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# Trade Liberalisation, Measurements, and Theories of International Trade: An Empirical Evidence from Recent Studies

**Abduraawf Hadili[1], Mohamed Khaled Al-Jafari[2*], Demetrios James Gizelis[3], Mohamed Bin Abderrazek Boukhris[4]**

[1]*College of Business Administration, Department of Accounting and Finance, Prince Mohammad Bin Fahd University, Al-Khobar, Kingdom of Saudi Arabia, email: ahadili@pmu.edu.sa*
[2]*Head of Accounting and Finance Department, Prince Mohammad Bin Fahd University, Al-Khobar, Kingdom of Saudi Arabia, email: mjafari@pmu.edu.sa*
[3]*Professor of Economics (Retired), Athens, Greece, email: dem.gizelis@gmail.com*
[4]*College of Business Administration, Department of Accounting and Finance, Prince Mohammad Bin Fahd University, Al-Khobar, Kingdom of Saudi Arabia, email: mboukhris@pmu.edu.sa*

**Corresponding author: mjafari@pmu.edu.sa*

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**Abstract:** Achieving economic growth and welfare constitutes the main incentive for adopting free trade policy in developing countries. However, not all countries that adopted such a policy have necessarily achieved a sufficient level of economic growth. This study surveys the recent theoretical and empirical literature emphasizing the impact of trade liberalisation on developing countries. Although traditional trade theories that rest on the law of comparative advantage emphasize the importance of trade liberalization on achieving economic growth, they do not take into consideration the complexity of today's production sectors and their implications on trade relations between countries. Consequently, modern theories are likely to focus on the role of differences in resources endowments, income differences, and economies of scale on international trade. The empirical literature indicates that promoting economic growth is not feasible especially when corruption, poor infrastructures, and weak government institutions surround these economies' environments. Hence, it requires supportive government policies to create a suitable business environment and to realise the promises of trade liberalization.

**JEL Classification**: F13; F14; F43; H11
**Keywords:** Trade Liberalisation and Measurements; Theories of International Trade; Economic Growth of Open Economies; Empirical Studies of Trade; Structure and Scope of Government.

# 1. Introduction

This research is motivated by the well-documented debate in the literature on the benefits and implications of trade liberalisation for the developing countries adopting such a policy without achieving a sufficient level of economic growth. Several international organizations, such as the International Monetary Fund (IMF) and the World Trade Organization (WTO) have encouraged developing countries to adopt free trade policy. They promised them that adopting such a policy would enhance their corresponding economic growth and social welfares if they focused on producing goods and services for which they have a remarkable comparative advantage. Based on this view, trade liberalisation is likely to lead to economic growth for countries exhibiting different relative efficiencies(Blinder and Baumol, 2011).

The main objective of trade liberalisation is to promote economic growth. In order to achieve this goal, resources need to be allocated efficiently in order to promote the products for which a given country has a comparative advantage. However, for the law of comparative advantage to operate in practice, a suitable economic environment characterised by fair competition, elimination of all trade barriers, and the absence of government intervention must be present. As a result, developing countries will benefit from increased capital accumulation, knowledge enhancement, and broadened know-how as well.

Yet, real-world experience has indicated that promoting economic growth in developing countries through trade liberalisation alone is not enough, especially when corruption, poor infrastructures, and weak government institutions are the main features characterizing these economies. Rather, it requires supportive government policies, to create a suitable business environment to concretize the promises of trade liberalisation(Irwin, 2020).

In the next section, we try to demonstrate the main benefits from adopting a free trade policy. A full review of how countries are categorised by the measurements of trade liberalisation, including the main indices of trade liberalisation, is presented in the third section. The fourth section aims to shed light on the most important theoretical aspects of international economics. The fifth section presents the main arguments against free trade policy. Section six offers a detailed review of the reasons for which trade liberalisation has failed to deliver the promised benefits. Finally, section seven summarizes the main contribution of this paper.

# 2. Gains from Free Trade

Advocates of trade liberalisation argue that it brings many benefits, such as specialization in production, exploitation of comparative advantage, economies of scale, lowers production cost, and increase in efficiency, which all lead to faster economic growth.

In the absence of trade barriers or government interference, demand and supply alone will determine prices and allocate resources to the sectors for which the participating countries enjoy a comparative advantage. Thus, every country has to specialize in producing goods and or services they are able to develop relatively cheaper than the others. This mechanism will entail the advantage of lower prices, which in turn gives the opportunity to trade and exchange with other countries competitively. Making the best use of the available resources allows both producers and consumers in a given country to produce and consume more goods, respectively. Both social and economic welfares are also increased as a result of free trade, and when countries specialize in producing goods at lower opportunity costs compared to their trading partners.

In addition, specialization allows countries to exploit economies of scale and to produce goods at lower average total costs. The resultant lower costs add benefit to consumers via lowering prices for finished

products. Adopting free trade policy exposes domestic industries to greater competition with other countries that produce the same or similar products. Therefore, reducing costs and increasing efficiency are the main concerns of these industries. Efficient use of resources, utilization of new technology, and innovation are required in order to achieve lower costs and maintain competitive prices.

