting of the Working Party, the issue of investment in the global economy is likely to be taken up in the March 2002 meeting of the Working Party.

policy conditionality. Similarly, after the collapse of communism in 1989 the former socialist economies embarked on a transition to a market economy, again under the aegis of the Bretton Woods institutions. These transition programmes also involved far-reaching and swift trade liberalization as an important element. However, alongside these widespread country-specific liberalization episodes, there were also developments in the multilateral trading system that pushed in the same direction. The most significant development in this connection was the successful completion of the Uruguay Round of GATT negotiations and the establishment of the WTO in 1994 that led to further trade liberalization among its then 120-odd member States. Parallel to this was the growth of regional trading arrangements in many parts of the world which brought about varying degrees of trade liberalization amongst its respective member States. In all, therefore, it could be said that there has been a significant shift towards more liberal trade policies in most countries in the world.

7. Tracing the effects of this wave of trade liberalization on the rate of growth and pattern of world trade is a necessary prior step to tracing its impact on economic growth and employment. But doing this is not as easy as it may seem since we cannot simply look at changes in world trade and assume that all the observed changes have been due to trade liberalization. There have been other factors. For example, the substantial lowering of transport and communications costs over this period is likely to have given a boost to the volume of world trade regardless of the degree of trade liberalization. Similarly, developments in new technology which have enabled the growth of global outsourcing have been the major factor behind the sharp observed increase in intra-firm trade in intermediate goods. This would have occurred independently of the degree of trade liberalization, although at a slower rate. In addition, changes in the level and pattern of demand in the global economy exert an important influence on the rate of growth of world trade that is, in principle, independent of the degree of trade liberalization. Nevertheless, even bearing the above conditioning factors in mind, it would be of significant interest to examine what has happened to world trade over this period of extensive trade liberalization, because there can be little doubt that changes in trade policies have been the major factor behind observed changes in world trade even if other factors have also been involved.
8. The most striking change is that world trade has grown faster than world GDP in the last 20 years. As a consequence, the ratio of trade-to-GDP at the global level has increased from 39 per cent in 1980 to 45 per cent in 1997.² This overall change was reflected in a significant rise in the trade-to-GDP ratio in a large number of individual countries. This overall change was accompanied by a substantial change in the structure of world trade. One aspect of this was a substantial change in the commodity composition of world trade. The share of primary commodities in world merchandise trade fell sharply from 43 per cent in 1980 to 19 per cent in 1998 while the share of manufactures in world merchandise trade rose from 54 per cent to 76 per cent over the same period.
9. As part of this overall picture, trade between the advanced and developing countries, especially in manufactures, also increased rapidly. This led to fears in the early 1990s that increasing imports from low-wage economies, together with the relocation of labour-intensive industries there, were leading to serious job losses among low-skilled workers in the advanced countries. This was seen by some observers as a major cause of high unemployment as well as of the rise in wage inequality between skilled and unskilled

² The discussion in this and the subsequent three paragraphs is drawn from Ajit K. Ghose: *Trade liberalization and manufacturing employment*, Employment Paper 2002-03 (Geneva, ILO, 2000); and Makiko Matsumoto: *Trade and the changing international division of labour*, unpublished draft, Employment Strategy Department (Geneva, ILO, 2001).

workers that emerged in this period. However, most of the subsequent research has shown that these fears had been greatly exaggerated. The widely accepted view now is that the growth of manufactured imports from developing countries has had only a small adverse impact on the employment of low-skilled workers and no effect on wages. The rise in the unemployment rate of low-skilled workers and in the wage differential between skilled and unskilled workers in many advanced countries over the past two decades has been mainly due to skill-biased technological change.

