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RECENT HISTORY OF GLOBAL INTEGRATION: THE GLOBALIZATION WAVE OF THE 1980s AND 1990s [‡]

The Trade Reform Wave of 1985–1995[†]

By Douglas A. Irwin*

For more than 40 years after World War II, the world was divided into three economic blocs that operated in relative isolation from each another. The first world of North America, Western Europe, and Japan consisted of democratic, market-oriented states that sought to increase trade through the General Agreement on Tariffs and Trade (GATT). The second world of the Soviet Union, Eastern Europe, and China consisted of communist states with centrally planned economies that managed trade with each other through institutions such as the Council for Mutual Economic Assistance. The third world countries of Latin America, Africa, and South Asia were generally nonaligned states with mixed economies that restricted trade through import substitution policies aimed at promoting domestic industry.

Between 1985 and 1995, the walls obstructing trade between these separate worlds crumbled. Developing countries around the globe reduced their trade barriers and adopted more market-oriented policies. The fall of the Berlin Wall and the collapse of communism led Eastern European countries to do the same, with a particular focus on integrating their economies with Western Europe. China and Vietnam remained communist states but opened their economies to global trade. These moves were reinforced by liberalization at the regional level, such as the expansion and single-market initiative of the European Economic Community in 1986 and the North American Free Trade Agreement in 1994. And at the multilateral level, the Uruguay Round of trade negotiations included developing countries as full participants. The negotiations reduced trade barriers, established new trade rules, and created the World Trade Organization (WTO) in 1995.

These dramatic policy changes helped produce a world economy more highly integrated than ever before.[1] Figure 1 presents one measure of global integration, the ratio of world trade to world gross domestic product (GDP). After creeping up before World War I, global integration fell sharply during the interwar period because of economic dislocation and trade restrictions. The ratio rebounded slightly after World War II and jumped in the early 1970s with the oil price shocks. Global integration then soared in the 20 years after 1985 before leveling off after the 2008–2009 financial crisis.

This paper examines the transformative decade from 1985 to 1995 when developing countries undertook a historic shift in trade policy. The paper emphasizes several points: the importance of the balance of payments in both the initial restriction and later liberalization of trade, the contribution of exchange rate flexibility to reducing the currency overvaluation that led to so many trade restrictions, the desire to boost exports and increase foreign exchange earnings as a motivation for reform, the unilateral nature of the shift toward open trade, and the importance of economists and democracy

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[1] Another contributing factor was the decline in trade costs due to shipping containers and airfreight; see Bernhofen, El-Sahli, and Kneller (2016). These changes in transport costs and trade policy made global supply chains possible.

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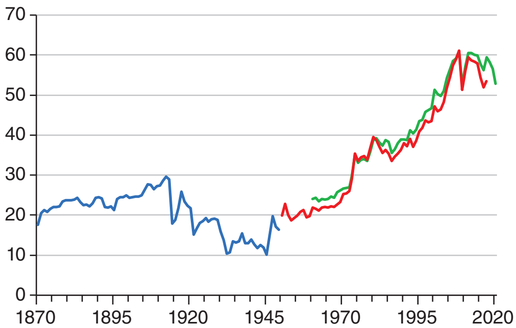

FIGURE 1. WORLD TRADE (EXPORTS + IMPORTS) AS PERCENT OF WORLD GDP, 1870–2020

AQ2 *Note:* Data are from Klasing and Milionis (2014) for 1870–1949, Penn World Tables (1950–2017), and World Bank (1960–2020).

(and the unimportance of special interests) in fostering the opening.

I. Background

The postwar restrictions on trade and payments in developing countries had their roots in the Great Depression of the 1930s. The collapse of export prices for commodity producers and the outflow of capital led many countries to impose exchange controls and import restrictions for balance of payments purposes. They chose to protect their gold and foreign exchange reserves by limiting foreign exchange outflows (particularly spending on imports) to prevent or limit the devaluation of their currencies (Eichengreen and Irwin 2010). These exchange and trade controls persisted into the postwar period.

