

## **Trade Policy and Industrial Sector Responses in the Developing World**

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### **Abstract**

Over the past two decades, a substantial body of evidence has accumulated on the firm- and plant-level effects of openness in developing countries. Some findings have recurred with sufficient consistency to become accepted as stylized facts. In particular it is generally agreed that trade liberalization squeezes price-cost margins among import-competing firms, this heightened competitive pressure induces productivity gains among these same firms, and further efficiency gains come from market-share reallocations.

Although these findings are useful, they leave many basic issues unresolved. One source of ambiguity is that they are based on flawed measures of firm performance. But more fundamentally, this literature:

- fails to identify empirically the mechanisms that link import competition to efficiency;
- only describes the short-run effects of trade liberalization;
- and does not translate firms' performances into welfare measures.

As such it is of limited use for policy analysis. Hence in this paper the authors develop a coherent dynamic model of industrial evolution in the face of heightened import competition. Their model yields predictions that are consistent with the findings of previous firm- and plant-level empirical studies, but it is more informative concerning managerial behavior, transition paths, and welfare effects.

The authors' results suggest that the intra-industry efficiency effects of foreign competition are probably more nuanced than commonly believed. Specifically the authors find that productivity gains due to the purging of weak firms are transitory, and likely to dissipate within ten to fifteen years of trade liberalization. As they fade, the cumulative effects of reform-induced changes in the incentive to innovate become more important. These are often negative, so foreign competition can create a longer-term tendency for the quality of domestic goods to deteriorate relative to imports. Depending upon the nature of the trade reforms, this tendency may or may not be offset by quality and efficiency gains due to embodied technological progress in imported capital. In any case heightened import competition is likely to be accompanied by permanently higher plant or product line turnover, combined with more rapid job creation and job destruction. Finally, there is a strong possibility of welfare losses on the part of domestic producers, but welfare gains among consumers due to lower prices are likely to be larger.