IS FREE TRADE ALWAYS THE BEST POLICY?

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In this essay, Florian Wicknig considers the vitally important question of whether free trade is always a suitable policy for promoting long-term growth and development. She compares the positive experiences of South Korea with the negative outcomes for Kenya and Nigeria. The author concludes that free trade is only beneficial if appropriate policies and circumstances are in place to support it.

Introduction

Economic theory is mostly unambiguous in stating that free trade leads to growth and welfare gains for the countries involved. Beginning with the theory of comparative advantage by David Ricardo, countless studies tried to pin down the exact benefits from trade.

There is a broad consensus that trade offers static and dynamic gains. A country, being specialized in the production of the good it has a comparative advantage in, will experience welfare gains and face a higher variety of products. The increased competition due to trade might raise productivity and stimulate benefits from economies of scale considering that with increased market size, average costs fall. In addition to these one-off effects, dynamic effects might benefit a country that is engaged in trade – in other words the long-run growth rate is affected. This may happen due to influences on technology by knowledge spillovers from other economies or the increasing incentive for R&D that results from more intense competition.

In short, economic theory states that trade is always the best policy since it increases growth and welfare permanently. However, this might fail to fully describe reality. The last decades involved the expansion of globalization worldwide and with it an increase in trade between most countries, yet it is easy to clearly identify countries that benefited from the opportunities of free trade (they grew) and others that apparently did not experience welfare gains.

Figure 1 plots the GDP per capita and the poverty rate of two world regions, East Asia and Sub-Saharan Africa (henceforth EA and SSA). Both regions had similar GDP per capita in the early 1970s and poverty was even higher in EA. However, for the last 30 years EA displays an extraordinary development that involved a huge increase in GDP per capita and the massive decline of poverty, whereas GDP per capita in SSA stagnated and poverty actually increased at times.

On basis of these observations, this essay will further analyse the question whether trade is always the best policy. Since both regions started at the same level, it is natural to ask, why free trade benefited one region but not the other. First, the economic development in the recent decades of both regions will be compared to emphasize certain characteristics that might have accounted for said observation. Then, a conclusion shall summarize the most important results, suggesting that free trade is almost always the best policy but that certain policies and circumstances must be in place to allow the gains from trade to be realised.

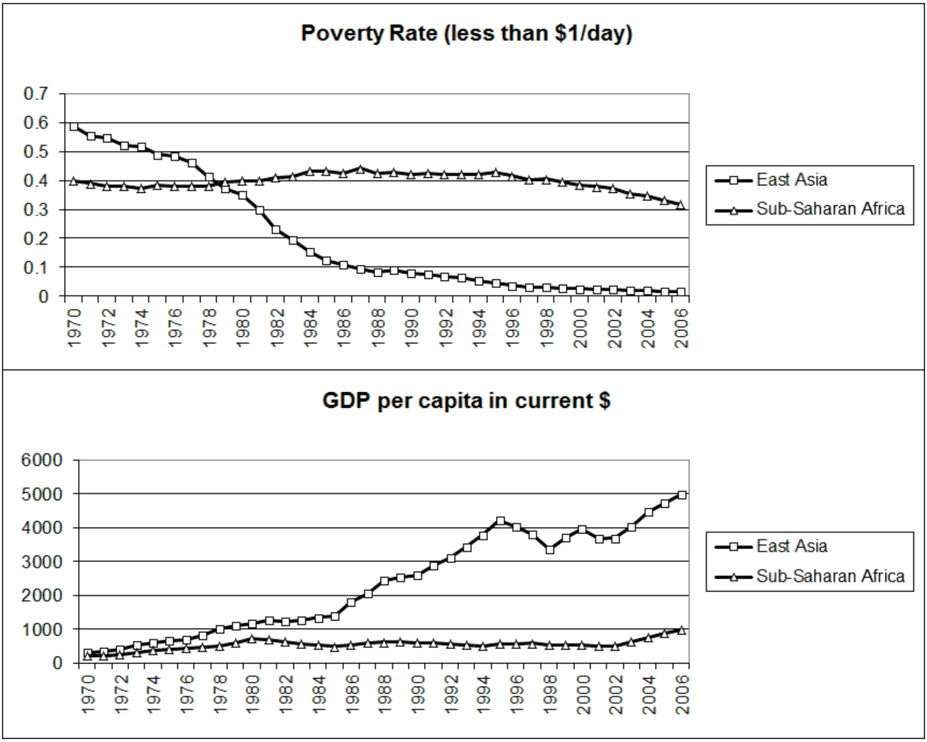

Figure 1: Economic indicators of SSA and EA

Source: Pinkovskiy, M. and X. Sala-i-Martin (2009),World Bank and own calculations

Economic Developments in these Regions

The following sections describe the economic development of two countries in said regions.