As indicated before, economic growth is the main driver underpinning free trade policy, especially for developing countries that suffer from excessive regulations, extended government intervention, imposition of high tariff rates, and other trade restrictions as well. Trade liberalisation allows each country to exploit its relative position of comparative advantage in global trade. In addition, specialization enters indirectly into the production function of trading partners and allows them to exchange their products more efficiently. Furthermore, in a free trade regime, specialization offers the possibility of maximizing labour employment, production, and wealth.

## 3. Measurements of Trade Liberalization

There have been many attempts to set up indices measuring the degree of trade liberalisation in a given country. These indices correspond to datasets on trade liberalisation status and trade liberalisation dates. In essence, they intend to cover all types of trade barriers and use the same currency (USD) to evaluate trade openness. Below, we present the most important indices formulated by individual researchers and international organisations.

i. Sachs and Warner index(Sachs and Warner, 1995)
ii. Wacziarg and Welch index(Wacziarg and Welch, 2003)
iii. Ju, Wu, and Zeng index (Ju et al. 2010)
iv. Economic Freedom index by the Heritage Foundation (Miller et al. 2011)
v. International Monetary Fund's Trade Restrictiveness Index(Krishna, 2009)

Most of these indices employ nearly identical criteria to measure countries' degree and date of trade openness. These criteria are defined as in the sections below.

### 3.1 The Average Tariff Rate for Imports

This criterion can be measured in two ways: as a weighted average of tariffs or un weighted average of tariffs. The weighted average tariff ($T_w$) is the ratio of total tariff revenue to total value of imports:

$$T_w = \sum t_i / \sum m_i (1)$$

Where:$\sum t_i$ is the total tariff revenue from imports, and $\sum m_i$ is the total value of imports.

Due to a shortage in weighted tariff data, some studies resort to unweighted average tariff instead. The unweighted tariff rate ($T_u$) is the average nominal rate in a country's tariff schedule:

$$T_u = \frac{1}{N}\sum_{I=1}^{N} J_i \ (2)$$

Where:$\sum J_i$ is the summation of tariff rates (%) on imported goods, and N is the number of types of goods imported from abroad.

### 3.2 Nontariff Barriers (NTBs)

They refer to any trade restrictions or obstacles other than tariffs, such as quotas, price restrictions, investment restrictions, and various other government interventions that may impede international trade.

### 3.3 Black Market Exchange Rate (BMP)

The BMP is the paid amount that exceeds the official exchange rate to purchase a unit of foreign currency in the black market. It is conceived as the percentage by which the paid rate exceeds the official one, and it is calculated as follows:

$$BMP_t = [(P_t^{BR}/P_t) - 1] * 100 (3)$$

Where: $Pt^{BR}$ is the black market rate at time *t*, and $P_t$ is the official exchange rate at time *t*.

### 3.4 Socialist Economic System (SOC)

The socialist economic system classification is used for countries that rely on central planning and is based on an index developed by Kornai (1992).A country is considered to have a socialist economic system if it employs central planning (where the allocation of resources is determined by a production plan made by a government that specifies output requirement) to maintain a closed economy. These types of economies a real ways governed by communist parties.

### 3.5 State Monopoly on Major Exports (XMB)

The government creates this type of monopoly. It represents the only buyer from domestic producers and the only exporter of such products. Domestic producers do not have the option to export their production directly, which results in extreme distortions from this export marketing monopoly. It usually applies to the primary sector of the economy, primarily agriculture, where the government purchases these goods at prices much below world prices and then resells them at world prices.

### 3.6 Trade Freedom (TF)

This index allegedly captures the trade freedom in a country. It includes two inputs: the NTBs and the trade-weighted-average tariff rate.

$$TF_i = (t_{max} - t_w^i / t_{max} - t_{min}) * 100 - NTBi \quad (4)$$

Where: Tariff max ($t_{max}$) and tariff min ($t_{min}$) stand for the highest and lowest bounds of tariff rates (%), respectively (i.e., the minimum tariff is zero percent, and the max tariff is 50 percent),

$t^i_w$ represents the weighted average tariff rate (%) in country I.

NTBs take a value of (5, 10, 15, or 20) points, where 20 points indicates that NTBs are heavily used across many goods and services, and 0 points means NTBs are not used to limit international trade.

To measure the degree of trade liberalisation, some indices treat a country as a closed one if the average tariff rate is above 40 percent. Others are more flexible and provide greater leeway in classifying a country (e.g., free if less than 10 percent, mostly free between 10 and 15 percent, moderate between 15 and 20 percent, restrictive between 20 and 25 percent, and highly restrictive when greater than 25 percent).

In terms of NTBs, some of the indices consider NTBs to be an obstacle if the percentage of imported products subject to NTBs is 40 percent or more. While others employ different intervals to classify NTBs (e.g., absent if less than 1 percent, significant between 1 to 25 percent, and highly significant if greater 25 percent). However, they have been criticised by international organisations since they believe considering countries with NTBs in the range of1 to 25 percent of imports to belong to the same category is unfair.

