

Trading Places: International Integration after the Crisis

Mona E. Haddad and Bernard Hoekman

The global financial crisis is stimulating a broad reassessment of economic integration policies in developed and developing countries alike. The crisis was associated with the “Great Trade Collapse”—the sharpest synchronized decline in international trade flows since the Great Depression (Baldwin 2009). The collapse—a whopping 36 percent fall in world merchandise imports between the fourth quarter of 2007 and the second quarter of 2009—followed a long period of steady expansion of global trade and direct investment flows. This growth was supported by a steady movement toward opening markets. Apart from pockets of protection in agriculture and in certain labor-intensive parts of certain sectors (for example, clothing), high-income countries at the start of the crisis had very low rates of protection. Many developing countries had also been dismantling trade barriers unilaterally or in the context of trade agreements.

The sharp and deep collapse in trade that occurred was primarily a reflection of the splintering of global value chains. As demand for final goods dried up following the credit shock and collapse in confidence in the

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second half of 2008—especially for durables and investment goods—so did demand for intermediate inputs and components and the associated transport and logistics services. The rapid recovery in trade flows that was observed between the second quarters of 2009 and 2010 is the counterpart to the collapse—because of the international nature of production chains, as demand for final products recovered so did demand for parts, components, and the associated assembly tasks. Uncertainty remains, however, about whether, in the medium term, the structure of production and specialization that had emerged before the crisis will be sustained.

Specifically, the crisis and its aftermath call into question whether development and growth strategies that are premised on deep integration into the world economy—the so-called export-led growth model—remain appropriate. For example, Klein and Cukier (2009:11) claim that “the era of export-led growth is over in its current form.” Outward-oriented or export-led growth strategies are being reassessed for two main reasons. The first is because of the speed with which the trading system transmitted simultaneous negative shocks in major markets to the rest of the world—thus contradicting extreme versions of the “decoupling” thesis and making outward orientation seem a riskier proposition. Di Giovanni and Levchenko (2009a) show that sectors that are more open to international trade are more volatile, and that as trade is accompanied by increased specialization, more openness increases aggregate volatility. Offsetting this is that sectors that are more open to trade are less correlated with the rest of the economy. This reduces overall volatility but not enough to offset the impact of the other factors.¹

Second, successful export-led growth strategies are often associated with large trade surpluses, foreign exchange reserves, and an undervalued currency (or “financial mercantilism”; see, for example, Aizenman and Lee 2008). The flipside of these trade surpluses has been large deficits in some of the main importing markets such as the United States and in many (less successful) developing countries. The prospect of continued (cheap) financing of these deficits will decline in the postcrisis period, and political pressures to restrict the continued export growth of surplus countries can be expected to remain high.

Some degree of global rebalancing is surely going to take place in the medium term. This process might limit the capacity of newly developing countries to rely on overseas demand, but it also offers low-income

countries an opportunity to expand trade with the more advanced emerging markets. Integration remains a key dimension of any development strategy. However, because the postcrisis period will most likely be characterized by a world with multiple growth poles and lower global growth than in the precrisis decade, developing countries will benefit from greater diversification across products and markets. A clear lesson of the crisis is that openness brings with it the risk of volatility and the associated human and economic costs. Diversification will help reduce such volatility.

A remarkable feature of the policy responses to the crisis was the limited recourse to overt protectionism in an effort to shelter domestic firms. The last time the world economy went through a global downturn, following the second oil price shock and the winding down of inflation at the end of the 1970s, there was a widespread resort to “voluntary” export restraints and quantitative restrictions for products such as cars, textiles, and steel. Nontariff barriers came to apply to over one-third of all developing country exports in the early 1980s (Nogues, Olechowski, and Winters 1986), on top of average tariffs that were significantly higher than they are today. So far, this response has largely been avoided in the current downturn (Evenett 2009; WTO 2009).

