www.elsevier.com/locate/worlddev

World Development Vol. 40, No. 11, pp. 2177–2193, 2012

0305-750X/$ - see front matter

http://dx.doi.org/10.1016/j.worlddev.2012.03.020

Trade Liberalization, Economic Crises, and Growth

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Summary. — Many economic reforms are undertaken during an economic crisis, but is a crisis a good time to undertake trade reform? We investigate whether an economic crisis at the time of trade liberalization affects a country's subsequent growth performance. We employ threshold regression techniques on five crisis indicators to identify the "crisis values" and to estimate the differential growth effects in the crisis and non-crisis regimes. Although trade liberalization in both crisis and non-crisis periods raises subsequent growth, we find that an internal crisis implies a lower acceleration and an external crisis a higher acceleration relative to the non-crisis regime.

Key words — trade liberalization, growth, crises

1. INTRODUCTION

Is an economic crisis a *good or a bad* time for a country to undertake trade liberalization? This is a question to which policymakers need an answer, since an economic crisis is often a politically *convenient* time to undertake economic reforms because the policy status quo is clearly unsustainable. But while immediate policy reforms in some areas are clearly called for, it is not obvious that the reform package should include significant trade liberalization, though it often does. Here we present evidence that an economic crisis at the time of trade liberalization does affect a country's post-liberalization growth performance. Furthermore, its effects depend on the characteristics of the crisis.

Trade liberalizations have been widespread in the last three decades, particularly among developing and transition countries. The reasons for this include the perceived limitations of import substitution as a development strategy [1]; the weight of empirical evidence suggesting a positive relationship between openness and growth [2]; and, not least, the influence of the International Financial Institutions (IFIs—World Bank and IMF) which often required that trade liberalization be included as part of a package of reforms when agreeing to loans. [3] Despite their early promise, recent experience and evidence suggests not all trade reforms have been as successful as anticipated (Singh, 2010). This is partly attributable to weaknesses in reform packages themselves, including inappropriate timing and sequencing of reforms, their lack of credibility to private agents and doubts over commitment shown by some political actors. In many cases it seems a crisis was necessary to trigger the reforms. Could it be, therefore, that an economic crisis is an unfortunate time to undertake *trade* reforms?

In this paper we examine whether the extent and type of economic crisis at the time of liberalization affects post-liberalization growth in a panel of 75 countries using annual data over the period 1960–2003. We consider five crisis indicators commonly used in the literature (output falls, inflation increases, exchange rate depreciations, increased external debt to export ratios, and increased current account deficits), which we are also able to combine into two factors roughly representing the internal and external dimensions of a crisis. We employ threshold regression techniques on our crisis indicators to identify the relevant "crisis values" and the differential post-liberalization growth effects in the crisis and non-crisis regimes. Our results indicate that an economic crisis at the time of liberalization does affect post-liberalization growth, with the direction of the effect depending on the nature of the crisis. An internal crisis implies lower growth and an external crisis higher growth relative to the non-crisis regime.

The remainder of the paper is organized as follows. Section 2 reviews the theoretical and empirical literature linking crises, liberalization, and growth. Section 3 discusses data, methodology, and long-run results, while Section 4 adds in short-run effects. Section 5 extends our analysis and examines robustness of our main results, and Section 6 concludes.

2. BACKGROUND TRADE LIBERALIZATION AND GROWTH

The potential growth effects of trade liberalization are well known. [4] While the immediate impact is likely to be negative as resources become redundant in areas of comparative

* The authors gratefully acknowledge helpful comments from two anonymous Referees. Falvey and Greenaway acknowledge financial support from The Leverhulme Trust under Program Grant F/00/114/AM. Comments from participants at the Conference on *Economic, Social and Environmental Consequences of the Liberalisation of Trade in North Africa and the Middle East* in Rabat, Morocco, 2007 are gratefully acknowledged. Final revision accepted: March 27, 2012.

disadvantage, their eventual reallocation into areas of comparative advantage will see a rise in the growth rate in the medium run as income moves to a higher steady state level. [5] Longer run gains in the growth rate must come through improvements in factor productivity and these can emerge through a variety of channels. Increased imports of capital and intermediate goods not available domestically may directly raise the productivity of manufacturing production (Lee, 1995) and increased trade (exports and imports) with advanced economies could indirectly raise growth by facilitating knowledge and technology spillovers. Learning by doing may be more rapid in export industries. [6] A liberal trading regime may attract export-platform FDI. The magnitude of these long-run growth effects will vary across countries, depending on their sectors of comparative advantage in particular.

While the empirical literature on openness and growth is voluminous (Dollar, 1992; Sachs & Warner, 1995; and Frankel & Romer, 1999 are prominent examples) that on trade liberalization and growth is more limited. Some comparative cross-country studies have been undertaken, including Little, Scitovsky, and Scott (1970), Krueger (1978), Bhagwati (1978) and Papageorgiou, Michaely, and Choksi (1991) (PMC). The latter is the most sanguine, concluding that trade liberalization results in a more rapid growth of exports and GDP, without significant transitional costs of unemployment. [7] Other studies find liberalization leads to growth in exports and improvement in the current account (although some of this is because of import compression), and that while some countries have increased investment following liberalization, others suffer an investment slump. So the impact on growth may be positive or negative, although there seem to be more cases of a positive than negative growth effect (Greenaway, 1998).

