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CAN FREE TRADE GUARANTEE REAPING THE GAINS FROM TRADE?

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A Teódula, por su collar y
las duchas de estrellas

RESUMEN

Las ganancias estáticas y dinámicas del comercio son las razones teóricas que explican por qué los países se embarcan en el libre comercio, esperando que éste promueva la industrialización y el crecimiento. No hay, sin embargo, nada en la teoría convencional del comercio internacional que garantice que dichas ganancias se materializarán y aún cuando lo hagan pueden no acelerar ni la industrialización ni el crecimiento. Esto porque existe un número de costos que la misma teoría omite o ignora. Ellos se refieren, *inter alia*, a los efectos monetarios de la especialización del comercio en la balanza de pagos, la pérdida de autonomía política y a la desindustrialización y el crecimiento sin empleo. Cuando los costos del libre comercio superan sus beneficios, la dilación del desarrollo económico es el resultado más probable. Para evitar esto, la intervención gubernamental es necesaria. En este trabajo, al contrastar las

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experiencias de México y China desde que se embarcaron en el libre comercio, los argumentos destacados son apoyados. Esta comparación permite destacar el tipo de políticas que economías en desarrollo abiertas, y las aún cerradas, deben implementar si desean garantizar las ganancias del comercio, alcanzando así el verdadero progreso.
Palabras clave: Libre comercio, ganancias del comercio, industrialización, intervención gubernamental, China, México
Clasificación JEL: F1, F13, F43

ABSTRACT

Static and dynamic gains from trade are the theoretical reasons that explain why countries embark in free trade, expecting this to promote industrialization and development. There is nothing, however, in the conventional theory of international trade that guarantees that these gains will materialise and even when they do so they might not accelerate industrialization and growth. This is because, there are a number of deleterious effects that the same theory omits and/or ignores. They refer to, *inter alia*, the monetary effects of trade specialization on the balance of payments, loss of policy autonomy, deindustrialization and jobless growth. When the costs of free trade overwhelm its benefits, the retarding of industrialization and development are the likely results. To avoid this, gradual openness and government intervention are necessary. In this paper, by contrasting the experiences of China and Mexico since trade liberalisation took place in these economies, the arguments mentioned are supported. The comparison sheds light on the sort of policies that both opened and still closed developing economies must currently implement if they want to reap the static and dynamic gains from trade, thus make real economic progress.
Keywords: Free trade, gains from trade, industrialization, government intervention, China, Mexico
JEL classification: F1, F13, F43

1. INTRODUCTION

According to the World Trade Organization (WTO, 2007), in 2006, nine out of the ten top economies that have the largest share of trade are developed. Their exports and imports accounted for almost 46% and for 49.3% of world's total exports and imports, respectively. Moreover, another ten advanced economies, from the sample of fifty, accounted for 10% and 9.9% on world's total exports and imports, respectively. Thus, overall, developed economies have the largest proportion of world trade. For this selected group of economies, one question is worthy asking: how did they make trade an engine of growth, industrialization and development?

The answer to this question can be traced in a sentence posed more than a century ago for the British economist Alfred Marshall: "The causes which determine the economic progress of nations belong to the study of international trade" (quoted by Thirlwall, 2003, p. 2). In effect, if one wants to understand how international trade aids growth, industrialization and development is necessary to study the way economies made trade an engine of these aims. Or more precisely, to study how they reaped the so-called static and dynamic gains from trade.

In general, the historical evidence indicates that to make trade an engine of economic progress economies, during the initial stages of their development, reaped the static and dynamic gains of trade applying policies detached from the conventional rhetoric of free trade. They instead used trade barriers to protect their infant industries from external competition. That is, they actively used, among others, trade and industrial policies, such as infant industry protection and export subsidies (see, for example, Amsden, 2001; Chang, 2002, 2003, 2004, 2007; Cruz, 2007; Lall, 2003, 2004). For this reason, "... historically, relatively high tariffs have accompanied major waves of industrialization" (Amsden, 2000, p. 1). Even today, in a globalise world, there is not developed country that does not apply some sort of industrial policy or argue to be totally opened. In this sense, paraphrasing Dobb (1975, p. 25), we live in an era of neo-Mercantilism.

If free trade was not the panacea for industrialization in advanced and new industrialized economies (NIEs), why developing economies insist embarking on (unfair) free trade. That is, how do they pretend to reap the gains from trade if they open their frontiers without being prepare to fierce competition, losing in this way not only employments but also economic policy autonomy and imposing additional restrictions to their process of industrialization and growth. That is to ask, in sum, why they follow dogmatically the conventional free trade theory. Today, one leading example in this regard is the Mexican economy. Since the mid 1970s, Mexico initiated its trade liberalisation strategy exactly as the conventional theory of trade indicates. However, since major trade reforms were implemented (in the mid 1980s) its economic progress has been paltry. The case of Mexico can indeed be generalised to those economies and regions that have applied (and are applying) dogmatically the strategy of rapid free trade liberalisation.

China started trade liberalisation almost at the same time as Mexico, however, and contrary to Mexico's experience, she has squeezed the gains from trade thanks to a strategy that has consisted, among others, in a gradual and thoughtful trade liberalisation coupled with industrial, technological, fiscal and monetary policies implemented and coordinated by the state. Her development strategy is in many ways a *déjà vu* of the strategies implemented by both advanced and new industrialized economies. As a consequence growth and industrialization have been impressive and poverty reduction has been substantial during the last quarter of a century.

The aim of this paper is to show, by contrasting Mexico's and China's road to globalisation, that the gains from trade, which to some extent explain the process of sustained growth, industrialization and development, cannot be reaped through market forces, namely free trade. To reap them, government intervention is necessary. The paper is structured as follows. In section 2, we present the conventional theoretical reasons that motivate an economy to embark in free trade and, at the same time, we stress some deleterious effects that the same theory omits. Then, in section 3, we argue, by presenting the Mexican experience of trade liberalisation, that this strategy has not been a

mean to attain industrialization and that indeed the costs of free trade have offset its benefits. We continue in section 4 exploring China's experience of trade liberalisation, showing that government intervention has been of paramount importance to make trade an engine of progress. Finally in section 5, we conclude presenting some policy suggestions that both opened and relatively closed developing economies can currently apply to reap the gains from trade.

2. FREE TRADE: GAINS AND COSTS

The standard recommendations emanated from the conventional rhetoric of international trade indicates that once an economy dismantles quantitative restrictions on imports, reduce import tariffs (and their dispersion), make the currency convertible for current account transactions, eliminate bureaucratic red tape and other impediments to foreign direct investment and improve customs procedures (Rodrik, 2006a), that is once the economy eliminates any government distortions, prices will reflect the correct cost of production and thus resources will be allocated optimally, that is where the country is resource-abundant. This will lead to increased specialisation. Eventually, the argument goes on, capital accumulation and technological progress (reflected in higher productivity) will rise as result of increasing competition. In the interim, the theory holds, the economy will exhibit an income and wage convergence with trade partners and also within the economy (in other words an improvement in the living standards is expected).

These are, in other words, the static and dynamic gains of trade. The desire to reap them represents the main economic reason that explains why economies embark on trade, through unilateral trade liberalisation and/or free trade agreements. In short, what countries expect is that trade becomes the paramount engine of growth, industrialization and development. The policy recommendation derived from this view, thus, is clear: the fastest the economy removes trade distortions, the sooner it will reap the gains from trade, leaving market forces accelerate growth, promote industrialization and improve the living standards of the population.

There are, however, several deleterious caveats (namely costs) with these static and dynamic benefits that must be taken into account when evaluating embarking on a strategy of free trade. Costs that the conventional theory of international trade (as well as the large number of empirical studies aimed at supporting conventional trade liberalisation) implicit or explicitly ignores and/or omits. First, the static gains, which arise from the allocation of resources from one sector to another as increased specialization, based on comparative advantage, takes place, are once-and-for-all. That is, the static gains of trade, once tariff and non-tariff barriers are removed, are exhausted (Thirlwall, 2003). In other words, the static gains are one-time improvements. Furthermore, they do not necessarily have a positive impact on the industrialization process. This is because, as comparative advantage (either based on the Ricardian or on the Heckscher-Ohlin model of trade) dictates, the specialization must occur in those goods with lower relative costs of production with respect to those of the world, which usually are those in which the country is resource abundant. If the economy under concern happens to be rich in labour and thus a labour-intensive producer, then it is condemned to specialize either in primary goods (whose terms of trade over time usually deteriorate against the manufactured goods ones and whose price and income elasticity of demand is low) or, alternatively, in the production of labour-intensive manufactured goods with very little domestic contribution in total value added. When this occurs, the country becomes a labour-intensive assembler of components.