One reason for the limited use of protectionist instruments is the globalization of production: countries that are a part of a specific production chain do not have an incentive to raise the cost of the imports that they process for reexport. Aside from changing political economic incentives to use trade policy, the crisis also revealed that international disciplines matter: the rules of the game that are embodied in trade agreements—both the World Trade Organization and regional arrangements such as the European Union (EU), the North American Free Trade Agreement (NAFTA), and so forth—constrained recourse to protectionism. The fact that the institutions that make up the global trading system proved to be robust illustrates the importance of further strengthening the trade regime.

Conclusion of the Doha Round will limit the ability of governments to increase tariffs or agricultural subsidies in the future and reaffirm the international community’s commitment to keep cross-border trade and investment flowing (Hoekman, Martin, and Mattoo 2010). As important, it will open the way to launch international efforts to limit the

possible negative spillovers associated with national policies and policy responses to external shocks. Although trade policy is likely to feature less prominently in the toolbox of governments, other instruments—such as the exchange rate or specific types of industrial (sectoral) policy—continue to have an important role to play. These are appropriate instruments for governments to use in the pursuit of growth and development goals, but they also can have beggar-thy-neighbor features and generate international tensions. Addressing these tensions—which are in part the consequence of successful pursuit of export-led growth—in a cooperative manner is important both to prevent recourse to unilateral retaliation by trading partners and to allow those countries that are most in need of effective proactive policies to use them without fear of negative reactions from the rest of the world.

The trade agenda moving forward does not center on stepping back from integration into the world economy. Instead, the focus should be on finding ways to maximize the benefits from trade and foreign direct investment while reducing the vulnerabilities that come with greater openness. Four broad policy implications flow from this assessment:

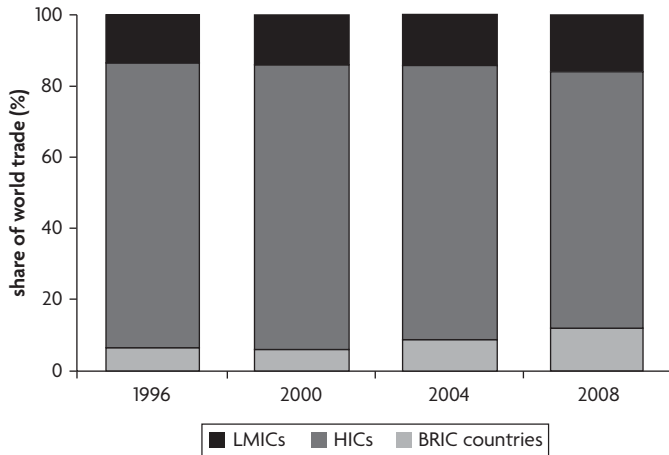
- *Focus more on South-South trade.* Higher growth in many middle-income developing countries (Brazil, the Russian Federation, India, and China [BRIC], and so forth) provides an opportunity (incentive) for more South-South trade. This will reduce exposure to possible prolonged slow-growth markets in Europe, Japan, and the United States. A policy implication is a greater focus on reduction of barriers to such trade, which are higher than for South-North trade.
- *Promote greater diversification.* More South-South trade will expand the number of markets developing countries trade with. Also, expanding the number of products they export—including services—can reduce output growth volatility.
- *Acknowledge that sustained export growth and successful diversification require supportive policies.* These include a competitive exchange rate and policies that support the ability of firms to operate on international markets.
- *Expand international cooperation* at both the global and the regional levels. Such expansion will help to manage the tensions that will arise as the result of both the rebalancing of the world economy (“the rise of

the rest”) and, more specifically, the use of policies that may have negative repercussions for other countries. Continued efforts are needed to agree to rules of the game that extend beyond the narrow ambit of trade policy.