It is worth to mention that although every one of the above indices takes tariffs and NTBs into consideration, only the Sachs and Warner index, and the Wacziarg and Welch index that employ the other criteria (e.g., black market exchange rate, state monopoly, and socialist economic system) as well. Thus, it appears that these latter indices capture the extent of trade openness more appropriately.

## 4. Theoretical Aspects of International Economics

This part reviews some aspects of the theory of international economics that are helpful in addressing the objectives of international trade. The following discussion sheds light on the instruments of trade policies and their impact on international trade. To illustrate the importance of cross-countries trade, the patterns of trade, and what nations gain from trading, we outline the major models in the field. To begin with, these theories are roughly categorised into either traditional or modern theories. We try to discuss the basic instruments of trade policies and illustrate the reasons why trade barriers are implemented, as well as, the effects of these barriers on the economic welfare of a concerned country.

### 4.1Traditional Theories of International Economics

Trade liberalisation rests on the law of comparative advantage developed by David Ricardo in 1817 in his Magnus opus: *On the Principles of Political Economy and Taxation*. He argued for a case in favour of free trade by presenting a detailed economic model featuring a single production factor with a constant labour productivity of two goods in the same country but with relative productivity differences between these goods produced in two different countries. His model demonstrates that trading via specialization could help countries enjoy more benefits than focusing only on their domestic labour input and then becomes the simplest general equilibrium model of international trade. This law indicates that two countries can both gain from free trade, provided that they have different relative (opportunity) costs in producing the same goods in the absence of trade(Ricardo, 1817).

More specifically, it states that a country has to specialize in producing those goods and/or services they are able to produce relatively cheaper than other countries. As the comparative costs differ, David Ricardo posited that it would still be mutually advantageous for countries to trade even though a given country exhibits an absolute advantage in producing both commodities. Therefore, specialisation leads

to an increase in both countries' wealth and allows their citizens to enjoy increased consumption without augmenting the factors of production.

A fundamental shortcoming of this simple model is that frictions from transportation costs and trade barriers are ignored. A further point of criticism is that the prediction of an extreme degree of specialization does not exist in reality. In addition, the model does not take into consideration the complexity of today's production sectors and its implications for trade relations between countries. It also ignores the role of differences in resources endowments and income differences as a cause of trade. Finally, economies of scale are not considered to have a significant role and to be as a cause of trade.

Heckscher–Ohlin (H-O) model introduced by Heckscher (1919) and Ohlin (1933), postulates that differences in resources endowments is the main factor that motivates trade between nations. This is so, because the relative abundance of the factors of production is the engine that influences comparative advantage. Consequently, if a country is abundant in productive resources, the owners of those resources benefit from trade presumably at the expense of their peers in a country that is less abundant in factors of production.

The Specific Factor (SF) model, which was originated by Jacob Viner and later developed and formalized by Jones (1971) and Mussa (1974), shows how free trade enhances export growth, and affects income. This model demonstrates the impact of trade liberalisation on income distribution among the exporting industries. It posits that as the demand for production factors, mainly capital and labour, is different from one industry to another and resources do not move immediately and without cost between industries, international trade has strong differential effects on income distribution. Since capital (the specific factor) is immobile while labour moves freely between industries, a shift towards free trade is likely to favour the owners of this specific factor in the *exporting* industry while harming the owners of the same factor in the competing *import* industry. On the other hand, freely moving employees across industries might benefit or lose if the real wage for export goods increases and simultaneously the real wage for import goods decreases.

The conclusion to draw from the SF model is that trade will benefit the specific factor in the exporting sector of a given nation but will harm it in the importing sector, with an undetermined impact on the mobile factor.

## 4.2 Modern Theories of International Trade

As we saw in the previous section, according to the traditional views justifications, trade liberalisation relies mainly on the law of comparative advantages as the main factor of international trade. The new modern theories focus more on the role of trade liberalisation and diversified economies in reaching economic growth (Silajdzic and Mehic, 2018).In this section, we elaborate on some recent concepts of international trade such as the role of economies of scale in international trade, and how trade restrictions on importation enhances exports.

The economic concept of economies of scale dates back to Adam Smith (1776). However, Paul Krugman, in his book *International Economics: Theory and Policy* (Krugman and Obstfeld, 2003), stresses the importance of economies of scale and how they can create trade opportunities and increase international trade. Economies of scale generally refer to the increase in output while the per unit cost of a product continues to decline usually up to the maximum efficient scale and thereafter it could remain constant and/or eventually start to rise (Suranovic, 2010). In graphical terms, the Long Run Average Cost (LRAC) curve of production, which mathematically is the envelope curve of a series of Short Run Average Total Cost (SRATC) curves at successive plant sizes, takes the familiar U shape with the bottom part retaining a horizontal straight line. The declining range defines an increase in return to

scale or economies of scale. Over the flat section, we have a constant return to scale. Finally, the rising section defines a decreasing return to scale or diseconomies of scale. The starting and ending points of the flat section correspond to the minimum and the maximum efficient plant size, respectively. It is worth mentioning that empirical studies have shown that in manufacturing the LRAC resembles an L shape, meaning that in practice producers will never push operations to the point of increasing per unit cost(Dean, 1976). Discussion of scale economies revolves around two aspects: internal economies, which affect firms based on its size, and external economies covering the industry, and its size. In short-run, production costs are divided into two types: fixed cost and variable cost. Fixed cost remains the same irrespective of the output level, whereas variable cost depends directly on the units of output produced. As the firm increases production, the fixed cost spreads over a larger number of units, but when the industry as a whole expands, it offers the possibility for suppliers to capture their economies of scale, which translates into lower input prices for the firm. Both of these outcomes in turn reduce per unit cost of production.

