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## Domestic Requirements and Complementary Policies for a WHFTA

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# Domestic Requirements and Complementary Policies for a WHFTA

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## I. Introduction.

To be ultimately successful, any free trade arrangement, global or regional, must depend in large part on the extent to which each of the individual partners, whether they come in one by one or en masse, puts appropriate complementary domestic policies in place. This requirement in turn has a built-in time dimension. Some elements of preparation are required before a country decides to adhere to a presumptive WHFTA; others deal with the process of implementation, which may last as much as a decade; still others have to do with the longer run environment for the WHFTA. This paper will endeavor to outline in some detail the rationale for paying a substantial amount of attention to a set of both macro- and micro-policy requirements at each point in time if a necessarily evolutionary WHFTA process is to be eventually successful. The objectives of the contracting parties are assumed to focus on enhanced growth and welfare as a consequence of the gains from trade, static and dynamic, as well as increased factor mobility.

Most analysis dealing with free-trade agreements and common market configurations, whether multilateral or regional, has in the past focussed all-too exclusively on the international dimensions of the process. This feature has also been one of the problems in the development literature in recent decades. We perceive the development process as equivalent to the

complementary blades of a pair of scissors, one dealing with "balanced growth" in the domestic economy, the other with the full mobilization of the international sector including capital movements and technology transfers, as well as trade itself. The implied inherent close complementarity between domestic and international policies must be fully recognized and acted upon. In other words, complementary domestic policies in the realm of macro-economic as well as micro-economic and related institution construction activities are extremely important if the developmental scissors are to be able to "cut." The domestic hinterland cannot be expected to be automatically "dragged along" by actions in the international economic sphere. Complementary actions are required at each step of the way if the full benefits of a WHFTA are to be realized.

While no unduly artificial time separation is intended here, we will find it convenient to divide the necessary complementary domestic policy actions into those which are essential before any national system is ready to seriously consider entering into a free-trade arrangement (Section II); those which are required to ensure that the gains from a free-trade arrangement, once entered into, are appropriately distributed and thus rendered politically acceptable (Section III); and those actions which are required to ensure that the longer term political and economic environment remains favorable, since a plethora of problems in the dispute settlements realm can threaten the long-term reaping of the full benefits of a WHFTA arrangement (Section IV). Section V will briefly summarize and conclude.

## II. Required Domestic Complementary Policies Prior to Individual Country Adherence to a WHFTA.

There are essentially two sets of policies which must be in place if adherence to a WHFTA is to make sense and have the best prospects for success. One is in the macro-economic sphere, by now fairly well recognized; the other really lies at a distance from the usually exclusive emphasis on such macroeconomic policies. It is much more concerned with policies which ensure that the second required blade of the developmental scissors, namely, domestic balanced growth is in reasonably good shape.

To place this discussion in proper historical perspective, we need to recall that most presumptive members of a WHFTA, like most developing countries in general, typically initiate their transition growth effort under the well-known import substitution policy regime. While there is no need here to detail all the components of this syndrome one more time, it should be recognized that it represents an initial development strategy yielding a system substantially penetrated by political forces in the effort to create the appropriate conditions for post-colonial developmental success. While virtually every developing country seems to have accepted the necessity of passing through some such phase at an early stage, it is also true that developing countries can be distinguished by the length and severity with which these policies were carried on before a more externally oriented or open policy phase was initiated in more recent years.

It is also clear and quite obvious that the movement from import substitution to export orientation -- preferably (non-subsidized) export substitution rather than (subsidized) export promotion --, should already have proceeded for some substantial distance, i.e. prior political force has already been substantially withdrawn from the economy and the role of relatively more impartial market forces in various dimensions has already advanced substantially.

Without wishing to rehash the extensive literature on macroeconomic policy reforms, as well as the ideal sequencing of such reforms, it is useful to recall that at least in three related areas macroeconomic policies complementary to the international trade regime proper have to be sufficiently advanced for a WHFTA to become really effective. One is that, as a country lowers its tariffs, gradually or not so gradually, in meeting its obligations under a WHFTA, it will be necessary to shift from international and usually agriculture-oriented export taxes and import duties to a mix of indirect consumption taxes and, later on, increasingly, income taxes. If there is no flexibility in the revenue structure, the whole trade liberalization process, which usually proceeds from QR reduction to equivalent tariffs and then, of course, especially during WHFTA entry, to a gradual harmonization and reduction of such trade-related taxes, is endangered. With expenditure requirements undoubtedly on the rise, maintaining a measure of macroeconomic fiscal balance very much depends on such tax capacity. Along with closely-related monetary policies, the

other important determinant of macroeconomic stability, the budget needs to be under control if domestic markets are to be able to function effectively. In the absence of such stability the well-known stop-go syndrome is bound to dominate, with negative results for the presumptive WHFTA partnership.

In the, seemingly inevitable, early import-substituting subphase, we have noted the virtual necessity of governments undertaking substantial infrastructural and organizational interventions to forge a society which is ready for the exercise of development policies in the first place. In that context, the government usually views money creation as a necessary instrument for acquiring purchasing power for itself and the wherewithal to shift resources to other favored parties, leading to the politicization of the development process at an early stage. Included is the fact that the larger the supply of rents emanating from natural resource based production, the greater the temptation for government to transfer such rents both to itself and to favored private parties, and the greater the temptation of such private parties, in particular the new industrial class, to engage in directly unproductive activities to ensure and preserve these spoils.

It should, moreover, be emphasized, especially in the context of this paper, that many of the interventions which are part and parcel of this policy regime involve domestic parameters. We need only cite the usual prevalence of internal terms of trade distortions, price controls on staples and basic raw material inputs, subsidies for various public utilities and a

severely repressed credit market to make the point. But even if we tend to view initial adoption of such a policy package as inevitable -- as the historical record seems to indicate -- its severity and the length of time over which it is exercised varies substantially across developing countries. A gradual liberalization process involving the domestic as well as international policy parameters is an essential precondition if joining the WHFTA is to yield substantial positive results.

