Optimal Globalization and National Welfare

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Introduction

In this paper we look at economic liberalization – both in the context of countries under transition from communism to capitalism, and in the context of developed market economies of North America and Western Europe. By "liberalization" we mean not just opening to external trade and capital, but also the freeing up of domestic trade and prices, as well as labor's ability to respond to national and international shifts in demand. We begin by reviewing briefly two recent books on the *international* aspects of liberalization, what has come to be known as "globalization". We then identify controversial aspects of reform in transition countries, and market economies, and review some of the recent empirical literature. Broadly, controversy surrounds the optimal pace and appropriate sequencing of reform, as well as the extent of liberalization. Finally, we draw out policy

implications of our analysis with a view to casting light on the debates over broadening and deepening of integration in the Americas.

The globalization controversy

Ever since the 1999 WTO meetings in Seattle, the word "globalization" has become infused with passion, with strongly-held opinions both pro and con. By *economic* globalization is usually meant free international movement of goods, services, capital and people: that is what we will comment on here, although the globalization of ideas and culture is perhaps even more profound.

Many economists were shocked and dismayed when one of their finest – Joseph Stiglitz – apparently broke ranks with the profession when he published his 2002 book, *Globalization and Its Discontents.* But Stiglitz's book is by no means a condemnation of globalization *per se*; rather it is a critique of the management of globalization by international institutions, especially the IMF and the WTO: institutions, moreover, that are dominated by developed-world interests. What shocks many economists, perhaps, is the passion with which Stiglitz makes his case. Passion is not an emotion that economists easily condone.

A more recent, and more nuanced, contribution to the globalization debate is Jagdish Bhagwati's 2004 book, *In Defense of Globalization.* As befits one of the profession's most practiced and prominent defenders of free trade, Bhagwati takes on all the common shibboleths about globalization: that it increases poverty, induces child labor, harms women, threatens democracy, imperils national cultures, undermines wage and labor standards, threatens the natural environment, and enhances predatory corporate power. He dismisses all these shibboleths both theoretically and empirically. Much of his theoretical logic follows from the economists' first article of faith – that trade voluntarily entered into between two parties must perforce benefit both parties. But there are subtleties: Bhagwati recognizes that when trade agreements are made at aggregate and national levels, some individuals will be made worse off just as others are made better off: Pareto improvements are virtually impossible.[1]

There is less substantive difference between Stiglitz's "discontent" and Bhagwati's "defense" than would first appear. Stiglitz highlights losers, Bhagwati highlights winners. Neither denies that globalization will produce both. Both recognize that free trade in capital is generically different from free trade in goods .… And both recognize that *the pace, coordination and sequencing of liberalizing reforms is crucial to their success in enhancing aggregate welfare.* This is a theme to which we will turn shortly in the broader context of reforms in transition economies.

Nevertheless there *are* substantive differences. Stiglitz puts much less faith in the efficiency, let alone fairness, of markets, as befits his position as the premier pioneer

[1] Similar arguments are made in another important recent contribution to the debate, Wolf (2004), who, as the title of his book suggests, comes down on the side of Bhagwati rather than Stiglitz.

of the theoretical consequences for market outcomes of asymmetric information between parties to a trade. Bhagwati is of the view that rough justice will prevail over time. In one instance (p. 255) Bhagwati actually challenges Stiglitz directly: Stigltz argues that imposing free trade on developing countries adds to their already-high rates of unemployment because of import competition. Bhagwati argues that, on the contrary, unemployment is unlikely to rise much if at all because new jobs will be created in export industries. Moreover, he points out that gains to consumers through lower prices must be set against losses to (some) workers. Hence at a theoretical level he is not only less concerned than Stiglitz about preserving Pareto optimality, at an empirical level he makes a different judgment about the effects of free trade on aggregate unemployment. Bhagwati takes a longer view of the relative attitudes of the World Bank and the IMF on tariff reduction, pointing out that traditionally it was the IMF that resisted free trade because tariffs represented an important source of revenue for governments facing balance of payments problems.

Economists pontificating on the liberalization of transition economies ten or even fifteen years ago were divided into two camps: big-bangers and gradualists. Big-bangers like Jeffery Sachs pointed to the success of rapid, simultaneous reforms in Poland. Gradualists cited Ronald McKinnon's pioneering 1993 book on the sequencing of reforms and pointed to China as a patent success and Russia as an abject failure (Dean, 2000c). To quote Bhagwati, "Today, the shock therapists have retreated, given the havoc that many feel they wreaked in Russia." (p. 253). Bhagwati remarks that even Adam Smith was no big-banger:

It may sometimes be a matter of deliberation, how far, or in what manner it is proper to restore the free importation of foreign goods … when particular manufacturers, by means of high duties or prohibitions upon all foreign goods which come into competition with them, have been so far extended as to employ a great multitude of hands. Humanity may in this case require that freedom of trade should be restored only by slow graduations, and with a good deal of reserve and circumspection. (Smith, 1937).

Sequencing

Most economists now agree that some reforms should precede others. For example, privatization without competition may merely substitute private monopoly for public monopoly. Privatization without legal enforcement and transparency of property rights leads to oligarchy and probably a mafia. Capital account liberalization prior to banking reform is a recipe for systemic financial crisis. Uneven price liberalization is a recipe for corruption. All of this would seem elementary common sense, yet Central and Eastern Europe, not to mention the former Soviet countries, abound with examples of liberalization gone awry. Not only have the consequences of clumsy transitions for income and wealth distribution been horrendous, simple per capita GDP in many transition countries may still be lower than it was under communism some 15 years ago. Certainly median income is

often lower. These dire consequences are less evident in Central Europe, but increasing evident as one ventures into Eastern Europe and beyond to the former Soviet Union (the Baltic countries being notable exceptions).

