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Economic Openness: Growth and Recovery in Asia

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ECONOMIC OPENNESS: GROWTH AND RECOVERY IN ASIA*

May 1999

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Foreword

The *EDRC Briefing Notes* are developed from notes prepared by staff of the Economics and Development Resource Center to brief Management and the Board of Directors. The *Notes* aim to provide succinct, nontechnical accounts of salient, current policy issues. They are not meant to be in-depth papers, nor intended to contribute to the state of current scientific knowledge. While prepared primarily for Bank readership, the *EDRC Briefing Notes* may be obtained by interested external readers upon request. The *Notes* reflect strictly the views and opinions of the staff and do not reflect Bank policy.

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Openness matters. By offering countries opportunities to trade with the outside world, openness stimulates growth through easier access to new technologies and skills and to international capital markets. Furthermore, it promotes market discipline.

Among developing regions, East and Southeast Asia, in particular, have taken the lead in adopting outward-oriented development policies. For instance, the Bank's publication *Emerging Asia: Changes and Challenges* (1997) calculates trade openness indexes based on four important aspects of trade policy. A fully closed economy scores zero and a fully open economy scores one. On this set of indexes East Asia scores 0.97, Southeast Asia scores 0.73, and South Asia scores 0.06.

Reflecting their greater openness, the growth of the East and Southeast Asian countries has been particularly strong in recent years. However, the ongoing financial crisis in Asia has raised some questions about the role of openness in promoting sustainable growth. In this note, we will argue there are many dimensions to openness and that for the purposes of policy, it is critical to distinguish between openness to trade, labor movement, and direct investment on the one hand, and openness to financial flows on the other hand. The case for openness in terms of the former remains strong. Nevertheless, developing Asia faces the challenge of ensuring that the global trading system continues to evolve fairly and takes into account the interests of developing countries. To meet this challenge, developing Asia will have to play a more proactive role in future multilateral trade negotiations as described in this note.

As for openness to financial flows, the case is compelling, yet nuanced. It depends on the strength of domestic financial systems; however, rather than providing a reason to postpone financial integration, this means that reform of domestic financial systems is imperative.

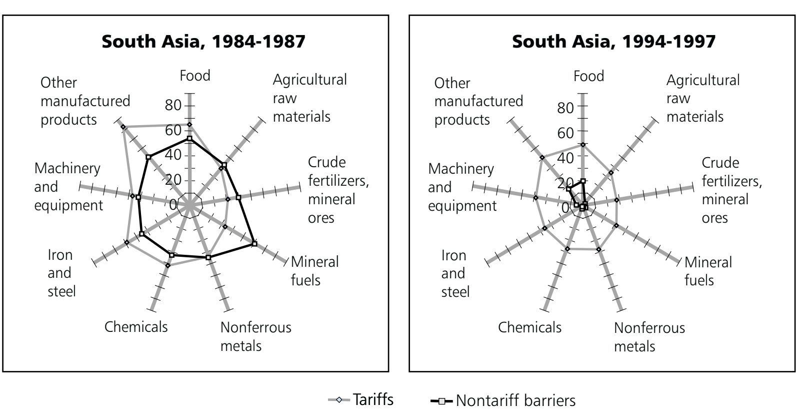
POLICIES TOWARD OPENNESS

The average growth of trade in goods in the People's Republic of China (PRC), the Newly Industrialized Economies (NIEs)[1], and Southeast Asia outpaced that in South Asian countries, and even in the world as a whole in recent years. These economies generally maintained much lower average rates of protection than South Asia and other non-Asian developing economies in the 1980s, and so their spectacular economic performance is hardly surprising.

However, in the 1990s many developing countries—including most South Asian countries—have attempted to emulate the trade and growth performance of the East and Southeast Asian economies by gradually adopting economic policy reforms, of which the most important is trade liberalization. This trend toward convergence in policy may be seen in Figure 1, which displays the recent evolution of patterns of commodity protection in South Asia. In comparison to the mid-1980s, tariff rates and especially the incidence of nontariff barriers have come down in recent years.