The Bretton Woods conference established a regime of fixed but adjustable exchange rates, but most countries were still reluctant to devalue their currencies. Officials feared that devaluation would fuel inflation, deteriorate the terms of trade, add to the burden of foreign debt, redistribute income in undesirable ways, and reduce the standard of living of urban workers. Because many developing countries also ran high rates of inflation, the failure to adjust nominal exchange rates led them to have overvalued currencies and recurring balance of payments difficulties.

As a result, countries employed a battery of discretionary controls—including foreign exchange rationing, nonautomatic import licensing, and advance import deposit requirements—as a way of managing trade and keeping the balance of payments balanced. These administrative controls could be tightened or relaxed depending on the level of a country's foreign exchange reserves. Of course, these restrictions led some domestic interests—namely, producers competing against imports or importers with preferential access to foreign exchange—to have a stake in continuing these restrictions, even though they were not necessarily the original impetus for them. These controls were reinforced by trade policies aimed at promoting industrialization via import substitution.

Very few countries undertook trade and payments liberalization in the Bhagwati and Krueger (1973) sense of moving away from disequilibrium exchange rates through a devaluation, the relaxation of quantitative restrictions on imports, and the use of only tariffs to regulate imports at an equilibrium exchange rate. Two early countries that did so were Taiwan (1958–1962) and South Korea (1964–1965). In each case, an important motive for reform was to boost exports and foreign exchange earnings to compensate for declining US foreign aid. Both countries attracted attention for their success but few followers in practice. In the 1970s, an abundance of foreign exchange, due to higher commodity prices and greater lending in the aftermath of the oil price shocks, meant that most countries could maintain their existing trade and payments regimes.[2]

The world changed in the 1980s. The difficulty in obtaining foreign exchange, due to the collapse of international lending and sinking commodity prices, put many countries under severe balance of payments pressure, if not a full-blown debt crisis. Almost half of all countries in the early to mid-1980s had overvalued currencies, often with black market premia above 40 percent (Easterly 2019, Figure 2a).

This scarcity of foreign exchange forced a shift in policy. Whereas deteriorating current account positions from the 1950s to the 1970s led to tighter import controls to forestall any devaluation, current account deficits in the 1980s were followed by a greater reliance on exchange rate adjustment and a relaxation of trade controls (Little et al. 1993).

[2] Two notable exceptions were Chile (1975) and Sri Lanka (1977).

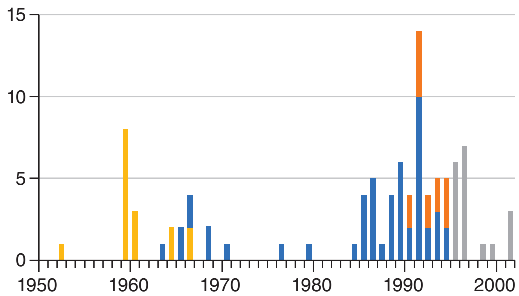

FIGURE 2. NUMBER OF COUNTRIES BECOMING OPEN, 1950–2000

Notes: Data are from Sachs and Warner (1995). Yellow represents Organisation for Economic Co-operation and Development countries, blue represents developing countries, orange represents Eastern European countries, and grey represents other countries later added by Wacziarg and Welch (2003).

As a result, the decade after 1985 saw an unprecedented number of trade liberalization episodes. Figure 2 presents the number of countries that flipped from being "closed" to being "open" according to the Sachs and Warner (1995) criteria.[3] The figure shows that a pronounced wave of trade reform occurred between 1985 and 1995. (The contrast with the 1970s, when there was an absence of reform, is stark.)

Several countries stand out as leading examples of this liberalization wave. Mexico had long maintained tight import restrictions and had initially responded to the debt crisis of the early 1980s with import repression. In 1985, it changed its approach by devaluing the peso, phasing out quantitative import restrictions, and reducing tariffs. In the mid-1980s, India began to adjust its exchange rate more frequently and relaxed some import controls. It went much further in 1991 when a sharp loss of foreign exchange reserves led it to devalue the rupee, abolish export subsidies, eliminate import licensing for capital goods, and move toward a flexible exchange rate and current account convertibility. China and Vietnam also began to open up their nearly autarkic economies when they abolished state monopolies on foreign trade, allowed foreign investment, and moved to unify the exchange rate.