Although many East Asian economies may be appropriate for this analysis, the focus will be placed on South Korea. This is because it is a member of the so-called Asian

Tigers, a group of countries that started to industrialize quickly in the 1960s, and displays different characteristics that contributed economic growth. Identifying suitable examples in SSA proves more difficult. This region contains many countries and is fraught with political, economic and social difficulties. Nigeria and Kenya were chosen as they are two of the biggest African economies and are likely to a good representation of the most important characteristics of the region.

East Asia: South Korea

In the first 60 years of the 20th century South Korean history was marked by conflicts. After being a Japanese colony before and during the Second World War, the Korean War (1950-1953) destroyed large parts of the peninsula and caused millions of deaths. Naturally, this meant the destruction of huge parts of the infrastructure and industry as well as a massive loss in terms of human capital (Library of the Congress, 2005). Until the late 1950s Korea did not recover as GDP per capita fluctuated around $120 – comparable to SSA countries – and the mostly agricultural exports only amounted to 3% of GDP (World DataBank, 2014). Furthermore, the economy was scarce in natural resources and for the most part agricultural. In short, the country was poor and not very well integrated into world markets.

Beginning in the 1960s, and gaining momentum in the 1970s, the country underwent a rapid industrialization and boost in exports, mostly due to policies that fostered industrialization and export-orientation. The central idea of those reforms was to secure that exporting was at least as profitable as serving the domestic market. Inputs used in the production of export goods were free of tariffs, indirect taxes or quotas. This 'virtual free trade regime' added up to approximately 66% of all export incentives in 1968 (Westphal, 1990). Furthermore, the government exercised far-reaching powers over the banking system it used to offer further export incentives. Firms could lend money according to their export activity and were offered preferential credits – the non-preferential loans were around 25-30% in the late 1960s, while preferential loans amounted to 6% (Westphal, 1990). Apart from that, the government tried to monitor export activity closely. Together with the export industries, it negotiated export targets that, if met, offered further rewards for companies. Undoubtedly, this encouraged firms to export even if the profit margin would otherwise be too small (Kuznets, 1988).

Most of these privileges were granted to all exporters. The government, however, also targeted small industries directly (e.g., ship building). These industries were protected from foreign competition by various means – e.g., the 'law of similars' that only allowed imports if no domestic firm would produce the good in a likewise fashion – under the condition to pursue an export-oriented strategy (Westphal, 1990).

In brief, the government employed partly interventionist policies that aimed at establishing a strong exporting sector. While governmental determined export plans sound like a planned-economy feature, it has to be stressed that these plans were adopted with an orientation towards the markets.

Another feature of the South Korean economy, that benefited growth, was a very competitive labour market. Firstly, the average wage rate was very low; therefore, South Korea had a comparative advantage in labour-intensive manufacturing at the beginning of its industrialization. Due to a high educational attainment – in 1982 approximately 24% of the 20-24 year olds visited a university while only 14% of the same age group were enrolled in higher education in comparable countries – it later shifted to skill-intensive and technological goods (Kuznets, 1988). Labour legislation was also weak as unions were at time forbidden (1971-1981) and if allowed, only had very limited rights to strike. The low wage, weak unions and (later) the well-educated human capital made the economy attractive to foreign investors and provided comparative advantages. In the end, higher wages and employment resulted that might have significant impact on the workers' welfare (Kuznets, 1988).

All these policies had a long-lasting impact on the South Korean Economy. The economic structure not only changed from an agricultural economy to an industrialized one but also did exports increase rapidly as visible in Figure 2. Nowadays, mostly vehicles, electronic devices and machinery are exported whereas in the 1960s South Korea mostly exported 'simple' goods, like shoes or textiles (Westphal, 1990).

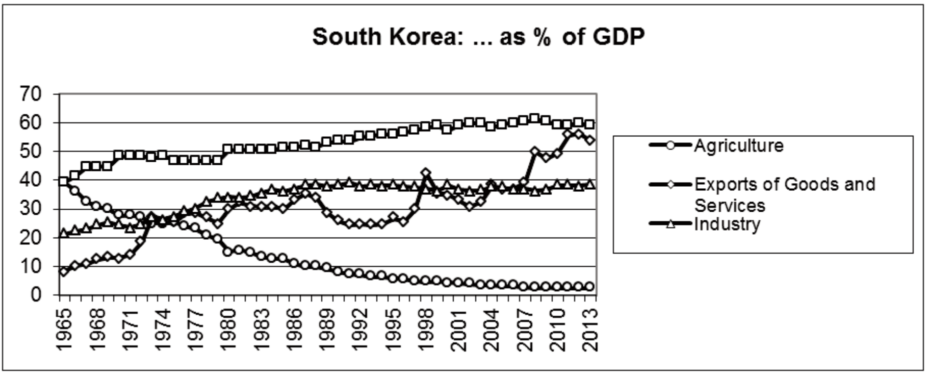

Figure 2: Exports and economic sectors of South Korea
Source: World DataBank and own calculation

