Trade Liberalization and Employment

by
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Introduction

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.

In this context the impact of trade liberalization on employment is of particular significance. The level of employment is a key determinant of overall economic welfare, especially in developing countries where systems of social protection are weak. In particular, the impact of trade liberalization on the level and structure of employment determines, to a large extent, its impact on poverty, wage and income distribution, and the quality of employment. These latter variables are clearly among the central points of contention in the debate over trade liberalization.

Viewed within the standard theoretical framework, trade liberalization is presumed to be 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.

From this standpoint 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.[1] 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".[2] This was the underlying basis for the long-

[1] See in particular L. Alan Winters "Trade and Poverty: Is there a connection?" (WTO; Geneva, 2000)
[2] 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).

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. Endogenous 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".[3] Apart from reaping the benefits of economies of scale there may be also positive externalities generated by an increase in the stock of knowledge 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 demand can support only a few oligopolistic firms (e.g., aircraft production) a country can capture significant benefits for the national economy.

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.[4] 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 stand 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.

Trade Liberalization and its Measurement

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.[5] 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

[3] ibid.
[4] 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.
[5] 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.

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.

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 polices are no longer viable.

Empirical Evidence on Trade Liberalization and Employment

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.

This latter characteristic of trade liberalization in this period is significant because the methodological problem raised above is highly relevant in practice. 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.

It is, thus, difficult to draw any firm conclusions on the impact of trade liberalization simply on the basis of 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. 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. Yet, as we shall see below, this has not deterred various proponents of trade liberalization from using such an approach to establishing their case.

(i) *Multi-country studies*

A prominent case in point are two studies, Dollar[6] and Sachs and Warner,[7] that 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 for. 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.

The findings of both these studies have been seriously questioned by a convincing critique[8] 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.

Another recent attempt to revive the issue is the recent paper by Dollar and Kraay (2001)[9]. 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 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. As pointed out by Rodrik the paper is also flawed by applying an "arbitrary set of selection criteria to their sample of countries".[10] In particular, they "combine

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[6] 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.
[7] J. Sachs and A. Warner: "Economic reform and the process of global integration", Brookings Papers on Economic Activity, Washington, 1995:1, pp. 1-118.
[8] F. Rodriguez. and D. Rodrik, op. cit.
[9] D. Dollar and A. Kraay: "Trade, Growth, and Poverty," World Bank Policy Research Department Working Paper No. 2615, Washington, 2001.
[10] D. Rodrik: "Comments on "Trade, Growth, and Poverty" by D. Dollar and A. Kraay" (mimeo, Harvard University, 2001).

a policy measure (tariff averages) with an outcome (import/GDP) measure in selecting countries. This is conceptually inappropriate, as policy makers do not directly control the level of trade … the tools at the disposal of governments are tariff and non-tariff barriers, not import or export levels." This is significant because the countries in the sample which implemented the deepest trade liberalization, as opposed to those who experienced the greatest trade expansion, did not perform well in terms of the rate of economic growth achieved. Similarly, it was inappropriate to attribute the higher growth in India and China to trade liberalization. In these countries "the main trade reforms took place about a decade after the onset of higher growth. Moreover, these countries' trade restrictions remain among the highest in the world."

A recent review of the empirical evidence on the effects of trade liberalization[11] 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.

There have been relatively few cross-section studies that focus directly on the impact of trade liberalization on employment. A major World Bank study[12] dating back to 1990 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 results have, however, been challenged. Greenaway[13] and Collier[14] have questioned these findings primarily on methodological grounds. More recently, Agenor and Aizenman[15] 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.

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[11] Greenaway et. al., op. cit.

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

[13] D. Greenaway: "Liberalizing foreign trade through rose-tinted glasses", *Economic Journal,* Vol. 103, (1993, pp. 208-23.

[14] P. Collier: "Higgledy-piggledy liberalization", *The World Economy*, Vol. 16, (1993), pp. 503-12.

[15] P. Agenor and J. Aizenman: "Trade liberalization and unemployment", *The Journal of International Trade and Economic Development*, 5:3 (1996), pp. 265-286.

A recent World Bank study on globalization [16] takes a less sanguine view of the employment effects of trade liberalization than some of its earlier studies. The new study, while reiterating the benefits of trade liberalization for both employment and wages over the long run, recognizes that there are significant transitional problems that need to be faced. It notes that the skill premium, and hence wage inequality, has risen in several countries in the aftermath of trade liberalization. It also notes that "a series of case studies on the effects of trade liberalization shows a considerable dispersion of the net impact on employment" (page 109). More significantly, it highlights the problem that "small declines in employment may hide substantial job churning" and that "some of the important losers from globalization will be formal sector workers in protected industries".

