Modern Trade Policies for the Global Economy

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1. Introduction

The almost unprecedented period of globalization that marked the latter part of the twentieth century was characterized by, among other things:

- Vast increases in the level and in the volatility of flows of international financial capital, spurred by improvements in communication, liberalization of trade in financial services, elimination of many domestic regulatory restrictions on international capital movements, and the development of new financial instruments.
- Major increases in the international division of labor in global manufacturing production, arising from and reinforcing the international spread of knowledge, and facilitated by improvements in communication, reduced transport costs, and liberalization of trade and investment.

This paper focuses primarily on the second set of phenomena, related to the spread of the international division of labor through trade and investment. Our particular interest is how these phenomena relate to domestic policies and international regimes for the regulation and taxation of international trade. The central question of the paper is what, if any, are the implications of recent trends in globalization for domestic trade policies and the international trade policy regime. The question is asked in both the positive and the normative sense. The positive question refers to the actual and likely future evolution of policies during the recent phase of globalization, and the normative one to the policy adjustments that might be called for as a result of globalization.

As a prelude to dealing with these questions, we briefly review international experiences of globalization, with special reference to how they relate to policy regimes.

2. Globalization: Winners, Losers and Policy Implications

Not all countries have fared equally well during the period of globalization in the last several decades of the twentieth century. Nor have all groups of people in any given country shared the same experiences arising from globalization. It is on these differences, both within and between countries, that a great deal of attention has focused in anti-globalization protests that now seem to be a fixture at all major international meetings, such as the December 1999 WTO ministerial meetings in Seattle and the IMF/World Bank meetings in Prague last year.

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2.1 The Asian Financial Crisis

The Asian financial crisis was an important element in catalyzing political and to a certain extent intellectual opposition to globalization. The speed with which reversals of short term capital flows to Thailand, South Korea and Indonesia (and to a much lesser extent Malaysia and the Philippines) and ensuing contagion effects triggered the loss of several years of economic growth in these countries showed the vulnerability of the global financial system to reversals of investors' sentiments.

This was primarily a financial crisis and had little, if anything to do with trade and tax policies. It revealed critical weaknesses both in the international financial architecture and in domestic policies, regulatory frameworks and institutions in the directly affected countries. Weaknesses included

- inappropriate monetary, fiscal and exchange rate policies (especially in Thailand in the period leading up to the crisis),
- premature liberalization and encouragement of short term capital inflows in the absence of adequate prudential rules and means of enforcement in the financial sector,
- weak bankruptcy and foreclosure laws, corporate governance practices, accounting standards, and risk management practices.

There are few, if any, direct lessons from this financial crisis for trade policies. However, the general conclusion, that domestic policies and institutions interact with international regimes to determine the effects of globalization on the domestic economy, certainly carries over to the case of trade policies. Whether countries benefit or suffer as a result of globalization depends crucially on their domestic policy environments. Globalization imposes stern disciplines on domestic policies and capabilities. Both the costs and the benefits of domestic policy decisions with respect to opportunities for economic development and income growth are magnified by recent globalization trends.

2.2 Liberalization and Expansion of World Trade

The freeing of international trade through reductions in tariff and non-tariff restrictions on trade over the past three decades has resulted in very rapid increases in trade in goods and services and in flows of international direct investment. Successive rounds of multilateral GATT tariff reduction programs and the more recent formation of the WTO, enshrining and establishing rules and institutions for the preservation of free trade, have played a major role in the freeing and rapid growth of international trade.

Despite the long-standing presumption and well-developed economic arguments about the gains from international trade, opponents of globalization have argued that the gains from the recent expansion of world trade have been very unevenly distributed. Among the most important criticisms have been that:

- Free trade has increased inequality in rich countries, with poorer workers suffering from falling wages and rising unemployment as a result of increased competition from developing countries.
- Free trade has resulted in a "race to the bottom" as social and environmental policies in richer and more socially enlightened countries have been degraded due to the need to compete with poorer and less enlightened countries. Poorer countries sometimes argue, on the other hand, that freeing of trade has led to accelerated environmental destruction in their own countries as resources are exploited at an increased rate to

feed rich country export markets, and as environmentally-unfriendly activities (dirty manufacturing industries and waste disposal) are moved to poorer countries with greater tolerance for pollution and lesser capabilities of enforcing environmental laws. International trading of carbon emission permits is a prime example.

- Free trade has benefited only a small subgroup of countries, to the detriment especially of poorer countries that have been left behind by and stagnated under the forces of globalization.

The question of trends in and causes of inequality, poverty and unemployment in rich countries is complex. However, reductions in trade barriers have not been a major source of any worrisome trends in these variables; nor are increases in protection a viable long-term solution to such problems. Long run changes in income distribution in rich countries are due to much more fundamental causes such as changes in technology and investment in human resources.

Some proponents of trade liberalization, for instance in debates over North American Free Trade, have tended to oversell free trade as a source of new jobs. A more accurate statement of the case for free trade in such contexts is that it will provide opportunities for better jobs, but not necessarily more jobs. But productivity improvements such as those being witnessed with the growth of the "new economy" create employment and income opportunities for those with appropriate skills. Long run changes in income distribution are driven by productivity growth and by investments in human skills as well as physical capital. The role of trade policy is a supportive one – to be part of a policy environment that promotes and rewards competition and innovation, the underlying sources of long term growth of opportunities and incomes.

The development of the new economy and its implications for long term growth and distribution of incomes is dealt with in much more detail in presentations by Rick Harris at this and a previous conference (Harris 2000, Harris, 2001). Similarly, issues related to the effects of globalization on the environment are discussed in Olewiler 2001. The latter shows in particular that there is little evidence to support the contention that globalization harms the environment.

The remainder of this section, therefore, focuses on the role of globalization of international trade and investment in shaping global inequality among nations.

Doubts about the beneficial effects of globalization of world trade and investment have been fostered by the observation of wide inter-country disparities in economic performance over the final decades of the twentieth century. Most discouraging has been the fact that while many of the world's richest countries appear to have benefited from globalization through continuing high growth, many of the poorest countries have languished in slow growth. The growth of world trade and investment, it is concluded, has been of benefit primarily to rich countries and has not brought the hoped-for acceleration of growth of poor countries and the resulting convergence of world per capita incomes.

Sachs and Warner (1995) examined this hypothesis in a simple but highly instructive review of international data on per capita income levels, growth rates and indicators of openness of trade policy regimes. Overall data on income levels and growth rates seems to show no relationship between initial income levels and growth rates over the latter part of the twentieth century. That is, there appears to have been no systematic convergence or divergence of incomes between rich and poor countries over this period of rapid trade and investment growth, thus giving some confirmation to the globalization sceptics.