Increasing South-South Trade

Trade levels began to recover starting in the third quarter of 2009, and world trade is predicted to grow by some 10 percent in 2010. A feature of the trade expansion is that it has been driven in part by restocking (which is of a one-time nature) and by the monetary and fiscal stimuli put in place by the major economies (Freund 2009). High debt and deficit levels in many Organisation for Economic Co-operation and Development (OECD) countries will continue to be drags on growth, and thus consumption, for a substantial length of time. Thus, developing countries may not be able to rely on developed countries to fuel their export-led growth, as rapidly industrializing countries, such as China in the 1990s and the Asian Tigers before it, were able to do. Over the medium term, the development of “export-led growth v2.0,” in which South-South trade plays a more important role, will be essential (Canuto, Haddad, and Hanson 2010).

Northern markets are still important, but low- and middle-income countries (LMICs) are increasingly a source of import demand and varied products. The import share of BRIC countries doubled from 6 percent to 12 percent during 1996–2008 (figure 3.1). Other LMICs increased their share from 13 percent to 16 percent. In relative terms, the importance of the high-income countries (HICs) as a direct source of import demand is decreasing, from a total share of 81 percent in 1992 to 72 percent in 2008. South-South trade increased at both the extensive and the intensive margins. Exports of LMICs to BRIC countries rose from 7 percent of the total in 2000 to 12 percent in 2008. By contrast, exports of LMICs to HICs decreased during the same period, from some 80 percent to 69 percent. The average value of a transaction from LMICs to BRIC countries increased 444 percent during 1996–2008, while that from LMICs to HICs increased only 180 percent. However, more trade among developing countries is not an exact substitute for trade with developed countries. For consumers in developing countries,

Figure 3.1 Developing Countries Account for an Increasing Share of World Trade

Source: United Nations Commodity Trade Statistics database (UN Comtrade).

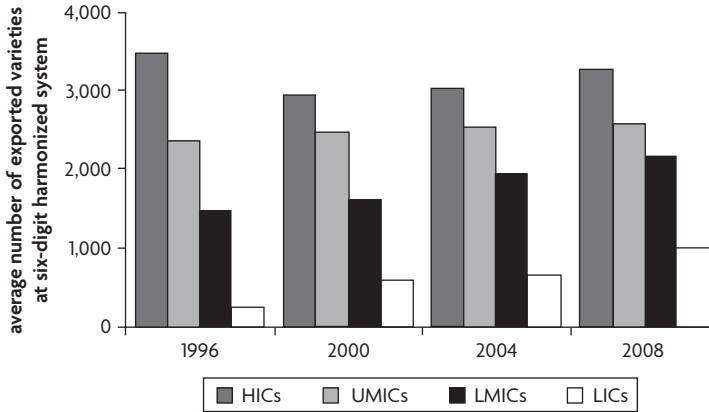
Note: LMICs = low- and middle-income countries, HICs = high-income countries.

price is a more important consideration than quality or variety (Kaplinsky and others 2009). Moreover, Southern countries still export substantially fewer varieties than high-income or even middle-income countries (figure 3.2).

The recent growth in South-South trade has been driven by three factors: growth of emerging economies, reduction of trade policy barriers, and, more generally, improvements in the investment climate. Rapid growth of gross domestic product (GDP) is behind a significant proportion of growth in import demand in low- and middle-income countries, and particularly in the BRIC countries (figure 3.3, based on gravity-model-based decomposition of trade growth). These effects exceed the combined contribution of GDP growth in the United States and the EU. Effective stimulus packages in the major Southern economies complemented actions taken by OECD countries to support demand. China has led the way on this front. The rapid return to relatively high growth in Brazil, China, and India has been an important stabilizing factor for global trade.

