

Trade Liberalisation, Profitability, Investment and Savings, and Capital Flows

This chapter reviews the underlying reasons for the capital flows revival which we are discussing. As was argued in the first sentence of this paper, although this is a paper about capital flows, one must locate these flows within the wider economic context – both cause and effect. This chapter takes the first step, by considering causes. As will already be clear, we locate this fundamentally in the liberalisations which have taken place in recipient countries.

4.1 The Process of Trade Liberalisation

The typical pre-emerging developing country is a capital-scarce, low-wage economy in which the productivity of capital is low, even although capital is scarce. The financial system is repressed. Because returns to investment are low, the return to saving cannot be high and may be negative. So savings are low, and they must be prevented from flowing abroad. They are probably channelled into 'priority areas'.

Reforming, opening and emerging change all of these things. The process of 'emerging' involves putting in place sound macroeconomic policies, which provide a guarantee of stability. Against this background, trade liberalisation, opening up the goods markets, promotes the reorientation of production, with an export sector serving the global market. The rate of return in the export sector will rise. This will attract foreign capital – and the inflow of foreign capital, by bringing new technology and supplementing domestic savings, will reinforce the process. Any policies responding to or attempting to influence capital inflows must keep these fundamentals firmly in mind.

4.2 Trade Liberalisation and the Profitability of Investment

There are four essential reasons for this rise in profitability.

(i) *comparative advantage*

Trade liberalisation enables the emerging economy to specialise in goods in which it has a comparative advantage – essentially low-wage assembly with semi-skilled labour resources. Under protectionism, imported inputs are either physically difficult to get hold of or are expensive. Domestic resources used in production are expensive in that their rewards and so costs are inflated behind the protective barrier. Freer trade removes these cost disadvantages, and so raises the rewards in the export sector.

(ii) *economies of scale in specialisation*

Opening enables the economy to escape from an inward-looking production system serving the home market, fragmented and small-scale, with none of the benefits of scale in its product lines which are too high-cost to serve the world market associated with freer trade.

Every extra industry added behind the barrier of protection requires the country to bear another set of fixed costs. The result is a manufacturing sector which has too high a level of fixed costs (it does too many things) and which gets too little reward for each set of fixed costs incurred. Liberalising trade leads to a rationalisation of the industrial sector, which bears fewer fixed costs by concentrating on fewer industries, and fewer product lines within each industry. Each of the remaining lines of production has a larger output and is sold on the infinitely larger and more competitive world market.

(iii) *technological catchup*

Stable policies and low factor costs make liberalising and reforming developing countries attractive places to which to transfer technology. Foreign capital and foreign knowhow can make high profitability in the export sector possible.

Trade liberalisation can also force producers to acquire and make use of international knowledge, in order to survive in more open international competition. Liberalisation causes enterprises in both the import-competing sector and the export sector to know that they have to compete in an open international trading environment. This encourages rapid adjustment to change. Firms know that to survive they must adopt the world's best practices. All these adjustments raise profitability, both in the industries making the adjustments and in those which use their outputs as inputs.

(iv) *domestic technological advance*

The opening of trade can help to focus 'positive feedback' in the accumulation of national knowledge which must go hand in hand with the process of technological catchup. Perhaps just as importantly, the opening of trade can lead to an industrial structure in which there is 'positive feedback' through spillovers: mutually reinforcing external economies of scale within a particular industry, and between industries.

It requires not just an increasingly skilled and educated workforce for an economy to be the recipient of technical inflow of the kind just described, but also the acquisition of competences specific to the industry in question. This is true whether for the car industry in Thailand or the growth of the software, data processing and accounting sectors in the Indian economy. Much of the required skills and competences can be acquired only by costly national R and D, education and training efforts (since the activity-specific knowledge and skills are tradeable internationally). The specialisation which goes with trade liberalisation means that it is no longer essential for an economy to attempt to spread this across the entire industrial range.