However, when countries were divided into those that had relatively open trade policy regimes over the study period, and those with less open trade policy regimes, two important conclusions emerged. First, countries with open trade policy regimes enjoyed uniformly higher growth than those with inward-oriented, or closed trade policies. Second, within the group of countries with open trade policies, there was significant convergence of per capita income levels. That is, among the set of countries with open trade policy regimes, not only were growth rates higher than in countries with closed trade policies, but those with lowest initial levels of per capita income tended to have the highest growth rates of all.

For a variety of reasons, the Sachs and Warner findings are far from conclusive. Nevertheless, they provide powerful evidence in support of traditional economic arguments in favor of freer trade. They indicate in particular that countries with open trade policy regimes have benefited significantly from globalization in the latter part of the twentieth century. Meanwhile, countries that have resisted the forces of globalization through inward-looking and restrictive trade and investment policies have paid a high price by not availing themselves of the opportunities made available by access to world markets.

As with the Asian financial crisis, an important lesson from the experience of trade liberalization over recent decades is that domestic policies play a key role in determining whether countries benefit or suffer from the forces of globalization. In this important sense, globalization has not emerged as a threat to national sovereignty.

Trade and investment policies are only one element in the policy and institutional framework that determines the success of countries in achieving their development goals in the global economy. Recent work in a variety of places has attempted to deepen our knowledge and understanding of the role of trade policies in this broader framework of strategies for economic development.

The World Bank's most recent *World Development Report* (World Bank 2000b) presents the results of a large volume of in-house and commissioned research on the determinants of economic development and poverty reduction. One of the principal background papers (Dollar and Kraay 2000) extended the work of Sachs and Warner to examine the effects of a variety of economic policies on economic growth, and in particular on the incomes of the poorest groups in each country. Their cross-country comparisons led them to conclude that

> "Income of the poor rises one-for-one with overall growth.…The effect of growth on the income of the poor is no different in poor countries than in rich ones….Policy-induced growth is as good for the poor as it is for the overall economy. Openness to international trade benefits the poor to the same extent that it benefits the whole economy. Good rule of law and fiscal discipline are other factors that benefit the poor to the same extent as the whole economy. Avoidance of high inflation is "super-pro-poor"." (Dollar and Kraay 2000, p.1)

The World Development Report 2000/2001 (World Bank 2000b) addressed the specific theme of "Attacking Poverty" (the subtitle of the report). While it dealt with a broad array of themes related to poverty reduction, it still concluded that open trade policies are a central element of any strategy for poverty reduction:

> "All countries that have had major reductions in income poverty have made use of international trade.…A more pro-poor [trade] liberalization is not necessarily a slower one; moving fast can create more opportunities for the poor." (World Bank 2000b, p.8)

This simple lesson appears to have been lost in many of the recent confrontations over the WTO and globalization. Part of the blame lies with the World Bank itself which could well be argued to have gone too far in the direction of stressing non-market aspects of poverty reduction strategies and in paying excessive lip-service to processes whereby poverty reduction strategies are designed and agreed upon. In many of their recent activities and much of their recent research work, the Bretton Woods institutions have paid considerable attention to issues of governance and the design of participatory processes for policy design and implementation. This is especially true of its most recent major study in this area entitled *The Quality of Growth* (Thomas *et al* 2000), and in the development poverty reduction strategy papers as a condition for World Bank and IMF assistance. While governance issues have been too much neglected in much of the previous work on policy reform, there is now a danger of going too far in the opposite direction and losing sight of some of the standard and fundamental economic lessons about market-based reforms.

The recent UK Government White Paper on international development (Secretary of State 2000) provides a particularly useful and balanced view of the role market-opening and other developmental policies in the promotion of development. While recognizing the importance of a wide variety of governance, and human, physical and natural capital investment policies, it recognizes the central role of trade policies in harnessing the forces of globalization for the benefit of the poor.

> "Everywhere it is clear that openness is a necessary – though not sufficient – condition for national prosperity. No developed country is closed. The initially poor countries that have been most successful in catching up in recent decades – the newly industrialising east Asian countries and China – seized the opportunity offered by more open world markets to build strong export sectors and to attract inward investment. This contributed, along with massive investment in education, to the largest reduction in abject poverty that the world has ever seen." (Secretary of State 2000, p.17)

In common with Sachs and Warner, Dollar and Kraay, the World Bank and other researchers and organizations, the White Paper stresses the key role of sovereign domestic policy decisions in the promotion of open trade and investment as major determinants of the effects of globalization in individual countries.

Despite differences in approaches, methods and interests, almost all of the serious research on recent effects of globalization concludes that liberal trade and investment policies, accompanied by prudent macroeconomic policies, the development of appropriate institutional and legal frameworks, and productive investments in human, physical and natural capital, holds the key to participating in and maximizing the benefits from the global economy. The factors that have led to "globalization" of the world economy present great opportunities for countries at all levels of development. Globalization also exposes countries and their citizens to higher levels of risk. The effects of globalization in any particular country – whether they are malign or beneficial – depend primarily on domestic policy choices made in that country.

3. The Multilateral WTO Trade Regime

The WTO-based multilateral trade regime has been the focus of much of the attention of anti-globalization protests. This is because the WTO represents the achievements of several decades of multilateral trade liberalization, and their culmination in an organization that coordinates, supports and enforces the rules-based trade regime that was the outcome of the most recent Uruguay Round of trade negotiations.

3.1 "Free Trade" Under the WTO

Despite the accusation (by anti-globalization protesters) that the WTO represents all the dangers and evils of free trade, it is still a far way from having achieved complete freedom of international trade. In fact, this is one of the greatest grievances of free trade advocates with respect to the current world trade regime. Weaknesses in the WTO are not the main topic of this paper, and so we will focus here only on some of the more important issues from a policy perspective in developing countries.

Remaining Protection in Developed Country Markets

The conclusion of the Uruguay Round left several major gaps in the free trade agenda. From the perspective of developing countries, the most important were in agriculture and in certain manufacturing sectors of special interest to poorer countries.

Powerful agricultural lobbies in Japan, the US and Canada, and most importantly the EU succeeded in preserving high levels of protection for number of major agricultural sectors in which some developing countries are potentially highly competitive. The result of this protection is a loss of export opportunities, and a significant decline in the terms of trade of potential exporters of such products.