Krugman has asserted that economies of scale provide countries with the incentive to specialize in production and trade regardless of differences in technology or resources between countries. His principle argument is that economies of scale lead to imperfect competition and that only few major producers can influence the prices and sell more. Two important models were set up to illustrate his point of view: The Monopolistic Competition model and the Dumping model.

The distinguishing feature of the Monopolistic competition models the importance it places on economies of scale as well as the increased variety of goods produced due to trade. These attributes, in turn, enlarge the world market, leading to lower average price and thus enhancing the availability of a greater variety of products. In the monopolistic competition model, an industry contains a group of firms producing differentiated products (real of conceived) and act as individual quasi-monopolists. However, additional firms may enter these industries attracted by the possible existence of monopoly profits. In this case, the enlarged market size leads to a new equilibrium with an increased number of participating firms, each one producing greater quantities at lower average total cost in comparison to the previous smaller market. The increase in total market sales will reduce average costs for a given number of firms and consequently will decrease prices. Because of the larger integrated market, everyone is better off, which is an indication that the previous arrangement was not Pareto optimal.

In this new environment, producers will produce more goods at lower cost and sell more, while consumers will have a wider range of choices at lower prices. However, in order to achieve economies of scale, firms should produce in one country and sell goods to customers in both markets (i.e., domestic and abroad). In advanced industrial countries, intra-industry (trading of the same goods) trade plays a major role because these countries tend to be similar in their levels of technology and in the availability of capital and skilled labour. As a result, the comparative advantage will soon disappear and eventually replaced by economies of scale.

The Dumping model focuses on the possible consequences of imperfect competition on international trade. One of the issues involved is called “dumping”. It takes place in imperfectly competitive markets when a firm charges a lower price on exports than it charges domestically for the same product, which results in market segmentation. In this environment, it becomes difficult for domestic consumers to purchase goods intended for export. Dumping offers the opportunity to a monopolistic firm to increase overall profits as due to exports.

The theory of Import Protection as Export Promotion was developed by Paul Krugman (1984).In his book *Rethinking International Trade* (Krugman, 1994),Krugman argued that import protection, under increasing returns to scale, may be used as export promotion. In order to explain his ideas, he

developed three different models based on two main assumptions: first, markets are oligopolistic and segmented, and, second, economies of scale are present. The first model (static economies of scale),shows that protecting the domestic market provides the opportunity for domestic producers to exploit more efficiently existing economies of scale and shield them from foreign firms' competition.

In the secound model (Competition in R&D), Krugman argues that dynamic economies of scale are involved in research and development (R&D) and have the same implication as decreasing cost. Furthermore, protection as promotion argument is valid. This model shows how protection increases domestic output and lowers foreign output as imports, which is equivalent of saying that protection increases domestic firm's production and sales at the expense of foreign firms. Model three (The learning curve) assumes that, as domestic firms and foreign firms compete over time and space in each market, the increasing returns take a dynamic form where the current higher output leads to reduced production cost at a later stage. Exclusion of the foreign firms from some markets will increase the cumulative output of the domestic firms and decrease it for the foreign firms.

## 5. Main Accusation against Free Trade Policy

Although free trade policy seems to have great benefits for an economy, there are some critics, such as Santos-Paulino (2002), Stiglitz (2008), and Pacheco-López and Thirlwall (2007), who posit that the present trend toward free trade policy encounters a number of problems. These issues are elaborated in the sections below.

### 5.1 Economic Growth

The argument that trade liberalisation enhances economic growth in developing countries is still empirically debatable. Browsing the literature, several researchers carried out empirical investigation on developing countries in the Middle East and North Africa, Latin American, and the Economic Community of West African States. For example, Santos-Paulino (2002), Ackah and Morrissey (2005), Fernandes (2007), Pacheco-López and Thirlwall (2007), Babatunde (2009), Ghani (2011), Ratnaike (2012), Kiyota (2012), Ulaşan (2015), Kurihara and Fukushima (2016),Cruz (2017), Agbahoungba and Biao (2019), and Hadili et al.(2020), found out that free trade policy has no significant impact on economic growth. Furthermore, some cases have resulted in a serious balance of trade and balance of payments problems. Notwithstanding the above, there are some authors such as Herzer (2013), and Fukushima and Kurihara (2016), who argued that trade liberalisation has improved the economies of developed countries by increasing their level of specialization, while at the same time has led them to impoverishing specializations that inhibit economic growth.