Final products and intermediate capital goods can be imported which have been designed elsewhere (see Romer, 1994). As a result, the R and D effort can be better focused and 'goes further'.

Furthermore, existing knowledge and competences are important for the success of future R and D. If these are more narrowly focused, then positive feedback will be stronger. The result can be a cumulative process, and so long as manufacturing is sufficiently specialised, then these cumulative gains can characterise the manufacturing sector as a whole. This cumulative process will lift the overall rate of growth of the economy (Grossman and Helpman, 1991).

Finally, the opening of trade can lead to an industrial structure in which there is 'positive feedback' through spillovers: mutually reinforcing external economies of scale in a particular industry, and between industries. As the size of successful industries increases, this will

- ❖ provide a large market for workers with specialised skills (thus encouraging specialisation by workers in such skills)
- ❖ induce the growth of specialised support services (inducing productive specialisation in the provision of these)
- ❖ bring about the reciprocal exchange of technology amongst firms in the industry.

Expansion of each firm and industry improves the environment for and lowers the costs of other firms and industries. Again there is the possibility of a cumulatively reinforcing process which lifts the economy-wide growth rate (Krugman, 1994).

All of this means that the return on investment will increase, investment as a share of national income will rise and these countries will come to be attractive places to invest. Sachs and Warner (1995) present evidence that once developing countries become more open, they begin to invest and grow at rates higher than those of developed countries and begin the process of convergence and catchup. This too is the central message of the *World Bank Global Economic*

Prospects (1996), which presents further empirical evidence and examples.

4.3 Long-Run Policy Response

(i) *mobilising domestic savings*

One long-run response to the higher demand for investment would be to raise the domestic savings rate. This was characteristic of the East Asian 'miracle'. According to Rodrik (1995b), 'In Korea and Taiwan, interest rates were controlled by the government, and in any case the bulk of investment funds were generated either by self-finance or through directed lending from the government. However governments in both countries did raise real interest rates for savers to levels that were either positive or only mildly negative (Taiwan in the 1950s and Korea in the 1960s). In this respect their policies diverged significantly from the gross financial repression favoured by other developing governments ... In addition, an increase in public savings made an important contribution to total savings in both countries ... [as it did in Korea].'

(ii) *mobilising foreign savings*

The other long-run response would be to move to a regime in which foreign savings finance a high proportion of the domestic investment, with the goods market counterpart of a current account deficit financed by an equal capital inflow. This would be the strategy of the colonial countries of the late nineteenth century, of Thailand in the late 1980s and early 1990s and of Mexico in the first part of the 1990s – until it ended in tears. The risks are well-known: those caused by the rise of foreign costs of funds; and policy risk in the face of withdrawal. In the following section, we discuss how best to minimise these risks and control the costs of negative shocks.

4.4 The Transition

Policies to raise the savings rate take time. Furthermore, consumers, seeing the possible effects of the policy reform, take heart at their rising real permanent income and spend more.

Opening the economy to capital inflow offers the possibility of immediate foreign financing of the high level of investment to which the liberalisation leads. That enables the investment to get underway more rapidly than if it were domestically financed. With a domestic rate of return higher than the foreign rate of interest, this offers the possibility of immediate net returns to the economy or to foreign investors in it. It is this large gap between the rate of return on domestic investment and the foreign rate of interest that both stimulates the investment and – with open international capital markets – encourages the capital inflow which finances it.

The problem is that in the short run there is macroeconomic disequilibrium. With domestic savings not keeping pace with the higher level of domestic investment, aggregate demand will exceed aggregate supply.

In addition, the financial reforms which permit the capital inflow will in general also be associated with the easing of restrictions on domestic residents; it is very difficult to separate domestic from foreign liberalisation. This will lead to relaxation of credit rationing on domestic consumers. Without care a consumption boom will accompany the investment boom, leading to a further imbalance between demand and supply.