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Trade Openness and Developing Countries' Vulnerability: Concepts, Misconceptions, and Directions for Research

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Summary. — This work focuses on the welfare costs of exposure to shocks and uncertainty linked to trade openness—a prominent issue in international debate. It contributes by presenting a comprehensive review of the literature on the “destabilizing effects” of trade openness, drawing together studies in different fields. It provides a conceptualization of vulnerability and three promising lines of reasoning (macro, micro, and meso) for future research on the link between trade and vulnerability.

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1. INTRODUCTION

According to theory, international trade improves resource allocation, lowers prices for consumers, and leads to a more efficient production. An open trade regime also encourages the integration of the economy into the global system and imports of modern technology, which results in productivity improvements. Accordingly, international organizations advocate policy reforms centered on trade liberalization to foster growth and welfare.

However, a key issue remains unanswered: does trade openness magnify exposure to foreign shocks raising uncertainty and, eventually, producing long term effects on partner countries' welfare? This topic is currently hotly debated by practitioners, while largely ignored by trade literature. Trade theory does not provide a full understanding of the links between trade openness, shocks, and uncertainty. Empirical evidence is mixed, scattered in separate fields of analysis and does not reach a common stance. A number of attempts have been carried out recently to investigate more carefully this issue both at the aggregate (Montalbano, Federici, Pietrobelli, & Triulzi, 2006, 2008; Guillaumont, 2009, 2010; Naudé, McGillivray, & Rossouw, 2009),¹ and at the household's level (Winters, 2002; Winters, McCulloch, & McKay, 2004). However, these pioneer works lack consistency in terms of conceptualization and methods.

This work aims at contributing to the above debate by providing a comprehensive conceptualization of “vulnerability from trade openness” and some directions for future research on this topic at different levels of investigations (macro, micro and meso).

A first challenge is to bridge two relevant issues, traditionally seen as separate topics: trade openness and vulnerability. While the debate around trade openness and its measurement has been extensively investigated since Krueger (1978) seminal work, vulnerability assessment is still at the “let a hundred flowers bloom” stage, as stated by Hodinott and Quisumbing (2003) and there are several misconceptions related to its analysis.

The main focus of this work is the vulnerability analysis of the effects of trade openness on partner countries. Specifically, this article addresses the issue of whether or not, and eventually under which conditions, trade openness leads to increasing

exposure to external shocks and/or raising uncertainty about the future on certain actors and/or specific social groups. The debate around trade openness remains indeed an important part of the story but it does not represent the main contribution of this piece of work. This article builds on McCulloch *et al.*'s (2001) operational view that the relative openness of countries depends largely on the extent to which international trade determines local prices, regardless of whether or not this depends mainly on deliberate policies.²

The article is structured as follows. Section 2 surveys the existing literature on the likely “destabilizing effects” of trade openness. Section 3 reviews the current theoretical and applied literature on “vulnerability,” presenting an overall conceptualization of the phenomenon as well as some of the most common misconceptions. Section 4 proposes a first conceptualization of the trade and vulnerability “link” and some directions for future research. Section 5 concludes.

2. IS TRADE OPENNESS DESTABILIZING FOR DEVELOPING COUNTRIES?

Most empirical work establishes a consistent and significant positive correlation between trade liberalization, growth and poverty reduction (Edwards, 1993; Frankel & Romer, 1999; Sachs & Warner, 1995; Dollar & Kraay, 2002, 2004; Cline, 2004; Winters, 2004). The drawbacks to trade openness are acknowledged basically in terms of short and medium run adjustment costs. The pervasive effects of trade openness on poverty and inequality, even in the long run, are acknowledged as well (Goldberg & Pavcnik, 2004; Lundberg & Squire, 2003; McCulloch, Winters, & Cirera, 2001; Winters *et al.*, 2004).

An issue largely ignored by the above literature concerns the analysis of possible “destabilizing effects” of trade openness.

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The hypothesis of a direct link between developing countries' instability and trade openness has several roots: (i) the apparent asymmetry between the process of increasing specialization and the presence of random, undiversifiable shocks in the export markets of open economies (Koren & Tenreyro, 2007; Razin & Rose, 1992); (ii) the tendency of commodity prices—which are at the core of the specialization process in developing countries—to be more volatile than those of manufacture goods (Malik & Temple, 2009); (iii) the possible inconsistency between the shocks prevailing in open markets and traditional coping mechanisms and local market structures (Dercon, 2001); (iv) the occurrence of boom–bust cycles of investment induced by trade openness in countries characterized by inadequate infrastructures and shortages of skilled labor (Razin, Sadka, & Coury 2003); (v) the role of trade liberalization in altering households' optimal portfolios, coupled with greater variability in new portfolio options (Winters *et al.*, 2004); and (vi) higher risk of policy mismanagement in response to an entirely new set of incentives induced by trade openness in contexts where political institutions are weak (Acemoglu, Johnson, Robinson, & Thaicharoen, 2003; Fatás & Mihov, 2003, 2005; Gavin & Hausmann, 1996; Rodrik, 1999).

