Trade Plenary
Tuesday 25 September 2012

Trade, firms and products in the development process

Plenary summary

Richard Newfarmer (IGC) opened the Trade plenary and introduced Eric Verhoogen (Columbia and IGC) whose presentation addressed two questions: What can policy-makers learn from research in international trade? and What can researchers learn from the concerns of policy-makers? To address the first question, Dr Verhoogen provided a brief history of trade theory, beginning with traditional thinking focused on sectors, through "new" trade theory, embodied in Paul Krugman's work, to "new new" trade theory, spurred by access to increasingly detailed data on firms and plants, which documented heterogeneity across firms. From here, Verhoogen moved on to the new frontiers of trade theory, discussing recent work on multi-product firms and product quality made possible by new datasets. In specific, he pointed to evidence of a strong correlation between the number of products that firms export and the number of destination countries they sell to, that value of trade is concentrated among multi-product, multi-destination firms, and to evidence that better firms endogenously choose higher-quality inputs to produce higher-quality outputs. This literature is particularly relevant to developing countries because it suggests that firms need to upgrade quality in order to be successful in selling to rich countries. The key message from research for policy-makers is to think about firms, products within firms, and activities (tasks) that go into making products within firms, rather than just about sectors.

Policy-makers are concerned about the links between the pattern of specialization and growth – in other words, whether what a country produces affects how fast it grows. This concern has not been central to the mainstream academic literature, which focuses on static issues, but Dr Verhoogen suggests it should be: researchers should take the signal from the policy community. To ground this discussion, Verhoogen utilized Mexico as a case study. Despite undertaking an ambitious program of reforms between 1985 and 1994, in line with recommendations from international institutions, Mexico's growth performance has been disappointing. Noting that there are many potentially valid explanations for this (one common one being the expansion of China), Verhoogen suggested that links between the pattern of specialization and innovation also played an important role. The Mexican manufacturing sector specialized in what was perceived to be its comparative advantage: less skill intensive and less capital intensive activities, both across and within sectors. It appears employment growth was low particularly in those less skill and capital intensive activities. These activities also displayed low rates of innovation and it is very difficult to sustain robust growth without a robust rate of innovation. If not China, another lower-wage country could have emerged to compete with Mexico. In Mexico's case, it seems there was a tension between short-term comparative advantage and the rate of innovation and growth. Dani Rodrik, Ricardo Hausmann and others have suggested that in an open economy, if a sector has greater dynamic learning potential, it may be optimal, under certain circumstances, to impose a tax or subsidy to push resources toward that sector, at the cost of static inefficiency. Hausmann, Hwang and Rodrik measure product sophistication using trade-flow data and show that it predicts future growth, conditional on current income. Thus the key message from the policy community for researchers is to examine the links between the pattern of specialization in products or tasks and innovation. Dr Verhoogen posed a research question: how does knowledge and productivity of firms evolve endogenously based on their investments in learning and on what they produce? Verhoogen conjectures that producing high-quality goods tends to generate technological improvements. While if there are externalities in the learning process, there is a potential case for industrial-policy interventions one important lesson of new work in trade is that interventions should not seek to provide blanket support for entire industries. The key task is to find creative ways to promote innovative activities, without presuming to have knowledge about where in particular the next innovation will come from. We need more research on what works in promoting innovation.