Trade in services has been increasing in the Asian developing economies (ADEs), reflecting a global trend. Transport, travel, and

Figure 1

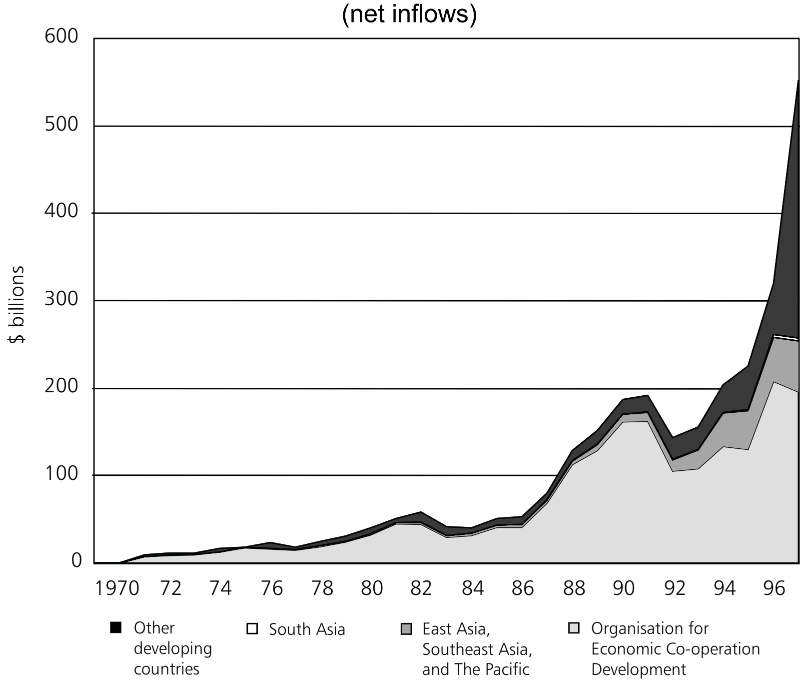


1. The NIEs include: Hong Kong, China; Republic of Korea; Singapore; and Taipei,China.

insurance have long been associated with the growth of goods trade and tourism in Asia. Nevertheless, widespread restrictions on international trade in services remain in effect, and services were subject to separate negotiations during the Uruguay Round.

Foreign direct investment (FDI) is among the major forces propelling the globalization of the world economy, and it is integral to the growth prospects of developing countries in the modern global economy. During 1985-1995, FDI in East and Southeast Asia represented a growing share of total FDI in developing countries (see Figure 2). However, in recent years, FDI flows to developing countries outside Asia have begun to match those to the ADEs. For example, in 1996 FDI in the ADEs outpaced FDI in non-Asian developing economies by less than $2 billion, compared to more than $3 billion in 1994 and more than $12 billion in 1993. Thus an important question for development in Asia is whether the declining

Figure 2: Foreign Direct Investment, Selected Country Groups, 1970-1996
(net inflows)



Source: World Bank (1998).

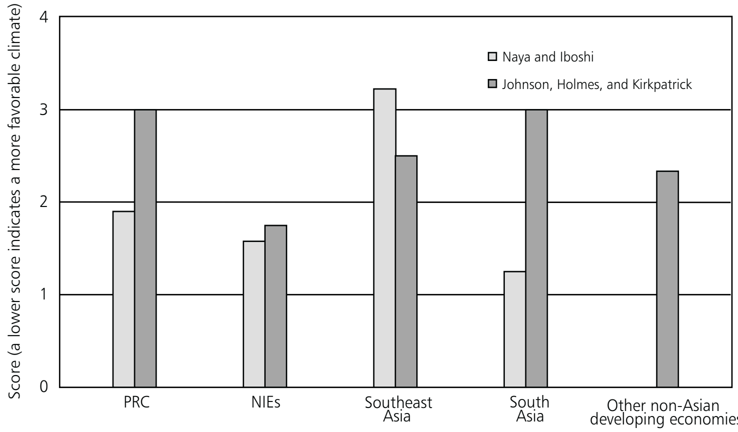
dominance of developing Asian countries in FDI flows observed during the early to mid-1990s represents a permanent shift.