Second, the essence of the dynamic gains of trade is that they shift outwards the production possibility frontier if trade is associated with more investment and faster productivity growth based on new technology, particularly through foreign direct investment (FDI).[1] Moreover, if production is subject to

[1] If the essence of conventional trade theory is to eliminate government distortions then the same theory is assuming that faster productivity through FDI can be attained by adopting a FDI-dependant-passive policy approach, which consists on "opening up to FDI and attracting investors to existing advantages –natural resources or cheap unskilled labour– for exports markets" (Lall, 2002, p. 80). The likely result, however, when adopting this approach is that there will be no incentives for domestic technologies to develop. In this approach, in other words, technology import is seen as a substitute of capability development.

increasing returns, export growth becomes a continual source of productivity growth. Also, export markets widen the total market for economy's producers. At the same time there is a stimulus to competition which is expected to improve productivity even further (Thirlwall, 2003, pp. 5-6). The central caveat regarding these dynamic gains is that nothing guarantees that all of them will occur. And even when they do so, there is not assurance that they will affect positively or accelerate significantly the process of industrialization.

On the one hand, effectively, trade makes exports markets widen, which in turn generates export growth. This might translate into a higher output provided exports are higher than imports[2] (needless to say that growing output does not necessarily imply industrialization, especially when this is not coupled with increments in sector's value added and employment creation), but the key point to notice here is that usually, in practice, transnational corporations (TNCs) are the main agents of export activity and their export dynamic might be not necessarily "harnessed" to the domestic producers. That is, if there is not a regulatory framework to link the tradable sector with local plants it is likely that domestic enterprises remain permanently out of international markets.[3]

Additionally, and also equally relevant, is the fact that "the expansion of exports does not necessarily indicate the growth in production capacity" (Shafaeddin, 2005, p. 6). This means that the increase in exports might not be coupled with a corresponding increase in manufacturing value added.

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[2] Recall that higher exports imply more import needs and in a free trade context there might be little incentive to satisfy the demand for inputs in the domestic market. This is certainly to occur if there are not domestic local content compulsory requirements on exports, if prices are cheaper abroad (through subsidiaries) and/or if there is a lack of local suppliers. As a result, the income elastic of demand for imports will grow, imposing a constraint on growth (see below Thirlwall´s law).

[3] A regulatory framework can include, among others, the approval for foreign investment projects, which are often contingent on technology transfer to domestic partners or the establishment of research centres, controls on the reduction of taxes, managerial autonomy, remittances of profits, external debt and equity finance, interference in supply chain management and product development, requirements to achieve a certain degree of local content and meeting the foreign exchange requirements through exporting.

Furthermore, "the evidence on international specialization suggests that developing countries are becoming increasingly similar to major industrial countries in the structure of their exports but not in the structure of their manufacturing value added" (UNCTAD, 2003, p. ix). Consequently "the presence of export-oriented FDI *per se* does not ensure the continue evolution of dynamic comparative advantage" (Lall, 2002, p. 80). Moreover, FDI is neither necessarily good for development nor it always is attracted in the form of *greenfield* investment (meaning investment in new facilities or the expansion of existing ones). (See Chang and Grabel, 2004 and Lall, 1995, for an interesting review about the complex effects of FDI and TNCs on industrialization). Besides, when the domestic conditions to attract *greenfield* investment have not been set out or improved (namely a highly educated labour force, good infrastructure, a strong and growing domestic market, a base of local service industries and suppliers, political stability and so on) it is likely that FDI will be attracted in the form of mergers or acquisitions.[4] The key point to stress here is that mergers and acquisitions might not add to production capacity (see Lall, 2002).

Third, and related to the point above, is the fact that, in effect, free trade can generate a stimulus to competition and make productivity to increase, but it will do so only when competition happens among companies that are similarly prepared. When large foreign firms *compete* with small domestic ones, the likely result will be either that the small firms will eventually disappear or they will be swallowed by the big ones producing a (new foreign) monopoly. This does not represent a step forward towards a competitive structure and as Lall summarises (2002, p. 78) "where countries have very different structural abilities to cope with free competition, a level playing field is to result in continuing and growing inequities" (see also Chang, 2007, in this respect). In the same line, technology transfer to domestic firms, which is expected to foster human, technological and administrative domestic

[4] This is particularly certain to occur if the economy is launching or is in the midst of a privatisation programme (in this sense it is likely that the flows of FDI will eventually decrease once the scope for more privatisation is negligible).

capabilities, might not occur or have very little positive effects if the host economy is unable to absorb it because, for example, the inadequacy of the technology or because the host country has poor domestic capabilities. On top of that, generally, it is not in the economic interest of TNCs to launch R&D, design and marketing in the host economy: "they are reluctant to transfer these to developing host countries because of the difficult learning and institutional linkages involved" (Lall, 2002, p. 85). In short, free trade through foreign investment might not produce a more competitive structure nor promote increments in productivity.

In sum, thus, as Thirlwall (2003, p. 6) points out "not all countries... necessarily share equally in the gains from trade. There is nothing in the doctrine of comparative advantage that guarantees an equal distribution of the gains from trade".[5]

But there is still more. Additional to the caveats just described, another important deleterious cost about the conventional trade theory is that it ignores, by assuming the balance of payments adjust itself automatically to equilibrium, the monetary consequences of the pattern of specialization and trade of individual countries. This effect is known as the balance of payments constrained growth, or the so-called Thirlwall's law.[6] This law states that if a country suffers a balance of payments deficit as a consequence of specializing in a range of commodities and the balance of payments cannot be rectified by relative price or exchange rate adjustment, then income will have to be forced to adjust to preserve equilibrium, implying an underutilization of real resources (Thirlwall, 2003, p. xi).[7] The underlying problems expressed in this law are,

[5] For an alternative criticism to the static and dynamic gains from trade see Geske (2000).

[6] In general, "...this rate of growth can be shown to equal the rate of growth of export volume (x) divided by the income elasticity of demand for imports (π)..." (Thirlwall, 2001, p. 82). Thus, the directions in which these variables move express the success or failure of an economic policy of industrialization.

[7] This law has been empirically supported for both developed and developing economies, suggesting that countries, in effect, grow at a lower rate than that with external equilibrium (see McCombie and Thirwall, 2004, which contains a variety of works aimed at studying Thirlwall's law; see also Santos-Paulino and Thirlwall, 2004, for evidence regarding the negative effects of trade liberalization on the trade balance in a number of developing economies).

on the one hand, that to sustain a growing demand for imports, exports need to grow as fast as imports or to recur to external borrowing. In the long term, this might not be sustainable. Thus, a restriction on growth is imposed by a continuous external deficit. The other problem is that this external deficit is explained precisely by the pattern of specialisation and trade. This means the sort of goods with high income elasticity of demand for imports and the commodities with low elasticity of demand for exports that developing countries trade.

Also, according to the conventional trade theory, it is argued that in the absence of free trade countries would attempt to exploit their international market power and the resulting equilibrium (trade war) would be inefficient for all countries involved. Free trade agreements, therefore, can be seen as a way to prevent a trade war (Maggi and Rodriguez-Clare, 2005). As a result, the theory recommends economies should embark on *reciprocal* free trade agreements, independently of their size and degree of development. The problem is that in these agreements developing countries are asked, as previously highlighted, "to expose their manufacturing industries to competition from more advanced and larger economies, potentially throwing those workers into unemployment, [but also]... to forgo attempts to promote their own... industries" (Stiglitz and Charlton, 2005). In other words, adopting a free trade strategy leads to a lost of policy manoeuvre to promote growth and industrialization (see Chang, 1998). Within the policy options that trade agreements restrict is the scope for management demand. This is so because it favours tight monetary and restraint fiscal policies in order to attain domestic and external equilibrium, aiming exclusively at maintaining inflation low and it also favours a low wage policy. Importantly, giving up management demand means switching off the main engine of growth as investment, which depends largely on the levels of aggregate demand, can not be stimulated any longer by monetary and/or fiscal policy (see Bhaduri, 2002). Absence of management demand also leads to a lower capability to avert the inherent downswings and upswings of the business cycle, meaning a major exposure to domestic and external volatility (see Stiglitz, 2003, and Shafeiddin, 2005). Finally, by abandoning the management of demand, the scope for allocating

resources to productive projects and/or potential industries is dramatically constrained. As can be deduced, in sum, "a trade agreement that would restrict the policy options of developing countries is not the best to promote long-term industrialization" (Stiglitz and Charlton, 2005).[8]