McKinnon (1993) set the template for sequencing liberalization in 1993. To quote:

> **Before direct central government controls are fully dismantled, the monetary-fiscal-financial system has to be converted from the *passive* mode that had simply accommodated the planning mechanism into an *active* constraining influence on the ability of decentralized enterprises, households, and even local governments to bid for scarce resources (3).**

McKinnon systematically laid out the steps that liberalization should follow:

1. **"Fiscal control should precede financial liberalization": government spending should be limited to a small portion of the GNP; taxes should draw upon a broad base of both the population and enterprises, should be at a sufficiently low rate, and should be efficaciously collected; and the government should withdraw from most business activities.**

2. **The domestic capital market should only be liberalized once the government has successfully completed the above step, and has also reduced inflationary off budget spending that is financed by monetary expansion. This is so the capital market does not have to cope with undue pressures from a lack of governmental fiscal control.**

3. **A liberalized domestic capital market must involve the payment and receipt of realistic interest rates, and the private ownership of banks should only come at the end of the domestic capital market liberalization process, when regulatory measures are strong and in place because of the threat of moral hazard .**

4. **When the balance of payments is liberalized, it should proceed more rapidly on the current account than on the capital account .**

5. **The exchange rate for both importers and exporters should be uniform prior to current account liberalization.**

6. **Quotas should be replaced with tariffs and subsidies, which have a "sunset clause" that requires their termination within a certain time frame, so as to allow inefficient national industries to make the requisite efficiency gains rather than simply fail in an instantly open market, or stagnate in a protected one.**

7. **Domestic capital market liberalization must occur prior to liberalizing the international capital market.**

8. **Full capital market liberalization is the final stage of economic liberalization and should only occur "when domestic borrowing and lending take place**

> **freely at equilibrium (unrestricted) rates of interest and the domestic rate of inflation is curbed so that ongoing depreciation in the exchange rate is unnecessary".**

To put it mildly, McKinnon's case for sequencing reforms was not universally heeded in the rush to liberalize post-communist countries. What is so astounding is that it took the economics profession most of a decade, after uncounted, unrecoverable losses in output in transition economies, to converge on a consensus today that is virtually identical to McKinnon's vision in 1993. Of course this was an indirect boon to researchers as it led to considerable variance in policy and in outcomes!

A benchmark for solid empirical research on the impact on real growth of the various components of reform was set by Stanley Fischer *et al.* (1996), who defined a "cumulative liberalization index" using data from the first four years of transition and argued that speedy reforms are beneficial. A second key result was that macroeconomic stabilization is necessary (though not sufficient) for sustained growth. De Melo *et al.* (1997) reinforced this result by establishing that while inflation stabilization was necessary, economic liberalization was equally important.

Since then the literature on transition and growth has become much larger. As a broad generalization, it groups explanatory variables into three categories: first, macroeconomic variables such as inflation and budget deficits; second, variables that proxy structural reforms; and third, variables characterizing initial conditions. Initial conditions include both macroeconomic and structural indices, and a second set of non-economic indices that proxy for such conditions as war or internal conflict. Recent work (e.g., Berg *et al.*, 1999 and Havrylyshyn *et al.*, 2000) has downplayed the importance of initial conditions (such as high levels of planned industrialization, or even war), showing that timely and reasonably rapid reforms can compensate. This work also shows that although early, rapid liberalization usually causes output to fall initially, growth does rebound. And if estimates of the informal or "underground" economy are added to official GDP figures, measured recovery occurs earlier (Dean, 2004). Hence we observe U-shaped time profiles for growth after liberalization occurs. Dramatizing this evidence, Havrylyshyn *et al.*, using a sample of 25 countries, separate transition into two Schumpeterian periods: "destruction" (1990-93) and "creation" (1994 onwards).

A fourth category of explanatory variables has recently come into vogue: "institutions", inspired by the pioneering work of Douglas North. Havrylyshyn and van Rooden (2002) employ two types of indices – those related to a "legal framework for economic activity", and those related to "political and civic freedom" and test their importance. They note that institutional reforms take much longer than does liberalization, privatization or restructuring. Happily for reformers seeking timely results, but rather surprisingly given the attention that has recently been paid to institutions, they find that macroeconomic stabilization combined with broad-based

liberalization, privatization and restructuring "remain the key determinants of growth in transition economies." This result is particularly encouraging for the two countries currently seeking admission to the EU, Romania and Bulgaria, since institutional reforms, particularly related to justice and criminality, have proved harder to implement than stabilization and liberalization.

In short, although rapid early reforms have been shown to pay off in the end, sequencing can be crucial. So too can coordination. Certain reforms reinforce one another in terms of increased growth; others do not, and may in fact interact to retard growth. And a second aspect of coordination has to date received little or no attention in the economics literature, although it is evident to any foreign-aid consultant in the field. Donors are often competitive rather than cooperative. They fail to communicate and, worse they often give conflicting advice. Witness the bewildering plethora of advice offered to Russia in the early 1990s.[2]

Now, a decade after McKinnon's 1993 message, the evidence is in: pacing and sequencing *do* matter when pursuing liberalization. Not only does it have implications for the economic well being of the country, how a state structures its liberalization program has clear ramifications for social issues such as poverty and inequality. Using episodic evidence based on financial crises, this conclusion becomes all the more clear.

Lessons from crisis countries for sequenced liberalization

Since the mid-1990s, unprecedented numbers of developing and transition countries have experienced financial crises. *Inter alia,* emerging market crises occurred in Mexico in 1994, Bulgaria in 1996, Czech Republic in 1997, Southeast Asia in 1997, Russia and Brazil in 1998, and Argentina in 2002. Bulgaria's banking collapse in 1996 was a stark illustration of the necessity of monetary stabilization alongside market liberalization. Czech Republic's currency crisis illustrated that passing privatization through an immature banking system is a recipe for disaster. Mexico and especially Southeast Asia taught us that rapid capital inflows into a liberalized but unsophisticated and insufficiently supervised banking system is a recipe for rapid capital outflows.

