DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

"A short history of trade liberalization in developing countries"

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Guest:

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Episode Summary:

Douglas Irwin, a professor at Dartmouth College and expert in the history of trade policy, talks with host David Dollar about some of the key events in trade liberalization in developing countries. From Taiwan to South Korea, and from Vietnam to some countries in Latin America and Africa, Irwin shares insights on how certain developing countries shifted to an export-strategy in the decades following World War II and began to integrate into the global economy.

DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast Dollar and Sense. Today, my guest is Doug Irwin, an economics professor at Dartmouth who is a leading expert on the history of trade policy. Doug has several recent papers on trade liberalization in developing countries, and that will be our theme today.

But first I want to mention that the Brookings Podcast Network has a new show that you might like called Vying for Talent about the U.S.-China competition for human talent. In the latest episode, the hosts interviewed former U.S. Energy Secretary Steven Chu. Here's more about the show.

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> **RYAN HASS:** Hi, I'm Ryan Hass with the Brookings Institution.
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> **JUDE BLANCHETTE**: And I'm Jude Blanchette with the Center for Strategic and International Studies. We're the co-hosts of "Vying for Talent," a podcast examining the role that human talent plays in competition between the United States and China.
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> **HASS:** Both the United States and China are vying to demonstrate which governance and economic system is best able to deliver results in the 21st century. Much of this competition hinges on economic performance, which is driven by innovation, which is being pushed forward by talented individuals in both countries.
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> **BLANCHETTE:** "Vying for Talent," puts faces and stories to the sprawling competition underway between the United States and China. Through this podcast series, we're using stories to shine a light on what more the United States can do to improve its edge for the future.
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> **HASS:** "Vying for Talent" is produced by The Brookings Podcast Network and distributed by both Brookings and the Center for Strategic and International Studies. You can download and listen to it on Apple, Spotify, or wherever you like to get your podcasts. Learn more at Brookings dot edu slash Vying for Talent.

DOLLAR: So, welcome to the show, Doug.

IRWIN: Thanks for having me. It's a pleasure to be here.

DOLLAR: So, let's start with Taiwan. Your recent working paper argues that Taiwan was the first developing country to shift to the export-oriented strategy after World War II. Can you describe this shift? You know, why they did it? What was the result?

IRWIN: Sure. So, most countries coming out of World War II had exchange controls, a lot of balance of payments problems, and they had a lot of restrictions on imports and all sorts of current account transactions. And what I was interested in is learning how countries began to peel away from that sort of mode.

And so Taiwan, as you point out, as I point out in the paper, was sort of the first, and they did so because they had a huge trade deficit throughout the 1950s that was basically financed by USAID. So, exports were pretty low—only about 5% of GDP. Imports were maybe double that. And the U.S. is giving them a lot of dollar loans and grants to to finance imports for military purposes, to keep their economy afloat.

But the U.S. by the end of the fifties announced they were going to start curtailing aid. And so then the question becomes, how is Taiwan going to make up this gap? Either exports have to sort of go up quite a bit to pay for those imports or they have to really restrict imports and the economy would suffer. And so it was sort of a conjunction of new economic ideas brought in by S.C. Tsiang, who maybe your listenership hasn't heard of before. But actually later became famous as a professor at Cornell and the University of Rochester. But he worked for the IMF, was a Chinese national, worked for the IMF in the 1950s. And he went to Taiwan in the mid-1950s at the invitation of the government there, not in an official capacity. And he said basically, you've got to devalue the exchange rate, liberalize a lot of these controls, and export your way out of the problems that you're going to be facing if you can't pay for your imports.

And there's a lot of bureaucratic discussion and debate about this, and they decided to do that. That's what they did in 1958. They had a black market premium on their currency of about 50%, which, as you know from your work earlier, is a huge impediment to exporting. It's like uphill battle if you're trying to have that premium on your currency. And their exports did quite well and they survived and grew rapidly in the 1960s and thereafter and sort of pulled themselves out of the mess they were in the late fifties.

DOLLAR: You know, Doug, I actually lived in Taiwan as a student in 1975, '76. So, this process was already well underway. But as a student, I remember the phrase "export pessimism." You know, there was a sense in a lot of developing countries that the demand for their exports was pretty inelastic. Mostly developing countries were exporting primary products. And there was this pessimism that things like devaluation, trade liberalization would make a difference.