The sequence by which such macroeconomic policies are adjusted in the direction of a more open and competitive system internally as well as externally has been much discussed in recent years. There seems to be some emerging consensus that after controlling budget deficits and the rate of monetary expansion, there is a need to shift towards a unitary and more realistic exchange rate, giving both non-traditional agricultural and non-agricultural exports a competitive chance in international markets. Simultaneously, even in the absence of WHFTA adherence, QRs are being gradually replaced by tariffs; tariffs may be harmonized while major tariff reduction is likely to be postponed. As an intermediate step, there is increasing resort to tariff rebates and export processing zones as transition measures. They permit domestic consumers to continue to be squeezed even as competitive export substitution proceeds, moving gradually from land to labor-intensive and hence to skill and capital intensive output mixes.

It is well known that the import substitution subphase of development has lasted longer and been more severe in many of the



potential Latin American members of a WHFTA than elsewhere in the developing world. This means that many presumptive Latin American members, especially the more industrialized countries such as Brazil, have moved into what is called the range of "secondary" import substitution, comprised of more sophisticated products and at a greater distance from world prices. Moreover the ability to shift from import to export substitution has proven more difficult here because of Latin America's early start and the consequently more deeply entrenched habits that have grown up. Finally, and once again in comparison with other parts of the developing world, Latin America has had the ability to subsidize inefficient production and output mixes through her relatively greater natural resources abundance. In this sense, the seductiveness of a country's continued ability to depend on the flow of land-based rents, supplemented in the 70s by foreign capital inflows available virtually for the asking, played an important role in creating a problem which needs to be addressed if accession to a WHFTA is to be truly successful.

One should indeed emphasize that an individual developing country's exercise of monopoly power through the printing of money as well as the compulsory purchase of foreign exchange, is usually far more damaging than the retention of import duties at the initial stage of development. Gradually moving toward the treatment of the money supply and foreign exchange reserves as mediums of exchange, rather than as purchasing power that can be artificially created and manipulated, represents a large step forward in macroeconomic policy adjustment terms. The fact is

that purchasing power management through expansionary monetary and fiscal policies represents a "quickie" solution to the understandably strong early needs of growth promotion. Achieving command over resources via inflationary finance and/or the exchange rate is representative of indirect, under-the-table transactions which stand in sharp contrast to the deployment of tax and expenditure policies operating via a more transparent, publicly debated process.

This is not to assert that settling some problems through the inflation tax can be done away with overnight, since the political art of consensus formation through an openly debated tax and expenditure policy has to be developed over time as depoliticization continues. But what is necessary is a gradual move towards an equilibrium rate of exchange and an equilibrium rate of interest, even if in the presence of some moderate inflation at the outset.

Once the system has proceeded beyond the first stage involving monetary restraint and a relatively cleanly floated exchange rate close to equilibrium levels, further monetary expansion, beyond the rising transactions demands of the economy, would be permitted only as a concession to governments' still substantial inability to raise non-trade taxes. When purchasing power management becomes disentangled from growth, i.e. once exchange rates and interest rates move flexibly at reasonably equilibrium levels, the government becomes less of a direct growth activist. It is only at this point that trade liberalization, even before a country joins any WHFTA, begins to make good economic sense for any of the countries in the region.

We all understand the pernicious effects of cascading tariffs with respect to violating Pareto optimality and rendering domestic relative price structures out of line with international prices. But more important in a dynamic context is the fact that the covert and whimsical nature of the resulting income transfers from consumers to some producers inhibit these so-called infant industries from experiencing sufficient pressure over time to graduate into healthy adolescence by learning to compete in the domestic markets, even though they may be forced to first compete in international markets. Indeed, if protective tariffs must be maintained for some time, partly for revenue reasons, the first step is usually to harmonize their levels and then adopt tariff rebates, export-processing zones and bonded warehouses. Such transitional devices contribute to an early integration of the export sector with world markets and permit the economy to reap the harvest of enhanced competitive efficiency without having to tackle the moral issue of domestic consumer discrimination.

Consumers are thus likely to be asked to continue to subsidize their infant industries for a time, even in the export-oriented phase of development. But this does not do too much damage. It is only when one gets to a much later stage of development, probably reached in some of the more industrialized of the Latin American countries, that consumers respond to the increased transparency of their losses by refusing to continue to support high-cost domestic industrial dispositions. Eventually, further tariff reductions as part of a WHFTA then represent a healthy evolution toward domestic market efficiency, once

industries have demonstrated their competitive efficiency abroad. Thus, quite opposite to the ordinary Linder thesis,<sup>1</sup> world markets can be seen as a laboratory for cutting one's teeth and experimenting with competitive fitness. Once the fear of competition in foreign markets is overcome, the domestic economy can be more fully opened to accept similar competitive pressures. But this also requires readiness in terms of adjusting the more strictly domestic parameters, including interest rates, price controls, domestic terms of trade, subsidies, etc.

The ideal sequence for a realistic change in tariff policy, prior to any WHFTA, may thus be seen as a shift from QRs to equivalent tariffs, followed by more uniform and somewhat lower tariff levels, mainly for revenue purposes, but still maintaining reasonably high protective walls for everything except capital goods; then, once the economy has been gradually readied, entrepreneurially and institutionally, the bulk of macro-policies move towards export orientation, including the early introduction of the aforementioned transitional devices. With the foreign exchange rate now no longer severely overvalued, incomes of primary product exporters are no longer transferred "under the table" as windfall profits to the urban industrial class. While domestic consumers continue to subsidize domestic producers, the third stage, gradual harmonization and pre-announced reductions in tariffs, undoubtedly part of any WHFTA, will then gradually eliminate that ultimate inefficiency in a coordinated, multilateral fashion.

Adherence to a presumptive WHFTA thus really requires macroeconomic preconditions which include (1) monetary and fiscal stabilization, yielding moderating rates of inflation, in the absence of which no markets, including the expanding markets presumably resulting from WHFTA adherence, cannot be expected to function effectively; (2) reasonably flexible exchange and interest rate policies, with a good deal of credibility attached to the maintenance of such policies over time; (3) early shift from quantitative controls to tariffs, which can then be gradually harmonized and lowered as part of a presumptive WHFTA agreement; (4) overall credit market reform, elimination of price controls and, if necessary, privatization of directly productive activities located in the public sector and/or efforts to rationalize the governments' activities in these areas.

The aforementioned macroeconomic requirements for individual countries as they face the possibility of adhering to a WHFTA agreement, remind one very much of the so-called "Washington consensus,"<sup>2</sup> with some additional suggestions on sequencing thrown in. The floating of the exchange rate returns to farmers their own purchasing power and helps initiate a market-oriented approach toward modernization. The reduction of export duties in the second stage gives farmers back more of their purchasing power and thus continues this process. Finally, the previous neglect of public sector investments in human and institutional overhead capital can be corrected once fiscal policy is capable of carrying the ball, i.e. taxes can fully replace the need to impose an inflationary levy.