The message for many economists (including both Stiglitz and Bhagwati) is that liberalization of short-term capital flows ought not to precede appropriate restructuring of banks. Restructuring banks means not just moving from administratively directed lending to sophisticated risk-return allocation, but also moving toward adequate capitalization, regulation and supervision: in other words, *deregulation* of banks in terms of moving to market interest rates and accurate assessment of opportunity costs ought not to precede rigorous *re-regulation*.

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[2] A study in progress by Nadia Mankovska at Simon Fraser University compares policy advice given to the Ukrainian government by the Harvard Institute for International Development (HIID) with that given by the German Advisory Group.

Southeast Asia also brought into dispute the once-fabled Asian model of close cooperation between government, industry and finance: whereas in 1996 this cooperation was still seen by many as "symbiotic" by late 1997 it was called "crony capitalism", aided and abetted by the moral hazard caused by implicit government guarantees on bank loans and even the exchange rate.

Russia taught us that implicit guarantees by the IMF can also cause crises: purchases of Russian-government bonds ("GKOs") in Frankfurt and New York were openly rationalized as "moral hazard plays on the IMF".[3] Brazil taught us that contagion matters (as did Malaysia, Indonesia and South Korea in 1997). Brazil also taught us that weak federalism matters, since the states were and still are able to force deficit sovereign finance and cause accumulation of unsustainable burdens of foreign debt. Argentina drove this message home, and also taught us that the market mechanisms and credibility upon which so-called currency boards depend don't work if wages are not flexible and if the government tinkers with the currency board arrangement sufficiently to undermine credibility in the international capital markets.[4]

Econometric evidence on sequencing and coordination

Beyond episodes, we now have systematic econometric evidence of the importance of sequencing and coordinating liberalization. Drawing on various survey papers, Staehr (2003) generalizes as follows:

1. **The main findings of Fisher *et al.* (1996) are confirmed: both monetary stabilization, liberalization, and structural reforms all contribute positively to growth. Some studies find that liberalization and reform have negative effects in the short run, but some do not.**

2. **The onset of transition *per se* inevitably causes a deep decline in output, even when reforms are very limited.[5] Hence it is not reforms that cause output to decline.**

3. **Growth declines and then rebounds independently of declines in factor inputs: labor, land, raw materials and capital. Factor inputs typically are reallocated according to market signals and the efficiency with which they are used increases. Of course one factor input – labor – is often withdrawn from the formal sector: i.e. official unemployment often rises for years at a time as restructuring proceeds.**

[3] There is an excellent overview and analysis of these events in Desai (2004).
[4] Steven Hanke, who is the world's leading authority on currency boards and was instrumental in helping to install Argentina's "Convertibility Law" in 1991, argues that Argentina compromised the currency regime from the outset by permitting partial backing of the peso monetary base by domestic government debt.
[5] China is a major exception. The reforms that began in 1978 were focused on agriculture, where output rose almost immediately. Restructuring of industry – which was in any case a small fraction of GDP relative to the former Soviet Union and most Central and Eastern European transition economies – began later and has proceeded very gradually.

4. **Initial structures and levels of economic development affect growth but only for limited periods of time.**

Despite this broad consensus, Staehr notes that two major lacunae remain. First, evidence on the individual importance of specific reforms is difficult to establish. This is mainly because indices of individual reforms are usually highly correlated with each other – they are multicollinear – liberalization, structural changes and privatization are typically implemented simultaneously. The second lacuna is that the importance of sequencing and coordination remains controversial.

Staehr's study significantly contributes to these two evidential gaps. Using annual data for 25 transition economies from 1989 to 2001[6], he estimates the impact on real GDP growth of eight reform indices (as well as some control variables such as inflation, a dummy for war, and indices of initial conditions). He uses indices constructed by the European Bank of Reconstruction and Development (EBRD) for the following types of reforms:

Liberalization

Price liberalization
Trade and foreign exchange system

Privatization

Large-scale privatization
Small-scale privatization

Restructuring and institution building

Banking reform and interest rate liberalization
Introduction of securities markets and non-bank financial institutions
Competition policy
Governance and enterprise restructuring

The econometrically innovative aspect of Staehr's study is that he isolates principal components of these reform variables, in effect "netting out" multicollinearity. His results are as follows:

1. **Inflation decreases growth.**

2. **Synchronized, broad-based reforms – the eight EBRD indices under three headings that are listed above – account for almost 80% of all variation in the indices and have positive impacts on growth in the medium term, although often negative short-term effects.**

[6] In Asia, China, Mongolia and Vietnam are excluded, as are Bosnia and Yugoslavia in Europe.

3. **Liberalization and small-scale reforms without other reforms account for 8% of all variation in the EBRD indices, and again have positive medium-term effects.**

4. **By contrast, accelerated large-scale privatization without small-scale privatization and structural reforms are likely to harm growth, even in the medium-term.**

5. **Conversely, small-scale privatization without large-scale privatization is beneficial to growth.**

6. **Less certainly, freeing markets - trade and prices - without privatization and enterprise restructuring may lower growth. However the reverse - privatization and restructuring without market liberalization - may be good for growth.**

Lessons from the Emerging Countries' Experience

How to sum up this part of our paper? First, complementarities between reforms are important: they reinforce one another. Hence the most effective reform package is one that is balanced and wide-ranging, involving simultaneous progress in liberalization, privatization and structural reforms. Second, if broad-based reforms are politically or otherwise impeded, it would appear that liberalization *combined with* small-scale privatization stimulates growth even in the absence of other reforms. These relatively easy reforms ought not to be postponed just because deeper and larger scale reforms are harder to implement. Conversely, certain sequences are detrimental to growth, notably, large- without small-scale privatization, market openings without accompanying reforms, and bank liberalization without enterprise restructuring.

It is notable that these econometric results are consistent with the episodic circumstances surrounding financial crises discussed above, even though these crises occurred in developing as well as transition countries.