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.[17] 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 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.

The sharply contrasting employment effects between countries 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.

(ii) *Country Studies*

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[16] World Bank: *Globalization, growth and poverty: Building an inclusive world*, by David Dollar and Paul Collier (Oxford University Press, New York, Dec. 2001).

[17] The web site for these and other studies on "globalization and employment policy" is: www.ilo.org/public/english/employment/strat/global/index.htm

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[18] 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[19] 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. In Chile,[20] the trade liberalization of the 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".[21]

There were also mixed results emerging from three studies of trade liberalization in African countries. In Zimbabwe,[22] 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[23] 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

[18] A. Ravenga: "Employment and wage effects of trade liberalization: The case of Mexican manufacturing" (World Bank, 1994).
[19] M. Mesquita and S. Najberg: "Trade liberalization in Brazil: Creating or exporting jobs?", Journal of Development Studies, Feb. 2000.
[20] J. Levinsohn: "Employment responses to international liberalization in Chile", Journal of International Economies, 47 (1999), pp. 321-344.
[21] Torres, R.: Towards a socially sustainable world economy, from Studies on the Social Dimensions of Globalization (Geneva, ILO, 2001).
[22] J. Rattso and R. Torvik: "Zimbabwean trade liberalization: Ex post evaluation", Cambridge Journal of Economics, 22 (1998), pp. 325-346.
[23] C. Milner, and P. Wright: "Modelling labour market adjustment to trade liberalization in an industrializing economy", Economic Journal, 108, March 1998, pp. 509-528.

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,[24] 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.

It is noticeable that most of these studies focus on employment in the manufacturing or the organized sector of the economy. Little is said about employment in the rural or urban informal sectors. Yet this is where the major part of employment occurs in low-income countries and where the majority of the poor earn their livelihoods. The impact of trade liberalization on employment in the rural and urban informal sectors is thus important from the standpoint of overall welfare.

There are several reasons for this relative neglect of these sectors. A basic one is the paucity of data on employment and other economic variables in these sectors. Another is that the primary impact of trade liberalization has been on the manufacturing and other organized sectors of the economy. Much of the economic activity in the urban informal sector and in subsistence agriculture consists of non-tradeables. The impact of trade liberalization on employment is thus largely indirect, occurring through changes in relative prices and in the probability of obtaining employment in the organized sector. In addition, there is considerable heterogeneity in the employment profile of individuals and households within these sectors. They vary greatly in terms of their endowments of assets and in their labour activity profile. This implies that the impact of trade liberalization on employment will also vary greatly according to these differences in initial conditions, making the analysis very complex. Variations in the institutional context in which different groups of producers find themselves compounds the problem since these differences affect the nature and extent of the impact of trade liberalization. Here again, therefore, there is a need for context-specific analyses that does not allow for easy generalizations.

A particular concern that has surfaced over the impact of trade liberalization on workers and producers outside the organized sector is that of their possible exclusion from the benefits of trade liberalization. From a labour market perspective, the concern is that even where trade liberalization results in a rapid increase in employment opportunities (in, for example, the labour-intensive manufacturing sector) illiterate or scantly-educated workers from the rural and urban informal sectors would be unable to benefit from these new opportunities. The reason for this is that even unskilled' jobs in the organized sectors require at least primary education that these workers do not have. The is similar concern over the ability of micro and small farms and enterprises to overcome the handicaps they face in terms of access to credit and knowledge on market opportunities and product standards in order to benefit from new opportunities created by trade liberalization.

(iii) *Wage Inequality*

[24] J. Currie, and A. Harrison: "Trade reform and labour market adjustment in Morocco" (World Bank, 1994).

Interest in the issue of the impact of trade liberalization on wage inequality has also been very pronounced. A special issue of the *Journal of International Economics* [25] explored several other channels, apart from the standard Hechker-Ohlin and Stopler-Samuelson one, through which trade could affect wage inequality. The first of these is that "trade liberalization can affect the relative bargaining power of labour versus capital. For example, if trade liberalization increases the elasticity of demand for labour, this would reduce the bargaining position of workers and therefore wages".[26] Of related interest is the argument advanced in another article on the impact of increased mobility of capital. It argues that this will have even stronger effects than trade liberalization in weakening the bargaining position of labour. It notes that "a subsidy for workers financed by a tax on capital income is the obvious remedy for redistributing the gains from international capital mobility", [27] but this requires tax coordination at the international level since tax competition becomes a greater problem with higher capital mobility.