Such macroeconomic preconditions must undoubtedly be met if a country is to gain maximum advantage from any new agreement and, in turn, provide advantages to its WHFTA partners, i.e. by making the necessary complementary decisions within each participant country. I would now like to proceed, however, to emphasize something which is perhaps a little less obvious, that is, the need for complementary domestically oriented actions required to enhance the domestic balanced growth blade of the development process. As pointed out earlier, this may prove critical to the success of WHFTA adherence on an individual country basis, relating especially to policy reforms affecting the non-traded sector, which is surprisingly important, even in relatively small countries.

The microeconomic and institutional dimensions of complementary domestic policy change required for taking full advantage of WHFTA adherence are usually much less emphasized. This is rather strange, especially if we accept the notion that the success of a shift towards an increasingly competitive position in world markets and, later, domestic markets depends on the complementary efficiency of the domestic economy, i.e. a balanced rural development in sync with open economy oriented growth.

Whatever the initial endowment of a particular society, WHFTA adherence is intended to help the system penetrate international markets through major changes over time in output mixes and technologies. But agricultural productivity change generating additional food supplies is also needed to help

provide the wage goods required by newly absorbed urban workers. At the same time it is necessary for the path of urban industrial growth to become more complementary to rather than competitive with rural non-agricultural activity.

Relations between the domestic agricultural and non-agricultural sectors, as well as the issue of how such relations affect the more prominent international trade-oriented parts of the economy, are, of course, not entirely new subjects. However, the issue of domestic linkages between agricultural and non-agricultural activities has often been too exclusively simply an afterthought to basic macroeconomic analysis, which, of course, admits of disaggregation into as many smooth, homogeneous sectors as tastes demand and data can supply. But that is not equivalent to understanding the interactions between major sectors which are not smooth and homogeneous in their behavior, especially if the rural economy is sizeable and not yet fully commercialized. Instead, to understand the conditions necessary for domestic balanced growth, we need to focus on the inter-sectoral financial, labor and commodity markets, all, in their own way, complementary to the markets dominating the international trade activities of the economy.

There have been a number of microeconomic studies focusing on linkages between agriculture and non-agriculture, in particular the location issue, in terms of both its static and dynamic effects. However, such macro- and micro- considerations have never been sufficiently integrated to yield a real understanding of the central question: how relationships between

agriculture and non-agriculture and the international trading economy influence the overall pattern of a country's potential response to an opening-up of the economy as would occur in the case of WHFTA adherence. There undoubtedly exists a strong relationship between the achievement of overall success in the development effort and the ability to generate dynamic, balanced rural growth at the outset.

We, of course, recognize that different countries differ in their initial conditions, including their size, natural vs. human resources, population pressure on the land, etc. Nevertheless, we are convinced that even in the relatively small countries of the region, rural sector neglect would be risky in terms of the needed preparation for a successful WHFTA. If the experience of other parts of the developing world, especially the more successful countries, is any indication, in all but the city-states of Hong Kong and Singapore our customary fascination with the internationally oriented activities of the economy could turn out to be dangerous. It could tempt us to ignore the fact that rural sector mobilization represents an important domestic requirement for a successful WHFTA.

As is well known, colonial policies and neo-colonial policies tend to inhibit the development of domestic industry through a combination of mercantilist/neo-mercantilist restrictions on the pattern of trade and investment, coupled with the relative neglect of food-producing agriculture as well as of domestically oriented non-agricultural or small-scale rural activities. The focus of attention of the policy community is



then normally on the export of cash crops and the auxiliary overhead services required to bring them to market. When these primary exports consist of minerals, e.g., copper, the resulting rural income distribution is even more unequal and the rural linkages even weaker than in the case of cash crop plantations, which themselves provide relatively weak "spill-over" effects with respect to non-agricultural activities. Cash crops which perform best in this context are individual household produced crops like cocoa and coffee. Moreover, once under the import substitution syndrome, we generally encounter another major source of bias -- at least in some of the major Latin American countries -- i.e., the presence of a sizeable large-scale urban industrial sector, competing unfairly with actual or, more likely, potential rural industrial alternatives as a consequence of the previously referenced policy package, which provides access to rents mainly to the large-scale urban elite. Urban industry is thus artificially favored relative to both medium and small-scale rural industrial production and food-producing agriculture.

If the opening up to a WHFTA arrangement is to really bear fruit, in other words, the domestic economy has to be altered, away from this description, and rendered "ready." Such readiness generically exhibits itself via the reduction of supply rigidities, enhanced response capacity and the encouragement of complementary instead of competitive relations between rural small-scale and urban large-scale industry and service activities. It is for this reason that we have placed so much

emphasis on the mobilization of the interior of the economy, couched in domestic balanced growth language -- a subject which has been short-shrifted in relation to the more visible and exciting trade, aid and private capital movements-related dimensions of development. This, of course, does not mean that rural development is a prerequisite for adherence to a WHFTA, only that it is necessary to render the enhanced export orientation expected from the agreement more effective and lasting.

Such vigorous domestic balanced growth is also important for ultimate success because it generates the capacity early on to produce niche goods for the domestic market which can later be exported to other developing country members of WHFTA. By niche markets we mean mainly consumer and some intermediate goods, not necessarily internationally specified, but appropriate, in terms of their attributes and production technology, for medium and low income customers in restricted and diversified domestic markets. Most Latin American countries currently contemplating eventual adherence to WHFTA are undoubtedly focussed excessively on the U.S. market potential and underestimate the potential for a vigorous expansion of intra-Latin American trade. Within an overall growing region we can, however, expect such trade, while admittedly at lower absolute levels to start with, to expand faster than trade with the U.S.