Finally, free trade has been seen as a source of the closely-related phenomena of premature deindustrialization and "jobless growth".[9] Premature deindustrialization means that the share of the (valued added) manufacturing sector in GDP and the share of the sector in employment start to decline persistently without recovering at lower levels of per capita income than those observed historically in advanced economies.[10] Deindustrialization is considered to be a normal phenomenon in the process of development of any economy, thus the sources of it have been associated with differentials in the growth rates of productivities in the manufacturing and services sector and differentials in the composition of demand, that is a shift in the demand away from manufactures toward services (see Rowthorn and Ramaswamy, 1999). Premature deindustrialization, however, is a more complex phenomenon with different sources causing it. One of them has been the switch of policy regime occurred in both advanced and developing economies from "keynesian interventionist inward" policies to "trade liberationist outward oriented" ones (Palma, 2005b). In the particular case of developing economies, as result of the strategy of rapid trade liberalisation introduced since the mid 1970s, there has been a re-orientation in the production structure of the economy towards either the production of primary goods or low skilled manufactured goods

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[8] In a recent study, Egger *et al.* (2007) show that, in any case, bilateral liberalisation is mostly preferable for countries with similar capital to skilled labour ratios, suggesting then that free trade agreements between countries of different degree of development does not promote higher welfare.

[9] It is important to recall that, as Geske (2000, p. 1567) highlights, if industry matters for development then the issue "of the impact of trade liberalization on industry is relevant and legitimate".

[10] This phenomenon has normally taken place when the country has reached a certain level of development in terms of income *per capita*, usually between US$10,000 and US$12,000, but now it is happening at levels of US$3,000 (see Shafeiddin, 2005, and Dasgupta and Singh, 2006).

(namely final labour-intensive assembly), exploiting mainly static comparative advantages, and as a result there has not been incentives for the manufactured valued added to increase. Thus, despite deindustrialization might be a normal response to changes in tastes and technology it might not be the case when is the result of dramatic policy changes. It is worthy noting, finally, that the fact that deindustrialization occurs at low levels of income per capita might imply that much of the excess of labour in agriculture will remain either in agriculture or will inevitable end up in low-productivity informal manufacturing and informal services. This might be reflected in the phenomenon of "jobless growth" (Dasgupta and Singh, 2006).

As can be deduced from what has been argued, free trade as recommended by the conventional theory is far from being a straightforward road to the status of developed economy. Despite that it is, in effect, a benevolent force able to promote industrialization, generate growth and alleviate poverty, it also entails harmful costs, which in fact can offset its benefits when is leave it exclusively to market forces. Additionally, it also imposes restrictions on growth and might rather lead to deindustrialization. For these reasons, free trade should not be seen as a mean but as an end. For latecomers economies the real question that they must ask is not whether to trade, but what and how to trade. Countries that have made themselves this question have put free trade within a well structured strategy of growth and industrialization, liberalising gradually and thoughtfully, meaning that they have done it according to the maturity of their productivity structure and, more importantly, have coupled the strategy of gradual trade liberalisation with industrial, fiscal, monetary and technological policies (designed and coordinated by the state) aimed at developing the human and capital structure (namely the domestic technological capabilities) to compete in international markets, thus maximising the benefits of trade.

Economies that have not made themselves the question posed above today are farer from industrialization that they were before trade liberalisation. They have liberalised very rapidly (seeing this strategy as a correction for past mistakes, namely the use of protectionist policies, but generally never achieving

pre-reform performance in terms of industrialization, growth and development) in the belief that the rhetoric of free trade will be mirrored in the reality, and in doing so, giving up the arsenal of policies that allow an economy to climb up the ladder to the rankings of developed economies. One clear lead of this is Mexico. This economy has dogmatically applied a strategy of rapid trade liberalisation.

If conventional trade theory were to work in the real life as it does in the textbook, then by now Mexico there would be enjoying the static and dynamic gains from trade and joining the ranks of the more advanced countries with solid growth, stability and prosperity. Nothing more distance from this rosy picture that the crude reality: Mexico is today still far from joining the ranks of developed economies and has, on the contrary, made little economic progress since trade liberalisation took place. But why did free trade has not been for Mexico a straightforward road to industrialization and development? The answer to this question is the topic of the next section.

3. MEXICO'S TRADE LIBERALISATION STRATEGY: BENEFITS AND COSTS

Mexico's new strategy of *industrialization* started in the mid 1970s, when it underwent its first major economic post 1950s crisis. As a result, Mexico's initial (unilateral) steps towards trade liberalisation were included in the list of recommendations of the IMF's and the WB's stabilisation and adjustment programmes (see Bazdresch and Levy, 1992). The strategy of trade liberalisation was intensified during the 1980s as a consequence of the incidence of more frequent and dramatic economic crises[11] and thus more conditional assistance from these international institutions. As a consequence, since 1985, Mexico

[11] Mexico underwent two major economic crises during the 1980s. The first one in 1982, the so-called debt crisis, and the second one in 1987 due, among other things, to an international financial market crash.

started to implement major economic reforms, intensifying markedly trade openness. For instance, it signed a bilateral trade agreement with the USA, compromising to eliminate subsidies to exports and in 1986 joined the General Agreement on Tariffs and Trade (GATT). Furthermore, in 1987, some licences for imports were eliminated (Moreno-Brid *et al.*, 2006). Moreover, a soft regulatory frame for FDI was approved and in 1993 a new law for foreign investment was launched. In 1992 Mexico signed a trade agreement with the USA and Canada (the NAFTA), which came into effect in 1994. Mexico joined (as founding member) the WTO in 1995. Between 1993 and 1997, Mexico unilaterally eliminated most-favoured-nation tariffs on over 1,200 products; the number of duty-free products increased from 414 in 1993 to 1,658 in 1997. This tariff elimination primarily concerned inputs and machinery used in the agricultural, chemical, electrical, electronic, textile and publishing sectors (WTO, 1998). By 1998, there is a general consensus that trade liberalisation has been completed in the manufactured sector.[12] Table 1 illustrates how rapidly the strategy of trade liberalisation took place.

Today, Mexico is one of the most liberalised developing economies. It has special trade relations with forty-three countries around the globe which translates into twelve free trade agreements. As a result of this trade liberalisation, measured by its trade size, Mexico is currently within the first fifteen economies in the world and its ratio of trade to GDP (a gross measure of trade liberalisation) more than doubled from the mid 1980s to the mid 2000s, going from 26% in 1986 to 65% in 2006.[13] The relevance of trade in the economy thus cannot be exaggerated. However, as we pointed out earlier,

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[12] See also Moreno-Brid *et al.* (2005) for a more detailed description of Mexico's trade liberalisation process.

[13] If the ratio of trade to GDP is indeed taken as a measure of trade openness (thus economic success within the conventional view) then it is worthy asking why high income OCDE members despite having remained relatively closed (their trade openness ratio has never been higher than 44% during the period 1980-2004) have kept registering increasing levels of industrialization and development.

TABLE 1

Mexico's imports tariffs 1985-94 (%)

	1985 June	1985 December	1986 December	1987 December	1988 December	1989 December
Domestic production value covered by import licensing	92.2	47.1	39.8	25.4	21.3	19.8
Production-weighted tariff averages	23.5	28.5	24.5	11.8	10.2	12.5
Domestic production value covered by official import prices	18.7	25.4	18.7	0.6	0.0	0.0

NAFTA's Tariff Elimination Schedule

Group A	Duties on goods of this category shall be eliminated entirely and such goods shall be duty-free, effective 1st January 1994.
Group B	Duties on goods of this category shall be removed in 5 equal stages beginning on 1st January 1994, and such goods shall be duty-free, effective 1st January 1998.
Group C1	Duties on goods of this category shall be removed in 10 equal stages beginning on 1st January 1994, and such goods shall be duty-free, effective 1st January 2003.
Group C2	Duties on goods of this category shall be removed in 15 equal stages beginning on 1st January 1994, and such goods shall be duty-free, effective 1st January 2008.
Group D	Goods shall continue to receive duty-free treatment.

Source: Pacheco-Lopez and Thirlwall (2004).