Reductions in the average level and the dispersion of border protection have also been a significant force behind South-South trade.² The average tariffs imposed by BRIC countries decreased 44 percent during 1996–2008. Tariffs in LMICs experienced negative growth rates of 31 percent during

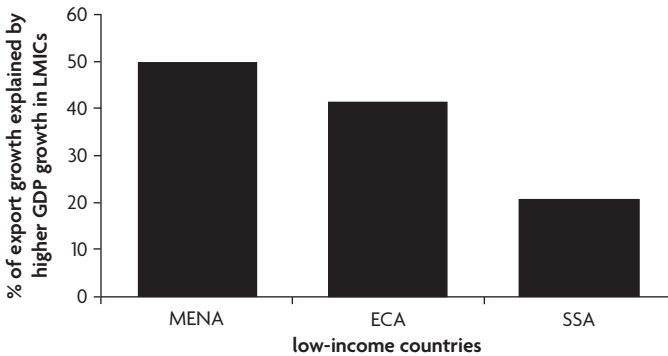
Figure 3.2 Southern Countries Still Export Fewer Varieties Than Northern Countries



Source: UN Comtrade.

Note: LICs = low-income countries, UMICs = upper-middle-income countries, LMICs = low- and middle-income countries, HICs = high-income countries..

Figure 3.3 LMIC GDP Growth Helps Drive LIC Export Growth, 2000–08

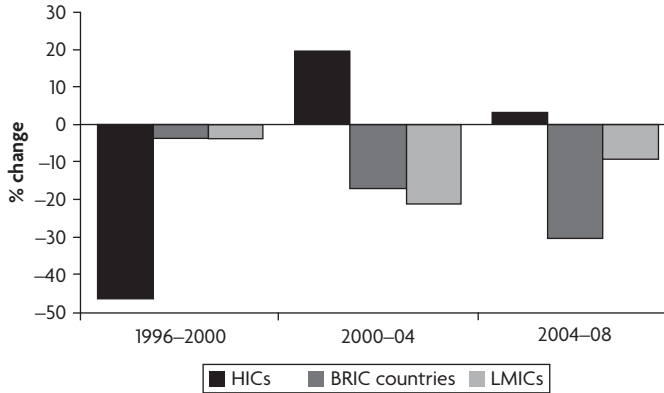


Source: UN Comtrade; World Integrated Trade Solution (WITS).

Note: MENA = Middle East and North Africa, ECA = Europe and Central Asia, SSA = Sub-Saharan Africa.

the same period. As noted, although there have been a variety of measures imposed to restrict trade during the crisis, in the aggregate these have not been significant (Evenett 2009; WTO 2009). However, the trend in the average level of tariffs in HICs has been up—although the movements reflected in figure 3.4 are exaggerated because the base in HICs is very low (the average is less than 5 percent).

Figure 3.4 Tariffs' Drastic Drop in Developing Countries Since 2000



Source: UN Comtrade; World Integrated Trade Solution (WITS).

Reducing Volatility from Openness

Globalization and openness increase cross-border economic interdependence and may lead to convergence of business cycle fluctuations. The crisis has generated a debate on international business cycle co-movements as a result of the remarkable growth performance of emerging countries and the increased intensity of South-South trade. Economic cycles in developing countries remain closely correlated with those in developed countries (Brahmbhatt and Da Silva 2009). While there has been no decoupling in the cyclical component of developing country growth (Kose, Prasad, and Terrones 2003), a decoupling in underlying trend rates of growth may have occurred after the 2000s—the trend rate of growth in developing countries was closer to that in developed countries before the early 2000s; since then, trend growth in developing countries has become substantially higher than in the advanced world.

Supporters of the “trend decoupling” hypothesis argue that there are three reasons to believe that it is possible to sustain the trend decoupling (Canuto 2009). First, the recent fast recovery in many large emerging markets has reflected the strength and sustainability of their national balance sheets. Second, even if the advance of the technological frontier

slows in developed countries, developing countries still have a wide scope for technological learning and catching up, given the existing “convergence gap” (Rodrik 2009). Third, the structural dependence of developing countries on exports to developed countries as an outlet for their increasing GDP levels may have been somewhat overstated.