Between 1985 and 1990, for example, total developing country exports to the industrial countries increased by 75%, while exports to other developing countries doubled. Even more telling

is the fact that when a particular developing region begins to grow vigorously -- with or without the benefit of a free-trade area --, such South-South intra-regional trade grows even faster. This has been demonstrated convincingly in Asia which has shifted from a pattern of exclusively concentrating on labor intensive exports to the advanced countries to also producing light manufactured intermediate and even some capital goods for its neighbors. Especially at a time when global growth is modest and can be expected to remain so over the foreseeable future, the expansion of intra-regional trade offers substantial opportunities for any WHFTA. For example, Asian developing countries' total exports increased by 13.8% during 1991, but intra-regional trade increased by 23%. The same phenomenon could be expected among Latin American countries, even more so, of course, if encouraged by a WHFTA arrangement. Not only would the mutual demand among Southern members of WHFTA provide something of a buffer in times of global recession, but one could expect substantial additional intra-Latin American growth to result. Increasingly such inter-Latin American trade could also be expected to include intermediate goods, with different levels of processing accomplished in different member countries -- facilitated, of course, by the kind of subcontracting possibilities involving medium and small-scale firms within each of the participants.

The policies requiring change are of both the macro- and micro-policy type, i.e., not only those dealing with the exchange rate and the interest rate, but also those dealing with the

allocation of infrastructure, of technology efforts, of credit and of foreign exchange to favored large-scale, usually urban, parties, as well as with the distortion of the domestic terms of trade in favor of the urban industrial sector.

There are thus country-specific bundles of actions required to enhance the chances for balanced mobilization of each participant's agricultural and non-agricultural rural activities. The precise weight of these, of course, will be very much a function of each country's initial conditions and cannot be generalized about. But, in summary, in most cases, most or all of the cited elements are likely to need attention. Usually required is the removal of unfair competition by protected urban industries and services, including the way in which infrastructure, credit and other scarce inputs are allocated. Another has to do with providing equal access to information and technology in both domestic and foreign markets. And a third involves the way in which the public sector operates in rural areas, i.e., the issue of public sector decentralization as a companion to the much emphasized enhanced private sector market orientation. A brief further word on each might be helpful.

1) Turning to the first element, i.e., reducing the customary discrimination against agricultural and medium and small-scale industry, we should recall that the advantaged parties include both public and private sector enterprises, as well as, to some extent, multi-national companies, all taking advantage of the same policy syndrome. Export-oriented cash crops, needed to help fuel the import substitution process,

continue to be favored relative to domestically oriented food crops, in terms of research, extension, irrigation, input allocation, price interventions, etc. When rural linkages are weak because of the relative neglect of food-producing agriculture, and when there has been destruction or displacement of pre-existing rural industry and services by subsidized urban activities -- instead of a complementary development between the two, e.g. via subcontracting arrangements -- the country is not in an ideal position to take full advantage of opening up to other countries through WHFTA adherence.

In order to prepare for such adherence, domestic policy change must be aimed at a more favorable environment in a number of dimensions. First and foremost has to be the reduction of discrimination against domestic food-crop agriculture relative to export cash-crop agriculture. This is related not only to a reduction in the distortion of the terms of trade against domestic agriculture and extends beyond the impact of macro-economic policy change, e.g. via an adjustment of the overvalued exchange rate. It goes to greater even-handedness of science and technology research as well as to extension efforts as between cash and food crops, and includes the reallocation of infrastructural investment towards the rural sector as a whole. It includes the fair pricing of utilities, i.e. a system which does not discriminate, once again, against rural activities; and it includes abandoning the customary system of granting specific fiscal incentives to industrial production and exports, usually out of the reach of dispersed medium and small-scale firms.

2) Secondly, while much has been written about the repressed financial markets of Latin America, their relevance to the current topic needs to be emphasized. In most countries in the region we still encounter a wide gap between official and informal or curb markets. There typically exists a lack of sufficient physical bank presence in the rural areas, plus too much emphasis on government credit lines, sometimes foreign-supported, instead of a focus on generating domestic savings and having these channelled by rural banks, whether of the cooperative, commercial or development variety, depending, of course, on local conditions. It is important also that crop-oriented or agriculture-oriented credit programs be replaced by rural credit programs at reasonably realistic interest rates, given the fact that many farmers, once things begin to gel, will increasingly have one foot in agriculture and one foot in non-agricultural activities, e.g. food-processing, services and other small-scale industry, sometimes allied with large-scale industry via subcontracting arrangements. Specialized, subsidized credit windows usually simply provide rents for large-scale cash crop oriented farmers.

A related point is the number of institutional fingers the organized financial market manages to make available in rural areas. In most country cases there is a clear-cut view held by central banks that the country is "over-banked" and that additional institutions or branches in rural areas are neither necessary nor desirable. However, if there is a chance to bridge the gap between the perhaps one-third of the country's borrowers

who have access to the official credit markets and the two-thirds who are forced to deal in informal markets, additional banking presence, even if it's in the form of mobile banks, is required. This is true both with respect to annual production loans and the longer-term rural capital needs which are often completely neglected. The claimed "overbanking" phenomenon is usually relevant only to the urban areas.

What is absolutely essential for equitable growth, in particular in the rural areas, is an environment in which household incomes and savings grow and deposits are made by rural families within their "own" local banking system, with much less reliance on credit from above, including from foreign lenders. This is very likely to require free entry and more market-oriented interest rates, with only general central bank supervision and perhaps reinsurance facilities. A problem which also usually needs to be addressed is the high intermediation cost of the banking system and the frequently large spread between deposit and lending rates. Such high intermediation costs may be a function of diseconomies of small scale, but more often are due to a lack of competitiveness of the banking system; they occasion windfall profits by banks which exercise excessive monopoly power and consequently feel little pressure to lend to disenfranchised, low-collateral new entrepreneurs.

Given a more competitive financial sector, one important ingredient of readiness for a WHFTA would have been achieved. Another, complementary to the expected increased openness to the outside, would be enhanced workably competitive pressures in the

domestic market. This would require something akin to an anti-trust policy or -- and more likely to make sense in the Latin American context -- a regulatory framework which does not permit private monopoly to form as public monopoly yields to the process of privatization.

3) The third policy area which needs to be addressed in this same context is the usual unavailability of infrastructure of the right type in the right place, especially away from the urban industrial sector. Any relatively greater emphasis on rural development, even in smaller would-be adherents to a WHFTA, probably means substantial decentralization of the public sector. It is probably only at the local level that a reliable determination of the real priority needs as regards communal irrigation, highways, the dredging of harbors, public utilities, industrial estates etc can be made. Local communities must be given a greater chance to determine their own infrastructural priorities once a willingness has been expressed to shift away from urban-oriented and towards rural locations. In other words, the vertical devolution of power to regional and provincial as well as lower levels is as important as horizontal coordination among the various agencies of a central government.