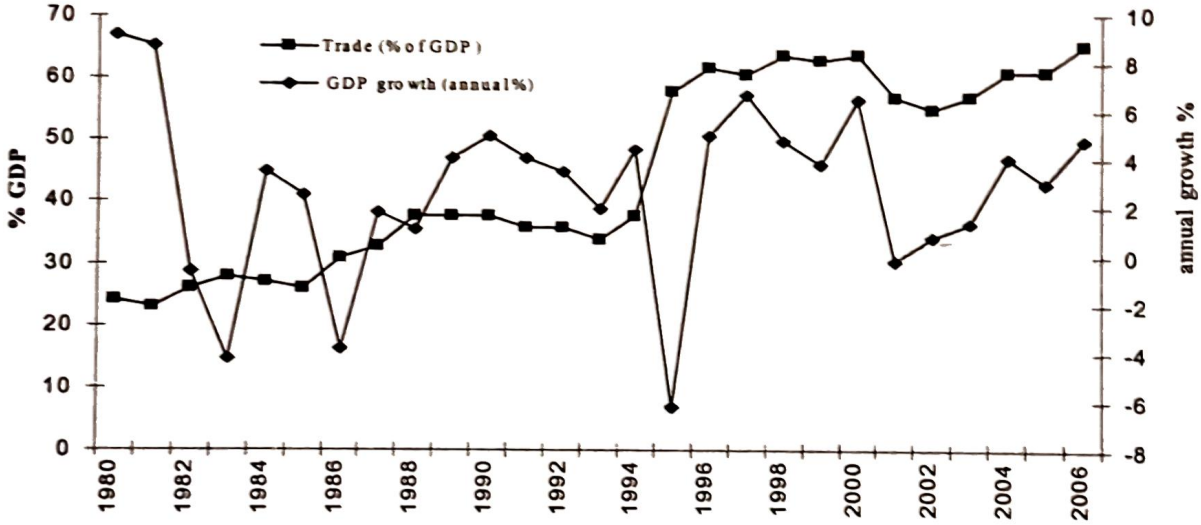
the period of trade liberalisation has been associated with a poor, indeed a very disappointing economic evolution (see graph 1).

Let us take two simple macroeconomic indicators to have a broad idea, though very illustrative, about the poor economic evolution of Mexico since trade liberalisation. The average rate of economic growth during the period 1982-2007 was 2.4%. This reflects a large step back in relation to the average rate of economic growth, 6.8%, attained when the economy was regulated, immerged in a import substitution strategy and where the government had a

large participation in the economy, that is, the period from 1961 to 1981. In terms of per capita GDP, the resulting comparative evaluation is even more disappointing. During the period 1982-2007 it grew at a pathetic rate of 0.77%. This rate largely contrast with the one of the pre-openness period, 3.7%, in which, by the way, population growth was much higher than during the last 25 years.[14]

GRAPH 1

Mexico's trade and GDP evolution, 1980-2006



Source: WDI online.

Given this background, we now show that the failure of Mexico's free trade strategy has been, as stressed in section 2, that its risks have materialised, producing higher costs than benefits and imposing further restrictions on growth, industrialization and development.

[14] If the Mexican economy is compared in these terms with others, particularly the Asian ones: the tigers and India, which, by the way, none is a straightforward story of export growth achieved through trade openness and free market forces (Rodrick, 2006a,b) the picture is even more depressing. From this it can be concluded that a quarter of a century has been simply wasted.

TRADE LIBERALISATION BENEFITS

Two are the main visible benefits that the Mexican economy has registered since trade liberalisation started (and which are in accordance with the conventional trade theory). They are export growth, particularly manufacturing growth export, and the raising share of FDI in the economy. On the one hand, in effect, exports have increased substantially. Not only the rate of growth of exports have showed an outstanding dynamic, growing at an average rate of 10.5% during the period from 1981 to 2007, but also the participation of exports in total output has been impressive, going from around 10% of GDP in 1980 to around 30% since the mid 1990s. Particularly important is that within this export dynamic, manufactured exports have played a key role. Since trade liberalisation began, Mexico's manufactured exports have grown at an average rate of 15% (1982-2007) and since NAFTA took place, this rate has been of 13.1%. Indeed one of the highest rates among developing economies. Moreover, since the early 1990s manufactured exports represent more than half of total exports and currently they account for around four-fifths. Furthermore, as proportion of total manufactured exports from developing economies the Mexican ones represent 12%, just after China, Korea and Taiwan and above Singapore (Palma, 2005a). In fact, in 2006 Mexican manufacturing exports share in total world market was 2.3%, closed to those of economies like Canada and Singapore but above of Switzerland. At the first glance, then, one could argue that the Mexican economy has shifted from being a primary export producer to one that exports highly value added commodities. We will see that this conclusion is deceiving.

The second major positive impact of trade liberalisation is that related to an increasing participation of FDI in the Mexican economy, which is in turn the cause of the high export dynamic highlighted above. Particularly from the early 1990s, FDI grew mainly due to the aggressive privatisation programme implemented by the government in these years. As a consequence, it rose from around 1.5% of GDP in the early and mid 1990s to reach 4.4% of GDP in 2001 (coincidentally when the programme of privatisation halted). Mexico, in fact,

has been one of the major recipients of FDI in the developing world (just lagging behind China, India and Brazil). Importantly, the manufactured sector absorbed 53% out of the total FDI that arrived during the ten year period 1994-2004 and it concentrated in three sub-sectors: metal commodities (48%), chemical commodities (16%) and food, beverages and tobacco stuff (18%). (Moreno-Brid *et al.*, 2006, p. 105).

With these superb positive benefits derivate from free trade, which are very similar or in some cases superior to those attained by some NICs, as we stressed, one would expect to see Mexico in the ranks of developed economies. However, as we pointed out in the previous section, behind these significant positive impacts, there are costs that have offset the benefits of free trade and additional restrictions have been imposed on Mexico's economic growth. All this can be observed on the evolution of the balance of payments, particularly the current account, the fall of total factor productivity, loss of policy autonomy to pursue development objectives and the phenomena of premature deindustrialization and "jobless growth".

TRADE LIBERALISATION COSTS AND FURTHER RESTRICTIONS ON GROWTH

Graph 2 shows the current account balance evolution during the period 1980-2006. It is clear that it exhibits, with the exception of only four years during the early 1980s, a permanent and some times very large deficit. This continuous external deficit has been mainly the result of, on the one hand, the growth of imports, whose evolution has been pretty similar to that of exports (11.1% during the period 1982-2007). This massive growth of imports has been basically due to the needs of manufactured exporters (mainly "maquila") for imported manufactured inputs. Given the fact that policies aimed at imposing domestic content requirements on exported final goods were eliminated and given the absence of a regulatory framework to create backward and forward linkages with domestic producers as well as the lack of local suppliers, exporters (that is TNC's whose share in total exports is at

least of two-thirds; UNCTAD, 2002)[15] found it more convenient to import most of their inputs needs (see Pacheco-Lopez and Thirlwall, 2004). Palma (2005a, p. 951) illustrates this clearly when he points out that in 2001 Mexico produced no less than 30 millions TV sets, 90% of which were exported to the USA, but 98% inputs of these TV sets were either direct imported or indirect ones (meaning inputs that are supplied by other foreign firms operating in Mexico, which themselves import all most of their inputs). Today, manufactured imports represent around 95% of total imports. This implies a dependence of exports on imported inputs. As a result of this, the income elasticity of demand for imports has more than doubled during the last fifteen years, going from 1.2% to around 3%. This fact has clearly imposed a restriction on Mexico's growth speed and rate: for every percentage point that the Mexican economy grows, the demand for imports triple (Moreno-Brid *et al.*, 2006). To fulfil the foreign exchange requirements, either exports must grow at the same rate as imports or the economy must incur in increasing foreign debt, which usually is unsustainable in the long term (Pacheco-Lopez and Thirlwall, 2004).