Such changes were not confined to these countries alone. Rather, country after country in East Asia, Latin America, and South Asia—and to a lesser extent sub-Saharan Africa—made the choice to open up their economies and increase their participation in world trade.[4] The question is: why did this happen?

II. Features and Explanations

What are some of the broad features that help explain how and why this historic wave of trade liberalization took place?

A. *Balance of Payments and Exchange Rates*

An underappreciated reason for the mid-1980s trade policy shift was the growing acceptance that exchange rate adjustments were a better way of dealing with balance of payments problems than trade controls. As Collier (1993, p. 510) put it, "The heart of liberalization is the conversion from using trade policy for payments balance to using the exchange rate."

The original rationale for many import controls was to help maintain balance of payments equilibrium in lieu of an exchange rate change. Given the general view that devaluations were to be avoided, countries opted for a combination of import controls and export subsidies to compensate for overvalued currencies and address external payments imbalances. In essence, import controls and devaluation were substitutes for one another.

During the 1960s and 1970s, economists accumulated evidence about the costs of such controls and their adverse effect on exports. Discretionary trade intervention and quantitative restrictions proved to be administratively complex and a breeding ground for special interest lobbying and corruption. Import substitution policies were increasingly seen as inefficient and even counterproductive (Krueger 1997; Irwin 2021).

Equally important, economists learned from experience that import controls were a bad way of addressing an overvalued exchange rate and a

[3] The data are from Sachs and Warner (1995), who defined a country as "closed" if it had an average tariff of more than 40 percent, a nontariff barrier coverage rate of more than 40 percent, a black market premium on its currency of more than 20 percent, a state monopoly on exports, or a socialist economic system.

[4] For a general overview, see Dean, Desai, and Riedel (1994).

poor substitute for a devaluation. Such controls could not match the ability of a devaluation to encourage exports, discourage imports, and help achieve external balance at one stroke.

Getting the exchange rate right was the first step in opening an economy.[5] Once countries eliminated overvalued currencies, they did not have to use import controls for balance of payments purposes. The trade reform wave coincided with a dramatic reduction in the number of countries with overvalued currencies and an increase in the number of unified exchange rates under more flexible regimes.[6]

B. *Exports and Foreign Exchange*

A primary goal in opening up the economy was to increase exports and earn more foreign exchange. Foreign exchange is the lifeblood of any small open economy because it enables the purchase of foreign goods, many of which cannot be produced (or can only be produced badly) at home. Many imports—food, fuel, raw materials, capital goods, spare parts—are necessary for the economy to function.

The foreign exchange that makes these critical imports possible could be earned through exports, received in foreign aid, or borrowed via foreign lending. An adverse terms of trade shock, a cutback in foreign aid, or a reduction in foreign lending often led to a shortage of foreign exchange.

The depletion of a country's foreign exchange reserves—the hard budget constraint imposed by the balance of payments—was often a stimulus for reform.[7] These problems did not always occur amid a macroeconomic crisis marked by hyperinflation or a growth collapse. For example, India's 1991 reform came about because the country exhausted its foreign exchange reserves, not because it was experiencing slow growth or high inflation.

Of course, governments could respond to balance of payments problems either by repressing imports through controls or promoting exports through devaluation. Once economists began to appreciate the benefits of exchange rate adjustments as opposed to import controls, policymakers began to respond to balance of payments shocks by altering the exchange rate. The problem with import repression is that it did nothing to increase foreign exchange earnings. And even if controls saved foreign exchange, they would constrain domestic production when important imported intermediate goods can no longer be easily obtained. (The need to repay international creditors during the debt crisis of the 1980s added to the urgency of increasing one's foreign exchange earnings.)

The move to a more realistic and flexible exchange rate proved effective in stimulating a country's exports and increasing its foreign exchange earnings.[8] This success not only became evident to policymakers around the world, it also created domestic constituencies to support the reforms.

C. *Technocrats or Special Interests?*

Work on the political economy of trade policy tends to focus on the role of interest groups. The political system is often thought to be biased in favor of trade restrictions because domestic producers competing against imports are organized and lobby for such protection, while exporters and consumer groups are either politically weak or not organized.