Similarly, failure to dismantle the Multi Fibre Agreement (MFA) has cut off the most important potential sources of labor-intensive manufacturing growth in developing countries. By preserving market shares through MFA quota arrangements, of course, it is felt that certain developing countries actually benefit from these trade restrictions. But in aggregate, there can be no question that the MFA is harmful to developing countries, and is especially harmful to the interests of low and semi-skilled labor in these countries.

The Uruguay Round agreement included provision for continued liberalization of agricultural trade and for dismantling the MFA by 2005. There has been virtually no progress on either of these fronts since the completion of the Uruguay Round, and it remains to be seen whether these commitments will be honored. It has been estimated that OECD agricultural protection causes losses of almost $20 billion annually to developing countries, which is equivalent to about 40 percent of aid to these countries in 1998 (World Bank 2000b, p.11).

Special and Differential Status for Developing Countries

It is not only developed countries that have an unfinished trade liberalization agenda. Developing countries have been given "special and differential status" in two important respects, not only in the WTO framework, but also in a wide range of regional and other plurilateral and bilateral trading arrangements. This special status takes two different forms; provision of special access to developed country markets and allowance for exception to and/or delays in implementation of WTO market-opening measures in their own countries. (See Whalley 1999 and Pangestu 2000.)

Special access is provided through exemption from the MFN treatment requirement for a range of exports to developed country markets. Exemption of developed countries from MFN requirements on imports from developing countries allows developed countries to provide preferential access to their domestic markets for imports from poorer countries, on a non-reciprocal basis.

This preferential access has been provided primarily through the vehicle of the Generalized System of Preferences (GSP). GSP access is usually conditional, subject to annual approvals, often governed by very restrictive rules of origin, and quota-restricted. Among the most important sets of GSP measures for many developing countries have been those granted to so-called ACP (Africa, Caribbean and Pacific) countries by the EU, especially through the Lomé Convention. Many of the goods of greatest interest to developing countries under the Lomé Convention have been agricultural products which otherwise are heavily protected under the EU Common Agricultural Policy (CAP).

A very recent innovation in GSP arrangements for developing countries is the Africa Growth and Opportunity Act (AGOA) that was passed by the US Congress in 2000. AGOA is unusual in that it provides tariff and quota free access for a much-expanded GSP list of goods for a period of five years (i.e. not subject to annual approval) to a large number of qualifying African countries. The eligibility relate to both some relatively basic indicators of rule of law and human rights policies, and to basic economic policies indicating a commitment to market-oriented policy reforms.

The second form of special and differential treatment offered to developing countries since the beginning of the GATT process has been exemption from or delays in implementing a wide variety of market-opening measures. The concessions have related to, among other things, removal of NTBs, the requirement to bind tariff offers, and the ability to maintain high levels of protection for industrial development or revenue purposes. The Uruguay Round was the first time in which all agreements were embodied in a single undertaking signed bay all members, developed and less developed. However, developing countries were given longer time periods to adjust to many new liberalization measures.

Special and differential treatment offered to developing countries, at least in the forms used in the GATT/WTO context, is a peculiar concept, and reveals what is really a fundamental contradiction in the post World War II multilateral trade liberalization process. The special market access provisions in developed country markets reveals a failure of five decades of trade liberalization to open markets in many products (agricultural and labor intensive manufactures) of the greatest direct interest to developing countries. And the relaxation of liberalization requirements of developing countries in order for them to continue with various forms of infant industry protection contradicts the underlying developmental objectives of trade liberalization that is supposed to underlie the GATT/WTO processes.

Fortunately the Uruguay Round negotiations saw some retreat from the near unanimity of developing country support for special and differential status. In the last quarter of the twentieth century, a significant number of developing countries had pursued unilateral policies of trade liberalization as a key part of their development strategies, and, as observed earlier, these tended to be the most successful performers among developing countries over that period. This experience had a salutary effect on negotiators in dealing with the special status and needs of developing countries. At the same time, there remains a great deal of unfinished business in liberalizing trade in developed country markets for goods of the most interest to many developing countries.[3]

Anti-Dumping and Safeguard Measures

Safeguards and anti-dumping procedures were introduced into the GATT/WTO process by developed countries to provide security against harmful surges of imports and "unfair" trade practices of foreign suppliers taking advantage of freer access to domestic markets following trade liberalization. Although the use of these measures has been enshrined in the multilateral trading system, it is developed countries that have been by far their greatest users, and developing country suppliers have often been the targets.

These procedures are generally agreed to have become one of the principal forms of GATT/WTO sanctioned protectionism used by developed economies. By design, they take a narrow perspective that considers the effects of protection only on the protected industry, and not on consumers or industrial users of the goods produced by the protected sectors. It should not be surprising, therefore, that safeguard and anti-dumping procedures have been captured by vested interests aimed at preserving protection against import competition. Recent proposals in the US to use anti-dumping duty revenues as a further subsidy to injured domestic producers would add another dimension to and incentive to use anti-dumping mechanisms.

The principal beneficiary of any anti-dumping or safeguard action is the sector given temporary protection by such measures. The principal losers are domestic consumers and users of imported products affected by the actions. In the many cases in which action has been taken against basic industrial products, it is downstream domestic industries that are hurt by rising costs that make them less competitive in domestic and international markets. In developing countries, it is exactly these sectors that should be the major source of income and employment growth through outward-looking industrialization.

In light of these lessons from developed countries, it is unfortunate that developing countries are now becoming the most rapidly growing users of safeguards and especially anti-dumping actions. Most developing countries will be even more vulnerable to the use of such measures by narrow vested interests using the rhetoric of infant industry protection and job creation to create special privileges for themselves. Through these WTO-sanctioned procedures, they will slip through the back door protectionist measures that will counteract the hard-won benefits of trade liberalization that have been achieved in recent decades, and slow the pace and neutralize the benefits of badly needed further trade policy reforms.

The greatest threat to developing countries arising from anti-dumping and safeguard procedures is not any harm that might accrue from their use by developed countries. Rather, it is the damage that developing countries will do to themselves through their own use of these actions.

Other Types of and Arguments for "New Protection"

Anti-dumping and safeguards have been part of the GATT/WTO environment for many decades. Other measures have emerged as newer types of potential protectionist threats.

[3] For further discussion of special and differential treatment in the WTO see Pangestu 2000 and Whalley 1999.

Among the more important, especially to developing countries, are sanitary and phyto-sanitary (SPS) and other kinds of "quality control" standards for internationally traded goods, and various kinds of measures being mooted to ensure enforcement of "labor standards" in developing countries.