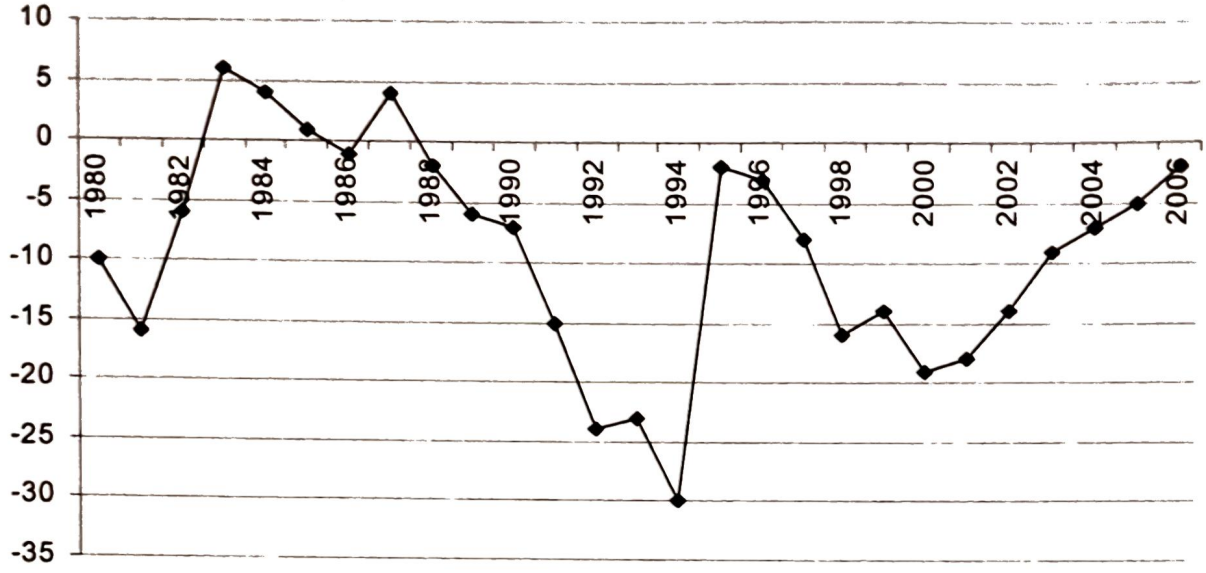
Moreover, the continuous deficit on the external balance is also due to a leak of foreign exchange through the payment of royalties, management fees, interest, and the overseas repatriation of profits. Again, due to the lack of controls to prevent these leaks, it has been easier and profitable for TNCs simply send their money back home.

Regarding, productivity, as we have highlighted, it is expected that trade liberalisation will, via competition, increasing returns to scale and FDI technology transfer, increase it. However, in the Mexican experience, this variable which is essential for growth and a successful export-led growth strategy has decreased since trade liberalisation was adopted. According to the IMF (2006) and ECLAC (2004) total factor productivity has decreased

[15] There is only a limited share of Mexican firms exporting to the USA and they export mainly commodity and low value-added manufacturing products (IMF, 2006). According to Dussel (2002) during the period 1993-1998 a small proportion of the domestic economy (6.6%) had participation on total exports.

GRAPH 2

Mexico's current account balance, 1980-2006, US $billions



Source: WDI online.

0.5% during the period 1980-2003, indicating that its contribution on growth has been negative (see table 2).[16] So, despite the high manufactured export growth, which implies the production of high valued commodities, practically none of the Mexican exports are produced with Mexican technology. In fact, the Mexican total value added contribution on most of manufactured export industries is negligible (see Palma, 2005a). Moreover, Mexico's manufacturing value added as a proportion of GDP has consistent and dramatically declined since 1988, reflecting that despite the structure of its exports reflects those of

[16] Furthermore, according to Romero *et al.* (2005) the rate of growth of Mexico's labour productivity has been -0.3% during the same period. This study also concludes that some manufacturing sectors, such as the automobile, that enjoyed a certain degree of protection and the benefits of an industrial policy, were the only ones that reported increases in productivity. See Karacaovali (2006) for a study regarding why protected sectors in the economy might end up with higher productivity that sectors that have not enjoyed protection.

industrial countries, the structure of its manufacturing value added, which is relevant for industrialization matters, remains one of a developing economy. This suggests that neither technological transfer to local partners has occurred in the way the conventional trade theory holds nor there has been an even level playing field that could promote competition and create more efficient companies. Furthermore, according to Moreno-Brid *et al.* (2006) and Dussel (2006) the increases in productivity that have been observed in some industries of the manufactured sector have been the result of employment reductions. In this sense, Mexico has become simply in an assembler of components and through the time has increased its technological dependence[17] and maintained its comparative advantage exclusively based on cheap unskilled labour.

Paradoxically, the WTO (1998) proudly states that "Mexico's trade policy is closely associated with the promotion of foreign investment flows". This organisation, however, misses to point out that Mexico has used a FDI-dependant-passive approach (exploiting mainly cheap unskilled labour) to attract foreign investors. As we previously stressed this approach does not ensure the evolution of dynamic export advantage, meaning increments in productivity.

Regarding whether the Mexican economy has been experiencing premature deindustrialization, the empirical evidence indicates that the share of manufactured value added in GDP, as we pointed out, has been steadily declining since 1988, when it fell around 3% with respect to the previous year. At the same time, though there is not complete information for the whole period 1980-2006, there is evidence that suggests that the share of manufacturing employment in the sector in the most optimistic case has remained steady, but during the period 2000-2005 has sharply decreased, going from 22.5% in 2000 to 18.5% in 2005. All this in a context where annual per capita income has not reached US$10,000 yet. At the same time, the number of workers that have joined the informal sector has soared, going from 4.7 millions on the 1980s to

[17] In Mexico, for example, every year around six thousand patents are registered, from those only 5% is from Mexicans.

TABLE 2

Mexico's sources of growth (annual percent change)

	Output	Output per worker	Contribution of: Physical capital per worker	Factor productivity	Factor productivity	Physical capital per worker
			In percentage points		In percent of total	
1965-1979	6.5	2.9	0.8	2.1	72	28
1980-2003	2.6	-0.4	0.1	-0.5	125	-25
1996-2003	3.5	1.1	0.4	0.7	64	36

Source: IMF (2006).

11.7 millions the 1990s to further reach 15.7 millions on 2000 (Godinez, 2004). Moreover, even if one were to attribute the (poor) economic growth to the impressive export growth during the period 1982-2007, it is worthy noting that it has been coupled with growing unemployment. The rate of unemployment in the midst of fully trade liberalisation (that is in 1992) was 2.8%, fifteen years later, in 2007, when trade liberalisation is a reality the unemployment rate is one percentage point higher, 3.8%. Importantly, had the annual average 400 thousand Mexicans since 2000 not emigrated (mainly to the USA) the unemployment rate would been much higher. Thus, even when the dynamic of the trade sector has been outstanding, not enough jobs have been generated to satisfy the growing demand for employment. The main explanation of this is that big companies (mainly TNCs) concentrate around 90% of total exports. This is to say that a large minority of medium and small companies, which, among other things, employ around 70% of the labour force, have no access (and have not accessed) to international markets. Trade liberalisation, in other words, has not had an important effect on employment creation. For the period 1993-98, the activities and firms that concentrate around 93% of total exports absorbed only 5.6% of the labour

force and they created only 13.5% of total employment (see Dussel, 2002).[18] As the evidence shows, and Palma (2005a) stresses, market forces have missed on "harnessing" the trade sector with the domestic economy. The evidence in sum suggests both premature deindustrialization and "jobless growth".

Last but not least important has been that the embracement of free trade has reduced the scope to and the autonomy for the pursuit of growth and developmental goals. In the first place, industrial and trade policies were subordinated to narrow macroeconomic priorities, such as fiscal budget and low inflation (in this sense management demand, that is monetary and fiscal policy, lost its pro-growth and counter cyclical objectives. Capital accumulation, consequently, has grown at very low levels (see table 2). Secondly, industrial policy was implemented in a horizontal way, meaning that the (low) existing resources were distributed without given sectors' priorities (Dussel, 2002). Third, as we pointed out previously, tariff and non-tariff barriers were dramatically reduced, eliminating scope for trade policies. Finally, the elimination of controls of capital flows has led to exchange rate instability and the implausibility to use the monetary policy and the financial system to support and promote domestic investors.

It is clear from the evidence presented that for Mexico conventional rapid trade liberalisation and market forces have been unable to guarantee reaping the gains from free trade. The minimalist state-intervention approach adopted has rather led, as we have showed, to the opposite results.

Today's developed countries and NIEs have reaped the gains from trade by liberalising gradually and at the same time their governments have deployed the rest of their policies according to their infant industry promotion (see Chang,

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[18] But no only the quantity of employments has been below the country's needs, also the quality of these employments has not increased. The wage per hour measured in US dollars in the manufactured sector has increased just 60 cents in 12 years, going from US$2.1 in 1993 to US$2.7 in 2005. Furthermore, the minimum real wage has dramatically fall (around 70%) since 1980. It is ironic, as Palma (2005a, p. 953) stresses, that "Mexican wages are trying to equalize them to those of its competitor (China, and Brazil) rather with those of its trading partner (USA)". (See also Mesquita Moreira, 2007, p. 361, for further evidence).

2002, 2007). In order to have a most recent example of this, in the next section we briefly illustrate how China reaped the gains from trade. China has indeed followed a trade liberalisation strategy that resembles (though of course is not equal) to that applied for today's advanced and new industrialized economies.

