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Trade Liberalization and Economic Development

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Both developed and developing countries have substantially reduced trade barriers in recent decades, triggering a rapid integration of world goods markets. Yet, while economists and policymakers have often touted trade liberalization as an attractive policy, it is not well understood whether the impact of trade liberalization depends on a country's level of economic development.

This essay investigates the extent to which trade liberalization affects developed and developing countries differently. In particular, we examine whether exports respond differently to changes in trade barriers in rich and poor countries.

> The effects from trade liberalization depend on a country's level of economic development.

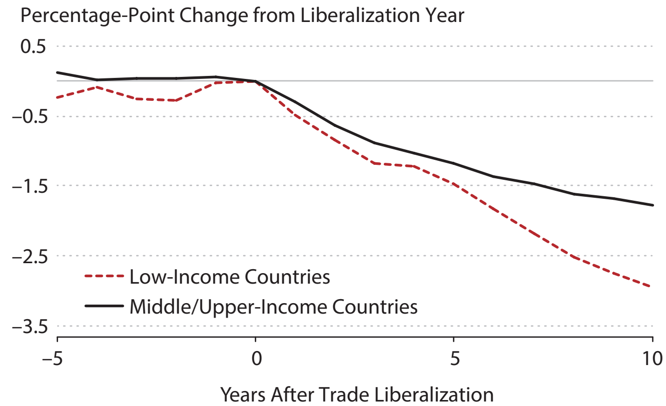
To identify trade liberalizations, we measure the average foreign import tariffs charged on a country's exports by each destination market. We use cross-country data from the World Bank, Organisation for Economic Co-operation and Development (OECD), and United Nations (U.N.) Comtrade over the period 1980-2006.

To illustrate our approach, consider the foreign import tariffs on U.S. exports. First, we measure the average import tariffs charged by each country that imports U.S. goods. We then weight the foreign import tariffs by the share of aggregate U.S. exports imported by each country.

Next, we identify episodes of trade liberalization based on a rapid decline in the average foreign import tariffs on a country's exports. In particular, we say that a country experiences a trade liberalization in a given year if the average foreign import tariffs on its exports declines at least 0.75 percentage points over the subsequent three years.[1]

Finally, we classify countries into two groups based on their level of economic development *in the trade liberalization year*: (i) low-income countries, those with real GDP per capita (in 2011 U.S. dollars) below $5,000, and (ii) middle/upper-income countries, those with real GDP above that threshold.[2]

Figure 1
Average Foreign Import Tariffs (percent)



SOURCE: World Bank, OECD, U.N. Comtrade, and authors' calculations.

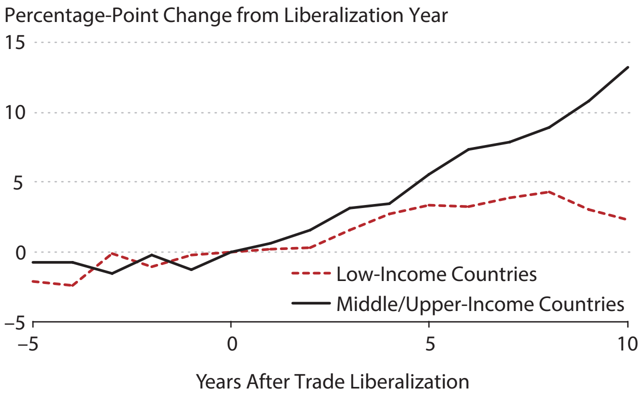
Figure 1 shows the average foreign import tariffs on the exports of each income group in trade liberalization episodes. The figure plots the change in average foreign import tariffs relative to the trade liberalization period (year 0) over the 5 years before and 10 years after trade liberalization episodes. The figure reports averages across a balanced panel of 19 middle/upper-income countries and 9 low-income countries.

First, observe that average foreign import tariffs on exports decrease during the first three years after trade liberalization in both income groups. This is true by construction, since we define a trade liberalization as a drop in tariffs. More importantly, tariffs are roughly flat in both groups in the period leading up to the trade liberalization. We interpret this change in the trend as evidence of the success of our strategy to identify trade liberalization episodes.

We also observe that low- and middle/upper-income countries experience trade liberalization of different magnitudes. In particular, average tariffs decline roughly 1 percentage point more in low-income countries than in middle/upper-income countries in the first 10 years after trade liberalization begins.

Figure 2 plots the export-to-GDP ratio for each income group from 5 years before to 10 years after trade liberal-

Figure 2
Exports/GDP (percent)



SOURCE: World Bank, OECD, U.N. Comtrade, Penn World Tables, and authors' calculations.

ization episodes. The figure indicates that the dynamics after trade liberalization differ based on a country's level of economic development. The export-to-GDP ratio increases by 13 percentage points for middle/upper-income countries but only by 2.5 percentage points for low-income countries over the period; this is despite the fact that average foreign import tariffs declined more in low-income countries than in middle/upper-income countries (see Figure 1).

This evidence suggests that the impact and potential gains from trade liberalization may differ based on a country's level of economic development. We speculate that financial underdevelopment, limited infrastructure, or limited human capital, among other characteristics, might hinder low-income countries and prevent them from scaling up production to sell internationally and take more rapid advantage of trade liberalization. Answering this important question will require further research, however.

Understanding the differential responses to trade liberalization across income groups is important for designing effective policies that allow low-income countries to fully benefit from openness to international trade. ■

Notes

[1] We focus on at least 0.75-percentage-point changes in average foreign import tariffs to ensure we observe a sufficient number of episodes to conduct our empirical analysis. If a country experiences multiple such episodes, we use the first episode.

[2] Our findings are robust to alternative classifications of countries by level of economic development.

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