To conclude the section about East Asia, it is necessary to point out some endogenous factors that benefited the development of South Korea. First of all, it mainly experienced manageable population growth and had a favourable geographic location at the sea. The fact that the region was – to the most part – free of ethnic tensions and that linguistic homogeneity was given facilitated the implementation of an integrated development strategy. Finally, South Korea experienced long periods of political stability that allowed implementing long-term growth agendas. This does not mean that it was democratic, quite the opposite as Figure 3 suggests: it was partly autocratic and the opposition was at times suppressed.

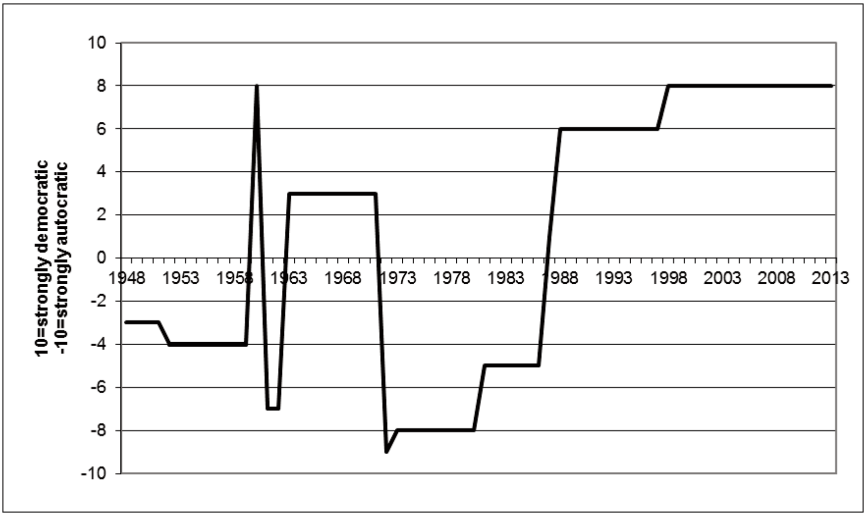

Figure 3: Polity IV-Index
Source: Polity IV Project and own calculation

Sub-Saharan Africa: Kenya and Nigeria

Nowadays, SSA is the poorest region in the world. Its problems are diverse – extreme climate, diseases, political instability and poverty – but so are also its advantages – abundance in resources and a huge internal market. Therefore, potential for gains from trade exists.

During the 1960s many African countries gained independence and the growth prospects of the region were similar to those of East Asia. Nigeria had better outlooks than Indonesia and Congo or Ghana had at least similar perspectives like South Korea. Therefore, the first years after independence often seemed promising with annual growth rates higher than 3% (Heidhues, 2009). Nevertheless, most states faced downturns in the 1970s with stagnating GDP per capita (see Figure 1) and a declining share of world trade – 4% in 1970 to 2% in 2005 (Bosker and Garretsen, 2008).

A good example of those developments is Kenya. After the independence from Britain the government pursued free market policies that aimed at attracting FDI and spent a lot on education. That is also reflected in growth rates that amounted to 6% on average in the 1960s and 1970s (Library of Congress, 2007). But at the same time the export structure remained undiversified and mainly included primary products which made it prone to fluctuations in world prices. Besides, wealth was distributed very uneven because the governing elite embezzled the surpluses and population grew rapidly – at the end most Kenyans did not experience an increase in standards of living (Library of Congress, 2007). Political unrest, coups d'état and corruption during the 1980s not only worsened the economic performance but also the investment climate. As a consequence, FDI and development aid were withhold and the growth rate declined to 1.5% in the 1990s (Library of Congress, 2007).

By the time policy changed in 2002, the new government faced severe problems like a weak infrastructure, a one-sided dependency on agriculture, ethnic tensions as well as high poverty and corruption.