Describing and classifying foreign investment regimes is extremely difficult. Restrictions and performance requirements on FDI are often intertwined with various tax reduction and fiscal incentives and with other subsidies in special packages designed to attract more FDI. Nevertheless two recent studies (Naya and Iboshi 1998; Johnson, Holmes, and Kirkpatrick 1998) document the climate for FDI in developing countries by assessing the restrictiveness of foreign investment codes, the regulations governing foreign ownership of businesses and property, the restrictions or bans on foreign investment in specific industries, the extent of performance requirements for foreign investment projects, and the ability of foreign investors to repatriate their earnings.

Figure 3 presents scores from these two studies. Both studies' findings accord reasonably for the East Asian NIEs and Southeast Asian countries; however, the Johnson, Holmes, and Kirkpatrick study scores indicate that foreign investment regimes in the PRC and South Asia are more restrictive than the Naya and Iboshi study suggests.

With the exception of East Asian NIEs, foreign investment regimes in developing Asia are not substantially more liberal than

Figure 3: Foreign Investment Climate, Selected Country Groups and the PRC, 1998



Note: Naya and Iboshi data are unavailable for other non-Asian developing economies.
Sources: Johnson, Holmes, and Kirkpatrick (1998); Naya and Iboshi (1998).

in other developing regions. The Johnson, Holmes, and Kirkpatrick study shows that foreign investment regimes in PRC; Malaysia; Philippines; and Taipei,China are all substantially more restrictive than in the non-Asian developing economies. In South Asia only Pakistan, with a score of 2, has a relatively liberal foreign investment regime. Of course, it should be noted that a number of regional economies have been loosening rules on a number of fronts including relaxing export performance requirements and foreign equity ceilings, to increase their attractiveness as destinations of FDI. Whether this further liberalization of policies toward FDI will be extensive enough to strengthen the international competitiveness of developing Asia, bolster export performance, and rekindle high and sustained levels of economic growth remains to be seen.

The rapid growth of private capital flows, and of portfolio flows in particular, to developing Asia in the last decade or so reflects the increasing financial integration of the ADEs internationally. This growth has been propelled and facilitated by technological progress, which has reduced the transaction costs of buying and selling financial assets. However, the liberalization of policies on international capital flows in both industrial and developing countries has also been critically important.

Hong Kong, China and Singapore are now ranked among the most open economies in the world in terms of capital account convertibility. As for the other DMCs, Table 1 reveals that Indonesia, Philippines, Thailand, and even Pakistan had joined Korea and Malaysia as economies with a high degree of financial integration. By the early 1990s, given the somewhat limited extent of financial integration in Pakistan and the Philippines in the mid-1980s, the process of opening up to financial flows accelerated sharply in these economies. This also seems to be the case for the PRC, which started from a low degree of financial integration in the 1980s, but had caught up with India by the early 1990s.

GAINS FROM OPENNESS: THEORY

Free trade in goods can lead to significant efficiency gains in resource allocation in trading countries. Moreover, it can lead to

Table 1: Changes in the Extent of Global Financial Integration, Selected Countries, 1985-1987 to 1992-1994

Country	1985-1987	Country	1992-1994
Korea	High	Thailand	High
Malaysia	High	Korea	High
		Indonesia	High
Thailand	Medium +	Malaysia	High
India	Medium	Pakistan	High
Indonesia	Medium	Philippines	High
Sri Lanka	Medium -		
Philippines	Medium -	India	Medium +
Pakistan	Medium -	PRC	Medium +
		Sri Lanka	Medium -
Myanmar	Low		
PRC	Low	Myanmar	Low
Bangladesh	Low	Bangladesh	Low

Note: The changes in the extent of global financial integration are based on an overall index of integration, which takes into account a country's access to international financial markets, ratio of private capital to GDP, and diversification of financing based on the composition of flows.
Source: World Bank (1997a).

large dynamic gains by increasing incentives to innovate, thereby enhancing growth and welfare in the global economy.