A second channel through which trade is thought to affect wage inequality is the increased role of outsourcing and the relocation of labour-intensive (and low-skilled) parts of production processes from advanced to developing countries. This shedding of relatively labour-intensive production in the advanced economies is likely to shift demand to skilled workers and increase their relative wage. There is evidence that outsourcing has increased but its impact on wage inequality in the advanced countries remains to be clearly established.[28] For developing countries, it has also been argued that participation in the production chains created through outsourcing has been a factor contributing to a rise in wage inequality. The basic reasoning here is that, given the large gap in skill levels between advanced and developing countries, the low-skill jobs transferred from the former constitute relatively skilled jobs (e.g. requiring a high school education) in a developing country. There is some empirical verification of this having operated in the case of Mexico.[29] A related argument in that skill-biased technological change occurring in the industrialized countries is being transmitted to developing countries through increasing trade and foreign direct investment flows. There is some fragmentary evidence that this may actually be occurring.[30]

A third channel through which trade liberalization can affect wage inequality is through strengthening incentives to produce for export markets. It has been argued that, in order to compete successfully in export markets, firms have to invest in more sophisticated and relatively

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[25] *Journal of International Economics*, Vol. 54, 2001.

[26] Robert C. Feenstra: Introduction, *Journal of International Economics*, op. cit., p. 1.

[27] Dani Rodrik and Tanguy van Ypersele: "Capital mobility, distributive conflict and international tax coordination", in *Journal of International Economics*, op. cit., p. 58.

[28] David Hummels, Jun Ishii and Kei-Mu Yi: "The nature and growth of vertical specialization in world trade", in *Journal of International Economics*, op. cit. See also Robert C. Feenstra and Gordon H. Hanson: "Global production sharing and rising wage inequality. A survey of trade and wages" (NBER Working Paper No. 8372, July 2001), which argues that taking outsourcing into account would significantly increase the role that is attributable to trade in the explanation of rising wage inequality in the advanced countries.

[29] See R.C. Feenstra and G.H. Hanson: "Foreign direct investment and relative wages: Evidence from Mexico's maquiladoras", in *Journal of International Economics* (1997) Vol. 42, pp. 371-393.This study presents evidence that the sharp increase in foreign investment in Mexico's northern border region contributed significantly to the rising demand for skill and hence the rise in wage inequality.

[30] Eli Berman and Stephen Machin "Globalization, Skill-biased Technological Change and Labour Demand" in Eddy Lee and Marco Vivarelli (eds) Understanding Globalization, Employment and Poverty Reduction (Palgrave Macmillan, 2004)

more skill-intensive machinery, hence pushing up the demand for skills.[31] However, there has been very little empirical testing of this hypothesis so far.

All this new work on the links between trade liberalization and wage inequality has been inspired by the need to explain the why, contrary to the predictions of the Hechker-Ohlin and Stolper-Samuelson framework, wage inequality has increased after trade liberalization in several countries. But it should be noted that this has been a phenomenon that has been largely confined to several Latin American countries, in sharp contrast to the experience in Asia. It remains an open question as to what has accounted for this difference.

Policy Issues

Nothing in the foregoing negates the proposition that there are gains from trade and that there are costs associated with protectionism. 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 liberalization and growth and employment is likely to be "a contingent one, dependent on a host of countries and external characteristics".[32] 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.

For this perspective it is important to note that the choice is not a simple "either/or" between protection and free trade. The options also include intermediate positions that may make good economic sense in particular circumstances.[33] 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.

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

[31] Feenstra, op. cit. See also D.J. Robbins "The impact of trade liberalization upon inequality in developing countries : a review of theory and evidence", International Labour Office. Policy Integration Dept. International Policy Group (Geneva : ILO, 2003) and J.S. Arbache "Trade and Evidence" (IPEA, Rio de Janeiro, December 2001) for reviews of the literature on this issue..

[32] F. Rodriguez and D. Rodrik, op. cit.

[33] See Eddy Lee and Marco Vivarelli (Eds) op. cit. especially chapters 4, 5 and 13.

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. More generally, trade liberalization needs to be embedded within a coherent set of macroeconomic and structural policies in order to be successful.

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. 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. A particular challenge is that of equipping poor producers and workers in the rural and urban informal sectors with the means to share in the benefits of trade liberalization.

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.

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 will 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.

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. 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 important.

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.