### 5.2 Export and Import Growth, Balance of Trade and Balance of Payments

Trade liberalisation might have a relative impact on import and export growth, as well as, the prices of traded goods, which in turn may have a direct impact on both the payments and trade balances. When imports grow faster than exports and relative prices cannot achieve the balance between the value of imports and exports' value, disequilibrium will emerge in the balance of trade and the balance of payments. Deterioration in the balance of trade, in turn, constitutes a constraint on growth since the

ability of countries to accumulate foreign debt and sustain deficits is limited. If the nominal exchange rate cannot bring forth the required adjustments in the balance of payments, it will be necessary to curtail output in order to reduce the pressure from imports, which will ultimately result in welfare losses. Looked from this perspective trade liberalisation may be considered as a constraint on economic growth.

Studies undertaken by Santos-Paulino and Thirlwall (2004),Santos-Paulino (2007),Pacheco-López (2005), Ju et al.(2010), Allaro (2012), Hoque and Yusop (2012), Mohsen et al.(2017),have indicated that trade liberalisation exerts a limited influence on export growth for developing countries. On the contrary, the impact on imports is much greater and in some cases trade liberalisation does not achieve export growth at all, which will create a deficit in the balance of trade and, additionally, may cause a negative impact to the balance of payments as well (Hadili et al. 2020).This adverse development is attributed to many reasons, such as poor domestic environment, weak government policies and institutions, limited resources(especially for food exporting countries), and low labour productivity.

### 5.3 Labour Market

Free trade policy requires specialization in production and re-allocation of resources, which in turn necessitates workers to shift from one sector or industry to another. This shift may take time, as it requires learning of new skills that current workers may not possess. Furthermore, due to increased competition, producers are forced to employ new technology and develop skills in order to cut costs. Unfortunately, labour cost is included among the cost saving changes. However, such initiatives may have a negative impact on the employment condition of a large number of workers, thus exacerbating unemployment and chocking off local economies.

There is no doubt that trade liberalisation has helped quite a few developed countries, such as the G7 group, to reduce unemployment and improve their labour markets (Gozgor, 2014). It has, also, increased the demand for labour in these countries and also increased the participation rate by creating new employment opportunities for some parts of the population that otherwise would have been excluded from the labour market(Francis and Zheng, 2011).

As far as the labour market of developing countries is concerned, trade liberalisation has not increased employment in the relevant industries(McMillan and McCaig, 2019). Instead, it had been accused of leading to a dramatic decrease in employment rate in those formal sectors and regions that have specialized industries and face larger tariff cuts. This result is explained by the impediments in interregional labour mobility and slow adjustments in capital utilization(Dix- Carneiro and Kovak, 2017). Furthermore, districts with large tariff reduction have experienced a significant decline in employment, and there has been no evidence that the newly created unemployed workers were able to move to other sectors. Instead, either they have become discouraged workers or dropped out of the labour force all together (Erten et al. 2019). In addition, Dix-Carneiro and Kovak (2019)found no evidence for inter-regional mobility in response to these sharp differences across local labour markets.

With regards to wages, trade liberalisation has been found responsible of contributing to widening income inequality in advanced industrial societies(Kwon, 2016). This in turn could lead to a slowdown in economic growth because high-income individuals exhibit smaller consumption propensities and save a greater percentage of their income than people in the lower strata of the income distribution scale (Salimi et al. 2014).However, the impact of such a policy on the labour markets of developing countries is ambiguous. While trade liberalisation has decreased wage inequality in Asian tiger

countries, it has increased income inequality in Latin America(Stewart and Berry, 2000; Arbache, 2001), and other countries such as China, India and South Africa (López-Calva and Lustig, 2010). In some cases, inequality has increased and continued to remain significant (Basu, 2007; Atkinson and Brandolini, 2010). Also, trade liberalisation may affect income distribution between and within countries (Allaro, 2012; Santos-Paulino, 2012).Additionally, trade liberalisation has increased wage inequality(Stewart and Berry, 2000), and worsened income distribution in most of the developing countries between skilled and unskilled workers (Galiani and Sanguinetti, 2003; Lundberg and Squire, 2003; Goldberg and Pavcnik, 2007). Furthermore, trade liberalisation has deteriorated the distribution of income between unskilled wage-earners and other workers within countries, and between rich and poor countries(Pacheco-Lopez and Thirlwall, 2009).

### 5.4 Other Accusations

Advocates of free trade policy insist that trade liberalisation has tendency to reduce poverty and increase welfare. In reality, trade liberalisation had been demonstrated to have a minimal impact on reducing world poverty and may have even increased it (Pacheco-López and Thirlwall, 2009). On the other hand, opponents of free trade policy share the opinion that the impact of this policy on the agricultural sector is very limited. Even more, it is likely to be negative for a significant number of developing countries. This would be especially true for countries that adopt a free trade policy but have a comparative advantage only in the agriculture sector. In such a case, this country is not likely to industrialize and would experience a limited growth in the agriculture sector due to adopting trade liberalisation (Stiglitz, 2008). Furthermore, when countries specialize and take advantage of economies of scale, sometimes they produce more goods than what needed in the world market. This may force them to get rid of the extra production by dumping the surplus internationally below cost and thus suffer from revenue losses. It is also possible that, under these circumstances, some efficient industries could face difficulties to keep their share of the market for long time. Furthermore, in a competitive environment, developing or new industries may not succeed without short-term protection policies from their respective governments. Lastly, competing with giant international firms will make it difficult for efficient small industries to exploit economies of scale; and this captures the essence of the so-called infant industry or infant economies (developing economies) protection argument.