The fundamental idea of trade theory—the theory of comparative advantage—is both simple and compelling. Countries trade so as to benefit from their differences in factor endowments. Countries will specialize in producing those goods and services that best suit their natural resources and physical and human capital endowments. They will trade the goods and services produced at home for goods and services produced abroad. According to the theory, free trade, with trade flows determined by comparative advantage, will yield the most efficient allocation of the world's resources, and thereby maximize global welfare, while restrictions on trade will reduce efficiency, and hence welfare.

Foreign Direct Investment and Labor

FDI brings benefits through four main channels:

- For the host country, FDI is an additional source of capital.

By adding to domestic savings, it can help increase the rate of growth of output.

- If the return to capital is higher in the host country than in the source country, FDI will improve the international allocation of capital.
- FDI can serve as a vehicle for technology transfer. Multinationals often bring in new production technologies, which generate benefits for both host and source countries.
- In the area of services, such as banking, insurance, and telecommunications, FDI is the main instrument for promoting trade.

Trade barriers undermine the benefits of FDI. In this case, some FDI may represent tariff-jumping rather than efficient investment decisions, particularly if the import-competing sector already has excess capacity because of protection.

The benefits of international labor mobility parallel those of FDI. In the host country it can alleviate labor shortages. It also permits efficient allocation of world resources and can help facilitate the flow of new technology through knowledge embodied in skilled workers.

Financial Capital

The case for international financial capital mobility is based on four simple arguments as follows:

- As capital is more productive in capital-scarce countries, capital mobility will increase income in both capital-rich and capital-scarce economies. In a world of capital mobility, a lack of domestic savings need not constrain countries with profitable investment opportunities.
- Capital mobility allows households and firms to hold an internationally diversified portfolio of assets. This reduces the vulnerability of income streams and wealth to real and financial shocks that may hit the domestic economy.
- Liberalization of capital flows can lead to efficiency gains because of increasing returns to scale. The production of many wholesale financial services is subject to increasing returns to scale that may be exploited through specialization.

- As the domestic capital market becomes integrated with the international capital market, domestic policymakers become subject to scrutiny by global investors. Thus capital market integration is a powerful disciplining device for policymakers to pursue policies that are conducive to macroeconomic stability and ensure growth.

The foregoing points all seem to support a favorable view of international financial integration. However, experience during the 1920s and 1930s and the recent Asian financial crisis indicates that private capital flows, particularly those relating to short-term debt, can be unreliable and excessively volatile. Depending on an economy's stage of financial sector development, for many developing countries the cost of financial integration may exceed its benefits.

GAINS FROM OPENNESS: EMPIRICAL EVIDENCE

The empirical evidence suggests that there are substantial gains from trade in goods and services, from technology, from FDI, and from labor mobility. The only exception is financial flows, for which the evidence is inconclusive.

The gains from trade can be measured using two broad approaches: assessing static gains from trade and assessing dynamic gains from trade. Standard estimates in the international trade literature suggest that in most cases, static gains from trade are equal to 1 to 2 percent of GDP, but in highly distorted economies these gains can be as much as 5 to 6 percent of GDP. Such gains are far from insignificant. However, the performance of economies over time clearly shows that the largest impacts of openness are dynamic in nature. Overall, the evidence establishes a strong link between openness and economic performance as measured by economic growth or total factor productivity growth.