- 10.** Another important aspect of change was that the gains from this growth in world trade were very unevenly distributed among developing countries. The gains were largely concentrated in a group of 13 developing countries and regions (Argentina, Brazil, China, Hong Kong (China), India, Indonesia, Republic of Korea, Malaysia, Mexico, the Philippines, Singapore, Taiwan (China), and Thailand). As noted earlier, the most dynamic source of growth in world trade was the two-way trade in manufactures between advanced and developing countries. A major share of these gains was captured by these 13 economies which increased their share in world manufactured exports from 9 per cent in 1980 to 22 per cent in 1996. Another ten developing countries also experienced an increase in their share of world manufactured exports but by a smaller margin than the 13 economies in the leading group. For these 23 economies as a whole, the average trade-to-GDP ratio rose from 32 per cent in 1980-82 to 51 per cent in 1996-98.
- 11.** The corollary to this was the marginalization of many developing countries, including virtually all the least developed countries, from the gains from the expansion of world trade. One indicator of this marginalization was that, excluding the oil-exporting countries in the Middle East, the rest of the developing countries outside the “group of 23” saw their collective share of world merchandise trade decline from 4 per cent during 1980-82 to 3 per cent during 1996-98. One reason for this polarized outcome was that many of the marginalized countries were highly dependent on primary commodities and therefore suffered from the stagnation in world demand for these commodities. This was reflected in limited opportunities to increase exports as well as, in many cases, declining real prices for these commodities. To a large extent this represented the continuation of a secular trend that is explained by the low income-elasticity of the demand for primary commodities, the continued development of synthetic substitutes for raw materials used in industrial production, and technical progress that results in savings in the use of primary commodities. But the fact that so far there has been only very limited liberalization of agricultural trade has also been a contributing factor. There is broad agreement that the liberalization of agricultural trade, through the increased demand that it would generate for the exports of agricultural products from many of these marginalized countries, would contribute to a reduction in the current unequal distribution of the gains from the expansion of world trade. But this alone is unlikely to be sufficient since part of the problem lies on the supply side. Many of the marginalized countries have been unable to benefit because they have been unable to shift their export base away from primary commodities to exploit the rapidly growing demand for manufactured exports. Many failed to develop the physical infrastructure and the skills base necessary for the development of manufacturing.
- 12.** A series of ILO case studies on China, India, Malaysia, Mexico and Brazil, focused on the effects of the growth of trade on employment and wages in manufacturing industries.³ The countries chosen for study had all experienced rapid growth in trade in the past two decades and were among the leading group of developing countries that had benefited most from the growth in world trade. The studies focused on the manufacturing sector because it

³ The web site for these and other studies on “globalization and employment policy” is: www.ilo.org/public/english/employment/strat/global/index.htm

had spearheaded trade growth and had felt the effects of trade expansion most strongly. In the three Asian emerging economies studied, trade growth had a generally favourable effect on employment and wages in manufacturing. Apart from stimulating output growth, trade growth has had the effect of increasing the employment intensity of manufacturing output. Unskilled (or low-skilled) workers, moreover, have benefited more than skilled workers because employment growth has been faster in export-oriented industries, which mainly employ low-skilled workers, than in other industries. It also appears that employment in import-competing industries continued to increase in spite of increased import competition. Real wages of unskilled workers have risen whenever surplus labour has become insignificant, but they have not declined even where surplus labour remains significant. Real wages of skilled workers have generally risen. Thus wage inequality has improved in some situations but has worsened in others. In contrast to what happened in these Asian countries, the favourable effects of trade growth on employment and wages were not observed in Latin American countries such as Brazil and Mexico. In these countries employment in manufacturing has either not risen appreciably or has fallen. Real wages of unskilled workers have tended to decline and the wage differential between skilled and unskilled workers has increased rather sharply. The studies suggest that these trends may be attributable to unfavourable initial conditions (extremely unequal distribution of assets, for example), problems of macroeconomic management and over-dependence on external resources, but more work is required to develop adequate insights.

13. An earlier ILO research project carried out for the Working Party also produced mixed results. This project consisted of case studies of seven countries (Bangladesh, Chile, Republic of Korea, Mauritius, Poland, South Africa and Switzerland) and a synthesis of these that also drew upon cross-section analysis of a larger sample of countries on some issues. The project covered globalizaiton as a whole rather than simply trade liberalization but it did yield conclusions on this issue that are relevant to the present discussion. One overall conclusion was that “the liberalization of trade and FDI has the potential to raise standards of living, but the process is neither instantaneous nor painless; adjustment costs can be considerable. Moreover, the report shows that international trade is associated with greater labour market turnover, with particularly detrimental consequences for workers with only modestly transferable skills.”⁴ The country case studies did not show uniform results on the impact of trade liberalization on income inequality. “In Chile and Bangladesh, income inequality grew during the trade liberalization process”⁵ and in Poland, the liberalization of trade and FDI was accompanied by increasing disparities between different regions in the country. In contrast, “in Mauritius, export-led growth over the past 15 years has been accompanied by an improvement in income distribution, while in the Republic of Korea, income distribution improved until the start of the 1997 crisis”.⁶ Similarly, trade liberalization was associated with substantial employment creation and a decline in the unemployment rate in Mauritius and the Republic of Korea. In Chile too there was a reduction in the unemployment rate from the mid-1980s, although this was a decade after the implementation of trade liberalization. However, in South Africa, “the situation on the employment front ... has deteriorated. Unemployment remains high and has been increasing ...”.⁷ The report attributes this to the fact that “trade liberalization

⁴ Torres, R.: *Towards a socially sustainable world economy*, from *Studies on the Social Dimensions of Globalization* (Geneva, ILO, 2001).

⁵ *ibid.*, p. 24.

⁶ *ibid.*, p. 30.