Econometric studies are relatively more plentiful [8]. Greenaway, Leybourne, and Sapsford (1997) use a smooth transition model to test for a transition in the level and trend of real GDP per capita for 13 countries in the PMC sample and relate these to liberalization. While all displayed a transition in level or trend, in the majority it was negative, [9] and where it was positive it generally could not be related to liberalization episodes. [10] Greenaway, Morgan, and Wright (1998, 2002) (GMW) use a dynamic panel model to examine both the short- and long-run impact of liberalization on growth in a large sample of countries. Results using three measures of liberalization suggest a *J*-curve effect, growth at first falls but then increases after liberalization. Wacziarg and Welch (2008) update the Sachs and Warner (1995) indicator of liberalization, and regress per capita output growth on country (and time) fixed effects and their indicator of liberalization. They find the difference in growth between a liberalized and non-liberalized country is 1.53% points. Salinas and Aksoy (2006) use an alternative indicator [11] and find trade liberalization increases growth by between 1% and 4%.

Although the later empirical evidence provides broad support for the hypothesis that trade liberalization improves economic growth, this support is far from universal and it is clear some liberalizations have been more successful than others. Given the variety of circumstances under which trade liberalizations have occurred this is hardly surprising. Where liberalizations have been the outcome of a specific policy review process, have had broad political support, and been undertaken in a stable economic and political environment they are likely to be sustained and successful. But in many cases liberalizations have been undertaken as part of a "package" of reforms emerging from an economic or political crisis.

Crises appear to facilitate some reforms. [12] Drazen and Grilli (1993) model a "war-of-attrition" in an economy that has settled into a Pareto–inferior equilibrium, and where reforms are resisted because of uncertainty over who is more willing to bear the costs. An economic crisis may then help to move the economy to a welfare-superior path, as reforms that would be resisted under normal circumstances, may be accepted if the losses from a continuing crisis are large. Such an approach seems particularly promising for explaining macroeconomic stabilizations, where the distribution costs are low and there is likely to be consensus on the policies required, and this is confirmed by the empirical evidence (see for example, Bruno, 1996; Bruno & Easterly, 1996; Drazen & Easterly, 2001; Alesina, Ardagna, & Trebbi, 2006). But with structural reforms (e.g. trade and labor market reforms) the distributional costs are higher and there is a lower likelihood of consensus on the appropriate policies (Rodrik, 1996). The empirical evidence on whether crises facilitate structural reforms is correspondingly less decisive. Lora (1998) finds empirical support (in Latin America) for the hypothesis that a crisis involving a decline in real income is likely to facilitate trade reforms, although he notes that the effect is quantitatively small. Tornell (1998) presents empirical evidence on the relationships among drastic political change, a major economic crisis (measured by inflation and a decline in output) and trade liberalization. Using Probit models explaining the start of liberalization he finds that the unconditional probability of reform is 2.7%, increasing to 27% with an economic crisis and 60% with both an economic and political crisis. Campos, Cheng, and Nugent (2010), however, find that, unlike political crises, economic crises have no significant impact on the implementation of reforms.

Even if an economic crisis facilitates structural reforms in general, it need not be a good time to undertake trade liberalization; for two reasons. First, trade reform works by correcting distortions in relative prices, but high and variable inflation can confound price signals, making it difficult to disentangle relative price changes from changes in the general price level, thereby blunting incentives to reallocate resources (Rodrik, 1989a). Moreover, the slowdown in domestic activity associated with crises can exacerbate transitional unemployment as resources shift between sectors, increasing opposition to reforms and increasing the likelihood they will be reversed. Second, if trade liberalization is to be successful (and sustained), the private sector must respond to changed incentives, and if private agents are sceptical of policymakers' commitment, they will be slow to incur the (sunk) costs associated with shifting resources between import competing and export sectors. Short-run adjustment will be prolonged and efficiency gains delayed. In such a situation there will be few gainers from liberalization, while some will lose due to increased foreign competition. Such an outcome is likely to make it politically difficult to sustain reforms as well as limiting their impact. Thus scepticism on behalf of the private sector may be more likely for liberalizations undertaken in times of crisis. This may be compounded if liberalization is undertaken as part of a package of reforms that countries were obliged to negotiate to secure financial support from the IFIs (Rodrik, 1989b). In the absence of a crisis and conditions requiring trade reform laid down by IFIs, it would be clear to the private sector that a government that undertook liberalization would be committed to the reforms. In the presence of intervention from IFIs however, there is an incentive for uncommitted governments to undertake reform temporarily to receive funds. In this situation it is difficult for the private sector to distinguish between a government committed to reform and one undertaking reform for financial gain. [13]