Although the decoupling of LMICs from HICs protects the South against demand shocks in the North, the outward-oriented strategy can still make the economies of developing countries more volatile. Greater openness to trade typically increases vulnerability to product-specific and country-specific shocks from overseas. Transmission of terms-of-trade volatility to output and growth rises as export earnings become a more important source of national income. However, a second mechanism works in the opposite direction. As a country’s export sector starts to operate more closely in tune with overseas market conditions, it necessarily becomes less strongly correlated with home market conditions. Because demand shocks at home and overseas are only imperfectly correlated, this force tends to reduce overall volatility of output.

Diversification can operate as insurance against volatility. Outward orientation means that a country is more likely to export more products to more markets. Diversification offers a way of buying the benefits of openness while managing the downside risks. It can take the form of breaking into new products or new markets. A higher degree of export concentration implies a greater impact of an idiosyncratic price shock on the country’s terms of trade, inducing greater fluctuations in a country’s growth process. Furthermore, a higher level of product diversification weakens the link between openness and growth volatility (Haddad, Lim, and Saborowski 2010). Geographic diversification also plays a role in reducing volatility. Countries whose main export markets are volatile are more likely to import volatility from their trading partners and be exposed to external fluctuations. Thus, if there is low correlation between the fluctuations in different partner countries, geographic diversification reduces the exposure of countries to external shocks. Yet, the relationship between exposure to shocks and geographic diversification is nonlinear, with the beneficial effect of diversification becoming smaller the more diversified a country is (Bacchetta and others 2009).

The exports of developing countries have become more diversified over time, driven in part by South-South trade. The export diversification

index based on the Herfindahl-Hirschman Index of concentration shows an improvement of around 10 percent for low-income countries between 1997 and 2007. South-South trade has driven much of this diversification. China's import share of capital equipment and its consumption goods imports from low- and middle-income countries nearly tripled between 2000 and 2008. Low-income countries are increasingly filling the apparel niche previously occupied by middle-income countries; they are shifting away from raw textiles like cotton toward simple manufactured clothing. Higher-middle-income country demand for petroleum, iron, and steel is also helping low-income countries diversify away from their traditional reliance on food exports to Northern markets.

With export product and market diversification acting as effective stabilizers, developing-country policy makers should emphasize measures that help broaden their countries' economic base and expand the range of exportable products. A comprehensive array of policies can help a country's exporters achieve this goal (see also Reis and Farole, in chapter 4 of this volume). This array spans four broad areas: facilitating the costly search process for exporters by alleviating information externalities (export promotion agencies) or setting tax incentives for firms to engage in the costly trial and error process of exporting; getting the incentive structure right to reduce or eliminate policy-induced bias against exports in relative prices; lowering the costs of trade-related services, including telecommunications, ports, transport, and customs administration; and instituting proactive interventions by governments, including notably export promotion and standards (Newfarmer, Shaw, and Walkenhorst 2009). Producer services are an important part of the equation (Francois and Hoekman forthcoming).

The idea is to shift the attention from interventions that distort prices (such as trade policies) to interventions that deal directly with other problems that keep trade low (Harrison and Rodríguez-Clare 2010). Thus, instead of reducing tariffs and increasing export subsidies, programs and grants that help improve market logistics can be more effective. This includes measures that increase the efficiency of the clearance process (that is, speed, simplicity, and predictability of formalities) by border control agencies including customs; improve the quality of trade- and transport-related infrastructure (for example, ports, railroads,

roads, information technology); and enhance the competence and quality of logistics services providers (for example, transport operators and customs brokers).

Policies to Promote Trade: A Competitive Real Exchange Rate

Real exchange rate undervaluation has often been used by developing countries to boost their exports. A policy of managed real depreciation was an important factor determining the success of the Asian export-led growth model (Rodrik 2008). While export-led growth strategies as such are politically relatively uncontroversial, the same cannot be said for a policy of managed real exchange rate depreciation, as recent debates illustrate (Evenett 2010).