So, by the time I got to Taiwan as a college student, I think a couple of things were evident. Taiwan had started out exporting primary products, things like pineapples. It actually turned out to be, you know, quite a bit of room to increase those exports. But then, more importantly, Taiwan very quickly got involved in the manufacturing trade, you know, with imported fabric and sewing machines from Japan and made garments, turned those around. So the pessimism really proved to be misplaced.

IRWIN: Absolutely. And Taiwan was one of the first, along with Korea and a few others, to show that countries, developing countries, could do well by exporting. And you're absolutely right. The fear was, well, if we just take Ricardo's theory of comparative advantage, you sort of double down on your existing goods that you're exporting, you're specializing in primary products. What you find is that with a real exchange rate devaluation, opens up a lot of new opportunities to be competitive in a lot of different types of exports. And when you combine that with free trade zones or export processing zones or openness to foreign investment or lower tariffs on intermediate goods, a lot of industries that you never thought of before become internationally competitive and exports can grow quite rapidly.

DOLLAR: So, South Korea followed pretty quickly on the heels of Taiwan, and you have a separate working paper on the Korean experience. And there I, I took away that you emphasize this issue of the U.S. withholding financial assistance. It seems like you were kind of developing a theory there.

IRWIN: Yeah. So, once again, it's another fascinating case that follows Taiwan in some of the particulars. They had a huge black market premium, a huge trade deficit that was financed by U.S. aid that the U.S. had sort of signaled was going to be coming to an end. It was about ten years after the Korean War thought they want to get the economy going, stagnant for some time, growing very slowly. And sort of the standard story you hear is that, you know, Park Chung-hee comes in, there's a military coup and then the economy starts booming, they focus on exports. And it doesn't work out quite that way.

Park Chung-hee, initially being a military leader, doubled down on import substitution and the black market premium on the Korean currency quickly rose in his first two years in office. And it was basically the U.S. and USAID in particular that were sort of acting as sort of the IMF enforcer at the time, saying, look, we got to do two things here. First of all, you have to restore democracy. You need to hold elections. And second of all, you have to get the economy going again.

And so, the U.S. withheld aid to force presidential elections and then to force economic policy changes. And the Korean economy was extremely poor at that time, very dependent on U.S. dollars for financing the imports that were necessary to keep the economy going. And so Park Chung-hee, even though he was a nationalist, was forced to to hold elections, which he won and then change economic policy. And that included a major devaluation, which was opposed at the time. But it once again jumpstarted exports. And in fact, Park Chung-hee sort of wanted the export oriented strategy because he realized we don't want to be under the thumb of the Americans. We have to pay for our own imports. And that's common across Taiwan and Korea, is that if you're going to sustain the level of imports, you're going to have need a high level of exports to finance that. Otherwise, you're really dependent on foreign aid and the influence of foreign countries.

DOLLAR: We'll get to some other countries. But listening to you, Doug, you know, I was involved for quite a while with Vietnam and their trade liberalization. And what made me think of it listening to you is that it was the Vietnamese General Vo Nguyen Giap, who was one of the big supporters of economic reform. You know, as a military man, the Soviet Union was collapsing in the late eighties and Vietnam, was it very much the kind of situation you just described and needed devaluation, trade liberalization. And General Giap was one of the main supporters of that because, you know, they need to replace a lot of lost imports that had been coming in from the Soviet Union and the Soviet Union was basically collapsing.

IRWIN: Yeah, I mean, in most countries, military leaders want to take a top down command and control sort of approach to the economy. But there are a few leaders who listen to economic advice and will go in a different direction and sort of loosen things up.

DOLLAR: So, you have a third paper where you deal with a lot of developing countries a little bit later in time. We could say it took a while for perhaps, you know, the lessons from Taiwan, South Korea, but then also the state of the world changed. So in that 1985, 1995 period, you know, you argue there were a lot of trade liberalizations. At that point, even after the success in Taiwan and South Korea, I still think there was a lot of pessimism. And the pessimism I was aware of at that time took the form of, these are pretty small countries in terms of population, you know, Taiwan, 23 million, Korea, more like 40 million—South Korea. So, what happens when China, with more than a billion people, you know, tries a similar route or Brazil or some of these other countries? So, so tell us a little bit about your paper on the 1985, ‘95 period. What do you see and what do you conclude from that?