In all commercial transactions, it is necessary for buyers and sellers to agree upon and be able to enforce agreements about the descriptions, quantities and quality of goods being bought and sold. When buyers and sellers are far apart and subject to different national jurisdictions, the problems are greater. Nevertheless, as long as there is a stable and reliable framework of commercial law in the relevant jurisdictions, private markets are generally able to find cost-effective and reliable solutions to these problems. International buyers of textile goods, footwear and electronics, for instance, have put in place extensive networks of sub-contracting, technical assistance and quality control assistance to ensure that they are able to obtain products needed for domestic markets. The international division of labor that has resulted from these networks has been of great benefit to developing and developed economies alike. The same phenomenon has been in place for some time, with similar results, in international commodity markets.

Through all of these arrangements, there has been little if any need for involvement of governments, other than to erect and maintain a stable commercial/legal environment. The commercial sector, by and large, has been able to find commercial solutions to informational problems arising from international trade.

Nevertheless, there is still a more active role for governments in the monitoring and sometimes in the regulation of quality control in the case of goods where there is deemed to be a broader public interest and it is judged that the private sector may give inadequate protection to legitimate concerns of consumers. This has been particularly true of pharmaceuticals and a variety of food products, where there is a long tradition of information and other quality control requirements imposed on domestic production and sales. In dealing with these kinds of issues, there is considerable international variety in the means chosen to deal with these regulatory issues.

When such goods are involved in international trade, it becomes necessary to find ways of extending domestic regulatory controls to imports and, less frequently, exports. The key issue in applying such measures to international trade is to ensure that they are not used, intentionally or inadvertently, as non-tariff trade barriers. This can be done either by applying stricter standards to imports than identical domestic goods, or by raising standards for goods which are available only from abroad in order to provide implicit protection for more distant domestic substitutes.

There is growing evidence that SPS requirements have been used, directly or indirectly, to provide protection in domestic markets. Malaysia, for instance, claimed to be the victim several years ago of a concerted lobbying campaign by US soybean producers to highlight health hazards from palm oil.

However, it is not only developing country producers that use and/or benefit from SPS measures to diminish foreign competition. Domestic pharmaceutical companies in Indonesia used SPS measures as well as tariffs and quotas to keep much less costly generic medicines out of the domestic market. This enriched a few domestic producers and their international partners at the great expense of Indonesian consumers requiring medical treatment. An even more interesting and subtle case was that of Thailand when it recently investigated harm done in Europe and the US from increased SPS standards for processed fish products. To the surprise of the Thai investigators, it was discovered that these measures benefited Thailand by keeping out new competition from up-and-coming producers in other countries that did not have the advantage of Thailand's network of developed country buyers and experience to be able to adhere to changing standards. An unintended effect of increased SPS standards is to be a barrier to entry benefiting established sellers, in this case including Thailand.

A more subtle danger to developing countries is when SPS measures are used, not simply to protect domestic producers, but also to provide "unreasonable protection" to domestic consumers. A recent study of SPS requirements in the EU (Otsuki *et al* 2000) found that stricter food safety standards are a major threat to exports from developing countries. Implementation of a new European aflatoxin standard, which differs from currently agreed international requirements, will reduce health risk by approximately 1.4 deaths per billion a year. At the same time, it will reduce African exports of cereals, dried and preserved fruits, and nuts by approximately $700 million.

Labor standards are becoming an even more controversial source of disagreement and contention between developed and developing countries. Developed countries, especially the US, are insisting that enforcement of minimum labor standards, including strictures against child labor, enforcement of rights to organize, etc. be a requirement for developing countries to meet in order to participate in the WTO system. While argued to be for the benefit of workers in developing countries, the latter perceive these demands to be nothing other than thinly disguised protectionism, based on the "cheap labor" myth peddled by protectionists for untold decades, and discredited by economists several centuries ago.

As indicated earlier, the most effective way to integrate workers and the poor in developing countries in the global economy, and to promote their sustainable and equitable development as a result, is through open markets, both domestic and international. For vested interests in developed countries to close their own markets and encourage protectionism as a viable economic strategy creates the cruelest inconsistency for the poor of the developing world. While the need to pay lip service to domestic interests advocating such views may be a political reality in some developed countries, it is irresponsible for governments and NGOs to promote international labor standards as a strategy for global poverty reduction and equitable development.

3.2 The Mercantilist Paradox in Free Trade Negotiations

The first lesson about trade liberalization is that its principal beneficiaries are the citizens and residents of the country reducing barriers to its trade with the rest of the world. For a small country, i.e. one too small to have a significant impact on world markets through its participation in these markets, the benefits of its own trade liberalization measures accrue entirely to itself.

This simple fact stands in sharp contrast to a common myth of trade negotiation – i.e. that tariff reductions are concessions to one's trading partners. Perpetuation of this mercantilist myth is arguably one of the largest costs of the multilateral trade liberalization exercises of the past several decades. By depicting and treating tariff reductions as "concessions," they have become a massive source of disinformation to policy makers and observers.

The language and the behavior of many of the negotiators seems to be based on the understanding that the benefits of trade liberalization by any member country are enjoyed principally by other members, and the "costs" of granting market access are borne primarily by the liberalizing country. As a result, negotiators feel it is their job to resist making concessions that reduce barriers to imports in their own markets.

This interpretation of the effects of trade liberalization is contrary to economic theory and empirical evidence that has accumulated around the globe and over the past two hundred years. While there might be some political necessity for viewing trade liberalization in this distorted manner, there is a real danger that negotiators and the stakeholders in the participating countries come to believe this protectionist rhetoric and conduct themselves accordingly. Negotiators in regional trade agreements, for instance, appear to be proud to have secured agreement on preferential tariff rates that exceed their WTO MFN commitments. Similarly, Uruguay Round negotiators took similar pride in achieving WTO commitments to tariff rates that were far in excess of rates actually been levied at the time.

Trade liberalization by any small country (and virtually all developing countries certainly fall in this category for all or at least the vast majority of their trade) has a negligible effect on world prices and hence on the trading possibilities of its trading partners. However, by bringing domestic prices closer in line with world costs and prices, it ensures a more productive and efficient use of its domestic resources, and lays the strongest possible foundation for long-term development. In addition, trade liberalization increases the degree of actual or potential competition in domestic markets, and hence provides strong incentives to improve domestic productivity and competitiveness. This is a major long-term dynamic benefit of trade liberalization.

Why, then do countries persist in the apparently irrational fiction of pretending that trade liberalization is a concession to others?

Viewed from a national perspective, an open trade policy regime is a key element of a strategy for long-term development and for raising the incomes of a country's citizens. However, from the perspective of particular vested interests, protection of a domestic market from foreign competition can be an immediate and significant source of profits and of incomes. Furthermore, the special interest gains from (increases in) protection are generally highly concentrated, while its costs are often much more widely dispersed. Hence, the political pressures for (increases in) protection are often much stronger than those for liberalization.