## 6. Why Trade Liberalization did not Work Well in Developing Countries?

From what we have discussed so far, it seems that the elimination of trade barriers is not enough to guarantee the achievement of economic growth. There are many reasons behind this failure that prevent trade liberalisation from delivering its promises. They are summarised in the following sections:

### 6.1 Structuralist Macroeconomics

Due to some macroeconomic constraints, trade liberalisation might have an adverse effect on developing economies. In his book *Structuralist Macroeconomics,* Lance Taylor (1983)argues that the influence of certain macroeconomic variables, such as income distribution, currency devaluation, price levels, and subsidies on developing countries in the short run may offset the impact of trade

liberalisation regardless of any type of natural resources they rely on for their exports. More specifically, he suggests that each country possesses its own idiosyncratic structural constraints. That is, resource-poor countries fundamentally face different restrictions than do resource-rich countries. He divides developing countries into two types of economies: The first mainly relies on agriculture and food production for which these economies are constrained by a fixed supply in the short-run. There is also a non-agriculture sector, i.e. primitive manufacturing, with fixed mark-up and capacity adjustment. The second type of economies focuses on mineral exports.

An increased demand for food exports in food exporting economies will boost the income of such producers but will also create unsatisfied food demand in the exporting country. Giving that developing countries that rely on the agricultural sector face bottlenecks in the supply of food due to limited resources (e.g. agricultural land), the price of agricultural products will increase. The impact on the non-agricultural sector will vary depending on the size of the Engel effect. In other words, changes in commodity demand are contingent on rising incomes, but the income elasticity of demand for food will be positive and less than one. If the Engel effect is strong, the increase in food prices will reduce the demand for the non-agriculture sector's products and the outputs of this sector will decrease. However, if the Engel effect is weak, then the unfilled food demand will bid up food prices and may increase the demand for non-agricultural products and output.

As we indicated above, the agriculture sector is constrained by a limited supply; i.e.; food production is not price elastic. Consequently, it relies on the adjustments of food prices to reduce the excess demand and clear the market. When trade liberalisation takes place, the domestic price of food products will be determined by the world market. The export response will be weak if the surplus production is less than the fixed food demand, which this is considered a major policy issue for food exporters. Food subsidies, also, have material policy implications. For instance, the imposition of a subsidy on food exports will raise the domestic price of these products by the full amount of the subsidy and deal a blow to food consumers. At the same time, subsidies will lead to a greater volume of production that would increase the economic rent of producers achieved via their enlarged surplus. This effect, most likely, is going to increase the aggregate demand. However, due to the constraint in the food supply, the increase inprices will somehow counter effect the extra quasi income stemming from subsidies and, thus, will reduce the overall effect on demand.

Promoting exports through subsidies is motivated by the desire to earn hard currency. The upside effect of this motivation is to encourage firms to produce and hire more employees. The shortcoming is that subsidies will affect the budget of the domestic government. In addition, another factor that must be considered is the relative size of the specific country in global trade. For small countries, the ramifications are going to be less significant than large countries. In large countries, because of the significant volume of exports, the world price has tendency to depress affecting the terms of trade and increasing even more the dead-weight loss. Looked from another angle, this extra loss places an additional burden on the government in the form of larger budget deficit. It represents a transfer of payments from the domestic government to foreigner buyers since they now purchase the product at a lower price. The irony is that importing countries should not complain about export subsidies because their consumers enjoy lower prices while producers are hurt. In this case, the government is often forced to impose countervailing duties. Lastly, we must mention that production subsidies are less distorting than export subsidies, and the WTO allows them.

Reductions in export subsidies, also, have their own policy implications because they may reduce non-agriculture sector output in the exporting countries. With a strong Engel effect, such a change will most

likely lead to a decline in consumer purchasing power induced by a fall in food prices, which could reduce the demand for non-agriculture products.

In mineral exporting countries, the economy is divided into three sectors: the mineral sector, the manufacturing sector, and the non-importable intermediate sector. The latter sector plays an ancillary role in providing a diverse array of services, such as transportation, infrastructure, and energy, which are limited in supply and used by both other sectors. Usually, the share of the mining sector in supplying inputs to manufacturing is modest. When mineral exports increase, the mining sector will need more intermediate inputs pulled from the manufacturing sector due to the limited supply. It will also increase the demand for manufactured goods, in which case their price will rise because of the extra pressure on the demand for such goods. Therefore, the increase in mineral production will boost the price of intermediate goods. However, the impact on the price of manufactured goods is less evident as it depends on which of the variables (i.e. increased demand from the mineral sector on manufactured goods, or an increase in the price of intermediate products) would exert the strongest effect on the manufacturing sector. If most of the influence stems primarily from the increase in the price of the intermediate goods, then the price of the manufactured goods will increase thereby reducing the consumption of and the export demand for these goods. In contrast, if the increased demand from the mineral sector for manufactured goods is more important, then most likely the output of the manufacturing sector will rise.