Another set of obstacles to the advantages of free trade can be found by examining Nigeria. Today, the biggest African economy with rich resources and the greatest population, it had, and still has, various problems that hinder the full development of its capacities. Besides problems with bad governance and a period of civil war in the past, it is said that its abundance in resources, mostly oil and gas, is its 'curse'. At first sight this might seem paradox since abundance in resources is said to lead to specialization and to gains from trade. But the large scale export of resources can lead to a surplus in the balance of trade that eventually triggers the appreciation of the currency. Consequently, the terms of trade for other exporting industries, often manufacturing, get worse so that the economy might start to de-industrialize which increases the already significant dependency on resource exports (known as Dutch Disease). Furthermore, huge money inflows may foster corruption and lead to a delay in reforms or investments in education considering that no direct need for such actions exists (Heidhues, 2009). A World Bank report estimates that 80% of the revenues from trade with fossils only benefit 1% of the population. Moreover, outside the energy sector the Nigerian economy is mostly inefficient and lacks well-educated human capital.

To sum up, most SSA states faced problems concerning bad governance. Often corruption and the suppression of the opposition led to a bad investment climate and hindered a rise in living standards for the majority of the population. Many SSA economies remained dependent on only a handful of export goods, often primary products. Both features are visible in Figure 4 that plots the exports and sectoral division of the Nigerian economy. A similar pattern of the graphs for exports and industry attracts attention that can be explained with the fact that approximately 90% of Nigerian exports are fossils – this sector is contained in the measure for industry. Apart from that, the absence of a trend in the data might be result of a lack of long-term macroeconomic policy due to the frequently politically unstable situation.

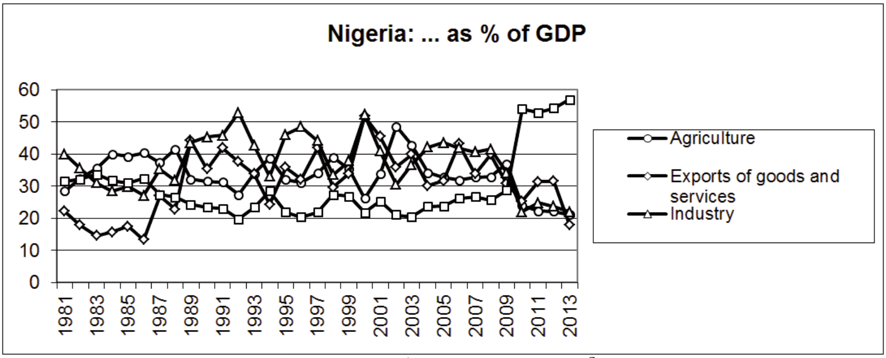

Figure 4: Exports and economic sectors of Nigeria
Source:World DataBank and own calculations

Furthermore, an often weak infrastructure prevented a large-scale industrialization. Nigeria was one of the most industrialized countries of Africa but power outages and high transport costs played their part in hindering an increase in the share of GDP.
Of course, external factors like the geographical position (land-locked = no harbour), often unfavourable climate and diseases also influenced the developments in SSA. Because of an arbitrary determination of borders by former colonial powers, ethnic tensions might have emerged that meant a restriction of growth perspectives.

Now: Is Free Trade Always the Best Policy?

After comparing two world regions that can be described as winners and losers from free trade in the last decades, a conclusion can be drawn.
EA showed that a stable and corruption-free government and well organised institutions matter because they enable the efficient implementation of a long-term growth strategy. Furthermore, the diversification of exports and the economic structure may also be crucial, for the reason that dependencies lead to unstable economic performances determined by world prices and demand. As a matter of fact, the ability to raise savings and to attract FDI as well as a good infrastructure enabled South Korea to grow rapidly. The analysis also revealed that democracy or abundance in resources are not necessary conditions for benefiting from trade. Regarding resources it may, at times, even be an obstacle like the case of Nigeria showed. Apart from these endogenous attributes, various exogenous characteristics promoted East Asian engagement in free trade, like a favourable geography or the relative freedom of ethnic tensions.

Surely, no single factor can boost or hinder growth alone; instead it is the combination of factors that leads to different outcomes. Besides, policies EA applied to promote industrialization, may not work for other countries or another time period. It often country specific characteristics or circumstances that enabled their successful development. If SSA countries nowadays pursue a policy of export-orientation that – like in EA – starts with industrialization in the textile sector, they face massive Chinese or Indian competition thus growth on basis of this sector is quite difficult.

Most importantly, the comparison pointed out that benefiting form trade was often not result of completely relying on market forces. All Asian Tigers used interventionist and partly protectionist measures to promote exports and protect infant industries. As a matter of fact, some SSA countries also pursued similar policies but were less successful. A possible explanation for that divergence may be that East Asian politics were marked by unusual stable conditions and that institutions were sufficiently developed.

In the end, it should be clear that free trade is not always the best policy since certain conditions have to be fulfilled to be even able to participate in free trade in a way that promotes growth.

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