IRWIN: Yeah, so there was this what I call the trade reform wave of 1985 to ‘95, where you see just so many countries across the world South Asia, Latin America, elsewhere in Asia, some African countries, really beginning to form their trade policies, their exchange rate policies in sort of the manner that Taiwan and Korea had done earlier. What’s interesting is, even though Korea and Taiwan did well, it’s not as though there were a lot of countries following them in the 1970s. And one reason for that is because one of the things that triggered reforms in those two Asian countries is a shortage of foreign exchange. And they really, their backs were against the wall.

In the 1970s with OPEC, there was a recycling of the oil surpluses, and so foreign exchange was in abundance. And that really postponed reform in so many countries. If there’s no pressure to reform, why do it? It’s going to be politically painful and upset the status quo.

So, in the 1970s and early eighties, there was really sort of this dearth of economic reform. But with the debt crisis, with a huge terms of trade shock for commodity exporters and others in the mid-1980s, other countries found themselves in the situation where foreign exchange was extremely short. And of course, when that’s the case, you have one of two strategies—you can really clamp down on imports or you can try to export your way out of it. And countries had already tried the import repression approach, and it really wasn’t going to work. I mean, you need food, fuel, intermediate goods to really make the economy work. And so they had to do something to boost exports so that required trade liberalization, exchange rate adjustments, and things of that sort.

And so I think that’s what’s accounted for this wave that we see happening. It’s not just circumstances, of course, but it’s also economists as policy advisers, supported by the bank and the IMF, but really indigenous policymakers that are willing to take the hard steps that are necessary to to change the course of the economy.

DOLLAR: So, you think the overall results were pretty good from this liberalization?

IRWIN: Well, there’s no doubt the 1980s was a very rough period. It’s been called the lost decade for Latin America. But, you know, after 1990, there have been two major developments in the world. One is, and study after study sort of shows this, much more rapid growth in the developing world, a convergence between the poor countries and the rich countries, whereas previous to that time, there had been that divergence. So, this convergence and rise in income is very important.

And of course, the reduction in poverty. So, the World Bank has estimated the poverty rate being about 42% in 1981 around the world. That’s extreme poverty, 42% in 1981. By 2015 or 2016, it’s down to less than 10%. So, going from 40% global poverty to 10% over the course of a little over two or three decades, following this period, this trade reform wave of countries opening up globalizing, is just a huge achievement that I think is now a little bit in jeopardy with the way the world economy is going.

But when you look back, it’s countries that you worked with—China, Vietnam, some Latin American countries, and some African countries have made progress, too, not nearly as much as those Asian countries. But you saw the process there and in the opening up really has helped for China, Vietnam, and so many others around the world.

DOLLAR: Yeah, I feel lucky that I happened to be able to witness some of that. When I was first teaching in China in 1986, you know, and they were just getting started in that process, but they had a multiple exchange rate system, and when you actually live through something like that, you just see the insanity of it. You know, you are in foreign exchange, the one activity you get you can convert to local currency at a particular price. If you do something else, you convert at a different price. It opens up the scope for corruption, of course, because you want to make sure you're categorized in the right category. And there's a lot of discretion, basically, you know. I didn't really have much to do with China for a few years. And then by the time I got involved again, they had unified the exchange rate, they devalued very significantly, and they were off on that export boom that, you know, as you as you say, put a lot of people to work and led to an extraordinary reduction in poverty.

IRWIN: And you put your finger on a very important point, too, is these import control regimes with misaligned exchange rates and a lot of trade controls, it's not just that it's constraining the economy, and it's that it leads to bureaucratic discretion and a lot of corruption. And then people become, as Anne Krueger pointed out, rent seekers rather than wealth seekers in some sense.

DOLLAR: So, let's talk a little bit about special interest groups—kind of follows naturally from talking about rent-seeking. So, in these major liberalizations that you've studied, is there a particular role for interest groups either opposing or supporting this liberalization?

IRWIN: Well, that's a really interesting topic, and that's one of the things that motivated me to start looking into some of these countries, because our basic theory of political economy says that there are a lot of forces aligned to support protectionist policies. You know, the benefits are going to be conferred on a few who are highly concentrated and organized. And and the benefits of more openness are widely diffused among consumers and exporters and so no one's going to lobby for them.

So, our political economy theory is sort of explain why we get trade restrictions, but not so much why we get rid of those trade restrictions unless exporters or consumers organize. And when you look at these cases, that's not really what's going on. It's not as though exporters should rise up and say, we can't take it anymore. We want the political system to move in different direction. It's not as though the the beneficiaries of protectionism are sort of becoming politically weak or sort of going away or or giving up the fight.