Probably the best way to support rural mini-infrastructural programs is by way of block grants to local bodies, rather than the traditional top-down politicized servicio model previously common in Latin America. Through such block grants, the scope for malfeasance and nonfeasance is reduced and the chances for local effort matching are enhanced. While there obviously exist



local elites as well, they can get away with less than central elites, given the transparency differentials. It is impossible to envision rural balanced growth -- which most countries in the region are capable of but haven't really fully experienced -- without a reallocation of existing expenditures in the infrastructural areas, both physical and institutional. The efficient allocation of such infrastructure and the proper prioritization of "what" needs to be done "where" is often simply related to the willingness to decentralize the public sector itself. What is meant by "decentralization" is something beyond a mere deconcentration or delegation of powers, but the devolution of some powers to local bodies, so that while the "how" of public infrastructure may remain the technical responsibility of the central government, the "what" and "where" become increasingly a function of local decision-making. Given the history of government in the ex-Iberian colonies, this may not be something that can be done overnight, but increased willingness to trust local bodies, whether the government itself is unitary or federal, must be an essential part of the package.

Block grants may be an important instrument to facilitate the enhanced efficiency of infrastructural allocations favoring both balanced growth and improved equity in the rural areas. Such block grants from above should have the features of automaticity, with priorities set by local bodies; of universality, i.e. national programs with all units receiving a certain fixed annual allocation, partly based on population, as well as on income differentials, with some redistributive

elements across regions included; and continuity, such that, whatever amounts can be afforded under customarily tight fiscal conditions, such amounts can be anticipated and planned for by the local bodies each and every year.

The advantages of a block grant program are not only its transparency and the willingness to express confidence in local governments' enhanced capacity to make their own decisions, but it will also permit additional fiscal resources to be raised; it is important, especially as WHFTA begins to reduce its take from import duties, that domestic taxes can be raised. The experience in other parts of the world where such block grant programs have been instituted, e.g. in Asia, is that there exists a substantial possibility for fiscal incentives working to ultimately reduce the necessity of top-down revenue sharing, permitting local bodies to raise more resources, retain some, and send the rest upstairs. Both these dimensions are crucial for the kind of rural mobilization which stands to facilitate reaping the full benefits of an increasingly open overall development path.

4) A fourth related major link in this internal development chain as a precondition for fully successful adherence to a WHFTA resides in the area of technology information, diffusion and market access. Typically, in countries in this region and elsewhere, the so-called scientific establishment on which substantial human and financial resources are being expended, as represented by the customary network of science and technology centers, does not manage to have a real impact on the workings of the domestic economy. There are a

large number of reasons for this, among which I will only cite that the internal incentive system of these institutes is customarily focussed on internationally sanctioned professional achievements rather than on the promotion of market-oriented adaptive technologies for the domestic economy. One way of creating pressures for a shift in the direction of science which is more appropriate to a country's level of development and of technology change which is of the adaptive and complementary (to imported technology) variety, would be to gradually reduce government institute subsidies on a descending scale and for such institutes to be phased out if unable to be supported increasingly by private sector contracts. It cannot be overemphasized that this type of science and technology application to both new goods and processes is likely to constitute an essential ingredient for any rural balanced growth effort and, in turn, for a really successful WHFTA adherence. Since the routinization of such processes is virtually synonymous with successful transition to modern growth, the current heavy institutional emphasis on internal criteria and/or frontier-oriented research can be extremely wasteful of both scarce fiscal and human resources.

I have already referred to the tendency to favor research on cash crops over food crops in agriculture. Similarly, in non-agriculture, it is important to decentralize the research community to the extent possible, via regional diversification and relocation away from the capital city. Usually there exists very little contact between market and technology-focussed

research centers and would-be medium and small scale industrialists whose need for information concerning possible variations in product specification, process choice, etc., is often not met. Such networks probably should not be constructed on the traditional agricultural extension service model, but rather placed in the hands of commercial or rural banks. In any case, there usually exists an urgent need for really relevant science and technology information to be transmitted, on request, to the local level and for innovational tinkering and information capacity, possibly assisted by NGO activities, to be put in place, even though it ought to be maintained as a function separate from the credit allocation function proper, which, as we pointed out above, should not be subsidized.

It may be concluded that the divergence in macro-economic policy regimes among presumptive WHFTA partners is being diminished as a result of structural adjustment lending and the initiative taken by many countries in the region over the past few years in response to the so-called debt crisis. This is undoubtedly less true of the domestic parameters, especially the micro-level policies aimed at encouraging balanced rural development, at least in a relative sense. Few structural adjustment packages have tried to make a dent in the traditional trend towards favoritism in infrastructural allocation, energy price setting and government centralization decisions.

Thus, getting ready early for adherence to a WHFTA by mobilizing what may appear like a "far away" rural economy indeed makes two major contributions. One, it provides a chance for

small and medium enterprises, instead of being hurt by increased international trade, as they were during the colonial period, or hurt by the unfair competition of urban industry in the post-colonial period, to become viable partners in such trade, as has been demonstrated by the recent Canadian example once it joined NAFTA. Secondly, the enhanced growth of incomes which is generated in this way should permit voluntary and tax savings capacity to be enhanced in turn, thus permitting the politically and economically difficult loss of revenue from import duties to be made up. Thirdly, the improved distribution of income which results from the decentralization of industry and the mobilization of the agricultural sector in tandem with such rural industry, will permit more domestic demand to be channeled towards domestic activities, providing a solid base for increased participation in domestic markets, both by freeing up labor for current participation in export activities and by ensuring public support for the gradual enhanced opening up to freer trade as stipulated under the time-phased WHFTA arrangements. The fears of increasing disparity among the recipients is often seen as an obstacle to the continued march toward openness embodied in WHFTA adherence. But the fact is that fully mobilizing the domestic economy of each participant would not only enhance equity within each but also generate maximum growth for each.

### III. Required Domestic Complementary Policies for Maintaining the Political Acceptability of a WHFTA.

Even though the gains from trade, both of the static and the dynamic variety, under a presumptive WHFTA are likely to be

substantial -- not only for the economy as a whole but even for working families as a whole --, the resistance of directly affected workers and entrepreneurs in the inevitable "sunset industries" represents the most important obstacle to the longer term effectiveness or even adherence to a WHFTA arrangement. To have policies in place addressing this problem may be necessary not only for the initial ability to gain political acceptance, but, as importantly, for continuing implementation over the years, including the retention of sufficient public support over the business cycle.