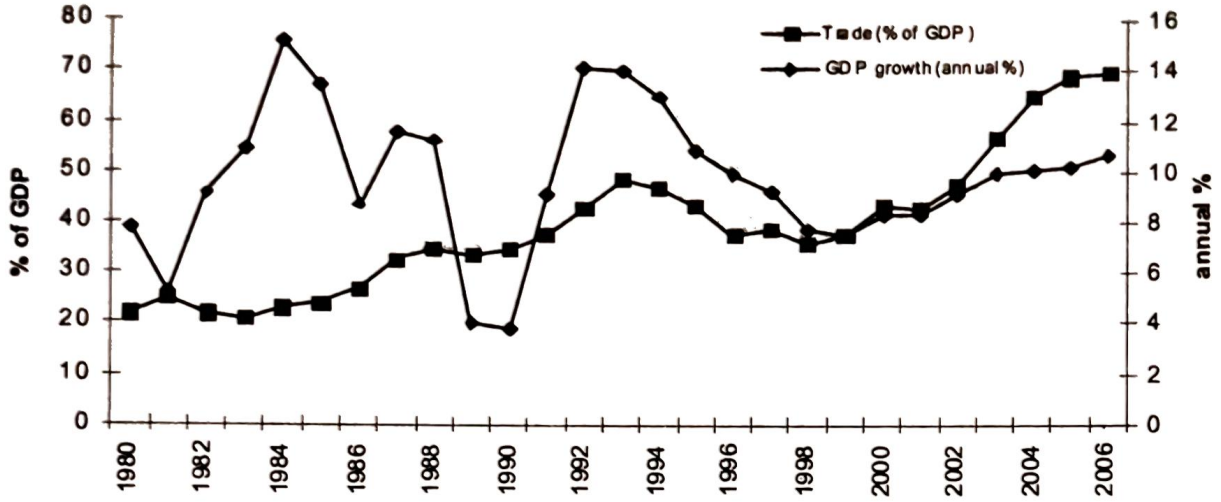
4. CHINA AND TRADE OPENNESS: A NON-CONVENTIONAL STORY

China's insertion into global markets started in 1978, virtually at the same time of Mexico's, when she began trade liberalisation reforms. However, in this case the progress of the trade reforms were neither simple nor straightforward (see Branstetter and Lardy, 2006, p. 4) and "significant reforms lagged behind growth... by at least a decade or more" (Rodrik, 2006a, p. 3). Importantly, trade reforms were not the result of the IMF´s or the WB´s impositions but of a change in the presidency of the Communist party (see Meza Lora, 2006). The view and pragmatism of the new Chinese leader, Deng Xiaoping, regarding the aim of the reforms can be summarized in his famous remark "it does not matter whether the cat is white or black as long as it catches mince" (quoted in Chang, 2007, p. 121). As a result, trade has become a real source of economic progress (see graph 3). Economic growth registered an impressive average rate of practically 10% from 1979 to 2007. Couple with this, per capita income has grown at a very high rate, 8.1%, and consequently there also has been poverty alleviation. This gross picture of China's economic evolution post (gradual) trade liberalisation contrasts with her pre-reform performance. During the period 1961-78, for example, GDP grew at an average rate of 5.1% whereas income per capita did it at the 3% rate. These figures, though no disappointing, were well below the country needs.

But, how did China exactly make trade an engine of economic progress? In other words, how did she reap the gains from trade? To begin with, as we mentioned, there is a consensus in the literature that China is not a straightforward story of growth and development achieved through trade

GRAPH 3

China's trade and GDP evolution, 1980-2006



Source: WDI online.

openness and free market forces. It is rather the story of a country that, as Rodrik (2006a, p. 1) states, applied "its own brand of experimental gradualism". The gradual process of trade openness is well illustrated by the evolution of China's import tariffs (see table 3). As can be seen, the average rates prevailing from the early 1980s until the early 1990s, though decreasing, were clearly those of a highly protected economy.[19] Furthermore, it was in 1999, prior to China's WTO accession and in the midst of the talks of the trade agreement with the USA, that she agreed to lower average tariff levels on industrial products to 8.9%. This gradual process was to some extent led to its extreme until very recently in 2005 when China agreed to eliminate all quotas, licenses, tendering requirements and other non-tariff barriers to

[19] Importantly, China's average rate, which is well above 40%, is similar to the one the US maintained on the manufactured sector during more than a century, from 1820 to 1931, when this economy was in its process of development (see Chang, 2002, p. 17). Even other advanced economies at the time (such as France, Germany or Italy) kept tariff imports as high as 25% by 1913. For the US it was 33% (see Bairoch and Kozul-Wright, 1998, p. 44).

imports of manufactured goods (Branstetter and Lardy, 2006). In sum, what took place in China was a "complex and highly restrictive set of tariffs, non-tariffs barriers and licenses" (Rodrik, 2006, p. 3).

What is important to notice within China's strategy of growth, industrialization and development is that she did not rely exclusively on tariff protection and its gradualism to prevent the static gains from trade were once-

Table 3

China's import tariffs (%)

	Unweighted average	Weighted average	Dispersion (SD)	Max
1982	55.6	...	...	...
1985	43.3	...	...	...
1988	43.7	...	...	...
1991	44.1	...	...	...
1992	42.9	40.6	...	220.0
1993	39.9	38.4	29.9	220.0
1994	36.2	35.5	27.9	...
1995	35.2	26.8	...	220.0
1996	23.6	22.6	17.4	121.6
1997	17.6	16.0	13.0	121.6
1998	17.5	15.7	13.0	121.6
2000	16.4	...	...	...
2001	15.3	9.1	12.1	121.6
2002	12.3	6.4	9.1	71.0

Source: Prasad (2002, p. 10).

and-for-all, guarantee the dynamic ones were achieved, avoid restrictions on growth, maintain policy autonomy and grow rapidly. To attain all this, she applied (and applies) the arsenal of policies such as industrial, exchange rate, technological, fiscal and monetary aimed at creating the infrastructure (human and capital) that allow trade became a real engine of growth and industrialization. That is, China promoted infant industry in a way that resembles that applied for today's developed economies. Moreover, the government was (and still is) the main and most active agent of industrialization and growth. Only in this way, reaping the gains from trade (or put it in another way, maximising its benefits and reducing its costs) has been guaranteed.

A DÉJÀ VU STRATEGY OF REAPING THE GAINS FROM TRADE

To guarantee technological transfer, increments on productivity and promote a competitive structure (that is to reap the dynamic gains from trade) the policy stance towards FDI was gradual and maintained important restrictions during a number of years. Within these restrictions there were the approval for foreign investment projects, which were often contingent on a regulatory framework that include technology transfer to domestic partners or the establishment of research centres, controls on the reduction of taxes, managerial autonomy, remittances of profits, external debt and equity finance, interference in supply chain management and product development, requirements to achieve a certain degree of local content and meeting the foreign exchange requirements through exporting. Importantly, many of the foreign firms targeting the domestic market were forced to form joint ventures with a local Chinese firm (in mobile phones and computers, for example), particularly a state owned enterprise (SOE). In this context, the domestic market (both its size and potential growth) was highly used as the "carrot" to attract TNCs[20] and eventually leading companies resulted

[20] Also, of course, fiscal incentives were offered (*i.e.* zero taxes for a number of years). Importantly, however, is the fact that local firms also benefited from this regime thanks to the so called "round-tripping", that is, "local capital that goes abroad and then returns disguised as foreign investment" (Mesquita Moreira, 2007, p. 364).

from joint ventures between foreign and domestic firms. It was until 1986 when there was a major regulatory change in FDI, dubbed as the "22 Regulations" (Branstetter and Lardy, 2006). This regulatory change represented an important lift in the previous restrictions, and as a consequence FDI increased in 1988 to reach around 1% of GDP. This tendency remained during the rest of the decade until 1993 when it reached 6.2% of GDP, a record figure. The growing inflows of FDI suggest that their adequate regulation did not stop China from accumulating large stocks of FDI. Furthermore, the measures imposed by the government represented explicitly its bargaining power capacity and implicitly the maintenance of its policy autonomy to achieved industrialization objectives. In this regard, the bargaining power was always used pursuing a clear objective: fostering domestic capabilities by ensuring the transferring of technology to domestic firms (Lall, 2003). In the fostering of domestic capabilities there was also important the "weak enforcement of intellectual protection laws [that] enabled domestic producers to reverse engineering and imitate foreign technologies with little fear of prosecution" (Rodrik, 2006a, p. 18). In this sense, China used a FDI-dependant-targeted policy approach "which involves strong and targeted interventions by the host government, both to direct FDI into higher value activities and to raise the quality of domestic factors, suppliers and institutions" (Lall, 2002, p. 81).