⁷ *ibid.*, p. 85.

may have shifted production in favour of capital-intensive factors to the detriment of labour-intensive ones”.⁸

- 14.** It is, however, difficult to draw any firm conclusions on the basis of such associations between changes in trade on the one hand and growth and employment performance on the other. The first problem is one of establishing causality between trade liberalization and growth and employment performance. An increase in exports and the trade-to-GDP ratio cannot automatically be attributed to the effects of trade liberalization as other factors are involved. This is an important issue since there are significant differences in the nature and extent of trade liberalization among the group of successful countries. Unless a clear causal link is established between trade liberalization and the other variables, the direction of causation could go either way. The growth in exports and the trade-to-GDP ratio could be the result of higher growth achieved through a successful development strategy or favourable external market conditions. This is especially so since export growth is typically a major component of overall growth and the two are strongly correlated. The second problem is that even if we leave aside this problem of causation and accept that the observed outcomes are due to trade liberalization, the sharply contrasting employment effects between countries begs a fundamental question. What explains the difference? Clearly, it suggests that country-specific and contingent factors are important, therefore undermining the value of any broad generalization on the link between trade liberalization and employment. This suggests that it would be more fruitful to look at country-specific studies in the search for answers. This consideration is reinforced by the fact that the fault-line in the debate over trade liberalization is located in area of policy prescription. It has been a standard prescription of the Bretton Woods institutions that substantial and rapid trade liberalization is always a good policy, a stance that has been the focus of criticism. For these reasons it is necessary to turn to the more specific literature on this issue.

III. What does theory tell us?

- 15.** Before turning to an examination of the empirical evidence a brief review of the economic theory pertinent to the issue will be helpful. A basic proposition in international trade theory states that free trade is superior to protection because it allows a country to fully exploit its comparative advantage. All countries gain from trade through specializing in the production and export of goods in which they are relatively most efficient and importing the rest of their requirements from other countries that can produce them at a relatively lower cost. The result is that a given level of output can be produced more cheaply for all countries participating in international trade.
- 16.** Two major extensions of this standard proposition, namely the Heckscher-Ohlin model and Stolper-Samuelson theorem, state the following: in elaborating on comparative advantage, the Heckscher-Ohlin model says that this is determined by a country's relative factor endowment. In a two-factor world comprising capital and labour as the only factors of production, capital-abundant countries will specialize in the production of capital-intensive goods while labour-abundant countries will specialize in labour-intensive goods. The Stolper-Samuelson refinement of this proposition yields the prediction that free trade along these lines will increase the demand for unskilled labour in the labour-abundant countries and also raise wages once any labour surplus is eliminated. Conversely, the demand for skilled labour will rise in the capital- (and by extension skill-) intensive countries. The demand for, and wages of, unskilled labour will, at the same time, fall.

⁸ *ibid.*, p. 85.

17. Viewed within this theoretical framework, trade liberalization is unambiguously good for developing countries since they are labour-abundant. Freer trade will not only increase efficiency and growth but will also simultaneously increase employment opportunities and wages for their most abundant resource, unskilled labour. This would also have the additional favourable effects of reducing wage and income inequality since the unskilled are among the lowest paid in the labour market. This view underlay the earlier literature on trade and employment in developing countries that had advocated a shift away from import-substitution policies towards more open trade policies. In the advanced economies, however, there will be a fall in the relative demand for, and wages of, unskilled labour while the opposite would hold true for skilled labour. In principle, this should not constitute a problem since the unskilled are a minority and the normal course of adjustment would require that the skill level of the labour force be continually be improved. In practice, however, there may be adjustment problems arising from market imperfections or social and educational handicaps among the unskilled that impede the necessary process of skill upgrading. Adjustment problems such as these probably spawned the fears in several advanced economies over the harmful effects of increasing trade with low-wage economies. Such trade, together with related fears over the impact of outflows of foreign direct investment to lower-wage production sites, was blamed for rising unemployment and wage inequality in the advanced economies.
18. From the standpoint of the core tenets of trade theory there should be no question that trade liberalization is beneficial in terms of its growth, employment and distributional implications. Translated into policy terms this would mean that unilateral trade liberalization would always be a preferable policy option to import substitution or protection. There are, however, important theoretical reservations to this position. Most of these arise from the fact that the above propositions rest on the assumption that there is perfect competition and that there are only constant returns to scale in production. This is clearly at odds with the real world where, especially in developing countries, market imperfections are common and where many branches of industrial production are characterized by economies of scale. Therefore, “in the presence of certain market failures, such as positive production externalities in import-competing sectors, the long-run levels of GDP (measured at world prices) can be higher with trade restrictions than without”.⁹ This was the underlying basis for the long-standing infant industry argument for the granting of initial protection to potentially competitive industries to enable them to overcome barriers to start up and hence to learn by doing. More recent developments in growth and trade theory have also provided additional arguments for protection. Internally-generated growth theories suggest that “trade restrictions may also be associated with higher rate of growth of output whenever the restrictions promote technologically more dynamic sectors over others”.¹⁰ Apart from reaping the benefits of economies of scale there may be also positive externalities generated by an increase in the stock of knowledge increased through these means. This is similar to the older arguments for import substitution based on the view that increasing returns and cross-firm externalities are ubiquitous in manufacturing and that protection to promote industrialization is justified on these grounds. This is often accompanied by the argument that prior industrialization is a necessary condition for later export success. From this perspective, trade liberalization is often deplored on the grounds that it sometimes leads to de-industrialization. “New trade theory” also makes the case that strategic trade policies can raise welfare under some circumstances. By supporting its firms to gain entry into sectors of production where world