As current debates within Mexico and the United States on the pending NAFTA legislation well indicate, it is specific, highly vocal, groups of workers and employers which are likely to represent an important challenge. Since the relatively few adversely affected in the short run are predictably well-organized and identifiable, while those benefiting from a WHFTA are relatively diffuse and invisible, much more thought has to be given to a viable adjustment assistance program within both the rich and poor members of a WHFTA than has thus far been in evidence.

With respect to not only the impact of freer trade but also the modest movement of people, the customary march of technology and even the ability to earn the peace dividend, the problem is essentially similar, i.e., individual countries are finding it politically difficult to accept the temporary dislocation of workers and entrepreneurs who are directly affected in the short

run. It does little good to cite the longer-term economic benefits of freer trade for the society as a whole, as long as domestic workers and entrepreneurs in particular locations, carrying considerable electoral clout, feel threatened by unemployment and dislocation or bankruptcy. Inevitably, even in non-election years, they will view foreigners and foreign goods as a clear and present threat to their livelihood and have little confidence in government promises to alleviate the problem down the road.

As WHFTA proceeds, we would, of course, expect ever larger participation of its members in international trade, partly because of the reduction of barriers within the WHFTA area, as well as due to secularly falling transport costs, the mounting speed and volume of information and technology flows, all contributing to the possibilities of enhanced specialization. The resulting mounting opportunities for a reassignment of comparative advantage in production, including the enhanced flow of both process and product innovation, have to be weighed against the potentially powerful rear-guard actions of the few who are, in fact, likely to be hurt and unconvinced by the theoretical possibility of a positive sum game. In my view, this backlash against a WHFTA, possibly even able to frustrate the initial full adherence of a member country, requires that a well-functioning, credible adjustment assistance program be put in place and operate effectively.

Such programs, of course, have been on the books of some industrial countries in the past. The Scandinavians, for

example, have reportedly done quite well with their worker retraining programs and the Japanese have had success in deploying their firm-level lifetime employment guarantees to absorb workers in sunrise branches as sunset activities fade away within the zaibatsu and keiretsu systems. But overall international experience has clearly been mixed. More importantly, it has never been fully scrutinized and analyzed. Consequently I believe it is essential early on to carry out a really thorough examination of such past experience. The purpose would be to come up with the outline of an effective, as well as politically acceptable, adjustment assistance program which could be adapted to the particular institutional conditions of each of the Latin American countries contemplating joining WHFTA. Such a program would have to provide a real safety net for the directly affected workers and entrepreneurs, while permitting a shift of resources towards new output and employment mixes in the sunrise industries.

One of the problems posed by past experience, at least judging by past U.S. adjustment assistance programs, for example, is that it is much easier to provide additional time and encouragement to resist change than to induce change by lowering the pain involved. The modest U.S. program has often been called "burial assistance" instead of "adjustment assistance" because when it operates through the extension of unemployment benefits, for example, it encourages people to assume that the competitive pressures being felt are only temporary and to wait things out; similarly, with respect to the provision of low interest loans to



affected entrepreneurs by the Small Business Administration, relatively little has been accomplished to change attitudes in the sunset industries and enhance entrepreneurs' capacity to make a move. In summary, the challenge is to devise programs which will, in fact, provide resources only in relation to a proven shift on the part of workers and entrepreneurs into new activities.

No one -- certainly not this author -- is ready to offer a precise blueprint for the ideal adjustment assistance program relevant to each WHFTA adherent. In some cases, for example Chile, it might be possible for governments to be involved in temporary or transitional employment cum training programs before resources can be absorbed by the private sector in the new and often ex ante unidentified sunrise industries. Or payments for training or relocation expenses could be made only ex post on the basis of documentary evidence. In any case, while attrition will, of course, take care of some of the affected parties, the real problem remains the political reaction from workers and entrepreneurs who can often exercise substantial veto power, even if their numbers are relatively small compared to the longer term beneficiaries of WHFTA accession.

A related suggestion would be to provide a fresh focus for the somewhat tired Latin American integration idea. Within IDB and other circles, the creation of a Latin American integration fund has been discussed. The possibility of deploying at least a portion of such resources to support national programs of adjustment assistance should be examined. Looking down the road

a bit, it might also be possible to devise adjustment programs which abide by evolving international standards and even sanctions along the lines the European Economic Community deployed as trade barriers were being removed, along with the use of the European Investment Fund.

Another suggestion that merits careful consideration, I believe, is that the richer country members of any WHFTA arrangement might be willing to channel some of their foreign assistance funds either to support bilateral or, more likely, multilateral adjustment assistance programs. Given the general budgetary stringencies in the advanced countries and the current tendency to look increasingly inward, it is very likely that any contribution to a regional adjustment assistance fund will have much easier sledding than bilateral or even multilateral contributions to foreign aid. It would presumably be much easier to convince parliaments to approve funds for a program which is much more closely tied to the enlightened self-interest of each of the contributing WHFTA members. It is moreover realistic to conceive of such a fund as revolving, possibly by imposing a small tax on the incremental trade volume being generated under a WHFTA (or possibly by slightly decelerating agreed-on tariff reductions and using the extra resources for such a fund, as has recently been proposed in the NAFTA context). In general terms, the notion that foreign aid spent at home might be more efficient and politically more viable and attractive over the long term to both the rich and poor members of a WHFTA, in the "trade-not-aid" tradition, carries a good deal of conviction.

It should also be recalled that the proliferation of safeguard provisions, escape clauses, anti-dumping rules etc., which continues to cause so much friction within the current GATT structure and in bilateral arrangements outside the GATT, would be substantially weakened if a credible adjustment assistance program, either at the national or possibly at the international level, could be put in place. There is little doubt that the frictions which arise in the context of dispute settlement procedures would tend to erode participating parties' faith in WHFTA and threaten the breakdown of the system, just as they have threatened to do within the GATT. While there is very little hope at the moment that we can quickly move to an ITO type multilateral enforcement system, it is also generally recognized that its absence has substantially frayed the GATT and helped render agreement on the current Uruguay Round so difficult. Similarly, to avoid the kinds of problems which have already become obvious in the short experience between the US and Canada in the NAFTA context, a major important lubricant would be an effective adjustment assistance program in each of the participating WHFTA members, possibly gravitating towards internationally negotiated rules of the game.