We turn next from the developing and transition economies to the developed market economies. Here a different set of issues surrounding liberalization becomes important, although, as we shall see, there are (perhaps ironically) lessons to be drawn from the experience of emerging economies for those that have already arrived!

The Optimal Speed of Liberalization

While in the context of transition economies, key questions relate to the optimal sequencing of reform, in the context of developed market economies, the chief policy

questions concern the optimal speed of liberalization, in particular, the removal of trade barriers. Here the debate may be framed in terms of the choice between "shock therapy" and "gradualism".

As a matter of economic theory, the "first best" or optimal policy always entails a sudden removal of trade or other distortions at the very beginning of the reform process. This result, which one of us (Dehejia, 2003) has previously dubbed the "Mussa proposition", after the economist Michael Mussa, who first articulated it formally, follows routinely from the fundamental theorems of welfare economics. Once the distortions have been removed, at the very beginning, the trajectory of economic variables is *a fortiori* efficient. This is true even if the adjustment process to the liberalization involves a costly and time-consuming reallocation of the economy's productive resources from, say, declining import-competing to expanding exportable sectors. It would have been better had the distortions never existed, of course, but, given that they do, removing them at one fell swoop, and reaping the consequences, is the best that one can do.

It follows as a corollary that any case for a gradual removal of trade or other distortions perforce rests on second best considerations. A number of such arguments have been furnished in the literature. They are surveyed in Dehejia (2003). We shall single out one particular argument, as, in our judgment, it has the greatest salience for the political economy of reform. The "Dehejia argument", as the economist John McLaren has recently termed it, postulates that a successful reform program must win the support of a majority, and that in some instances gradualist reform may succeed in this whereas its shock therapy counterpart would fail. While Pareto-improving reforms may in principle be designed to ensure that no one is made worse off, through a lump sum tax and transfer scheme, in practice such compensation is rarely feasible or cannot be perfectly implemented.

What, then, of a trade reform which is efficiency-enhancing in aggregate, but leaves some workers worse off in the short run adjustment period? Might gradualism work in such a case where shock therapy does not? The answer is indeed in the affirmative. Gradual dismantling of trade barriers, or, what amounts to the same thing, maintaining temporary protection, tempers the adverse income losses of affected groups, and makes a gradualist alternative politically palatable when a shock therapy reform of identical magnitude is not.

There is considerable policy relevance to this argument in a variety of contexts. To take just one instance, the original Canada-US Free Trade Agreement, which was later transformed into the North American Free Trade Agreement (NAFTA), included explicit provisions for the slow phase-outs of protective tariff barriers, with the intent of allowing affected groups in import-competing sectors an opportunity to adjust. In the absence of such phase-outs, a backlash might have developed which would have led to the stalling, or perhaps even a reversal, of the trade liberalization. Thus "optimal liberalization" is not necessarily immediate liberalization – it may require a gradualist approach. Interestingly, this result, in the context of the

developed market economies, is echoed in the transition experience we have surveyed above, in the context of the related question of sequencing. Thus, "optimal liberalization" also is not necessarily a "big bang", but may need to be sequenced. These two sets of considerations may be interwoven, so that real world optimal liberalization may entail both gradualism and sequencing.

Liberalization and Labor Market Outcomes

While in the emerging economies of either the developing or transition varieties the question of capital market liberalization is still of central importance, as we have seen above, this is not the case in the developed market economies. In all OECD economies, capital markets are more or less completely liberalized, and have been for several decades. Interestingly, however, the important policy questions revolve around determining and managing the impact of liberalization on the other important factor of production – labor. This reflects not only the economic importance of labor (accounting as it does for about two-thirds of national income in most developed economies), but also the political clout of labor – both in the sense of organized labor as a lobbying force that governments must pay heed to (as evidenced by the important and controversial role that the AFL-CIO played in influencing President Bill Clinton's public pronouncements at the failed 1999 Seattle summit of the WTO), and of the electoral power of workers as individual voters. As Bhagwati notes, liberalizing labor and immigration policies is contentious enough that it has lagged significantly behind adjustments to other factors. As a consequence, labor mobility and immigration policy will become the focus of the following section.

A sensible discussion of immigration policy requires that the economic analysis both reflect, and be situated squarely within the context of, economic and sociological analysis (Bhagwati 1998). Both *push,* or supply side factors affecting the interest and willingness to emigrate, and *pull,* or demand side factors that affect the demand for immigrants in the destination country (Delisle 2002), drive citizens of economically disadvantaged states to migrate into more prosperous and stable ones. Empirical evidence of this *push-pull* relationships is not difficult to find.

***Pull* factors have lead to 30 percent of Mexican born workers in the formal sector to work in the United States. This figure rises to almost 40 percent when the 1.3 million workers in the *Maquiladora* region are included. Furthermore, of the 9 million agricultural workers in North America, over 85 percent are Mexican (Helliwell 2004). The U.S. continues to be a demand factor since immigrants can still find employment in high turn over industries such as farming, manufacturing, meat packing industries, construction, and service jobs in places all over the country (Latapi et al, 2002). As migrants begin to move into better paying jobs resulting in better living conditions for themselves, they often decide to reside in the United States on a permanent basis. This often matures into a series of *network* factors, that**

lead newly permanent migrants to serve as connections for other migrants entering the United States.

On the *push* side, a Spanish speaking population in the United States of over 35 million, centralized in the border states of Arizona, Texas, New Mexico, California and Florida, reduces the cultural barrier to migration that is much more profound in the European context (Helliwell 2004). Other supply side factors include: the opportunity for higher wages, better career opportunities, the possibility to overcome or avoid unemployment and poverty, to receive a better education or gain access to other segments of the social welfare system (Tassinopoulous and Werner, 1998).