⁹ F. Rodriguez and D. Rodrik: “Trade policy and economic growth: A skeptic’s guide to the cross-national evidence” (NBER Working Paper 7081, Apr. 1999).

¹⁰ *ibid.*

demand can support only a few oligopolistic firms (e.g., aircraft production) a country can capture significant benefits for the national economy.

19. It has also been pointed out that standard trade theory also assumes that resources (including labour) are always fully employed and that trade will always be balanced.¹¹ These assumptions rarely apply in the real world (*vide* the high levels of unemployment prevailing in many countries). In these circumstances, in contrast to the comfortable predictions of smooth and costless adjustment in standard theory, trade liberalization can impose heavy adjustment costs in the form of a contraction in output, high unemployment and wide trade deficits. Another strand of the literature also argues that adjustment costs may be high where there is monopolistic or imperfect competition, factor immobility and wage and price rigidity.

IV. Empirical evidence

20. Before proceeding to examine the empirical evidence, it is necessary to review a few issues relating to the concept of trade liberalization and its measurement. Conceptually, trade liberalization is often defined in terms of the bias in the incentive structure between exports and imports.¹² The free trade position is one where incentives are neutral between exports and imports. Trade liberalization could thus be achieved either by the reduction of tariffs or of any anti-export bias through other means (e.g., introducing or raising export subsidies). Another element of trade liberalization is the replacement of an instrument of trade control by another that is less distorting of the incentive structure. A common example of this is when quantitative restrictions on trade are replaced by a tariff. In practice there are several ways in which the extent of trade liberalization can be measured but there are problems with each of these. One measure usually adopted is that of relying on announced changes in policy such as a reduction in tariffs or the removal of quantitative restrictions. This, however, must be checked against actual performance and the possibility for instrument substitution, that is, changes in other policies that may negate the intended effects of the announced policy changes. A second measure is based on a direct estimate of the change in the bias in trade regime as reflected in changes in relative prices. This, however, often runs into problems of weighting and aggregating price changes. A third measure is to use multiple criteria such as tariff changes and changes in relative prices but this too faces the same problems of weighting and aggregation.
21. It is also important to briefly note a few methodological problems that are commonly encountered in studies of trade liberalization. A particularly challenging problem is that of separating out the effects of trade liberalization from those of other policy shifts, macroeconomic crises, and other externally-generated shocks that may occur at the same time. Another is that of the counterfactual (or the alternative scenario that it is assumed would have prevailed in the absence of trade liberalization) that is used to establish the effects of trade liberalization. This counterfactual is often assumed to be a situation where pre-existing policies would have prevailed. This may not be appropriate since trade liberalization often occurs after an economic crisis and, in these circumstances, pre-existing policies are no longer viable.

¹¹ J.A. Ocampo and L. Taylor: "Trade liberalization in developing economies: Modest benefits but problems with productivity growth, macro prices, and income distribution", *Economic Journal*, Vol. 108, No. 450, Sept. 1998, pp 1523-46.

¹² D. Greenaway, W. Morgan and P. Wright: "Trade reform, adjustment and growth: What does the evidence tell us?" *Economic Journal*, Vol. 108, No. 450, Sept. 1998, pp. 1547-61.