Given the heterogeneity of the situations above, it is worth making explicit here: first, what is meant with “economic instability,” second, why should we care; third, what are its link with trade openness.

(a) *Economic instability and its long term impact on developing countries*

Economic instability refers, generally speaking, to a situation of excessive fluctuations of economic variables: a phenomenon which is indeed increasing over time for a high fraction of low and middle income countries (Agenor, McDermott, & Prasad, 2000; Kose, Prasad, & Terrones, 2003; Loayza, Rancière, Servén, & Ventura, 2007; Wolf, 2005). Fluctuation is usually measured by the volatility of economic variables, proxied by the standard deviation of the first differences of observed time series (Aizenman & Pinto, 2005; Wolf, 2005).³ It reflects, empirically, the amount of uncertainty and risk of the economic variable, where risk is normally proxied by the predictable component of variability and uncertainty by its “unpredictable component.” A workable difference between risks and uncertainty has been highlighted by Knight's (1921) classic work: while risk permits one to assign probabilities to the different outcomes, uncertainty normally refers to situations where several outcomes are associated with an event, but the assignment of probabilities to these outcomes may not be possible (the so-called “knightian uncertainty”). In this respect, empirical volatility can be considered more as an allied to risk in that it provides a concrete measure of the possible variation or movement of economic variables (Aizenman & Pinto, 2005). On the other hand, it has been highlighted that the volatility of economic variables is seldom predictable and, hence, total observed volatility may overestimate risk (Aizenman & Pinto, 2005; Dehn, 2000).⁴ Several applied methods have been thus put in place by the literature to extract the “unpredictable component” (i.e., uncertainty) from “pure risk” and sample variability (e.g., Demir, 2009; Hnatkowska & Loayza, 2005; Wolf, 2005).

It is from Lucas' (1987) seminal work onward that economists have dealt with the macro analysis of the “cost of fluctuations.” According to Lucas' calculations, these costs account little in terms of welfare. This contributed to divert much of the previous attention on the issue as well as in favoring

growth centered policies with respect to economic stabilization ones. However, Lucas (1987)' results are not compatible with a number of stylized facts, for example, the so-called “equity premium puzzle” (Mehra & Prescott, 1985).⁵ Moreover, as Aizenman and Marion (1999) highlight, while risks do not necessarily do,⁶ “knightian uncertainty” produces pervasive long term effects, since agents are more reluctant to embark on new activities. Finally, from the work of Ramey and Ramey (1995) onward⁷ empirical cross-country studies have consistently found a negative relation between volatility, long-run growth and welfare, especially in developing economies (Aizenman & Marion, 1999; Demir, 2009; Fatás, 2000; Hnatkowska & Loayza, 2005; Kose *et al.*, 2003; Pallage & Robe, 2003; Wolf, 2005).

As Loayza *et al.* (2007) highlight, two are the main reasons one should care about volatility in developing countries: (i) the substantial welfare loss of deviating from a smooth path of consumption, in case of consumption volatility; (ii) the indirect welfare loss in terms of future consumption, in case of a negative impact of volatility on growth. Loayza *et al.* (2007) underline as well that developing countries not only face more volatility than industrial countries but suffer larger volatility effects, because of the intrinsic instability of the developing process (mainly linked to the weakness of their financial systems and the main characteristics of their specialization process of production); the concrete risk of policy mismanagement (e.g., as in the case of procyclical and/or erratic fiscal and monetary policies), and the presence of weaker mitigating and coping mechanisms.

(b) *Economic instability and trade openness: a survey of the literature*

The phenomena of “trade induced” instability have been traditionally seen as terms-of-trade shocks (Rodrik, 1998). However, open economies show, overall, greater output volatility and, in some cases, greater consumption volatility too (Hnatkowska & Loayza, 2005; Loayza *et al.*, 2007).

Winters (2002) provides a first analysis of the conditions under which foreign shocks can have specific impacts on households in developing countries, *via* the main transmission channels of trade openness: when foreign shocks are greater than domestic ones (e.g., when world markets are more variable than local ones); when trade liberalization affects governments' ability to operate price stabilization policies; when trade reforms change the emphasis among the different activities engaged by households (e.g., in the case of farmers, switching from subsistence to cash crops). He concludes that international trade has *a priori* ambiguous implications for macro stability.

To investigate more in depth this issue, it is useful to gather current applied literature on the “destabilizing effects” of trade openness into two main strands: empirical analyses that emphasize the role of trade openness as a key determinant of aggregate volatility (Easterly, Kremer, Pritchett, & Summers, 1993; Gavin & Hausmann, 1996; Kose, 2002; Kose, Prasad, & Terrones, 2005; Kose & Yi, 2001, 2006; Mendoza, 1995; Prasad & Gable, 1998; Rodrik, 1998; Wolf, 2004); and empirical analyses that look at trade openness as a complementary, real aspect in currency crises (Milesi-Ferretti & Razin, 1998, 2000). In this latter case, trade openness has been seen both as a means to trigger “sudden stops” (Cavallo & Frankel, 2008), or as a vehicle to spread out crises, especially in regional contexts (Easterly & Kraay, 2000; Forbes, 2002; Glick & Rose, 1999).

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