The number of migrants will only continue to rise, as will the recognition that wealthy states are unable to restrict the growing number of illegal immigrants, who circumvent the archaic immigration regimes currently in place (Miller and Stefanova 2004). The continued increase in migration during the 1990s supports the notion that Mexican migration is continuing along a migration hump, though it remains unclear as to whether it is at the peak or continues along the upslope (Martin 2004). Some observers believe that the upward trend on the European migration hump, driven by demand in a selection European destination countries, will continue at least another ten years and that the sole means to reduce it is through economic convergence (Alba 2004). This is supported by a recent EUROPOLL that asked Europeans what they would do to improve their career prospects. While 22 percent answered "further training", and fifteen percent said they would "change jobs", with nine percent answering that they would simply "work harder", the majority of Europeans who responded (fifty-two percent) answered that they would "leave the country" to improve their career prospects.[7]

Economic liberalization, and the question of "how much" to liberalize, is implicated in at least two major ways: the potentially malign direct effects of trade liberalization on the wages of (especially unskilled) workers, and the indirect effects through the mediating channel of labor standards. Critics of globalization in the United States particularly argue that "excessive" liberalization of trade barriers has induced a sharp increase in wage inequality, with university-educated, skilled workers gaining at the expense of uneducated, unskilled workers. This is often coupled with the claim that liberalization of trade and capital flows, by making firms more cost-conscious and footloose, has led to a degradation of labor standards. This latter argument came to the fore during the 1992 US Presidential election campaign, when the third candidate, Ross Perot, argued against the NAFTA, claiming that it would pit American against Mexican workers in what he evocatively termed a "race to the bottom". Ironically, this echoes fears that were expressed in Canada during the 1988 federal election, fought on the issue of the proposed Canada – US FTA, when some argued that the increased mobility of goods and people across the border would induce a worsening of Canadian social institutions

[7] See http://europa.eu.int/eures/home.jsp?lang=en for complete EUROPOLL questions and responses

and labor and environmental standards down to US levels. We shall assess these two sets of claims in turn.

On the first, more conventional, argument, that trade liberalization reduces the wages of unskilled workers, and thereby increases what labor economists refer to as the "wage premium" earned by skilled workers, what do theory and empirics have to say? As a matter of economic theory, the argument is perfectly sound, and can be rationalized as an instance of what is known to trade economists as the "Stolper-Samuelson theorem": protection benefits the scarce factor of production and harms the abundant factor, and conversely trade liberalization benefits the abundant factor and harms the scarce factor. If we imagine a stylization of the world pattern of relative endowments in which the poor countries of the "South" are abundant in unskilled labor, and the rich countries of the "North" are abundant in capital and skilled labor, it follows that the South will export unskilled-labor-intensive goods, such as primary commodities or low-value-added manufactures, to the North, which in turn will export skill- and capital-intensive goods, such as high-value-added manufactures and services, to the South. Given this pattern, successive waves of trade liberalization will benefit skilled workers, and harm unskilled workers, in the North, with the reverse holding in the South.

In a 1993 conference at the American Enterprise Institute in Washington, DC, perhaps the first to investigate such claims systematically, one of us (Dehejia) and Jagdish Bhagwati cast doubt on this conventional trade-based explanation, arguing both that it is not a theoretical necessity, and further that it fails to match the empirical evidence (Bhagwati and Dehejia, 1994). In brief, the conventional (Stolper-Samuelson) trade explanation rests on very strong theoretical assumptions, so that it should in no sense be considered an "iron law". Further, even if we grant that the mechanism could be at work, it is not borne out empirically: relative prices of unskilled-labor-intensive goods have, if anything, risen in the United States, and all sectors of the economy have become more intensive in the use of skilled labor, both of which are at variance with the conventional explanation. We therefore argued that the conventional trade explanation carried, if at all, little explanatory power, with the chief "culprit" instead being skill-biased technological change. While this view was then controversial, it has now become the conventional wisdom.

We went on, however, to suggest an alternative, trade-based explanation, which we hypothesized may be of some importance, albeit secondary, to the technological explanation. This alternative explanation, which in the empirical trade literature has come to be known as the "Bhagwati-Dehejia hypothesis", postulates essentially a link from international trade to unskilled wages through an increase in job turnover, induced by greater volatility of patterns of comparative advantage, or what we called "kaleidoscopic comparative advantage". The mechanism that we had in mind was that increased turnover would have a more deleterious effect on unskilled workers than skilled, as the former often possess firm-specific training whereas the latter embody more general-education-based human capital. A complementary causal channel would be that unskilled workers suffer a longer unemployment spell

between jobs than skilled workers, thus further widening the gap in human capital accumulation and hence exacerbating wage inequality.

This, of course, is a hypothesis, whose importance must be tested empirically. We are not aware of a systematic test for the United States, but, in a recent study using Canadian data, we have found support for the Bhagwati-Dehejia hypothesis as one of the contributors of wage inequality in Canada in the 1990s (Beaulieu, Dehejia, and Zakhiwal, 2004).

We turn next to the alternative, indirect mechanism through which "excessive" liberalization may harm workers, via the "race to the bottom". Again, we wish to ask two questions, can the argument be made theoretically cogent, and what does the evidence have to say?

As a matter of economic theory, the "race to the bottom" is an instance of what Hans-Werner Sinn (2003) has termed "systems competition". To be more precise, it may be the result of strategic behavior by different jurisdictions competing for mobile capital and firms. In the first best, cooperative equilibrium, all jurisdictions keep standards high, and there is no distortion to firms' investment decisions. But, depending on the incentive structure of the game, there may be a temptation for any one jurisdiction to defect from the cooperative solution, and lure mobile capital by offering laxer labor (or for that matter environmental) standards, on the assumption that this reduces firms' production costs and may make that particular jurisdiction a more attractive location to set up shop. This may then lead to a classical Prisoners' Dilemma, in which, in the noncooperative equilibrium, all jurisdictions set standards too low, and yet no one benefits, as there is no change in the marginal incentive to locate in any one jurisdiction. If they could, jurisdictions would commit to raising standards to the optimal level, and, if they did so simultaneously, there would be no associated loss in competitiveness to any one jurisdiction. In the absence of a credible commitment device, however, such as an internationally enforceable treaty, jurisdictions will be stuck in the "bad" equilibrium.