22. As mentioned earlier, the case against import-substitution policies in developing countries had been built up through a series of studies conducted by the OECD¹³ and the National Bureau of Economic Research (NBER).¹⁴ These studies documented the large inefficiencies associated with an import-substitution strategy with some heavily-protected industries yielding negative value added when output was measured at world prices. In contrast, following a more outward-oriented strategy, Asian NICs experienced rapid growth in both output and employment. The explanation offered for these contrasting outcomes consisted of both the static and dynamic losses associated with an import-substitution strategy. The former consisted of the higher costs of production in protected industries as well as the inefficiencies associated with the lack of competition in domestic markets, rent-seeking activities and delays caused by the system of quantitative restrictions on imports. The dynamic losses arose from the fact that import-substitution policies supported less competitive and more capital-intensive industries that grew more slowly. It was also claimed that by being less open to trade, the import-substitution strategies resulted in less access to foreign technology and knowledge, thereby benefiting less from an important source of growth. It has also been pointed out that import-substitution policies had appreciable negative macroeconomic effects that were insufficiently recognized at the time. Maintaining the import-substitution regime often required foreign exchange controls to support an over-valued exchange rate. In addition, limited growth of exports and heavy dependence on imported inputs often led to severe balance of payment problems that made it difficult to maintain macroeconomic stability. Consequently, it was difficult to achieve sustainable long-term growth under an import-substitution strategy. These studies established a presumption that outward-oriented strategies were superior to import-substitution but were relatively silent on the issue of *how* a shift from one strategy to another should be achieved. Yet, this is probably the most preoccupying question facing policy-makers in developing countries. The answer provided by the Bretton Woods institutions was that there should be substantial and swift trade liberalization, or “big bang” approach as it is also known. This was the type of policy conditionality included in many structural adjustment programmes in the 1980s and in the programmes for the economies in transition in the early 1990s.
23. A major World Bank study¹⁵ attempted to demonstrate the benefits of substantial trade liberalization. Based on examining 36 distinct episodes of trade liberalization in 19 countries, it offered very reassuring conclusions about the benefits of trade liberalization. Among its conclusions was the view that “even in the short-run liberalization went hand in hand with faster rather than slower growth” and that “trade liberalization did not as a rule raise unemployment even in individual sectors of the economy such as manufacturing and agriculture”. It explains the latter outcome in terms of the fact that a slowdown in manufacturing growth was compensated by a rise in agricultural growth and employment as a result of trade liberalization. It also claimed that this increase in agricultural growth, together with the fact that there was an increase in labour-intensive exports, increased the demand for labour overall and hence led to an improvement in income distribution. These

¹³ I. Little, T. Scitovsky and M. Scott: *Industry and trade in some developing countries* (London, Oxford University Press, 1970).

¹⁴ A.O. Krueger: *Foreign trade regimes and economic development: Liberalization attempts and consequences* (Lexington, M.A., Ballinger, 1978).

¹⁵ D. Papageorgiou, A. Choksi, M. Michaely: *Liberalization of foreign trade in developing countries: The lessons of experience* (Washington, the World Bank, 1990).

results have, however, been challenged. Greenaway¹⁶ and Collier¹⁷ have questioned these findings primarily on methodological grounds. More recently, Agenor and Aizenman¹⁸ have pointed out that these studies provide only limited evidence on changes in employment in non-manufacturing production activities or changes in the aggregate unemployment rate. These problems are compounded by methodological shortcomings in the case studies. As such the sanguine conclusions about the employment effects of trade liberalization are not sustainable.

24. Two studies, Dollar¹⁹ and Sachs and Warner,²⁰ have been highly influential in forming the widely accepted view that countries with lower policy-induced barriers to trade experience faster growth, once other relevant country characteristics are controlled. Both these studies are based on a cross-section analysis for a large number of countries on the relationship between an index of “openness” of the economy and growth performance. The Dollar study claimed to show that for a sample of 95 countries over the period between 1976 and 1985, growth was negatively correlated with each of the two indices of openness used. The first index was a measure of real exchange rate distortion while the other was an index of real exchange rate variability. The rationale for the use of these indices was that the more open an economy the lower would be the extent of exchange rate distortion and the less the variability in the exchange rate. The Sachs and Warner study arrives at a similar conclusion on the relationship between the degree of openness and growth. The study is a cross-section analysis of a large sample, of 70 countries. Countries were classified as either “open” or “closed” based on five criteria – the level of average tariffs, the coverage of non-tariff barriers, whether or not it had a socialist economic system, whether or not it had a state monopoly of major exports, and the level of the black market premium.
25. The findings of both these studies have been seriously questioned by a recent detailed and convincing critique,²¹ which centres on the fact that the indicators of “openness” used are seriously flawed. They are not reliable measures of trade barriers and are also highly correlated with other sources of poor economic performance. As such the proposition that trade liberalization by itself leads to higher growth remains unproven.
26. Another recent attempt to revive the issue is the recent paper by Dollar and Kraay (2001). The paper identifies a group of countries, the “post-1980 globalizers” that have seen large increases in trade and significant declines in tariffs over the past 20 years and claims that “their growth rates have accelerated from the 1970s to the 1980s to the 1990s, even as growth in the rich countries and the rest of the developing world has declined”. The paper also claims that “since there is little systematic evidence of a relationship between changes in trade volumes (or any other globalization measure we consider) and changes in the

¹⁶ D. Greenaway: “Liberalizing foreign trade through rose-tinted glasses”, *Economic Journal*, Vol. 103, (1993), pp. 208-23.

¹⁷ P. Collier: “Higgledy-piggledy liberalization”, *The World Economy*, Vol. 16, (1993), pp. 503-12.

¹⁸ P. Agenor and J. Aizenman: “Trade liberalization and unemployment”, *The Journal of International Trade and Economic Development*, 5:3 (1996), pp. 265-286.