The empirical evidence shows that real exchange rate variations can affect growth outcomes. Hausmann, Pritchett, and Rodrik (2005) analyze more than 80 episodes of growth acceleration between 1957 and 1992, which last for at least eight years, and encompass acceleration in growth of at least 2 percentage points. They find that faster economic growth is significantly associated with real exchange rate depreciation. Easterly (2005) finds a negative correlation between real exchange rate overvaluation and per capita growth rates. Johnson, Ostry, and Subramanian (2007) show that real overvaluation hampers the export sector and leads to a fall in economic growth.

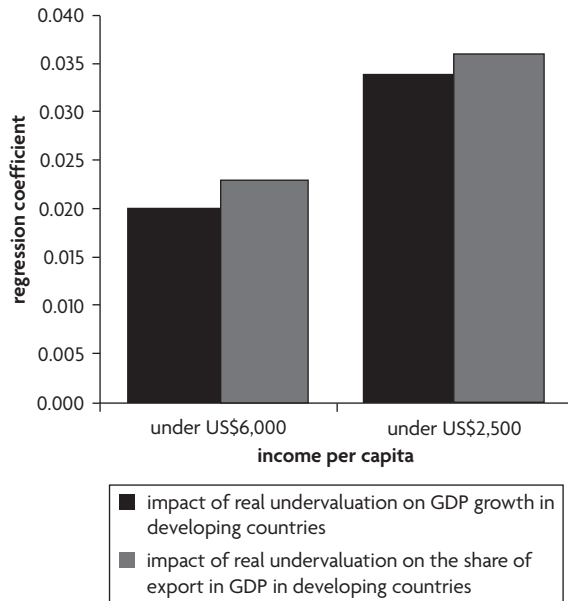
Rodrik (2008) argues that real undervaluation promotes economic growth, increases the profitability of the tradable sector, and leads to the expansion of the latter's share in domestic value added. He contends that the tradable sector in developing countries suffers from institutional weaknesses and market failures more than the nontradable sector. A real exchange rate undervaluation can then work as a second-best policy to compensate for the negative effects of these distortions by enhancing the sector's profitability, thus promoting investment that expands capacity to be closer to what is optimal, and by increasing economic growth.

The real exchange rate can be used as a policy tool since in most developing countries it is largely determined by economic policies rather than market-driven factors. The real exchange rate depends on the balance between savings and investment and expenditures and income. Policies

that produce higher savings with respect to investment can lead to real exchange rate depreciation. Governments have a variety of policy instruments to achieve a competitive real exchange rate, including moderate fiscal consolidation in the presence of low private absorption, controls on capital inflows and liberalization of capital outflows, targeted intervention on foreign exchange markets, and anti-inflationary policies such as price and wage moderation. However, undervaluation has not had a significant impact on growth and exports, except for some low-income countries (figure 3.5).

A stable real exchange rate is critical for sustained growth. Large misalignments of the real exchange rate from its equilibrium can hamper economic growth, as can real exchange rate variability (Eichengreen 2008). Aguirre and Calderón (2005) show that both large real exchange rate overvaluation *and* large real exchange rate undervaluation (devaluations) reduce growth. Bleaney and Greenaway (2001) find that exchange rate instability negatively affects investment in Sub-Saharan African

Figure 3.5 Positive Impact of Undervaluation on Export and GDP Growth for Low-Income Countries, 1950–2004



Source: Data for 187 countries based on Penn World Tables.

countries. Bosworth, Collins, and Chen (1995) provide evidence that, in a large sample of industrial and developing countries, real exchange rate volatility hampers economic growth, reducing productivity growth. Aghion and others (2006) replicate this result but also show that the negative effect of real exchange rate volatility on economic growth shrinks in countries with a higher level of financial development.