It is, of course, an empirical question how strong these incentives for strategic behavior on the part of governments are, and whether they exert a sufficiently strong effect on firms' profitability actually to induce a downward spiral in standards. In a recent study, we examine these questions using a formal econometric test, and find no evidence to support the claim that weaker labor standards increase the attractiveness of countries to inward foreign direct investment or increase their export competitiveness (Dehejia and Samy, 2004). But the evidence is still preliminary, and to be fair the jury is still out on the potential importance of this causal mechanism, especially in the context of regional trade agreements such as NAFTA, in which there is, at any rate, anecdotal evidence of firms relocating to jurisdictions with laxer labor and environmental standards (such as US firms operating in the *maquilladoras* in Mexico along the border, whose sole purpose is export back to the US market, duty free access being guaranteed by NAFTA).

The evident disconnect between theoretical and empirical suppositions about the impact of liberalizing labor mobility, coupled with the political contention that has consistently surrounded the topic, makes the idea of "big bang" liberalization in any regional context generally inconceivable. The question than becomes how to manage the demands of a growing number of immigrants and potential workers in light of political resistance in most domestic contexts. The answer is not a simple one. Because in most nations labour mobility and migration is managed almost exclusively at the border, the nature of the role played by the border regime – and its impact on the effectiveness of the policy regime – should be recognized as particularly relevant when developing recommendations for labor policies.

Seemingly paradoxically, but upon reflection not so – particularly given the strategies employed by most developed nations - some labor economists argue that stricter border security actually results in a higher number of illegal immigrants, because migrants who had previously gone back and forth for work are more reluctant to return, as the chances of being caught have increased. The problems caused by this artificial worker retention include a perceived displacement of domestic workers by low-wage laborers, the strain placed on country relations, the cost of patrolling a volatile border area, and the social costs of families separated by the pursuit of economic prosperity.

This theory is supported empirically by one of the largest migration relationships today, which takes place across the Mexico – United States border. A brief cross-temporal analysis will illustrate that there is a consistent if not growing migratory pressures being absorbed by the U.S. economy. This pressure - measured by the number of applications relative to the number of available visas, coupled with the amount of migration occurring outside the official regime (i.e., illegal migration), has seen little improvement despite ongoing political demand for change.

The Mexico-U.S. labor relationship began long before NAFTA, thought it was not until the United States entered the First World War and domestic labor shortages began to develop, did U.S. commence begin drawing on the labor pools of other nations. Structural changes in the U.S. economy also increased the demand for foreign workers as the agriculture sector continued to develop labour shortages, further exacerbating the need to look abroad (Rodrigues – Scott 2002) Because of Mexico's close proximity, negotiations towards a guest worker program were called between then President Roosevelt and Mexican President Avila Camacho. The Mexican Farm Labour Program (MFLP), or *Bracero* program, provided contracts for Mexicans to migrate into the United States and fill jobs in sectors facing a shortage of workers.

Since then American immigration policy towards Mexico has reflected the desire to balance traditional security concerns with pressing economic demands continuing to grow domestically. This early period in the US – Mexico relationship illustrates the largely reactive and unsystematic nature of U.S. immigration policy toward Mexico.

It was not until the passing of the Immigration and Naturalization Act of 1965 that an overarching policy was established, which led to a temporary decrease in the importance of immigration issues to Presidential administrations and Congress (Rodrigues – Scott 2002). But by the mid-1980s it became apparent that a new policy was needed in order to deal with the failings of previous policies. The Immigration Reform and Control Act of 1986 (IRCA) was passed to control unauthorized immigration to the United States. Employer sanctions, increased appropriations for enforcement, and amnesty provisions of IRCA were the primary means of accomplishing its objective. Employer sanctions provisions designate penalties for employers who hire aliens not authorized to work in the United States. Under the amnesty provision, illegal aliens who lived continuously in the United States since before January 1, 1982, were eligible to apply to the Immigration and Naturalization Service (INS) for legal resident status by May 4, 1988, the application cut-off date.[8]

The impact of the policies developed by various administrations appear to have done very little to curb migration from Mexico, and in fact may have even promoted an increase in illegal migration. The growth of immigration fees between 1921 and 1924 prompted the onset of illegal migration; a problem further exacerbated by the Great Depression and political instability in Mexico. It is highly questionable whether the IRCA was at all effective in reducing the number of undocumented individuals entering the United States in search of employment. Studies tend to argue that IRCA only increased illegal immigration to the United States. Statistics by the U.S. Bureau of the Census and the INS certainly do not reflect a decrease. The average annual growth of illegal migration into the United States between 1992 and 1996 was over 275 000; illegal Mexican migration comprised 145 000 of this figure.[9]

Migration flows have not stopped or significantly decreased for two main reasons. First, migration has become a social process. Secondly, conditions in the country of origin are not favorable enough to deter migrants from taking dangerous risks in crossing the border illegally or in many cases having to live through much difficult time in the U.S. due to language and cultural barriers, discrimination and isolation, and lack of work or educational skills. The number of aliens located and/or expelled from the United States has continued to increase steadily since the 1960s; a strong indication that both the number of aliens living the country had increased, as had the level of enforcement occurring.

The basis of policy theory during the NAFTA period focused on the liberalization of production factors relative to the restrictive regulations on labour movement from Mexico into the United States. The countries' rhetoric focused on public safety and the need to educate migrants about the potential dangers of crossing the border (Waslin 2003). But the risk of increased economic instability

[8] See U.S. Department of Agriculture at http://www.usda.gov/agency/oce/oce/labour-affairs/ircasumm.htm
[9] See United States Citizenship and Immigration Services at http://uscis.gov/graphics/shared/aboutus/statistics/299.htm

became apparent as the movement of capital was relatively free and movement of labour relatively restricted. In this situation, a recessionary situation is further enhanced as capital can move to another country where interest rates are higher, but labor must remain, pushing unemployment rates potentially even higher. Furthermore, in a period of strong economic growth, capital inflows can increase dramatically, but labor cannot follow suit and maximize the productivity of capital.