And so what I found in country after country, and maybe your experience reveals this as well, is you really need political leadership to sort of overcome this. Yet the interests are not going to organize in favor of of openness and liberalization. They're going to organize against it. And so the only thing that the political system can do to overcome that is by having political leaders and economic leaders in policymaking positions who are willing to try something new. Often, of course, it occurs within a crisis when sort of something has to be done, but sometimes without a crisis as well, you can get that political leadership and move countries' economic policies in a different direction.

DOLLAR: Yeah. But crisis, it really is often the impetus for these reforms. It's kind of, you know, unfortunate, and there are some examples that have not involved a crisis. But probably the most common pattern, you know, is the crisis. I remember asking a Vietnamese official around about 1990, you know, what was the impetus for doing all these dramatic things they were doing with the exchange rate liberalization? And he answered with one word. He said "desperation." It's not nice, but they were getting all that Soviet aid that I mentioned. Soviet Union collapses. They've got no friends. I came away from that thinking, you know, there's some advantages to having no friends. Right? You know, you have no friends then, you know, you've got to reform and you've got to earn your way with with exports. And they're one of the countries that have had this tremendous poverty reduction.

IRWIN: In some sense, Vietnam is sort of a very similar to Taiwan and Korea in the U.S. In the previous cases, it was the U.S. that was sort of bankrolling them and keeping them afloat and saying we're going to cut you off. And of course, in the late eighties, it's the Soviet Union cutting off Vietnam and then having to turn to once again need exports to earn the foreign exchange to purchase the imports that are necessary to keep the economy going.

DOLLAR: So, this poverty reduction that you mentioned, it definitely involves quite a few different countries. But, you know, let's be honest, there are some poor countries that have really been left out of the process, I think particularly in sub-Saharan Africa, we have some countries that are very lightly integrated with the global system. And frankly, I feel like a new kind of export pessimism is developed when when I talk about these countries with, you know, some experts, they worry that with automation and with growing protectionism in advanced countries, that the route we've been discussing is really not going to be open for more countries. So so so, what do you think about those arguments?

IRWIN: Well, first of all, you're absolutely right that Africa is really the next frontier in terms of being the least globalized continent on Earth. And so I think there's huge potential there. And there have been some bright spots, you're absolutely right that we haven't seen sort of big double digit growth rates like we've seen in some of the East Asian countries. But Ethiopia has done very well over the past several decades, Uganda has done much better, and Ghana, too, is sort of steadily doing well.

Once again, there are important policies that should be reformed in those countries to have much more competitive exchange rates to promote other activities besides the primary products. Ethiopia has sort of done that, has become sort of a textile hub to some extent.

And I think the question is, can you maintain macroeconomic stability and domestic political stability to keep that process going? It could be a longer haul. But actually when you go back and look at the Asian countries, too, these things didn't happen in a span of five years or so. It did take Taiwan and Korea, it a took a long time for reform and it was a long time coming.

So, I wouldn't say I'm pessimistic about Africa, but they do have a lot of pitfalls ahead. But I do think there's a lot of potential for great improvement in the years to come.

DOLLAR: So, a key factor in the background through most of this period we're talking about is that the United States was very open to imports from the developing world. And now the United States is reluctant to enter any new large trade agreements, I think, particularly ones that involve significant numbers of developing countries. Would you characterize the U.S. as backsliding on free trade, or is it more kind of treading water or staying in place? Is that going to be an impediment for a continuation of this kind of model?

IRWIN: I would think for the poor developing countries who are trying to get their foothold in the global economy, U.S. policy wouldn't be so much an impediment to them, because their market shares are very small, and I think the U.S. is relatively open. The U.S. has taken more actions on sort of steel and on countries that are not allies, to put it bluntly, you know, China, Russia, and things of that sort. So if these countries can remain outside that geopolitical conflict, I think the U.S. would still be relatively open to them.

But I think you're absolutely right that U.S. policy, which was much more favorable to liberalization in the post-World War II period, that's clearly changed. The Trump administration introduced a lot of big changes, the Biden administration hasn't really changed all that much. So, you know, there's big question marks about the future direction of U.S. trade policy and how much further inward we would sort of turn.