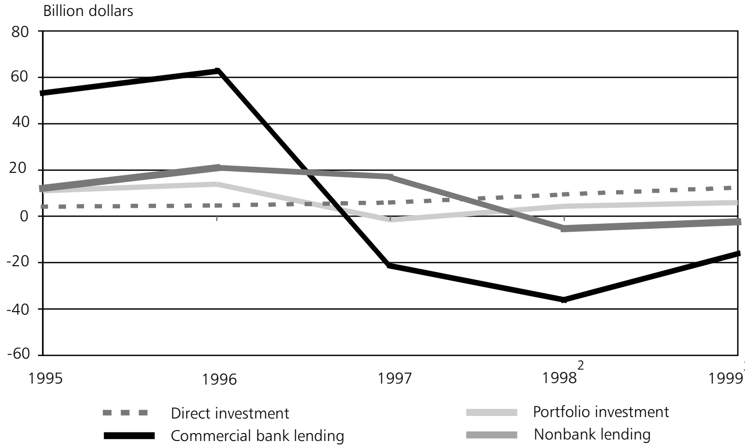
A clear benefit of economic openness is that it gives a country access to technology developed elsewhere in the world. New technology can be embodied in the capital goods used in actual production. A recent study shows that countries with a higher ratio of capital goods imports to investment grow faster in terms of GDP per capita. The implication is clear. Economies that have erected barriers to the importation of capital goods have done so at a significant cost to their economic growth.

A recent empirical study investigates whether FDI has promoted growth in developing countries and, if so, the necessary conditions under which it has done so. The key finding is that the higher the stock of human capital in an economy (proxied by education levels), the greater the impact of FDI on economic growth. For the average developing country, the benefits of a dollar of FDI have exceeded those of a dollar of domestic investment. A number of surveys of companies in Southeast and East Asia have found that in terms of positive growth effects, the diffusion of knowledge through FDI is more important than its general contribution to raising investment levels.

While the benefits of international mobility of financial capital are widely acknowledged, surprisingly, rigorous quantitative estimates of these benefits are lacking. However, historical evidence suggests that a number of European countries benefited substantially from foreign financial flows. Two recent studies have attempted to investigate the impact of capital account convertibility on an economy's macroeconomic performance, but come to contradictory conclusions. While this demonstrates the urgent need for more rigorous empirical studies in this area, recent experience does indicate that volatility in flows of financial capital, especially those that are debt-creating, can be very disruptive for recipient countries. Consider Figure 4, which shows the net flow of private capital to the five economies hit hardest by Asia's financial crisis. Perhaps the most salient feature of the figure is the extent of volatility in commercial bank lending. Such volatility in debt-creating flows can be very destabilizing in countries with relatively weak capacity for efficient financial intermediation and high degrees of leverage in the corporate sector. By contrast, FDI flows have been far more stable both in the run-up to and through the crisis.

As for the gains from labor mobility, the results of a simulation study that estimates the impact of international labor movement in the world economy are dramatic. It shows that removing global controls on the free movement of labor and allowing labor to move from poor to rich countries could double world output. The calculations

Figure 4: Net Private Capital Flows to the Five Most Crisis-Affected Asian Economies[1]



Notes: [1]Indonesia, Malaysia, Philippines, Thailand, and Korea.
[2]IIF estimate.
[3]IIF forecast.
Source: Institute of International Finance (1999).

show that the efficiency gains from a marginal increase in labor mobility are likely to outweigh the corresponding efficiency gains from either trade or investment liberalization. Thus the relaxation of controls on labor mobility is one of the most crucial policy issues facing the global economy.

Most of these efficiency gains result from labor movements between poor and rich regions, not between particular countries. For political reasons, the chance of large increases in labor movements from developing to industrial countries in the foreseeable future is minimal. However, the simulations suggest that even minor increases in labor mobility could confer substantial gains.