Towards the end of the early NAFTA period, serious discussions were beginning between Mexican President Fox and U.S. President Bush; talks held much promise and the scope for a co-operative approach to labour migration was being established. The Presidents had agreed to a set of "guiding principles" for migration that included: a humane approach, protection of American workers, fairness, joint commitment, and a new temporary worker program.[10] Unfortunately, all the promise of negotiations between Mexico and the United States during the NAFTA period came to a dramatic halt on September 11th, 2001. The attacks on that day on the World Trade Centre and Pentagon would move security back to the top of the U.S. agenda and eliminate any hopes of the Mexican "whole enchilada" being realized in the near future. The most positive impact was that the pre September 11 dialogue on reforms did set a precedent for future talks on the liberalization of the border regime.

Although no census figures are currently available for the post September 11th period, it is widely believed that the population of illegal Mexican migrants in the United States continues to grow, despite a lull immediately after September 11th and the further increase of U.S. personnel at the border.

Clearly the various programs developed by the United States have had minimal impact on illegal migration or more broadly, migratory pressure. Of the 1.65 million aliens apprehended in 1996, 1.6 million were from Mexico, and in comparison with a legal migration growth in 1996 from Mexico of 164 000, the illegal migration growth in 1996 was 154 000. In all, of the 5 million illegal aliens estimated to be living in the United States in 1996, some 2.7 million were believed to be from Mexico.[11]

The ideal migration system has no migration barriers and a low level of actual migration. This is ideal for several reasons. First, mass migration in either direction is an economically destabilizing factor[12]. As was previously discussed, a sudden influx of labor has the potential to displace the native workforce, depress wages, increase underemployment and strain a nation's welfare system. A sudden

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[10] See U.S. Department of State at http://www.state.gov/p/wha/rls/fs/2001/fsjulydec/5019.htm

[11] See United States Citizenship and Immigration Services at http://uscis.gov/graphics/shared/aboutus/statistics/299.htm

[12] In most cases mass migration also strains a country's political system and has in extreme cases led to civil unrest and even violent conflict. While we recognize the significance of these phenomena, political/sociological destabilization is not our focus, so we shall not say much more about this important question.

exodus of labor can create an underutilization of the other factors of production, lower productivity and raise the overall cost of living (Dornbusch et al 2002).

Therefore, the ideal migration situation is one in which there are few significant incentives to migrate between countries. However, coming to a point at which *push-pull* factors are substantially mitigated will not be achieved with archaic border tactics like those currently employed by the United States. In order for free labour mobility to be accomplished, a convergence must occur on both an economic and a political level; convergence on the economic level of wages, incomes and opportunities (Martin 2004) and a convergence of rights that will lead to a higher level of public acceptance of continuing migration (Polaski 2004). So long as this convergence does not occur to an appreciable level, it will be politically and economically infeasible to realize the free movement of people, particularly within the North American context.

While this topic requires a systematic analysis that has not been conducted to date, preliminary research seems to indicate that it is possible to have free movement of labor across a border between a less developed and a more developed country, if the shift towards free movement of labour is gradually introduced over a long enough time frame to permit demographic and structural changes to take effect. This will require a fundamental change in the border regime from the current system, that fosters both illegal migration and discontent among potential migrants, to one that acknowledges the need for managed large scale legal migration to ensure long-term economic stability in the region.

Optimal Process: Unilateral, Multilateral, Plurilateral, or Mixed?

We have examined to this point questions around the optimal extent of liberalization, and related questions on speed, sequencing, and impacts on salient groups such as labor. The question that we address in this section concerns the optimal process of achieving the ends of liberalization. Should liberalization be achieved unilaterally, by an individual state acting alone? Should it be achieved instead multilaterally, through international institutions (e.g., the WTO)? Should it be achieved through smaller groupings of countries, either of two countries, in which case bilateral liberalization, or three or more, in which case plurilateral liberalization? Or, should a mixed approach be adopted, with some of each of these elements in play?

There is a strong tradition in international economics, going back to Smith and Ricardo, extolling the virtues of unilateral liberalization. The very point of the debates around the repeal of the Corn Laws was that Great Britain could benefit by repealing its tariffs on foreign grains and moving unilaterally to free trade, even if unreciprocated by any of its trading partners. The success of Britain as a unilateral liberalizer ensured that this remained the orthodoxy until the end of the 19^{th} century. At that point, with Britain entering a period of relative economic decline,

and the rise of the United States, there arose claims for "reciprocity": that is, trade liberalization by one party should be matched by reciprocal concessions from its trading partners. This was the foundation of the multilateral, rules-based system of trade negotiations embodied in the GATT and its successor the WTO.

To some economists reciprocity smacks of mercantilism, since it seems to imply that there cannot be gain with unilateral liberalization, which is patently incorrect. What this criticism misses is that reciprocity has a strategic, or more specifically a negotiating, value for countries. After all, if one unilaterally eliminates all of one's trade barriers, one has nothing left to negotiate with, and hence no levers to pry open protected foreign markets. If one liberalizes, and so does one's trading partner, in a reciprocal negotiation, then there is a "double gain". Having said that, it is a pertinent observation that trade negotiations are conducted for the most part by lawyers, not economists, who are schooled in the doctrine of an adversarial system, and hence of a zero sum game, which is a misleading metaphor when it comes to trade liberalization.