Yet the discussion here suggests that the trade and payments regime of many developing countries was shaped as much by the balance of payments and exchange rate policy as it was by domestic producer interests. Import controls arose as an ad hoc way of addressing the failure of foreign exchange earnings to keep pace with foreign exchange outlays, something

[5] "In practice, the celebrated success of so-called 'outward looking' or 'export promoting' strategies of development is built largely around the use of 'realistically' valued exchange rates," Keesing (1979, p. 24) noted at the time.

[6] See Reinhart and Rogoff (2004). Levy-Yeyati and Sturzenegger (2003) find that more flexible exchange rate regimes are associated with faster economic growth and reduced output volatility in developing countries.

[7] In many cases, a reduction in foreign aid has proven to be a stimulus for reform. Declining US aid spurred Greece (1953), Taiwan (1958), and South Korea (1964) to reform. The declining support from the Soviet Union pushed Vietnam to undertake its *doi moi* reforms in 1986, and curtailed foreign aid to Tanzania also forced it to reform in 1995. Conversely, abundant foreign exchange, it is said, "kills the will to reform." The absence of reform in the 1970s illustrates this point.

[8] Freund and Pierola (2012) find that export surges follow more from exchange rate devaluations than trade liberalization, although the two are often related.

that was largely a function of the exchange rate. (Of course, once in place, the exchange control regimes were strongly supported by those who benefited from it.)

The trade and payments reforms of 1985–1995 did not come about because of the demands of producer interests.[9] The impetus usually came from economists in finance ministries and central banks (Harberger 1993). That is where the idea of using exchange rate policy instead of trade policy to achieve balance of payments adjustment entered the policymaking process. The key battles over policy reform were often between different agencies within the government rather than between the government and private interests.[10] Commerce and trade ministries tended to oppose the relaxation of controls, reflecting institutional interests.

When foreign exchange reserves were low and policy adjustments were required, economists in policymaking positions helped tip decisions in favor of devaluation and the liberalization of import controls. In country after country, high-ranking economists in government—often with past World Bank experience—have been tied to the spread of trade liberalization around the world (Weymouth and Macpherson 2012). Not only were they able to convince political leaders of the necessity of these reforms, but those reforms could be implemented by executive action. The executive had broad authority to change the exchange rate and relax nontariff import restrictions without legislative approval and with few direct political constraints.

While special interests can often explain the persistence of a policy, economists and their ideas can—under the right circumstances—be important in changing policy.[11]

D. *Unilateral Policy Actions*

The dramatic changes in trade and payments regimes were largely undertaken unilaterally by the countries themselves, not in multilateral negotiations. The nontariff barriers related to trade payments were permitted by Articles XII and XVIII of the GATT and not subject to bargaining with other nations. The reform of payments and exchange rate systems were more likely to be discussed in bilateral consultations with the International Monetary Fund (IMF).

The tariff reductions of developing countries that followed exchange rate changes and payments reforms were also largely unilateral. From 1983 to 2003, the weighted average tariff for developing countries fell from 29.9 percent to 11.3 percent. Of this 18.6 percentage points reduction, Martin and Ng (2004) find that two-thirds were undertaken unilaterally, one-quarter in multilateral negotiations, and one-tenth in regional trade agreements.[12] In the Uruguay Round negotiations, developing countries agreed to reduce their bound tariffs, but these were usually much higher than their applied tariffs, which were unchanged as a result of the negotiations.[13]

World Bank and IMF conditionality may have facilitated reform in some countries that were already determined to change their policies, but these institutions were not the driving force behind the reforms.[14]

Thus, the trade policy changes of the 1985–1995 reform decade were largely initiated by the countries themselves. It was they who isolated themselves by their own policies, and it was they who decided—sometimes by

[9] As Bates and Krueger (1993, p. 455) conclude from a series of case studies on policy reform, "one of the most surprising findings … is the degree to which interest groups fail to account for the initiation" of policy reform.