Trade liberalization agreements with other countries can serve a very useful purpose in this context. They can be described as a means of securing preferential access to the partners' markets – each member agrees to provide such access to its markets in exchange for reciprocal measures on the part of its partners. Trade liberalization can then be "sold" to domestic protectionist interests as a means of securing expanded market access for its own producers and sellers. Once entered into, such agreements then serve as a credible commitment to trade liberalization. The agreements can be a powerful tool, both to secure trade liberalization in the first place, and to resist domestic pressures for subsequent increases in protection.

The danger, however, is that perpetuation of the myth of trade liberalization as a concession to foreigners gives exactly the wrong message to the true stakeholders in economic reform –

the domestic citizens who will benefit from the domestic impacts of liberalization. The economic argument for free trade is apparently subtle and non-intuitive. To muddy the waters with economic nonsense for short term political gain might have very serious long-term economic costs.

3.3 Regionalism

Regional preferential trading arrangements (PTAs) have a long history in global trade policies. The EU and the Canada-US free trade agreement are among the most important among developed economies. AFTA, Mercosur and many other actual and nascent arrangements have been entered into in recent years among developing countries. Largely and certainly initially at the behest of the EU, there has emerged a growing number of special arrangements between developed and developed economies. These have included both bilateral and plurilateral agreements, some reciprocal and some not. The Lomé arrangement between the EU and the so-called ACP (Africa, Caribbean and Pacific) countries has been a long-standing non-reciprocal preferential deal to give limited access of developing countries to European markets. This is now to be revised to encompass more reciprocal conditions under which developing countries will also have to offer tariff "concessions" to the EU.

It has long been recognized that formation of a PTA is not necessarily a movement in the direction of free trade, and that it might be welfare enhancing or welfare reducing for the participating countries. Despite this, the trend towards PTAs of this sort has been one of the most important features of the world trading system, especially in the past decade.[4]

International experience has taught a number of simple lessons regarding the economic impacts of preferential trade liberalization schemes. Some lessons relate to the aggregate economic impacts of preferential trade liberalization, and others to the distribution of benefits and costs among member countries. There has also been considerable discussion, especially in recent years, of broader political and social impacts of regional trade liberalization. Among the more controversial and yet unresolved issues in this regard is whether regional and other preferential forms of trade liberalization promote or hinder MFN-based trade liberalization.

Unilateral, MFN-Based Liberalization Versus PTAs

As indicated earlier, the principal beneficiaries of trade liberalization are the citizens and residents of the country reducing barriers to its trade with the rest of the world.

Is there any economic benefit to be gained by liberalizing trade with respect to only a subset of its trading partners, as is done in a PTA? In strict economic terms, the answer is clearly no. There is no benefit from doing so, and there is a potential cost if it has the effect of inducing the country to import from a higher cost international supplier as a result of preferential tariff rates given to the higher cost source (see section 4.3 below). MFN-based (i.e. non-discriminatory) trade liberalization is always economically superior to preferential liberalization.

This is not to say that preferential trade liberalization is necessarily bad. There are two broad arguments for preferential trade liberalization.

[4] For a recent in-depth review of the economics of regional trading arrangements see World Bank 2000a.

The first is based on "second best" considerations. If for political or other domestic reasons, non-discriminatory liberalization is not possible, preferential liberalization *might* be a second best alternative. Whether preferential liberalization is economically preferable to the *status quo* depends on the circumstances in each case and, in particular, whether the trade creating effects of the measures undertaken outweigh their trade-diverting effects. The greater is the extent of trade diversion induced by a PTA, the greater is the chance that it will be inferior to no liberalization at all.

The second argument for preferential trade liberalization is that it can be used as a device either to secure preferential or otherwise improved access to external markets, or to bind domestic policy makers to enter into and maintain market opening measures with respect to their own market. In other words, collaborative trade liberalization among a set of countries can be used to ensure commitment to tariff reductions and other market opening measures, over the objections of domestic vested interests opposed to liberalization. This is discussed in the following section.

Regional Liberalization as a First Step to Freer Trade

If we accept the myth of trade liberalization as a concession to others, regional PTAs might be easier to sell than multilateral agreements or unilateral action. It can be described as a means of securing preferential access to the partners' markets without having to open up the domestic market to all potential foreign competitors. As with multilateral trade agreements, however, they do represent a first step towards opening of domestic markets, entered into with reciprocal commitments from one's partners, and hence difficult to abrogate.

Collaborative trade agreements differ in the degree of compulsion or conditionality attached to market access. Most agreements involve some kind of reciprocity requirement. AFTA, for instance, imposes a condition of sectoral reciprocity for a member to gain preferential market access under the agreement. That is, a country cannot gain preferential access to any sector in a partner country until it had already met its agreed liberalization targets for that sector. As issues have arisen in recent years concerning delays in the originally agreed implementation schedule, AFTA has also introduced punitive sanctions. Under these new provisions, a country which delays implementation of market opening commitments can be subject to countervailing penalties by any partners judged to be harmed by such actions.

APEC, on the other hand, is quite unusual in this respect. Tariff reductions and other trade liberalization measures "offered" under APEC are made available to all countries on an MFN basis. That is, market opening is provided on a non-preferential basis, to all countries in the world qualifying for MFN treatment, regardless of their membership in APEC. Under this non-preferential, voluntary trade liberalization scheme the only form of commitment is of a "moral" or self-interested nature on the part of any liberalizing member. In reality, APEC is primarily a "talk shop" in which members can discuss issues related to trade liberalization and provide mutual encouragement and demonstration effects in their individual efforts to achieve the benefits of opening their markets to international trade. Despite the absence of any kinds of sanctions or reciprocation requirement, APEC has been a remarkably effective commitment mechanism for governments wishing to pursue trade liberalization policies.

The APEC experience provides evidence regarding the extent to which regional and other forms of PTAs encourage or discourage the movement towards MFN-based, global free trade. APEC is clearly designed to encourage multilateralism and openness. Do other more exclusive PTAs such as NAFTA, Mercosur, and the growing array of bilateral and plurilateral "free trade" deals do the same, or do they encourage balkanization of the global economy into isolated groups?

While most PTAs claim to be based on a commitment to "open regionalism", the evidence on their net effects is not yet clear. Nevertheless, the fact that this question is raised so frequently suggests at least a real danger that the proliferation of PTAs might be a stumbling block rather than a building block for global free trade.