¹⁹ D. Dollar: “Outward-oriented developing economies really do grow more rapidly: Evidence from 95 LDCs, 1976-85”, *Economic Development and Cultural Change*, 1992, pp. 523-544.

²⁰ J. Sachs and A. Warner: “Economic reform and the process of global integration”, *Brookings Papers on Economic Activity*, Washington, 1995:1, pp. 1-118.

²¹ F. Rodriguez. and D. Rodrik, op. cit.

income share of the poorest, the increase in growth rates that accompanies expanded trade leads to proportionate increases in incomes of the poor". The paper is, however, more convincing on the effects of trade *expansion* on growth than on the effects of trade *policy*. Although it tries to overcome some of the criticisms of earlier cross-section work on the relationship between trade and growth, it admits "that the available data on trade, growth and other policies may not be sufficiently informative to enable us to isolate the precise partial effect of trade on growth".

27. A recent review of the empirical evidence on the effects of trade liberalization²² also comes to a more nuanced conclusion than the earlier Dollar or Sachs and Warner studies. This review concludes that trade liberalization has resulted in both an increase and a decline in the growth rate depending on country circumstances. Many countries were observed to have experienced an investment slump after trade liberalization, suggesting that a "J-curve" effect is at work. This suggests that there are at least short-run costs of adjustment after trade liberalization. Trade liberalization has also tended to be associated with an increase in current account deficits in spite of an increase in exports. These mixed results indicate that the impact of trade liberalization is not uniform but, on the contrary, is strongly influenced by factors such as the nature of the liberalization programme, the extent of pre-existing distortions in the trade regime, and the flexibility of markets.
28. This view is supported by the divergent results that are revealed by recent country studies that examine the relationship between trade liberalization and employment. A study on *Mexico*²³ found that in the period between 1984 and 1990 a 10 per cent reduction in tariff levels was associated with a 2 to 3 per cent reduction in employment. The wage differential between skilled and unskilled workers also widened. The study also argues that the absence of large aggregate employment effects was due to wage flexibility; wages declined significantly throughout the adjustment period. A study of *Brazil*²⁴ found that the trade liberalization at the beginning of the 1990s had a slight negative short-term impact on employment. It found that between 1990 and 1997 there was a 32.4 per cent drop in employment in capital-intensive industries and a 13.3 per cent decline in the labour-intensive industries. Not all this decline in employment could be attributed to trade liberalization since the trade reforms were carried out in a macroeconomic environment that was marked by high inflation and recessionary conditions. Among the explanations that it offers for the decline in employment are a sharp increase in productivity in the capital-intensive industries and poor export performance in the labour-intensive industries. Another study of trade liberalization in *Costa Rica*²⁵ found that the relative wage of skilled workers increased after the trade liberalization that began in 1984. It established that this could not have been caused by changes in the relative supply of skilled labour and attributes the rise in the relative wage of skilled labour to a rise in demand due to increased imports of capital goods after trade liberalization. In *Chile*,²⁶ the trade liberalization of the

²² Greenaway et. al., op. cit.

²³ A. Ravenga: "Employment and wage effects of trade liberalization: The case of Mexican manufacturing" (World Bank, 1994).

²⁴ M. Mesquita and S. Najberg: "Trade liberalization in Brazil: Creating or exporting jobs?", *Journal of Development Studies*, Feb. 2000.

²⁵ D. Robbins and T.H. Gindling: "Trade liberalization and the relative wages for more-skilled workers in Costa Rica", *Review of Development Economics*, 3(2), (1999), pp. 140-154.

²⁶ J. Levinsohn: "Employment responses to international liberalization in Chile", *Journal of International Economics*, 47 (1999), pp. 321-344.

1970s coincided with severe macroeconomic shocks. The effects of these on employment far outweighed that of the trade liberalization. The combined effect of these two factors resulted in an 8 per cent decline in net manufacturing employment between 1979 and 1986. An interesting feature of this study is that in addition to looking at net changes in employment levels, it also attempts to estimate, using firm-level data, job creation and destruction. This suggests that about a quarter of all workers in manufacturing changed jobs in this period, indicating that there was a far greater extent of labour-market adjustment than what was suggested by looking only at industry level figures on the net change in employment. The study also stresses the importance of looking at the impact of trade liberalization on the size structure of enterprises. In the case of Chile, it is important to note, however, that after 1986, employment performance improved significantly although concern was still being expressed in the late 1990s that “a relatively large number of jobs being created include little or no employment or social protection and the situation appears to be worsening”.²⁷