#### IV. Complementary Domestic Policies Over the Longer Term.

The view down the road is always more problematic and imprecise, especially for economists, who are much better at projecting the past. Nevertheless, a few comments might be useful in terms of the complementarity of domestic policies over

the longer term to ensure that a WHFTA reaps the fullest possible benefits and that the threat of reversal is minimized.

Ideally, to reap the full benefits of freer intra-regional trade, the WHFTA should be viewed as an important stepping-stone towards a broader, multilateral, free-trading world. This assumes eventual successful negotiations under the GATT and the eventual joining of various regional structures, including that of the EEC and WHFTA and a possible third grouping in Asia at some future date. It is indeed not beyond the scope of reasonable expectations that such fuller multilateralization might eventually be accompanied by the establishment of an ITO as envisioned in the early post-war period.

The assumption that multilateralization may be in the cards over the long haul -- in spite of the current evidence on rising nationalism and protectionism -- is based not on romantic illusions or wishful thinking but rather on the fact that increased globalization seems inevitable, given the march of technology and information, plus continuous reductions in transport and transactions costs. We may therefore think of a successful WHFTA in the longer term as an important way-station en route to the removal of inter-regional obstacles en route to taking full advantage of dynamic comparative advantage across the globe. Once individual countries within WHFTA have adopted their own adjustment assistance schemes and have thus permitted dynamic comparative advantage to hold sway, the momentum can be expected to continue to move participating countries in the direction of greater political as well as technical capability to adhere to

agreed-on WHFTA transition rules. Given the anticipated acceleration in the march of technology, of both the process and product variety, we can expect the "flying geese" of the future to have shorter wings than those of the past, thus adding to the pressure of adjustment requirements over relatively short periods of time. This also means that the possibility of a global adjustment assistance fund, following agreed-upon international rules of the game, and contributed to unequally by developed and developing country WHFTA members, becomes an increasingly realistic option.

To ensure the smooth maintenance of the so-called dynamic product cycle it is, moreover, important not only that an effective adjustment assistance program be in place in WHFTA, as in other regional groupings, but that a workably competitive environment is maintained domestically within each adherent country. Since we can reasonably assume that changes in technology, especially in terms of product innovation, will in the future be more and more rapid, we can envision a heightened need for flexibility both within WHFTA and in terms of the trading world at large. Consequently it becomes increasingly necessary to think in terms of timely actions dictated by the market, but facilitated by a market-friendly government policy framework. This essentially requires regulatory emphasis to avoid market failure, along with government failure, i.e. continuous attention paid to the necessity of taking timely preventive action before bankruptcy looms or massive unemployment appears. It also argues for continuous adherence by all the

trading countries within a presumptive WHFTA to effective internal antitrust policies, so that companies cannot resist change via the exercise of monopoly power, i.e., by raising prices through output restrictions, instead of shifting their technology and output mixes as the competitive environment forces them to adjust.

When we discuss the relative roles of government and markets in this context, it is important to distinguish between centralized and decentralized public sectors, as well as between workably competitive and oligopolistic private markets. This might mean heavy emphasis on vertical decentralization, especially of the type that devolves critical allocation decisions to local government bodies; elsewhere it might include emphasis on horizontal decentralization, as between central government ministries and as between the executive and legislative branches at various levels of government. In whatever combination, depending, of course, on the individual country situation, including whether it is a federal or a unitary state, there will exist a continuous need for appropriate institutional and regulatory flexibility, so that workably competitive conditions in both public and private sectors can be maintained over time.

It should also be noted in this context that, if a WHFTA is to have fullest possible impact, more important for the avoidance of domestic government and/or market failure than the actual trend of policies in both the public and private sectors is the reduction of the frequent oscillations of policy which have

bedeviled the Latin American arena over the historical past. Fortunately, most Latin American societies seem now to have recognized that they have virtually exhausted the stop-go alternatives, open/interventionist, populist/military, and orthodox/unorthodox, and that it is most important to achieve credibility of the internal as well as the external economic strategies of each of the presumptive WHFTA members in order to maintain a steady path in the right direction. In other words, it is the consistency of a particular policy mix that is required so that the private sector can count on particular rules of the game, even if they are less than optimal. The highest risks are associated with the frequent fluctuations in both the nature and extent of government interventions, or even the importance attached to the personality of the finance minister.

The absolute size of the public sector, either in terms of its role in overhead construction or in directly productive activities, does not by itself tell us too much about the appropriateness of the decision-making locus and process. Religious views about privatization are not very helpful. In fact, government should really not be treated as a homogeneous entity any more than the private sector. The contrast between decentralized competitive markets and centrally planned economies is only useful to ideologues. It is not helpful to those who want to build appropriate domestic policy structures within each of the participating members of a future WHFTA. Here the reality is much closer to having to choose between an oligopolistic, rent-seeking private sector and a workably competitive private

sector, on one hand, and between a predatory, elitist government and a decentralized, devolutionary public sector, on the other. Our main concern should be with government failures if it refuses to decentralize, and with market failures if it fails to yield to workably competitive pressures via a regulatory process.

The longer-term benefits of trade liberalization and the reaping of the full benefits of WHFTA over the longer term, in other words, have much to do with the domestic market structure which evolves. This, in turn, depends crucially on the flexibility of response mechanisms that are created and maintained in the private sector of the economy, plus public sector actions to ensure the avoidance of market failure through continuous attention to the regulatory framework in a supportive sense. While it is unrealistic to envision anything approaching textbook competitiveness, attention to entry conditions, both for domestic and foreign firms, and to the maintenance of antitrust vigilance in existing industries, remains critical. The basic reason is that knowledge is critical to growth -- and the role of technology, its transfer within the WHFTA, as well as its internal adaptation and diffusion, depends not only on the extent of external openness but also on internal market structure phenomena. Indeed a major hallmark of successful development, and thus the assurance of the continuous flow of benefits resulting from any WHFTA, would be the assurance of continuous entrepreneurial response capacity in the context of inevitably changing external conditions. We know that the future pace of international technology change can only be expected to speed up.



We know that the product cycle will continue to accelerate. We know that the wings of the flying geese will become shorter and shorter. And we therefore know that technological flexibility and adaptability on the part of firms and workers will become increasingly crucial elements in the full achievement of synergy between trade and domestic growth cum equity objectives in each of the individual participating countries of the region.