Rules of Origin in PTAs

A special and unavoidable problem that is peculiar to PTAs and does not arise in connection with multilateral or unilateral free trade arises from the need for rules of origin. Rules of origin are necessary in a PTA in order to avoid "trade deflection, " whereby foreign suppliers gain access to the markets of a high tariff member of the PTA by exporting initially to a lower tariff member.

Rules of origin are meant to prevent trade deflection by specifying minimum degrees of domestic content, processing or value added in order for an import from a member country to qualify for preferential treatment under the PTA. The problem is that any kind of domestic content requirement is a form of non tariff barrier to trade that provides protection to the value-added processes or activities specified by the rules of origin. At the same time, these rules provide negative protection to the users of goods being protected.

Recognizing this as a means to provide hidden protection within the context of a "free trade" agreement, negotiators in many PTAs create rules of origin that impose major distortions in trade incentives in order to create preferences and encouragement for the development of domestic industries within the PTA. This is directly opposed to the goal of trade liberalization, and as a result can often turn into a major stumbling block in the path to true trade liberalization.

Rules of origin have been a source of considerable contention in negotiating PTAs. These differences often result in a substantial tightening of initially-proposed rules of origin, with specific rules drawn up for a large number of significant manufacturing products. This is generally done in order both to achieve greater "clarity" of the regulations and to achieve industrial development goals. It is the use of rules of origin as instruments of industrial development, however, that is greatest importance from a trade policy perspective.

Many industries of interest to developing countries are now characterized by globalization of production for the world market. For industries such as garments and textiles, footwear, and electronics, production is dispersed across the globe according to differential costs at each stage of the process. This applies to raw materials, capital goods, intermediate inputs and assembly and sub-assembly processes.

The stages of the process represented in any location depend on the availability and costs of the necessary locally sourced inputs, especially labor and local services. To participate at all, of course, requires smoothly functioning and relatively low cost trading infrastructure, including ports, customs services and domestic transport. High costs and/or low reliability of these basic trading services result in loss of production opportunities, and lower returns to the participating domestic factors of production.

For many developing countries, the usual entry point is in the assembly of final products or particular sub-components, based on availability of low cost, relatively unskilled labor. The most frequently observed examples are in the garments and textiles, electronics and footwear industries.

If production is aimed primarily at the protected domestic market, the process usually starts and ends with simple domestic assembly of final consumer products. However, if international markets are the targets of the investors, the picture is usually quite different.

First, the scale of operation for export-oriented production is generally much larger than would be the case of production aimed only at a protected domestic market. Most domestic markets and many regional markets are not large enough to support internationally competitive production plants.

Second, the assembled products in export-oriented production are just as likely to be components or intermediate products for use in production processes elsewhere, rather than final consumer goods. It is generally the goods at the most labor-intensive part of the production chain that are the first to be produced or assembled in developing country locations. In the case of garments and textiles, this often applies to final consumer products, where stitching and assembly are highly labor-intensive. However, in the case of electronics, the components and sub-components sectors can often be the most labor-intensive.

Third, in the case of successful and sustainable export-oriented production, the investment process is dynamic and continues to grow. Over time, expertise and skills in labor-intensive assembly improve. This is generally accompanied by a variety of scale and other factors that make it profitable to broaden the range of related products produced locally. Backward and forward linkages expand with the development of local supporting industries. As the process continues, the location might even lose its comparative advantage in the labor-intensive activities that characterized the initial investments.

The development and evolution of such industrial "clusters" is an ongoing process in successful export-oriented investments. The process has been observed in electronics, footwear, and garments and textiles in many parts of the world. In east and southeast Asia, this has become known as the "flying geese" pattern of industrial development. A similar process is now underway in the garments and textiles industry in parts of southern Africa. Mauritius some time ago became an attractive center for investment in export-oriented garment production, especially in the form of labor-intensive knitwear and in cutting and sewing garments from imported cloth. From the beginning, investments in these activities were export-oriented and aimed at world markets.

Success of these export-oriented investments, together with accompanying experience and skills development, have led to rising wages and shifting patterns of Mauritian comparative advantage. Mauritius is now facing declining comparative advantage in labor-intensive garment production. At the same time, expertise and competitiveness are growing in textiles and in supervision and coordination of garment production in more labor abundant regional locations. Mauritian investors are now involved in garment production in Madagascar and a number of SADC countries, including Botswana, Lesotho, Malawi and South Africa. They are also involved in logistics and in the development, coordination and sourcing of textiles from Mauritius, South Africa and international markets. Mauritian workers are shifting towards more skill-intensive, higher wage activities, in other sectors as well as the skill-intensive parts of the garments and textiles sector.[5]

The changing patterns of production, trade and investment in this sector are similar to and just as dynamic as those seen in east and southeast Asia over the past two or three decades.

The export-oriented flying geese model of east and southeast Asia (and Mauritius) is quite different from the inward-oriented model being pursued through vigorous application of strict rules of origin under many PTAs. The approach is often superficially similar to the flying geese model inasmuch as strict rules of origin are meant to encourage the evolution and development of supporting industries in a number of manufacturing sectors, including garments and textiles, motor vehicles, and electronics.

The key difference, however, is in the extent of outward orientation. The rules of origin are a requirement that must be met for preferential access of finished goods to the protected market of the PTA members. As is often the case, however, the PTA market is too small to support globally competitive scales of production in most, if not all, upstream or downstream industrial sectors. This is especially so in the case of PTAs among developing countries.

The danger, especially for the lesser developed members of such a PTA, is that by orienting themselves to the rules of origin bound, inward-looking development model, they will be doomed to perpetual lack of international competitiveness and to correspondingly low incomes and development prospects.

Many of the dangers of the rule-of-origin-based, forced industrialization model can be avoided if the members are sufficiently outward-oriented in their trade relations with the rest of the world. If the members pursue vigorous programs of MFN-based trade liberalization in parallel with and at a similar speed to their preferential tariff reductions and other trade facilitation measures under the PTA, international competition will reduce the dangers of the development of small-scale, uncompetitive supporting industries. Access to inputs and raw materials on internationally competitive terms would permit investors to gain access to world markets, and not become reliant on small regional markets. A virtuous cycle could be created in which the region becomes a dynamic and competitive part of the global economy.

Trade Creation and Trade Diversion

As indicated earlier, preferential trade liberalization has some effects that are efficiency and growth enhancing and others that are efficiency and growth reducing. The former, known as *trade creation* effects, improve efficiency and increase growth by bringing domestic prices more in line with world prices and increasing competition in the domestic market. This is the principal effect of non-discriminatory trade liberalization.