[10] As Haggard and Webb (1994, p. 13) note, "Frequently, the most vociferous opposition to a change in policy comes not from interest groups, legislators, or voters, but from ministers and bureaucrats within the government or even from the executive himself." They also add, "Contrary to conventional political economy expectations, relatively low levels of business resistance to trade reform were found in countries studied here, in part because policies were packaged effectively" (18).

[11] As Rodrik (2014, p. 205) has observed, "Because of their neglect of ideas, political economy models often do a poor job of accounting for policy change."

[12] Bureau, Guimbard, and Jean (2019) find that most developing country tariff reductions in the later period of 2001–2013 were also made unilaterally, although WTO accession was important in some cases, including China, Vietnam, and Saudi Arabia.

[13] See Finger, Ingco, and Reincke (1996). For example, Argentina agreed to bind all of its tariff lines in the Uruguay Round negotiations, but its average bound tariff on merchandise was 31 percent, while its average applied tariff was 10 percent.

[14] As noted earlier, sometimes withholding aid proved more effective in producing policy reforms than providing aid. In the case of Kenya, Michael Bruno, the former chief economist at the World Bank, said, "We did more for Kenya by cutting off aid for one year [thereby promoting reform efforts], than by giving them aid for the previous three decades" (Devarajan and Kehmani 2018, p. 216).

conviction, sometimes by necessity—to change course and open up.

E. *Democracy and Reform*

It is commonly thought that democratic governments face electoral pressures that make it difficult to undertake economic reforms that are painful in the short run. Authoritarian governments or military regimes, by contrast, can suppress political opposition and force through such measures.

While some authoritarian governments embraced trade reforms prior to the 1980s, most did not.[15] (This is evident from the lack of reform prior to 1985 seen in Figure 2, a period when democracies were rare in the developing world.) Rather, to stay in power, autocratic regimes often had to buy the support of elites by granting privileges and sharing rents. Trade controls and preferential foreign exchange allocation were among the ways of doing this. In fact, Giuliano, Mishra, and Spilimbergo (2013) find that democracies were more likely to undertake economic reforms than other forms of government.

The reform decade of 1985–1995 established an even clearer link between trade reform and democracy.[16] The "third wave" of democratization that swept the world in the 1980s and 1990s changed politics in a way that fostered trade reform. As Milner and Kubota (2005) point out, new democracies opened a country's political system to previously disenfranchised groups and broke up established coalitions of interest groups and political leaders who used trade policy (and foreign exchange scarcity) for political purposes. Democratic politicians campaigned against the corruption of previous regimes that had used rents as a way of winning support of select groups. Taking away rents from corrupt insiders proved to be politically popular, as did support for freer trade (Baker 2009).

[15] See Geddes (1994). As Biglaiser (2002, p. 13) points out, "Contrary to popular belief, an important common denominator among most military officers in the developing world is their intense opposition to policies supported by neoliberal economists."

[16] Meseguer and Escribà-Folch (2011) find that democracies confronting economic crises are more likely to liberalize trade as a result of learning from other country experiences, whereas personalist dictatorial regimes are most resistant reforming.

As a result, there have been relatively few major trade policy reversals, except where weak democracies have slid back to autocracies.

III. Conclusions

The decade from 1985 to 1995 was a historic period in which developing countries opened their economies and thereby transformed the world economy. The policy shift was followed by, and arguably contributed to, two remarkable developments. Starting around 1990, developing countries began to grow more rapidly and catch up to the higher income levels in advanced economies (Patel, Sandefur, and Subramanian 2021; Kremer, Willis, and You 2021). Largely as a result of that growth, the past few decades have witnessed a massive reduction in global poverty. The share of the world's population that lives in extreme poverty fell from 42 percent in 1981 to 10 percent in 2015, according to the World Bank.

Will the globalized era persist? Figure 1 suggests that the financial crisis of 2008–2009 might mark a high-water point of global integration. Exchange rate policies and trade controls have been reformed in many countries, and the removal of remaining barriers may have a smaller impact on global trade. And some of the factors that promoted integration in the past have weakened, including the retreat of democracy and the now-high level of foreign exchange reserves. Still, there is little doubt that the 1985–1995 decade fundamentally remade the global economy, taking three separate worlds and integrating them into one.

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