Quite distinct from the question of unilateral vs. reciprocal trade liberalization is the issue of whether reciprocal negotiations should be pursued multilaterally or plurilaterally. Here too, the conventional wisdom has shifted in recent years. After the Second World War, with the establishment of the GATT, the American and indeed Canadian view was that negotiations should be centered at the GATT in Geneva, and that regional or preferential trading agreements should be discouraged, or pursued only under special circumstances. Such circumstances evidently existed in the case of the European Community, whose creation was as much a political act of reunifying former wartime adversaries, and in particular embedding Germany and France in a common political and economic project which would make future hostilities between them unthinkable. But the United States steadfastly refused to participate in such preferential arrangements, the sole exception being the bilateral trade agreement with Israel, which is much more a tool of foreign policy than of economic policy.

The turning point came during the negotiations of the original Canada – US Free Trade Agreement in 1988, between the Republican administration of President Ronald Reagan in the United States and the Conservative government of Prime Minister Brian Mulroney in Canada. This represented an about-face for the Americans, and was a calculated strategy to reinvigorate the faltering Uruguay Round negotiations at the GATT, which were bogged down due to European intransigence. The US rationale was that since the multilateral route was temporarily unavailable, it would travel the preferential route instead. Canadian rationale was much simpler: to lock in access to its largest trader partner, freeing it from the vagaries of the multilateral process, which appeared to be stalled.

As it turned out, the Canada – US FTA proved to be a watershed, in that it marked a decisive shift in the US attitude towards preferential trade agreements, which were now not only tolerated but actively pursued in tandem with, and sometimes to

the detriment of, the multilateral process. This trend, begun in the Reagan and Bush Senior administrations, accelerated during the Clinton administration, and has continued apace during the Bush Junior administration.

While economists agree that multilateral trade agreements are preferable to preferential trade agreements, because they avoid the possibility of welfare-worsening "trade diversion" and ensure "trade creation" (the celebrated terms coined by Jacob Viner), in practice the choice between them, or the pursuit of both channels simultaneously, is often a matter of political expediency, not of economic calculus. The degradation of the public discourse is such that all trade agreements, whether of the multilateral or preferential variety, are lumped together as free trade!

Amongst trade policy commentators today, Jagdish Bhagwati is the staunched and most vocal critic of the regionalization of trade policy. In his view, this represents a fragmentation of the global trading system, and leads to what he colorfully describes as a "spaghetti bowl" of crisscrossing trade preferences and their increasingly arcane and convoluted rules of origin (necessitated by the fact that these are typically not customs unions, hence without common external tariffs). On this view, then, the proliferation of regional and preferential trading agreements, in the Americas, Europe, and elsewhere, creates a distortion in the global pattern of trade, and represents the wrong sort of liberalization. The Bhagwati proposal is to freeze the growth of, if not roll back, such preferential agreements, and work instead to bolster the multilateral system as embodied in the WTO.

As against this, analysts such as Gary Hufbauer of the Institute for International Economics in Washington, DC, and Michael Hart of the Paterson School at Carleton University, argue to the contrary, that regional trade agreements are the platform from which to build deeper integration initiatives than those that are possible at the multilateral level, and to serve as a laboratory for integration initiatives that may eventually be transferred to the multilateral sphere. This alternative view is much more benign towards the proliferation of preferential agreements, seeing them as "building blocks" rather than "stumbling blocks" (in Bhagwati's noted phraseology) towards eventual multilateral liberalization.

Conclusion: The Optimal "Breadth" and "Depth" of Liberalization

To conclude, and to return to the questions with which we began this paper, we reflect on the lessons that may be learned from our foregoing survey and synthesis of theory, empirics, and policy analysis, in both emerging and developed market economies. To summarize our enquiry pithily, we may ask: Is *maximal* liberalization always *optimal*? Or does optimal policy in some instances entail limiting the breadth and depth of liberalization?

Our analysis evidently reveals that while, in theory, and in a first best world, maximal liberalization may indeed be optimal, in the second best world of practical policymaking, it often is not. Thus, we have seen that "big bang" and "shock

therapy" reform strategies that are preferred on paper, have come a cropper in practice. Instead, prudence suggests an appropriate sequencing of reforms, to ensure macroeconomic stability, and a gradual dismantling of protective barriers, to allow affected groups to adjust at the micro level.

By contrast, we have seen that some commonly articulated fears about globalization, centering on putative adverse effects on workers' wages and labor standards, while theoretically possible are empirically contentious. Robert Hunter Wade (2004) usefully reminds us that statistical measures are controversial, and can be easily manipulated to make whatever case the author wishes. The fear of globalization is often hinged on misconceptions, on both sides, of what the other is trying to achieve. But as Bhagwati (2004) so eloquently articulates, globalization does have a human face, and can be a positive force for change.

What does this tell us, in the end, about the liberalization project, and its international dimension: that is, globalization in particular? We can surely agree with Jagdish Bhagwati, who argues that the old question, whether globalization is "good" or "bad" for welfare, workers, the environment, or whatever else, while it may animate ideological debates in the academy, does not resonate in the policy realm. Policymakers across the political spectrum have accepted the notion that globalization is inevitable, and that turning the clock back and "de-globalizing" is simply not a feasible option. The policy-relevant question that then follows is, how should each nation best manage the globalization enterprise so as to maximize the benefits, and minimize the harms, that accrue therefrom? And, how should the institutions that regulate international economic relations be improved so as to maximize the gains, and minimize the harms, of globalization, for citizens of emerging and developed market economies alike? These questions are a perfect instance of what Hans-Werner Sinn has dubbed the "selection principle": that governments should refrain from interfering where markets function well, and intervene optimally to correct market failures where these exist, either at the national or supranational level, and if necessary through intergovernmental cooperation.

These are difficult questions, and we doubt that there is a universal answer. Rather, we expect that the particular circumstances of each individual country will inevitably shape the optimal solution for that country. Nonetheless, we would argue broadly that policy measures that might mitigate putative national welfare losses from globalization include appropriate governance, transparency, optimal regulation of labor, product and financial markets, institutional safeguards, and adjustment assistance. These will ensure that the fruits of globalization are spread as widely as possible, and ameliorate its possible harms. So while Stiglitz highlights losers and Bhagwati winners, the "optimal" liberalization should create winners without losers.

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