OPENNESS, THE WORLD TRADE ORGANIZATION, AND DEVELOPING COUNTRIES' INTERESTS

International trade and open world markets are vital for the growth of Asian economies. Notwithstanding the Asian financial crisis, regional commitment to open trade policies is strong. However, for the most part, the ADEs have played a reactive rather than a proactive part in multilateral trade negotiations. Given the importance of openness and economic growth, it is time the ADEs took a more proactive role in such negotiations.

A Comprehensive Round of Trade Liberalization

The General Agreement on Tariffs and Trade, now administered by the World Trade Organization (WTO), was designed to liberalize cross-border trade restrictions such as tariffs and quotas. It is in this area that multilateral trade agreements have been the most successful and the least controversial. The most important aspect of a more proactive ADE approach toward multilateral negotiations must be to keep the process of trade liberalization moving forward. This could be accomplished through a comprehensive, multilateral round of trade negotiations.

Even though average tariffs in industrial countries are coming down to levels of 3 or 4 percent following the Uruguay Round, there is still a long way to go before free world trade in goods is achieved. While the ADEs have made great strides toward liberalization in recent years, they continue to have sufficiently high tariffs to give them the bargaining power to engage the industrial countries in a new round of multilateral trade negotiations. Tariffs in South Asia remain extremely high. Tariffs in East and Southeast Asia are lower, but remain still high by industrial country standards.

Multilateral Agreements on Investment and on Labor Mobility

The establishment of relatively open goods markets in the products that industrial countries export means that they have shifted their attention from liberalizing goods markets to liberalizing service and factor markets. The phenomenal expansion of FDI has created a powerful lobby in industrial countries for introducing an international regime to smooth the flow of FDI.

The following four priorities should guide the ADEs in any future discussion of multilateral investment agreements:

- The ADEs should ensure that any agreement is strictly limited to FDI. Trade and FDI are indisputably beneficial for developing countries, while the benefits of other capital flows differ across countries.

- The ADEs should ensure that negotiations on investment include the PRC, which is the world's second largest recipient of FDI, and among developing countries is by far the largest recipient. The ADEs would limit their bargaining power in negotiating on FDI without the PRC.
- The ADEs should insist that any agreement contain provisions to end subsidies for FDI.
- The ADEs should link an investment agreement to one on labor mobility. Labor mobility is the area in which market access has, for obvious political reasons, been most restricted.

Competition Policy

Competition policy is concerned with restrictive business practices (RBP). A consensus has emerged between industrial and developing countries in favor of initiating the work necessary for possible inclusion of competition policy into the WTO. FDI by multinationals makes competition policy both more important and more difficult. When the size of a national market is small, large multinationals can exert market power and engage in restrictive business practices.

Despite the possibility of international RBPs, whether the WTO needs a competition policy mechanism is debatable. Nevertheless, if competition policy is eventually to be included in the WTO, two considerations are particularly important for the ADEs. First, the working group on competition policy should pay equal attention to the interests of all members of the WTO, to developing country members as well as industrial country members. The momentum for including competition policy in the WTO system on the part of the United States and the EU has emerged out of frustration with *keiretsu* and retail distribution systems in Japan that impede market access. Thus the US and EU proposals will likely focus excessively on RBPs prevailing in Japan. However, asymmetries in developing the WTO code on competition policy should be avoided at all costs. This can be accomplished to some extent by including practices to restrict competition on the part of governments as well as RBPs in the private sector.

Second, many developing countries are simply not equipped to implement a comprehensive competition policy. Therefore, the WTO competition policy should either be limited in scope—focusing on the most egregious RBPs and competition-restricting practices—or developing countries should be permitted exemptions until they have adequate enforcement machinery in place. The danger otherwise is that countries with lagging competition policies become vulnerable to trade sanctions in retaliation for failure to deliver on competition policy commitments. This would mean that in a complete reversal of its stated objective, competition policy would be in danger of becoming an instrument of protection.