We may even dream of the possible eventual harmonization of domestic monetary, fiscal and social policies within the WHFTA region, very much as is now being hesitantly discussed within the EEC, as open markets in goods, later capital, still later labor, provide an impetus for gradual convergence, even if WHFTA will presumably lag substantially behind the European case. One advantage that WHFTA may have is that it can benefit from the earlier European experience, perhaps seek a more gradual and less dramatic progression towards ultimate economic (and even political) integration of the North and South American region in the twenty-first century.

It seems clear not only that international trade provides continuous discipline for domestic economic policies, as we have long ago learned in terms of post-import substitution liberalization efforts in individual developing countries, but also that there is a discipline which emanates from balanced domestic policies. These help us avoid excessive market failures as well as government failures, and to resist the temptation to impede competition in response to inevitable domestic pressures. Thus, if we are sufficiently determined to stay the course, a

mutually beneficial "virtuous cycle" can be initiated and maintained as we make gradual progress in the direction of an integrated common market on the American continent.

Even though the notion of moving beyond a free trade area in the Western Hemisphere through the removal of barriers to migration and the harmonization of policies across countries at very different stages of development may currently seem more than a bit romantic, it is not out of keeping with what has been happening in Europe, especially when one considers the less developed countries in Southern Europe joining the more advanced countries of Northern and Central Europe. But it is also useful to note in the same context that it will be necessary to maintain continuous discipline in the complementary domestic policies, e.g., agriculture, as a lesson to be learned from the European experience, especially in very recent months. It is just as important for the future good health of the WHFTA, in other words, to maintain the discipline coming from the invisible domestic policeman, as the maintenance of domestic discipline is enhanced by the trade liberalization associated with the international pressure generated by a WHFTA.

#### V. Summary and Conclusions

An excessively single-minded concentration on the international dimensions of a presumptive WHFTA, both with respect to the initial preconditions which must be met and the rules of the game which must be adhered to over time, is bound to be misleading and dangerous. Both theory and experience tell us

that, even for small countries in which trade is bound to play a relatively large role, the interplay between the trading and non-trading sectors of an economy is crucial to the success of the WHFTA adherence and the development process as a whole.

We have tried to stress this general point in each of the relevant time dimensions: as an individual country considers the option of joining the WHFTA and tackling the remaining domestic obstacles which stand in the way of achieving maximal benefits from such a decision; as an individual country, once a member, needs to ensure that policies are in place which provide safety nets for workers and entrepreneurs negatively affected in the short run -- while the longer term gains from adherence are distributed as equitably as possible; and finally, as each country endeavors over the longer term to reduce inevitable frictions with its trading partners via reasonable dispute settlement schemes and considers gradual additional steps in the direction of the harmonization of relevant domestic policies.

The potential future members of a WHFTA are likely to be quite heterogeneous in character, with respect to size, income, endowments, and stage of development reached. No single set of prescriptions can be general enough to fit all, or specific enough to fit any one. But there, finally, are some basic general points worth emphasizing:

- 1) In preparing for WHFTA adherence, macro-economic policy change must focus simultaneously on both the domestic and international "blades" of the developmental "scissors." The sequential liberalization of various markets, i.e. in the

monetary and fiscal sphere, in foreign trade, foreign exchange, etc., must be accompanied by micro-economic and institutional reforms concentrated in large part on the mobilization of the rural economy, both its agricultural and non-agricultural components. Attention has to be paid to the improved functioning of the inter-sectoral financial, labor and commodity markets which are seen to be necessary complements to the hoped-for invigoration of international trading activities. This usually means reducing the biases in the allocation of infrastructure, credit, technological attention etc. against food producing agriculture and medium/small-scale industries, and being more even-handedly supportive of balanced domestic growth and the participation of rural industry directly or indirectly (via subcontracting arrangements) with the large-scale, including in foreign trade and in "neighboring" niche markets. Public sector decentralization policies, specially of the truly devolutionary type, accompanied by block grants to local bodies, would be especially helpful in this context.

2) In accommodating to WHFTA adherence, in both the economic and political senses, systems must be fashioned which reduce the short-term resistance of workers and entrepreneurs in the sunset industries and facilitate their access to sunrise industry activities. The continuous march of dynamic comparative advantage within the WHFTA will require devising viable adjustment assistance programs, possibly supported by IDB or WHFTA's own integration funds, as well as diverted foreign assistance allocations by the bilateral donors.

3) In seeking to maintain the momentum for harvesting the maximum benefits from the WHFTA over time, it is necessary to "stay the course" and avoid undue oscillation in both the macro- and micro-policies affecting both the externally and domestically oriented blades of the economy. The credibility attached to sustaining a government policy direction previously defined is critical if the private sector is to respond appropriately and avoid the worst of both worlds, often a symptom of multi-dimensional "stop-go" policy experiences of the past. Consistent decentralization of the public sector, accompanied by policies which consistently seek to avoid private sector monopoly, will provide the best protection over time against the twin dangers of government failure and market failure. Hopefully the WHFTA, along with other regional groupings (in Europe and, possibly, Asia) will experience enhanced harmonization in monetary, fiscal and other policies, even if a "United States of the Americas" may be a long way off. More critical is the avoidance of the simultaneous construction of higher external barriers which might work to the disadvantage of the eventual forging of a multilateral trading world (under the GATT or possibly even a revived ITO).

As the late Irving Kravis<sup>3</sup> and, more recently, Elhanan Helpman<sup>6</sup> have maintained, trade remains a hand-maiden to growth. But the right type of domestic growth, i.e., participatory and balanced, can have a large feed-back for trade. Internal policy changes accommodate changes in output growth which break down internal barriers as well as inducing export growth. With full

causality running in both directions, the maximum benefits of a WHFTA, which clearly reside in the generation and transmission of technological impulses associated with enhanced trade, can be realized.

#### Notes

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2. John Williamson. The Progress of Policy Reform in Latin America. Washington, D.C.: IIE, 1990.
3. Irving Kravis. "Trade as a Handmaiden of Growth: Similarities Between the 19th and 20th Centuries." Economic Journal, December 1970.
4. Elhanan Helpman. "The Hypothesis of Export-Led Growth Revisited." David Horowitz Institute for Research of Developing Countries, 1988.



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