29. There were also mixed results emerging from three studies of trade liberalization in African countries. In *Zimbabwe*,²⁸ it was found that the drastic trade liberalization implemented in the early 1990s resulted in a contraction in output and employment that was accompanied by a sharp increase in imports and a rising trade deficit. The study argues that the contraction in output was associated with de-industrialization, a development that may also have had unfavourable effects on the future growth potential of the economy. Real wages also fell in the wake of trade liberalization. In contrast, a study on *Mauritius*²⁹ found far more favourable outcomes from trade liberalization. The reduction in protection for local firms that was implemented in the period 1985-87 led to the expected rise in employment in export industries but no contraction in employment in the industries producing importables. The latter was due to an increase in the supply of female labour (which eased the labour supply constraint) and strong overall growth in the economy. In *Morocco*,³⁰ the substantial trade liberalization implemented during 1984-90 did not have very strong employment effects. The average level of import penetration increased only slightly due to a contraction in domestic demand and the devaluation of the currency. A 21 per cent decline in tariff protection in “high impact” industries led to a 6 per cent decline in employment. At the same time a 24 per cent decline in tariffs in the export-oriented sectors led to only a 1.7 per cent decline in employment.

V. Policy implications

30. Nothing in the foregoing negates the fundamental truth that an open multilateral trading system is clearly preferable to a world economy with limited trading links. The gains from trade are undeniable as are the costs of protectionism, so the issue is not *whether* countries should try to benefit from freer trade but *how* this should be achieved. What the preceding discussion has tried to suggest is that there is no basis for a blanket prescription of “big bang” trade liberalization that is applicable to all countries. The relationship between trade

²⁷ Torres, op. cit., pp. 72-73.

²⁸ J. Rattso and R. Torvik: “Zimbabwean trade liberalization: Ex post evaluation”, *Cambridge Journal of Economics*, 22 (1998), pp. 325-346.

²⁹ C. Milner, and P. Wright: “Modelling labour market adjustment to trade liberalization in an industrializing economy”, *Economic Journal*, 108, March 1998, pp. 509-528.

³⁰ J. Currie, and A. Harrison: “Trade reform and labour market adjustment in Morocco” (World Bank, 1994).

liberalization and growth and employment is likely to be “a contingent one, dependent on a host of countries and external characteristics”.³¹ Differences in country circumstances (such as the level of development, whether a country has comparative advantage in primary commodities or manufactures) are likely to warrant different strategies of trade liberalization.

- 31.** For this perspective it is important to note that the choice is not a simple “either/or” between import-substitution or free trade. The options also include intermediate positions that may make good economic sense in particular circumstances. This point emerges quite forcefully in the context of the literature on the reasons behind the East Asian economic miracle. Free traders have interpreted this experience as one that epitomizes the virtues of trade liberalization. They have highlighted the trade liberalization in these countries as the key to the successful export-led industrialization that transformed these economies. But there is a persuasive literature that points out that this is an over-simplification. These countries did not undertake a “big bang” trade liberalization but moved towards a more neutral trade regime through selective export-promotion policies. The trade policies were also embedded in a coherent home-grown development strategy within which the state played a central role in mobilizing domestic investment and in influencing its allocation. Prior import-substitution to develop a manufacturing base was also held to have been a necessary precondition for the later success in achieving a rapid increase in manufacturing exports.
- 32.** The implications of this for trade policies does, however, depend on whether the capacity to implement the East Asian type of strategy exists in other developing countries. The successful implementation of an interventionist strategy of promoting infant industries and “picking winners” in industrial policy requires a strong state and an efficient administration, conditions that are not widely met in developing countries. To this extent therefore such a strategy may not be widely replicable even if underlying economic circumstances make it potentially feasible. Nonetheless, even without opting for a more interventionist strategy, countries can still choose to exercise more discretion over the timing of trade liberalization measures, the initial extent of the liberalization, the pace of implementation, and whether or not other liberalization measures should be implemented simultaneously. For example, on the latter point, some observers have pointed out the dangers inherent in implementing trade and capital account liberalization simultaneously.
- 33.** Another related source of concern over trade liberalization strategies in developing countries is that the need to adhere to WTO obligations may unduly restrict policy autonomy. Meeting these obligations is costly in terms of administrative and financial resources and diverts these from meeting higher priority development objectives. It may also result in the import of inappropriate institutions that can retard development. More generally, the increasing obligations faced by developing countries to conform to international regulations in trade as well as other areas of economic relationships narrows the scope for them to adopt optimal development strategies.
- 34.** The potential benefits from trade liberalization can be increased not only through a careful choice of national policies but also through making the multilateral trading environment more supportive of the efforts of developing countries. As we have seen earlier, a majority of developing countries still remain marginalized from the benefits of trade expansion in the global economy in spite of having, in many cases, undertaken significant trade liberalization. As such an important priority for the international community is to take measures to ensure greater market access for these countries. Progress in liberalizing trade

³¹ F. Rodriguez and D. Rodrik, op. cit.

in agriculture will be particularly important. Further liberalization of trade barriers on labour-intensive manufactured products will also be helpful. But, as noted earlier, these measures will not be sufficient. They need to be complemented by effective programmes of external assistance to overcome supply-side constraints to export expansion in the least developed countries. Careful consideration should also be given to the capacity of these countries to bind themselves to the wide range of multilateral trading rules that have emerged and that are likely to be further expanded. A less demanding approach may be warranted in some cases in view of evident limitations in domestic capacity and special developmental needs.