The majority of mineral exporting countries suffer from balance of payments pressure as a result of increased demand for imports and extra government spending. Thus, certain adjustments have to be carried out in order correct these imbalances. One of the common instruments used in this case is the currency devaluation, which will primarily affect the intermediate imports and the manufactured exports. However, the effect on the balance of payments is not going to be unidirectional. Specifically, given positive exchange rate elasticity, devaluation will lower the world price of exports and increase the export volume. Contrarily, to the extent that export demand response is anaemic, the output of the non-mineral sector will decline due to increased prices of intermediate goods, ultimately forcing the price of the non-mineral sector's output to go up.

## 6.2 Domestic Business Environment

Implementing trade liberalisation in developing countries requires a pertinent business atmosphere in which the free trade policy can deliver its promises. Some economists, such as Douglas Irwin (2020), in his book *Free Trade Under Fire,* and Freund and Bolaky (2008), assert that in developing countries, trade liberalization alone cannot achieve economic growth. Rather, it needs the support of government initiatives to provide a suitable environment to implement trade liberalisation. This insight is particularly significant because most developing countries suffer from corruption, very strict regulations, poor infrastructure, and other impediments that have a negative implication on the outcomes of free trade policies and prevent countries from achieving their objectives. It is natural to expect that a conducive institutional environment should have a positive impact on economic development. One measurement of sound institutional arrangement rests on the quality of governance, and the depth of democracy (Acemoglu et al. 2005).There are certain important elements, such as corruption, cost, time, and regulations on trade, and political stability that determine the nature of domestic business environments and prevent free trade policies from promoting economic growth. These elements are discussed in the following sections:

### *6.2.1 Corruption*

Although the notion of corruption differs among countries, the most common definition is the abuse of public office by bureaucrats for personal benefits(World Bank, 1997). When corruption take place in a significant way, private investment (domestic and direct foreign) in the corresponding developing country is discouraged and this in turn slows down the process of economic growth. There is a consensus that wide spread corruption is not compatible with high levels of capital accumulation and economic growth. Many research studies estimated that a corrupt country is likely to generate aggregate investment levels of almost five percent less than a relatively un-corrupt country and might sacrifice output of about half a percentage point of GDP per year. Moreover, corruption materially discourages foreign direct investment and the concomitant much needed transfer of modern technology and know-how(Kaufmann et al. 2007).

Generally, it is usually difficult to trace out corruption and it rarely can be pinpointed in reality. This makes its measurement in any country on an aggregate level a very difficult task. Therefore, because objective measures are hard to come by, subjective measures have received much attention by researchers and governments as well. Hence, perceptions of corruption are based on polls, firms and household surveys, and expert assessments. In this regard, the Transparency International's Corruption Perception Index (CPI) is the most reliable among the existing corruption indices. This is the reason why it is most commonly used for the purpose of estimating the extent of corruption. This index classifies countries based on the existence of corruption and its degree among politicians and public officials. It uses a scale from zero to ten to rank countries, where a score of zero corresponds to the maximum corruption level.

### *6.2.2 Cost, Time, and Regulations on Trade*

Restrictions on trade include all kinds of interventions that may act as impediments to trade and make it less appropriate to enhance economic growth. Excessive regulations, high costs, and lengthy time to export or import are part of trade restrictions.

In many economies, strict regulations prevent firms and investors from entering the market, and block labour from moving freely across firms or sectors. Under these conditions, trade liberalisation cannot induce specialization when the movement of factors of production is restricted, which, in turn, does not allow free trade policy in these countries to achieve the desired rate of economic growth. By government regulations on trade, we mean variety of legal requirements necessary to start a business and the time, fees, and documents required to export or import. Bolaky and Freund (2004) found strong evidence that a highly regulated country does not generate increased trade and is not necessarily able to stimulate economic growth (Bolaky and Freund, 2004). Furthermore, business entry regulation greatly reduces investment (Alesina et al. 2005).

In a recent study, Djankov et al. (2010) showed that each additional day of delay reduces trade by at least one percent. Meanwhile, a one-day reduction in delays before a shipment sails is equivalent to reducing the distance to its export destination by about 70 kilometres. While a one-day delay may reduce exports by six percent on average( Djankov et al. 2010).One of the best indices for measuring government interventions/regulations on trade developed by the World Bank is called Doing Business, and it covers 183 individual countries.

### *6.2.3 Political Stability*

The economic growth of developing countries depends, among other things, on capital accumulation and profitable investments, with Foreign Direct Investment (FDI) playing a significant role in achieving this objective. In this connection, political stability becomes one of the key factors to determine whether establishing a business venture in a country is worthwhile for investors. A country with lengthy and continuous political stability is usually attractive to foreign investors. While an unstable country is very risky and costly, not to mention the cost of equipment and the difficulty of convincing workers to move to the country. Notwithstanding the above, there is evidence of some daring businesspersons who target unstable countries for investment lured by the higher expected returns to compensate for the increased risk involved.