An export-led growth strategy paired with managed undervaluation is likely to incur costs if the real exchange rate is kept too low for too long. It may cause an excessive accumulation of low-yielding foreign reserves, which is inefficient and may imply an adjustment pattern characterized by high and destabilizing inflation. From a global perspective, current account surpluses in a large number of developing countries would have to be matched by deficits in the industrialized world. One result of the crisis is that large-deficit countries such as the United States may be neither prepared to run nor capable of running ever larger deficits to absorb an increase in the exports of developing countries. Instead, a reduction in consumption spending in deficit countries is likely and a global rebalancing almost inevitable. While this is a critical issue for large players such as China, it is likely to be less significant for most developing countries. For these countries, the challenge is to diversify across more markets—including the BRIC countries. Maintaining a competitive real exchange rate is a key precondition for beginning to expand market shares in these countries. Appreciation of currencies of large middle-income countries will benefit low-income exporters.

The use of the exchange rate as a policy instrument to boost exports and growth would be ineffective if many developing countries were to employ it, due to competition among them. It would also hurt both domestic consumption and export-oriented industries with high import content. Thus, undervaluation should be considered only for small countries at an early stage of development, with stagnant export growth and a need to enter more resources into the tradable sector (Freund and Pierola 2009).

Deepening International Cooperation

The real exchange rate is a key determinant of the ability of firms to be able to compete on export markets. But many other policies also play an important role, including elaborating and implementing trade agreements

that enhance access to markets and creating economic zones, programs that signal the existence of potential partners and help to screen associates that can be trusted from a quality and credit perspective, investments in infrastructure and trade corridors, trade support and investment promotion institutions, financial support and tax incentives to promote quality upgrading, and so forth. Greater product and market diversification needs to be supported by a comprehensive array of policies to help a country's exporters upgrade existing products, break into new geographic markets, and launch and consolidate new lines of business abroad.

Trade agreements can be an important tool to support better access to markets—especially other developing country markets, given that barriers to trade are still substantially higher in the South than in OECD countries (by a factor of 2, 3, or more). They can also be an important instrument to help governments manage proactive policies that aim to offset market and government failures that create a bias against investment in tradable activities. Joint surveillance of the effects of policies, their incidence, and effectiveness can be a source of valuable information and accountability. Agreements can be structured to increase the credibility of exit strategies—helping to ensure that support does not become a source of rents and to keep in place activities that are not viable. Finally, and most important, trade agreements offer a mechanism through which the potential negative externalities that are created by national policies can be addressed in a cooperative manner.

Looking Forward

In our view, the crisis has not in any way weakened the case for international integration to be a core component of development strategies. What it has illustrated is that a globalized world economy can generate very severe volatility. This calls for social policies and countercyclical policy instruments, but does not imply that countries should in the future devote less effort to integrate further into the world economy and seek to expand the tradable sector of the economy—both goods and services. Diversification across markets and products can help reduce output volatility, especially volatility that is due to idiosyncratic shocks that are specific to a sector or source of demand. The type of highly synchronized global credit crisis that the world has just gone through is likely to be a very infrequent occurrence.

An important consequence of the crisis is that the differential growth performance between high-income and emerging-market economies that was already evident will be strengthened. One result is that South-South trade will continue to expand, in the process helping to diversify trade patterns. From a policy perspective, a multipolar world calls for efforts by developing countries to reduce the barriers to trade they impose on each other. Initiatives that can make a difference include the extension of duty-free and quota-free access for least-developed-country exporters by all G-20 members;³ further reductions of tariffs and non-tariff barriers on a nondiscriminatory basis on products in which poorer developing countries have a comparative advantage; and a concerted effort to cooperate on a regional basis to lower real trade costs created by poor trade and transport-related infrastructure, inefficient logistics services, and border management.

Notes

1. Di Giovanni and Levchenko (2009b) extend the analysis to the more disaggregated firm as opposed to sector level and show that country size matters importantly—trade increases aggregate volatility much more (by a factor of 10) in a small economy like Belgium than in a large economy like the United States.
2. For example, between 1991 and 1995, Brazil's tariffs fell from an average of 29 percent to zero percent. During that period, Argentina's exports to Brazil quadrupled while its exports to the rest of the world increased only 60 percent (Bustos 2010).
3. Members of the G-20 are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, the Russian Federation, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union.

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