

## Will International Trade Reduce Poverty? A Background Note to Norad

Arne Wiig, Line Tøndel, Espen Villanger  
with contribution from Ottar Mæstad

**R 2007: 16**



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## 1. Introduction<sup>1</sup>

Developing countries' share of world exports has surpassed the 1980 level and was at 32% in 2003, partly reflecting the increasing role China and India play in international trade. At the same time, Sub-Saharan Africa's share of exports continues to shrink. Most African countries are dependent upon a few primary products for export revenue. As the prices of primary products tend to fall over the long term, so does the share of these countries in world exports as long as the volume and number of products do not increase sufficiently to mitigate the revenues lost from price reduction.

The outlook is better, though, for developing countries that are increasing their export share. The number of products in exports has increased and for many the share of manufactures in merchandise exports has also increased. Adding value and reducing risk through export diversification helps developing countries realise the potential of trade liberalisation to increase overall income. New global trading patterns, partly reflecting liberalisation in services and productivity improvement in information and communication technology, have provided substantial income gains for some developing countries.

It is striking that there are such large differences between developing countries that have been able to take advantage of trade opportunities and those that have not been able to generate trade successes. The main purpose of this report is to assess what we can learn from the winners in the trade race, and sum up what the research can tell us about how trade can be stimulated and how to make it a tool for increasing growth and reducing poverty. The report will also address some of the barriers that hinder some poor countries in unleashing their trade and growth potential. This is a high ambition, however, for a vast and complicated theme. It is necessary to underline that this report serves as an introduction to the issues, and that it is not meant to provide comprehensive coverage of all aspects of the problems it considers.

One important finding is that it seems that willing and capable governments are able to use trade policies to foster economic growth and poverty reduction. On the other hand, passive liberalisation seems to generate quite modest gains on average. Moreover, since there are winners and losers from trade reform, both between and within countries, attention and effort should be devoted to compensating the latter group. There are many countries where liberalisation of their own economies may not be a tool for achieving growth and poverty reduction. It is important to stress that although the generalised messages apply to many countries, it is necessary to proceed with in-depth country studies before specific policies on the different issues are spelled out.

The terms of reference (ToR) emphasise that the report should give an introduction to the main challenges within trade and development and the main challenges for development cooperation. The ToR underline that the report is not meant to give an overall picture of the theme, but to concentrate on the following specific problems:

- Trade, growth and poverty reduction, including the national development agenda, vulnerable groups/gender dimension and the environment.
- Developing countries' role in world trade, their trade policies and their actual implementation of trade policies. Regional trade cooperation and agreements.
- Multilateral trade policies and developing countries, including the advantages and disadvantages as seen from the South, and the Aid for Trade debate.

Initially, NORAD also asked for examples of an action plan on how to promote development objectives through trade policy. However, it was agreed that it was not possible to develop such a

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plan within the time frame of this study.<sup>2</sup> Such a tool may be important for a government in a poor country that wants to take a firm grip on the challenge of how to utilise trade opportunities to foster economic growth and reduce poverty. We suggest therefore that an action plan be prepared as a follow-up to this study.

The structure of the report is as follows. Section 2 contains an overview of developing countries' shares of world trade, the composition of the trade and their trade policies. In section 3, we provide an overview of the most important interlinkages between trade, growth and poverty reduction as discussed in the literature. We differentiate between the short-term and long-term perspectives in order to capture the essential differences between the forces that come into play in the trade liberalisation process. In section 4, we discuss the challenges involved in using aid to reduce trade barriers. Finally, section 5 concludes.

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<sup>2</sup> We thank NORAD for financial support. The TOR are presented in Appendix 1. This report is a revised version of the background report to NORAD of 11 January 2007 "Trade, growth and poverty reduction: An introduction to the main challenges within trade and development".

## 2. Developing countries, world trade and trade policy

In this section we first address the role of developing countries in world trade, and what changes have been seen over recent decades. We find that after experiencing a decline in the 1990s, developing countries' share of world exports has increased and had reached 32% by 2003. This increase has accrued to Asia, and to China in particular. African countries' share in world exports declined continuously from 1980 up to 2003. Developing countries still depend upon primary products for exports. As their prices tend to fall, so do export revenues as the volume and number of products exported does not increase sufficiently to make up for the lost revenue. Some developing countries have managed to diversify and increase the share of manufactures in merchandise exports. South-South trade is also growing in terms of trade-shares, mostly due to the use of imports from developing countries in the Chinese economy. Intra-regional trade is becoming more important, even on the African continent.

The service sector is growing in low-income countries; however, the share of services in trade remains relatively stable. The Doha round of negotiations will thus be important to developing countries and their role in world trade.