- 35.** The efforts of developing countries to benefit from the liberalization of world trade requires essential support from the right national economic and social policies and institutions. The foundation for this is democratic, transparent and competent governance of a well-functioning market-based economic system. Without this the potential gains from trade liberalization and other economic reforms will be thwarted by obstacles such as barriers to entry into newly competitive activities, market failures and other limitations on factor mobility. In addition, the gains that are realized are also likely to be unevenly distributed because of the lack of an even playing field for all economic agents. An essential component of this foundation is respect for the fundamental rights at work defined in the ILO Declaration on Fundamental Principles and Rights at Work. Freedom of association is an indispensable element of the civil and political liberties that underpin a democratic and transparent political system. In tandem with the right to collective bargaining, it also constitutes a countervailing force to unequal economic power that can bring about a more equitable distribution of the benefits of economic growth. Full respect of these rights, as well as those relating to the elimination of forced labour, child labour and discrimination, are thus essential for defusing some of the most graphic contentions of the anti-globalization movement such as those relating to a rise in inequality and poverty and in exploitative labour practices. Moreover, these rights contribute to improved economic efficiency in several ways. The elimination of discrimination and child labour makes for a more efficient allocation of human resources in the labour market. The social dialogue that these rights foster contributes to the attainment of macroeconomic stability, the mobilization of broad-based support for economic reforms, and the creation of an environment where labour-management cooperation to achieve productivity gains, rather than wasteful industrial conflict, becomes the norm. It is also relevant to note that beyond the fundamental principles and rights at work encompassed by the Declaration, ILO Conventions and Recommendations as a whole provide guidelines on sound labour policies and institutions that are necessary for responding to the economic and social challenges of globalization.
- 36.** The other elements of the ILO's decent work strategy are also important for maximizing the employment benefits of trade liberalization and related economic reforms. A number of these are set out in the ILO "Global Employment Agenda".³² An obvious priority is in the area of education and training policies. Low levels of education and skills in the labour force are a basic barrier to industrial development, even in many labour-intensive industries. Greater effort to achieve universal primary education and skill-development programmes that are responsive to changes in labour demand are therefore required in the least developed countries. Similarly, in the emerging market economies the expansion of secondary and tertiary education with an emphasis on meeting the demand for new technical skills will be an important instrument to counteract the tendency towards a widening of wage differentials between skilled and unskilled workers in the aftermath of trade liberalization that has been observed in several countries.

³² Paper for the 282nd Session of the Governing Body, GB.282/ESP/1/1, ILO, November 2001.

37. Another important area for action is to increase the employment intensity of growth. Since the majority of the labour force in low-income countries is still employed in agriculture, measures to stimulate agricultural exports will obviously be important. This will comprise measures to remove any policy discrimination against the agricultural sector as well as programmes to provide small agricultural producers with the necessary credit, extension services and marketing assistance to enable them to take advantage of new export opportunities. Such measures are also likely to have a positive impact on the reduction of poverty. Policies and programmes to develop a dynamic small enterprise sector that is linked to export markets are also likely to raise employment growth and improve the distribution of income. This is because of the high labour intensity of this sector and the predominance of poorer workers within it. Policy changes to remove biases against small enterprises, to provide incentives for subcontracting from small firms, and to increase the provision of information and marketing assistance to small firms will be highly beneficial.
38. Active labour market policies to facilitate adjustment to changes in the structure of production brought about by trade liberalization will also need to be emphasized. Measures to provide retraining for displaced workers, job search assistance and other measures to facilitate labour mobility will be important in this connection. As mentioned earlier, the effectiveness of such programmes is also likely to be greatly enhanced by the strengthening of social dialogue on economic reform programmes and of worker-management cooperation in handling restructuring at the enterprise level. Social dialogue aimed at reaching consensus on labour market reforms that improve the functioning of labour markets while preserving essential protection for workers will also be helpful.
39. Finally, the strengthening of social protection will be essential for mobilizing broad popular support for trade liberalization and other economic reforms. Providing adequate income support for displaced workers is a necessary complement to active labour market and poverty-reduction policies. More generally, trade liberalization and other economic reform programmes must be sensitive to their likely social impact. Every effort needs to be made to minimize their social cost through measures such as an *ex ante* analysis of their social impact. In particular the impact of price changes on the poor, of the possible destruction of markets important to poor producers, and of changes in the demand for labour need to be given serious attention in policy design.

Geneva, 26 October 2001.