I still think that, you know, the world economy is a big place. The U.S. is not just is one market among many. And it's no excuse for other countries to say, well, we shouldn't reform because the U.S. might close up to us. But they have to do so or they should do so to bring domestic benefits and they'll find places that they can export to. And I think Vietnam, which is to some extent getting hit every now and then with the anti-dumping duties and the trade diversion from the trade war with China is sort of a mixed blessing for them—probably a little bit more on the positive side, because it's an opportunity for Vietnam to take further advantage of the friction between the U.S. and China.

DOLLAR: So, last question for you, Doug. Both our political parties have become interested in industrial policy, and I think there's broad support for policies that would aim to bring at least some manufacturing back to the United States, particularly in semiconductors. And I think you have a recent *New York Times* op-ed about some of these issues. So, can you talk a little bit about the risks and opportunities? And how should we shape industrial policy to get good economic results rather than shooting ourselves in the foot?

IRWIN: You're absolutely right that there's been a revival of discussion of industrial policy, sometimes for the sort of prudential grounds that too much semiconductor production is located in South Korea and Taiwan. And those are vulnerable countries if there are some military conflict in Asia, or it could be cut off in a future pandemic or a military conflict. And then obviously, the pandemic's raised issues about stretching supply chains too, too thinly and across too many different countries.

You know, once again, I sort of look to the past for some lessons. And in the past, you know, in the 1960s and '70s, a lot of OECD countries were supporting their steel industries. There was a lot of consolidation going on and countries wanted other countries to consolidate their industries, but not their own for the fear of job losses. So, what happened is every country started subsidizing their own domestic steel industry, and that led to a really bad outcome. A lot of anti-dumping and countervailing duty complaints, a lot of expensive government subsidies. And what resolved that was the OECD in the early 1970s sort of getting countries together to talk about reining in these subsidies and coordinating what their policies would be.

I think the risk today is that the European Union, the U.S., if everyone starts pursuing an industrial policy with regard to semiconductors and they want more manufacturing just in their own country, you get sort of this race of increasing subsidies.

So, the key issue, I think, is geopolitics. We don't want to be too dependent on potential enemies, but we shouldn't fear being too dependent on friends, and our friends are of course Canada, other OECD countries in Western Europe and elsewhere. And so we just want to make sure that we don't have a policy that breeds friction among these friends, on subsidy rates or what have you. So, what Chad Bown and I, of the Peterson Institute, in this *New York Times* op-ed, call for sort of a coordinated policy with our allies to just make sure that the subsidies work to the benefit of all of us within that club and not cause friction within the club and economic inefficiency along the way.

DOLLAR: Yeah. No, that makes a lot of sense. So, you know, if you try to take a number of different industries and then have them all fully developed within every advanced economy, we're just going to have all kinds of inefficiencies and we're going to miss the opportunity to get the efficiencies of economies of scale. So, do you think do you think Congress will Congress will follow your advice?

IRWIN: I don't know. Hopefully administration officials would, if not the Congress themselves, which tends to be much more parochial and worried about where the semiconductor industry is going to be located in the U.S. rather than whether we coordinate with other countries. But once again, another lesson from the past is that let's get all these countries, as you point out, doing the same thing at the same time, you get excess capacity that undermines profitability and just leads to the need for more structural adjustment down the road. And you don't want to go down that path, I think it just causes, as you pointed out, economic inefficiency, trade frictions, and ill feelings.

DOLLAR: I'm David Dollar, and I've been talking to my friend Doug Irwin, professor at Dartmouth College. I'm a big fan of economic history. I think probably all economists really like economic history because, you know, we learn a lot from what's actually happened in the past. And Doug has these wonderful papers about trade liberalization in different developing countries. So, if you want more detail, I encourage you to take a look at the papers. And it relates to some important contemporary issues, what's going to happen with our industrial policy in the United States and our trade policy, though our focus today has really been on the developing countries. So, thank you very much, Doug.

IRWIN: Pleasure to be here. Thank you very much.

DOLLAR: Thank you all for listening. We release new episodes of Dollar and Sense every other week. So if you haven't already, follow us wherever you get your podcasts and stay tuned. It's made possible by support from producer Fred Dews, audio engineer Colin Cruickshank and other Brookings colleagues. If you have questions about the show or episode suggestions, you can email us at podcasts@Brookings.edu.

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Until next time, I'm David Dollar and this has been Dollar and Sense.