[5] This process presents some important domestic policy challenges in Mauritius. A number of sectors of the economy remain heavily protected from external competition. Some parts are heavily dependent on imported labor. The economy continues to be shaped by special arrangements for the sugar sector, without which it would be far less competitive internationally. The longer run challenges for Mauritius in making the transitions discussed here relate to both a continuation of deregulation and reduced dependence on protection, and programs to enhance human skills and the strength and flexibility of its market economy. For further discussion of regional integration issues in southern African development, see Flatters 2000.

In the case of discriminatory trade liberalization, however, there is an additional effect. As a result of preferential treatment of partner imports, there is an incentive to source imports from higher cost partners rather than from their lowest cost international source. This *trade diversion* reduces tariff revenues with only a partial (or maybe no) offsetting cost reduction to consumers or industrial users of imported goods. The difference between the loss of tariff revenues and (smaller) reduction in import costs is a net loss to the economy.

Because of the potential for trade diversion, PTAs are economically inferior to non-discriminatory trade liberalization, and might actually be worse than no liberalization. A key consideration in engaging in a PTA, therefore, is to minimize the dangers of trade diversion. The potential for and costs of trade diversion are greater the higher are the costs of imports from one's trading partners, and the greater are the differences between preferential and non-preferential tariff rates.

Differences between a country's preferential and non-preferential tariff rates are much more controllable than are differences between costs of its PTA partners and non-partners. This has important policy implications. To maximize the benefits and minimize the dangers of preferential trade liberalization, a country should ensure that its MFN tariff rates remain as close as possible to preferential rates it offers to its PTA partners. If MFN rates are liberalized in parallel with PTA rates, trade diversion will not occur. Furthermore, under this strategy, a country's economic self-interest ensures that regional/preferential tariff reform is a major building block for multilateral trade liberalization.

Intra-Industry Trade and Deeper Integration

Trade liberalization – reduced tariffs, removal of non-tariff import barriers, and measures to improve trade facilitation – improves economic welfare by lowering the cost of imported goods. This is of direct benefit to consumers. However, the largest users of imported goods in most economies are producers, who import intermediate goods, raw materials and capital goods as inputs in domestic production. Trade liberalization, therefore, has a major impact on domestic producers by increasing competition and lowering costs in markets for their raw material and intermediate inputs. This is one of the important avenues through which trade liberalization improves international competitiveness of domestic producers in countries engaging in trade liberalization.

Intra-industry trade in intermediate inputs as well as final products has been a major source of the success of effective regional PTAs in both lesser and more developed regions of the globe. The EU and NAFTA have both had enormous success in facilitating integration of markets at all stages of manufacturing production. AFTA has been predicated largely on the goal of supporting the free trade of raw materials and components among member countries and with the outside world. The result has been specialization in production of components for sectors such as electronics and motor vehicles to increase not just the regional but more importantly the international competitiveness of these sectors. This is being achieved, not through inward looking industrial and trade policies and restrictive rules of origin, but rather through facilitating free and efficient trade in all industrial goods, and especially in raw materials and components.

Successful intra-industry trade of this sort requires far more than relaxation of tariff barriers. It requires much deeper economic integration, starting with domestic market institutions and strong, stable and transparent investment environments. For developing countries, this usually demands action on a broad range of areas aimed at improving market institutions and regulatory performance. Deeper integration requires the provision of trade infrastructure and services at international standards. This means regulatory reform and promotion of domestic and international competition; it requires world-class performance by public and private sector actors, from transportation companies to port and customs services.

Deeper integration and a broadened scope for intra-industry trade go hand-in-hand with open regionalism in making for successful, outward-looking regional integration.

Distribution of Benefits Among Members

Among the generally agreed findings about trade liberalization are:

- it is mutually beneficial to all trading partners (i.e. trade liberalization is a positive sum game) and
- small countries have more to gain from trade liberalization than do larger countries.

Furthermore, open trade regimes generally promote more rapid and equitable development of poor countries than do inward looking protectionist policies. However, as has been apparent in some of the preceding discussion, regional trade liberalization is sometimes more complex than unilateral or MFN-based multilateral liberalization.

There is considerable experience to suggest that regional/preferential trade liberalization has many of the same effects as non-preferential free trade, and in particular that it promotes the development interests of poorer countries. Spain, Ireland and Portugal have been major beneficiaries of European integration; the same is true of Mexico in NAFTA.

However, there are exceptions to these findings (see ch. 3.3 of World Bank 2000a and Venables 1999). Within regional groupings with richer countries, poorer members have benefited much less if they have lagged in implementing broader market-based domestic reforms. The absence of such reforms has reduced Greece's benefits from participating in the EU, and has caused it to lag behind the pace of European development. The lesson here is that trade liberalization, regional or MFN-based, is most effective when conducted in a market-friendly economic environment.

Within south-south regional agreements, there is a danger that the relatively poorer and less-developed members of the group might suffer at the expense of richer members. It is argued, for instance, that Tanzania and Uganda stagnated while Kenya derived most of the industrial development benefits from the East African Economic Community.

This asymmetry in the distribution of benefits from regional integration arises primarily from a combination of differences in structures of comparative advantage and policy-induced trade diversion. The argument is as follows. As less developed countries, the members of a regional PTA among poorer countries all tend to have a comparative disadvantage, relative to the rest of the world, in many manufacturing sectors. These are the same sectors that are often heavily protected in the member countries. Within the grouping, however, the relatively more developed members tend to have less of a comparative disadvantage in these sectors than the poorest members.

In these circumstances, the formation of a regional PTA can give rise to considerable trade diversion, in which members substitute imports of manufactures from other member states for imports that previously came from outside the group. With their relative comparative advantage in these sectors within the group, the richer members become the main source of these diverted imports. While this drives the richer members into trading and production patterns that are out of line with their global comparative advantage, there can still be a net benefit for them, arising from their increased access to intra-group markets. On the other hand, the poorer members can be made worse off as a result of this trade diversion of manufactured imports from low cost international sources to higher cost suppliers within the PTA.

Two conditions are necessary for this undesirable outcome of a regional PTA. First, the richer members must have a relative comparative advantage in all or at least most of the heavily protected manufacturing industries represented in the membership of the group. There is no natural reason for this to be the case. Second, there must be substantial differences between preferential tariff rates on these goods within the PTA and the external tariffs on imports of the same goods from the rest of the world. In an outward-looking PTA, in which regional integration is part of a general strategy for global integration, high external tariffs will be eliminated, and the general level of external protection will diminish in parallel with the process of regional integration. This is sufficient to prevent the type of harmful trade diversion described here.