It is important to mention that the likely penalizing effects of high import tariffs, the exchange rate controls (see below) and the restrictions on FDI on export and output growth, were neutralised, among others, through rebates of taxes, duty free import on capital for export processing, incentives for export investment projects as well as credit allocated by the government to support export growth. These measures did indeed boost export growth, particularly during the 1990s. Exports soared from less than 10% as a fraction of GDP in the mid 1980s to more than 30% since 2003. Unlike the Mexican experience, China's export booming has translated into a "harnessed" economic growth, even though TNCs have been the drivers of this export performance (in 2003, they accounted for 55% of exports and 19% of industrial value added, but local firms respond to nearly half of total exports and nearly 80% of

industrial value added; Mesquita Moreira, 2007). Furthermore, export boom and economic growth have been coupled with job creation. Unemployment rate fell from 5% in the late 1970s to almost 3% in the mid 1980s, since then it has gradually and steadily increased but without reaching yet the level attained during the late 1970s.[21]

Within the gradual liberalisation strategy, in order to stabilise the foreign exchange and alleviate foreign exchange pressures, which was crucial to subsidize capital imports and to control the flows of FDI, China applied capital controls. These controls included a 100% foreign exchange surrender requirement for exporters, tight limitations to hold foreign currency and controls on the outflow of capital (Branstetter and Lardy, 2006, p. 9). Moreover, when convenient, the authorities eventually relaxed these restrictions and also allowed gradual adjustments in the exchange rate, going, for example, from renminbi (RMB) yuan $1.5 to the US dollar in 1985 to $8.7 in 1994 and then to $8.3 in 1995, a rate that did not change until 2005. Since then it has been moving gradually.

Also important was the autonomy of management demand during the whole period. Fiscal and monetary policies, in other words, were supportive of the infant promotion policy. Fiscal policy has been, for example, counter cyclical and has been widely used to foster investment. A clear lead of this occurred during the 1997 South-East Asian financial crisis when the government sought to use a sizable fiscal stimulus to boost domestic demand. Moreover, during the whole decade of the 1980s and 1990s the government practically registered an increasing deficit. With respect to the monetary policy, the authorities cut interest rates several times and lending by state banks was expanded. This reflects the role of the monetary authorities as promoters of growth instead of the narrow inflationary view that prevails in most of today's centrals banks (see Epstein, 2006). Finally, according to Branstetter and Lardy (2006) capital

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[21] These official rates nevertheless, according to Giles *et al.* (2005), are widely believed to underestimate the true rate of unemployment. They estimate that the urban unemployment rate was 14% in 2002.

investment (see table 3) or private consumption, both stimulated rather than constrained by the government, can be also ascribed to explain mucho more the recent success of China's growth. In sum, a central part of China's strategy consisted on strength and expand the domestic market.[22]

What is more important, and that indeed justifies the series of measures to control FDI as well as other complementary policies, is the sort of sophisticated commodities that China started to produce and eventually to export: "China has somehow managed to latch on the advanced, high-productivity products that one would not normally expect a poor, labor abundant country like China to produce, let alone export" (Rodrik, 2006a, p. 4). This is particularly true for consumer electronics. In this context, the evolution of China's manufactured exports share on total world market is impressive, reaching 10% by 2006, just behind the European Union's and similar to the USA's. In fact, according to Adams *et al.* (2006) China's growth of manufactured exports products continues to increase rapidly, in line with world market growth, and her high-tech exports increases even faster, they represented in 2001 the 43% in total East Asia high-tech exports, nevertheless China was not yet as technologically advanced as Korea or Singapore (see also Schott, 2006).

Also, as a result of the strategies just described, China has registered since the early 1980s until the mid 1990s essentially a trade balance, with minimum deficits or surpluses, avoiding in this sense any possible constraint on growth coming from the external accounts. This, in turn, has been the outcome of a decreasing elasticity of imports (gauged by the ratio of average growth of imports to the average growth of output) which went from 3.3% during the decade of the 1970s to 0.8% in the decade of the 1990s (see UNCTAD, 2003, p. 142). Evaluated in these terms, thus, the strategy of China is a successful one as she has been able to relax the balance of payments constraint as well as

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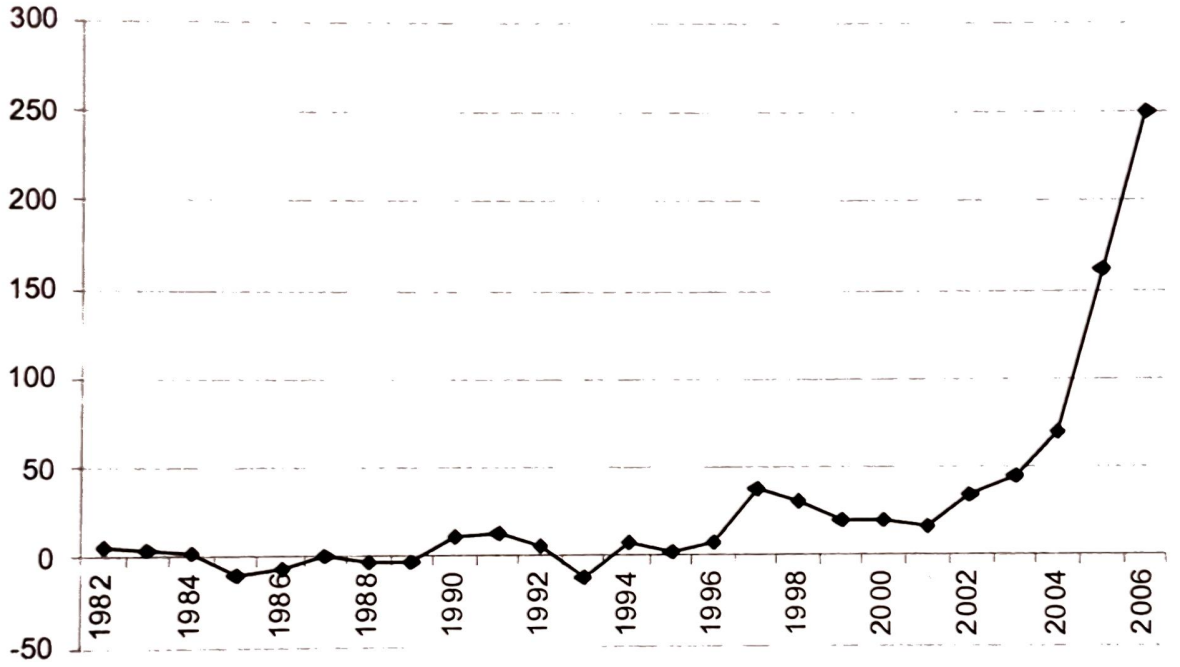
[22] In this setting, on September 27, 2007, *The Economist* stressed that "... the popular notion that China is dependent on export-led growth is a myth; domestic demand is much more important. This year the increase in China's net exports (*i.e.*, less imports) is likely to account for about one quarter of its growth –a record amount–. But even without this external boost, GDP growth would still have been a respectable 9%".

accelerating at the same time industrialization and growth. It is important to notice, finally, that since 1994 trade surplus soared going from US$7 billion to US$161 billion in 2006 (see graph 4). This evolution has allowed further room for manoeuvre in terms of exchange rate policy management.

GRAPH 4

China's current account balance, 1982-2006, US$ billions



Source: WDI online.

The outstanding increase of China's exports on total world share, lagging just behind Germany and the USA, has been the result of increases in the country's competitiveness which, in turn, has been based not only on the exchange rate policy, consisting in maintaining the exchange rate against the US dollar stable and making necessary adjustments (devaluations) when necessary, but also on increases in total factor productivity, particularly in labour productivity (see table 4). In fact, according to Rodrik (2006, p. 15) there has been a process of productivity diffusion within the economy: the productivity gains associated

with producing a set of sophisticated exportables is spread around the economy as labour moves across industries. In addition, low wages and available supplies of unskilled labour as well as the reduce costs of communication and transportation and foreign direct investment have been factors that are at the root of China's competitiveness (see Adams *et al.*, 2006 and Branstetter and Lardy, 2006).