Antidumping

With the hands of WTO members increasingly tied with respect to conventional instruments of protection such as tariffs and quotas, the use of safeguard measures, especially antidumping measures, has intensified. From the perspective of the ADEs, there are a number of concerns as follows:

- The incidence of antidumping measures against ADEs is rising. From July 1994 to July 1995, of 153 antidumping and countervailing investigations initiated or measures imposed, as reported to the WTO, nearly half were targeted at the ADEs.
- The industrial countries can use the sunset clause in the Antidumping Code to legitimize antidumping duties for five years, even though the industry concerned may have recovered far more quickly from the injury that led to the duties.
- The prohibition by the Uruguay Round against using voluntary export restraints could lead to increased antidumping actions that might be more damaging than voluntary export restraints, and might fall disproportionately on developing countries.
- The complexities of the system and the cost of compliance with antidumping investigation proceedings may result in small and medium firms in the ADEs encountering difficulties in defending their interests. ADE governments can provide at best limited assistance to these firms. This helps explain why a larger share of cases result in prosecution for ADE firms than for industrial country firms.

- The anticircumvention measures are of particular concern for the ADEs. Circumvention occurs when firms subject to antidumping duties bring components rather than the final product into the importing country and assemble the final product there, thereby circumventing antidumping duties. Alternatively, the same firms may take the components to a third country, assemble them there, and then export to the country where they face antidumping duties on direct exports from their home countries. The concern for ADEs is that anticircumvention measures could become a highly potent instrument of protection.

The ADEs may need to consider a strategic approach to ward off antidumping measures used in the guise of protection. One possibility may be to mimic the restrictive elements of US, EU, and other countries' laws. This course has two potential benefits. First, if challenged in the WTO as inconsistent with the Antidumping Measures Code, the same challenge would apply to other countries' similar antidumping laws. Litigation by a single country would effectively liberalize the laws of many countries. Second, even if restrictive antidumping measures are not challenged, or are upheld as permissible under the code, the symmetry of restrictive antidumping measures across countries would set the stage for negotiated liberalization.

Regionalism

The global trading environment has been characterized by a trend toward regionalism. If this trend continues, then the ADEs stand to lose considerable market access and export demand, especially if the European Union and the North American Free Trade Agreement expand to include more countries. Therefore, ADEs should push for a sunset clause on regional arrangements that would discourage the formation of trade blocs that intend to stay closed.

CONCLUSION

The ADEs' best route for ensuring economic growth and prosperity is through openness and liberal economic policies.

Economic theory and empirical evidence clearly demonstrate that outward-oriented trade policies should be a central part of development strategies in poor countries. The financial crisis does not change this; however, it does raise questions about the desirability of completely free capital movement and full capital account convertibility.

ADEs should take a proactive rather than a reactive approach to multilateral trade negotiations. To maximize the benefits of economic openness as East and Southeast Asia emerge from the financial crisis, the ADEs should push collectively for a comprehensive round of multilateral trade negotiations and develop a common negotiating strategy to promote Asian interests. Many of the products that the ADEs export still remain subject to high tariffs.

Empirical studies suggest that the European Union and the North American Free Trade Agreement have a large and increasing effect on trade diversion at the expense of the ADEs. Therefore, it is in Asia's interests to push for a sunset clause on regional arrangements in the next round of multilateral trade negotiations.

Finally, as the world nears the start of the new millennium, the global economy faces a number of issues, and the ADEs, the traditional high performers in the global context, are still in the throes of an ongoing economic turmoil.

Ironically, while the ADEs, in the face of tremendous economic difficulties, remain resolute in their commitment to trade liberalization and openness, the industrial countries vacillate and engage in restrictive trade practices. These negative protectionist tendencies in the industrial countries must be checked. If global markets are kept open, the impending slowdown in the global economy will be short-lived, but if these negative tendencies triumph and markets are closed, the global slowdown is likely to be long, arduous, and painful. Indeed, the path to continued global prosperity—and recovery from the ongoing economic crisis—lies in an open global environment and not in a move away from it. This is an important lesson the global economic leadership would be well advised to heed.

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