For a small or poor country worried about the prospects of being harmed by participation in programs of regional integration, there is a simple lesson from all the cases considered here – make sure that regional integration does not get in the way of more important programs for global integration, MFN-based trade liberalization, and domestic market reforms.

4. Modern Trade Policies in a Global Economy

The focus of attention in this discussion is on policy issues at the national level. Despite vastly increased interdependence that has come with globalization in recent decades, sovereignty over almost all important policy decisions continues to reside with national governments. Membership in the WTO and in other bilateral and plurilateral agreements and organizations places some constraints on national decision-making. However, participation in such agreements is itself a sovereign national decision. Furthermore, these agreements still leave enormous scope for policy decisions at the national level on almost all important trade policy issues.

The simple conclusion of this paper is that globalization has not led to any qualitative change in the prescriptions for "good" trade policy. Outward looking trade policies are a key element of a strategy for sustainable and equitable development in the global economy. The standard policy prescriptions continue to hold. Countries should not distort production, consumption and investment incentives by utilizing non-tariff barriers to international trade – on imports or exports. Import tariff structures should be simple and transparent. A good tariff structure is one with low and uniform rates, and with minimal use of exemptions or special rates based on end uses or users. The tariff structure should be stable and should not be subject to influence due to the special pleadings of vested interests. Anti-dumping and other trade remedy measures should be utilized with extreme caution, and all decisions with respect to their use should take account of the interests not only of producers in the sector at hand, but also of domestic consumers and industrial users of these goods.

In negotiating international trade agreements with other countries or groups of countries, national governments should be guided first and most importantly by the national interest in liberalization of its own trade. Trade policy reform should not be delayed for fear of granting unnecessary "concessions" to other countries. Entering regional PTAs makes it even more important to proceed as speedily as possible with MFN-based tariff reductions, in order to avoid the dangers that arise from divergences between MFN and preferential rates.

In developing countries, import tariffs serve an important revenue-raising role due to the underdevelopment of capacities and mechanisms for collecting revenues from other sources. As revenue raising capabilities improve, countries are able to replace import duties with less distorting revenue collections from taxes on income and consumption. Income taxes raise particular difficulties in developing countries due to both the large share of incomes that are generated in kind of from owner-operated businesses, and due to the insufficiently developed accounting systems. Corporate income tax systems are often further compromised by the tendency to grant tax holidays and other similar incentives to attract foreign and domestic investment. Such incentives create a hole in revenue raising capabilities at the same time as creating costly, unintended and non-transparent distortions in investment incentives. (See Boadway, Chua and Flatters 1995 and Boadway, Flatters and Wen 1996.)

The goals of neutrality and of administrative transparency and simplicity in revenue collection call for simple tariff structures, with relatively low and uniform rates. As countries improve their domestic tax systems, it might even be possible and desirable to do away entirely with import taxes and rely entirely on a (higher) single rate VAT. A very large proportion of VAT collections in most tax systems, especially in developing countries, is collected initially at the border, and so share with import duties the administrative simplicity of border tax collections. Revenue neutral reductions in tariff rates and simultaneous increases in the VAT rate will reduce the anti-trade distortions imposed by import duties and almost certainly increase the neutrality of the overall tax system.

While the qualitative conclusions about trade policies are not changed by globalization, the quantitative implications of domestic policy decisions in this regard are almost certainly larger. Globalization has magnified the opportunities to participate in and benefit from international trade and investment. The rewards from following "good" trade policies are almost certainly greater in a more tightly integrated global economy. At the same time, the costs of bad trade policies are also greater in the era of globalization.

As indicated earlier, good trade policies are only one element in the set of policies required to promote sustainable and equitable development in a global economy. As is the case of trade policies, the benefits of good complementary policies are also magnified by globalization. Patterns and rates of long-term growth depend on levels and the efficiency of investment in physical, human and natural capital. Such investments are the underlying determinants of productivity growth. Regulatory frameworks that promote efficient capital markets, together with education, and environmental and resource management policies are critical to long-term development prospects. Good trade policies are a vehicle to ensure that the economy is best equipped to take advantage of the global opportunities for making use of such investments in the global environment.

5. Malaysian Lessons

Over the final quarter of the twentieth century Malaysia has provided an excellent model of how a country can benefit from globalization. The hallmarks of Malaysian policy have been

- liberalization of merchandise trade through elimination of NTBs, lowering and reducing the range of import duties, and streamlining customs, ports, and tax procedures for importers and exporters,
- openness to inward and outward bound foreign investment and creation of a stable market-friendly investment environment, and
- stable macroeconomic policies, characterized by prudent fiscal and monetary policies, a steadily improving and generally well designed and administered tax system, and an open and realistically valued exchange rate regime. (See Boadway 2001 for a more detailed review of tax policy issues.)

These macroeconomic framework policies have provided an environment that has encouraged foreign and domestic investment and provided a backdrop against which large private and public investments in education have been able to bear appropriate rewards for Malaysian citizens.

For its relatively small size, Malaysia has received a remarkable amount of attention on the world stage as a model of appropriate policy responses to globalization. This is especially true in developing countries, particularly in Africa, where the Malaysian model is held up as being especially useful for other small developing countries. Given the success of the Malaysian experience, this should not be surprising.

What is surprising and somewhat alarming, however, is that the Malaysian model is often held up as one for resisting the forces of globalization. While this is largely a result of the rhetoric surrounding Malaysia's "unorthodox" approach to the Asian financial crisis, the lessons being drawn are much larger. In many African countries, for instance, Malaysia is referred to as showing how a country can prosper by resisting the forces of globalization, and is used to justify targeted industrial policies, domestic and foreign capital market interventions and resistance to trade liberalization.

These are not the lessons that most persons would draw from the Malaysian experience over the past quarter century. In fact, if one were to look for negative lessons from Malaysia's experience, they would be exactly in the areas where Malaysia has engaged in targeted industrial policies, selective import restrictions and tax incentives, and capital market interventions aimed at frustrating and compensating for "adverse" effects of market outcomes.

Malaysia's success over the past quarter century provides a model for how to approach the new global environment of the "knowledge economy". Openness to trade and investment, continued development of market institutions, especially in capital markets, and continued investment in human capital provide the keys to continued growth of productivity and incomes in Malaysia. Repetition of earlier mistakes in selective industrialization and capital market interventions to fulfill the fantasies or special interests of particular groups would benefit these groups at the expense of longer-term national development. It would also provide the wrong example for poorer countries that look up to Malaysia as a model for policy-making in the global economy.

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