TABLE 4

China's sources of growth
(annual percent change)

			Contribution of:			
	Output	Output per worker	Physical capital per worker	Factor productivity	Factor productivity	Physical capital per worker
			In percentage points		In percent of total	
1960-1980	4.04	1.83	0.76	0.64	35	41
1980-1999	9.75	7.85	2.63	4.71	60	33
1960-1999	6.78	4.72	1.66	2.6	55	35

Source: Bosworth and Colins (2003).

Finally, important to highlight is the fact that despite China's accession to the WTO, she has not gave up her policy autonomy to pursue growth and developmental goals. Chinese authorities, for example, maintain controls on TNC's like the enforcement of technology transfer to local partners, which somehow are permissible within the Trade-Related Investment Measures (TRIPs). China retains the state monopoly in of some key imports commodities such as crude oil, refined petroleum products, fertilizer, cotton, grain and vegetable oil and key exports such as tea, tungsten, silk, cotton products and fossil fuels. Also, she will eliminate tax preferences for foreign firms in a 6 to 8 years period. Additionally, maintains average statutory import tariff rate for agricultural products. In the service sector, China did agree to deregulate the

banking and insurance sector five years after WTO accession but liberalisation on the securities and fund management has been more restricted, since foreign ownership restrictions are more severe. Furthermore, joint ventures securities firms are not allowed to trade in A shares (Branstetter and Lardy, 2006).

TRADE LIBERALISATION COSTS

Of course, it is not reasonable to argue that China's strategy has been perfect at all. There have been costs associated with government intervention. However, as we have emphasized, so far government intervention has produced higher benefits than costs, putting the economy in the right track of industrialization and growth. For now, nevertheless, her trade liberalisation Aquilles' heel belongs to the topic of wages. They still remain pretty low, specially when compare them with those of trade partners. In other words, there has not been a wage convergence and due to the remaining infinite excess labour supply and despite growing productivity it seems unlikely that wages will increase in the short or medium term. On the contrary, it seems clear that China will keep her cheap labour competitive advantage as long such as the supply starts to decrease and/or most of the labour force finds a place in the secondary and/or tertiary sectors.

5. CONCLUDING REMARKS: ARE THERE CURRENT POLICY ALTERNATIVES TO REAP THE GAINS FROM TRADE?

The empirical evidence of Mexico and China presented in this study indicates that in order to reap the gains from trade and thus promote industrialization, growth and development trade liberalisation must be gradual couple with a pervasive governmental presence. In other words, we illustrated that "trade helps economic development only when the country employs a mixture of protection and open trade, constantly adjusting it according to its changing needs and capabilities" (Chang, 2007, p. 83). Free trade and market forces

have serious limitations and leave them on their own are likely to lead to a point in which the gains from trade offset its costs and impose further restrictions on growth and retard industrialization. These costs and restrictions are enormous and are always omitted or ignored by the conventional trade theory. This has been the experience of Mexico. For this reason, to reduce and avoid these costs, state intervention is necessary. China has proceeded accordingly and as a result industrialization, high growth and development are the norm. The experience of China confirms the general pattern by which advanced and new industrialized economies have made the gains of international trade an engine of economic progress.

Ironically, the advocators of free trade insist that in case policymakers attempt to implement any alternative policy to promote industrialization, such as import substitution strategy, the economy risks forgoing the gains from trade (Chang and Rowthorn, 1995). In today's international context, however, it is worthy mention that the scenario in which advanced countries and NIEs (even China) set up their growth and industrialization strategies has changed substantially due to, *inter alia*, the current new rules of trade (namely the WTO). For many developing economies, like Mexico, it might be unthinkable to replicate the usual way these countries climbed up the ladder of industrialization given its current level of trade openness (and the irreversibility of it) whereas for other less developed yet not totally opened economies the opportunity is still there, though with restrictions. In either case, it seems clear that "trade is simply to important for economic development to be left to free trade..." (Chang, 2007, p. 83). Thus, the state should not be seen as an intruder but, on the contrary, as a mean to promote industrialization, growth and development. In this sense, perhaps, the real question to put forward is not whether the presence of the state is necessary but if the mistakes of the past can be avoided or, in other words, if the benefits of government intervention can offset its costs. Only in this way, policy recommendations such as "...overcoming excruciating credit constraints on local producers... and boosting the frail local technological capabilities..." (Mesquita Moreira, 2007, p. 373) represent feasible and attainable goals. In this sense and on the view

that "... each country must choose the [political economy] alternative that is appropriate for its conditions and its people" (Stiglitz, 2003, p. 9), a relevant concern for developing economies is to know the policy alternatives to industrialize, accelerate growth and develop that are still there. Or more specifically, identify the alternative policies that developing economies can apply to leave behind low-productivity activities, moving towards the production of high valued added goods and services. Based on what has been presented in this study, we offer the following brief guideline.

First, all developing economies must invoke clauses that allow for industrialization within the predominant WTO regime. For example, countries can invoke the balance of payments clause, use temporary safeguards or impose anti-dumping duties to protect themselves against foreign competition that is affecting their balance of payments or their industries. These measures have the advantage of being discretionary, in the sense that the country can decide in which commodities impose them. Also, as in the case of safeguards, they can be used to protect infant industries for eight years. Developing countries are also allowed to maintain or even strengthen local content requirement. Furthermore, subsidies are relatively allowed. For example, exports subsidies are permissible for least developed economies. Besides, subsidies for agriculture, regional development, basic R&D and environment-related technology upgrading are still allowed. In addition, subsidies are allowed as long as trade-related policies are not break (Amsden, 2000; Chang, 2004). These measures might avoid the once-and-for-all effects of initial trade openness.[23] Additionally, developing countries must explore and exploit grey areas in the current trade regime. Other countries, under the old GATT regime, like Korea, did it.

Second, all developing countries, but particularly those whose degree of openness is quite advance, should eliminate the narrow view of fiscal balance

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[23] Importantly, Rodrik (2006b) has suggested that rather to specialize in the production of a single commodity during the initial stages of trade, as the conventional theory advocates, an economy must diversified in producing a range of goods and then eventually specialize in some of them.

and inflation targeting and reinstall management demand on their priorities. This can be easily done as there are not international rules that prohibit the establishment of a pro-industrialization and growth management demand. Of course, this has to be done within a well designed strategy of industrialization and development. Management demand implies favouring employment creation and supporting the development of domestic industries through a strong and growing domestic market (recall that specialization is limited by the size of the market but this in turn is limited by the extent of domestic demand and, in the same vein, only through growing domestic demand private investors' animal spirits can be woke-up and kept wide awake, fostering in this way capital accumulation). It also implies to be able to counter balance domestic and external shocks that might affect local producers. Furthermore, it allows the necessary policy autonomy to allocate as much resources as necessary to strategic industries, canalize credits, support R&D, promote science and technology, prepare the labour force through education, invest in infrastructure and so on. All of them are necessary, as we have seen, to develop the domestic technological capabilities. In this context, it is essential to expand public investment and maintain as many as necessary SOEs in strategic and/or potential sectors and industries, particularly where private investment is unlikely to be executed due to inexistent private returns.

Third, foreign exchange stability is necessary to subsidize imports, which are vital to continue the process of development, especially capital imports. A well proved strategy to achieve this aim consists on adopting capital controls and/or imposing exchange rate convertibility. These sorts of policies not only provide exchange rate stability, they also offer policy autonomy (particularly monetary policy) and, importantly, reduce the scope for suffering speculative attacks. Moreover, capital controls promote development by attracting favoured forms of foreign investment. For these reasons, developing economies must adopt (or maintain) some sort of capital control. It is important to mention that according to the IMF Articles of Agreement (specifically Article 8) exchange rate selective convertibility is allowed (Chang and Grabel, 2004).

Finally, as "economic development is all about absorbing advanced foreign technologies" (Chang, 2007, p. 127), in other words as "... economic development (whether in industrial or less developed economies) requires a combination of imitation and innovation, emulation and diversification, copying and surpassing..." (Wilkings, 1998, p. 95), it is paramount to establish a strategy to develop and upgrade technology in order to be able to compete in the international markets. Successful experiences have followed either a FDI-dependant-targeted strategy or an autonomous one (which "have minimised or selectively reduced reliance on FDI as a means of technological transfer. [Thus] entitl[ing] pervasive interventions..."; Lall, 2002, p. 81). In either case, a high degree of government intervention has been necessary "to create the skill and technological capabilities if they are to result in sustainable development" (*Ibid.*, p. 84). Thus, economies, following any of these strategies, must aim to set up the infrastructure to innovate, develop and upgrade their technology. At this respect it is important to recall that the enforcement of technological transfer from TNCs to local patterns is permissible within the current TRIPs.

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