Studies that have attempted to assess the relationship between political stability and foreign direct investments found that within countries that have historically attracted high FDI, political stability and business operating conditions are highly correlated with the level and frequency of FDI(Singh and Jun, 1995). Among political stability criteria, the absence of internal conflict, government stability, fundamental democratic rights, and consistent law and order are the most appealing (Busse and Hefeker, 2007).One of the most important determents of FDI in North African and Middle Eastern countries is the degree of instability associated with investment risk(Chan and Gemayel, 2004).

Most indices that measure political stability rely on subjective measures. They are based on a variety of sources, such as stakeholders' attitudes including households and firm survey respondents as well as experts' opinions working for private and public agencies. One of the most reliable indices that measures political stability and violence is called Political Stability and Absence of Violence, which is also created by the World Bank.

## 6.3 Resource Curse

As proposed by the resource curse literature, relying on natural resources as the main source of income is not always advantageous. Rich oil-exporting nations have not succeeded to enhance their economic growth. Instead, their growth rates were lower than other nations not enjoying the same level of natural resources (Auty and Warhurst, 1993). Focusing on one sector, such as oil or gas, usually makes countries neglect other productive industries. Therefore, any fluctuations in the world price of this sector will have a direct impact on the country's economy. In addition, wages will be higher in natural-resource sector than the national average. Consequently, skilled labour will move from their original sectors to these appealing sectors, which will decrease the competitiveness of the other productive and tradable sectors in global markets. Furthermore, foreign capital accumulation will appreciate the local currency, which in turn, will decrease the relative price of imports and thus increase the overall demand for all kind of goods produced abroad, damaging domestic industries and creating imbalances in the balance of trade. These kind of economies usually suffer from several issues ranging from the lack of economic diversification and the spread of corruption to the weak development of economic institutions.

Mavrotas et al. (2011), and Isham et al. (2005) suggest that, growth rates in nations enjoying abundance of natural resources are often low and this is primarily attributed to poor governance that arise from oil and mineral dependency. Resources are therefore poorly allocated based on temporary booms in the relative

price of those minerals Murshed, 2004). Although a price increase in exports may have a positive short-term effect on economic growth, it may also negatively impact economic growth in the long term(Collier and Goderis, 2008). Acemoglu et al.(2005) suggest that a good institutional environment can have a positive effect on economic development. In addition, they emphasise the negative impact of oil and minerals economies on governance, which they consider more important for the purpose of growth. Furthermore, the unsatisfactory outcome in oil and minerals rich economies depends on the quality of institutions.

In addition, there is strong evidence that due to commodity prices fall, countries that rely heavily on oil or gas exportation face negative economic growth rates. Furthermore, because of boom–bust cycles, this type of economies may be devoid of their resource rents and stay away from industrialisation. Nations enjoying high levels of natural resources are likely to have a higher overall price levels. Their non-natural resource industries are generally too weak to compete successfully in the international arena. Moreover, governmental neglect of other production sectors and currency appreciation may deeply affect the export sector and make it less diverse. An opposite suggestion in this connection is that the export structure that relies on manufactured goods may raise economic growth significantly (Murshed, 2010).

There is the possibility that the resource curse may not be relevant, especially in a country, which has institutions that can help it transform its economy from resource abundance to a well-diversified economy. Well-established institutions will have a positive impact on economic growth. Further, a greater degree of democracy relying on checks and balances not just electoral competition, might raise economic growth. In addition, a low growth rate may cause political regime instability where greed, grievances, and institutional failure are the main explanatory factors of civil war.

Overall, the empirical studies indicate that implementing trade liberalisation is not enough to enhance economic growth especially in the case where the export sector is the main source of revenue for a country. Moreover, poor infrastructure and business environments, poor labour productivity, underdeveloped and inefficient financial markets, minimal use of modern technology, and unpredictable government policies are the main features of most developing countries. Interpreted together, these factors could add extra costs and make competition with other countries almost impossible as the latter provide high-quality products at very competitive prices. In addition, high quality and competitively priced foreign products might make domestic consumers favouring them over locally produced ones. This may result in an increase in import growth and thus introduce a heavy burden to balances, trade and payment.

## 7. Conclusion

Achieving economic growth and increasing welfare are the main incentives behind adopting free trade policy in developing economies. However, the elimination of trade barriers cannot guarantee that this objective is going to be achieved. Instead, trade liberalisation may not enhance the economic growth of developing countries. In fact, it could even become a major hindrance to pursuing this goal when the resultant losses outweigh the benefits.

There is no doubt that trade liberalisation benefits the economies of developing countries with the presence of the right infrastructure. The achievement of industrialization and economic diversification in the desire to enhance export growth requires a pertinent local business atmosphere, good quality of governance, and supportive governmental policies especially in oil exporting countries because they rely mainly on oil exportation and ignore other productive sectors of their economies. Protections from imports, export promotion, and gradual opening to global trade are considered useful instruments in order to mitigate possible harms resulting from the adaptation of free trade policies. Government intervention is also important to work as safeguard to correct any imbalances that free trade might cause. Developing countries ought to be very well prepared to combat any potential downsides before liberating their economies.

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