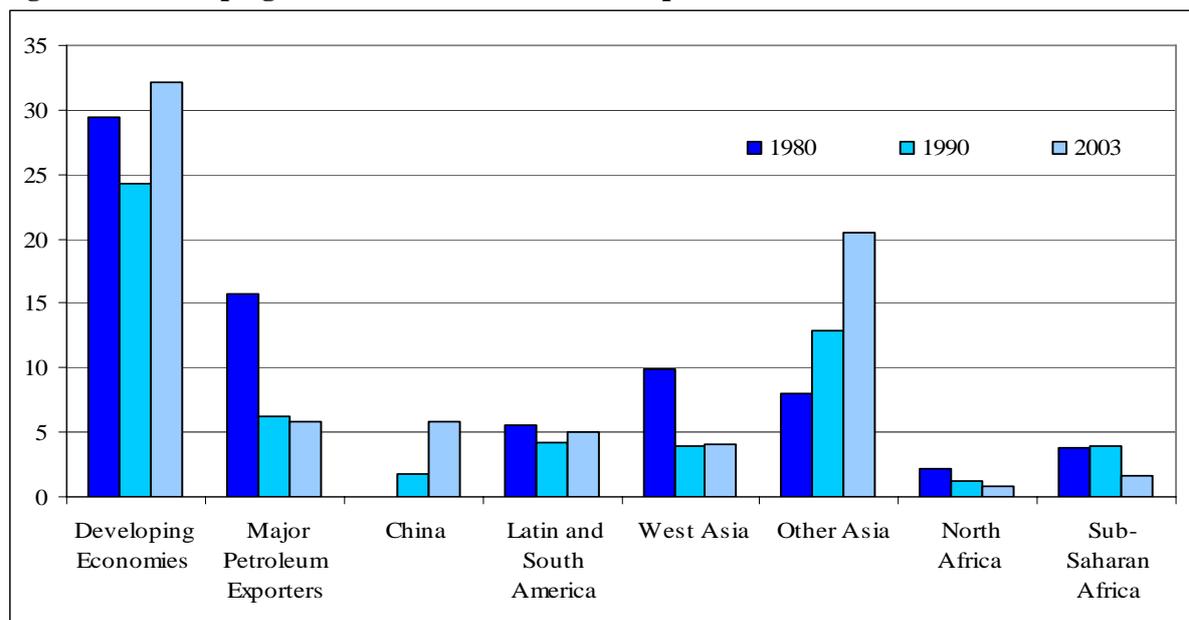
We also provide an overview of tariff structure. We find that in most developing countries, average tariffs on manufactured goods are higher on imports from other developing countries than from developed countries. A reduction in tariffs and equalisation of tariffs faced by developed countries might contribute to strengthening South-South trade.

### 2.1 The role of developing countries in World Trade

Developing countries are more dependent upon trade than developed countries in terms of the size of trade relative to GDP.<sup>3</sup> Figure 2.1 illustrates the changes in developing countries' share of world exports from 1980 to 2003. We see that following a drop in 1990, the total share of developing countries had increased and surpassed the 1980 level by 2003.

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<sup>3</sup> See Appendix 2 for a comparison of the importance of trade to GDP between groups of countries.

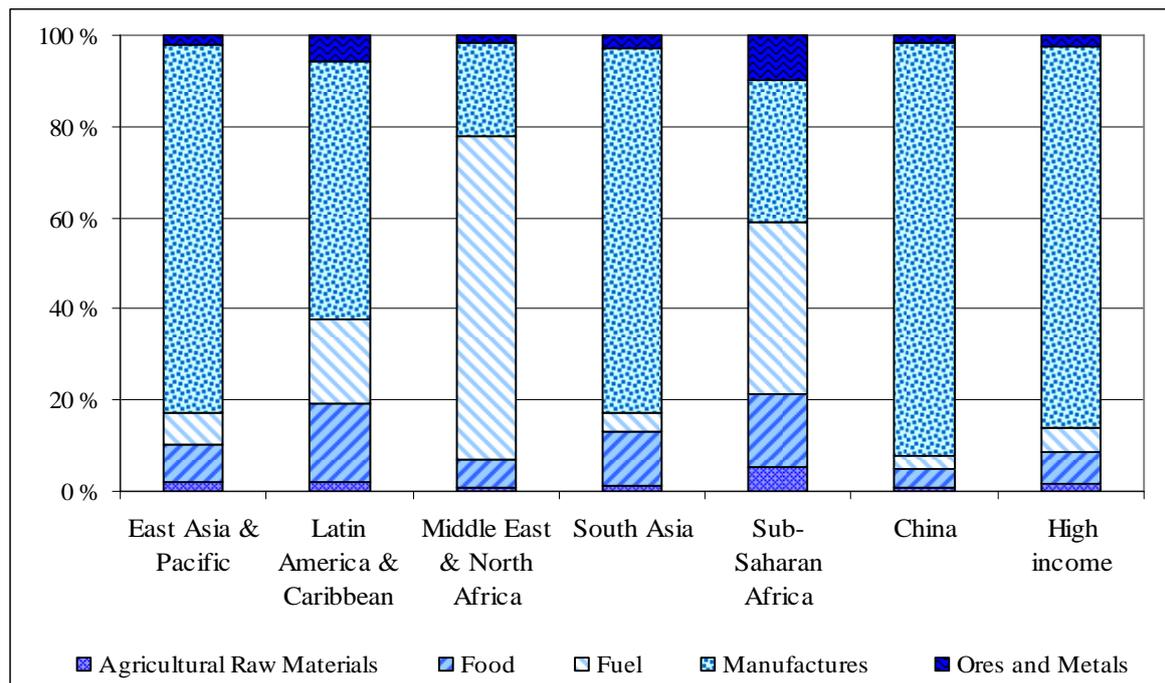
**Figure 2.1 Developing Countries' Share in World Exports<sup>4</sup>**

We see that there are differences across groups of developing countries. In 1980 more than 50% of the developing world's trade accrued to the major petroleum exporters. This share has been reduced, partly due to a drop in oil prices. The entry of China into the global arena contributed to the increase in trade share from 1990 to 2003. The Latin and South American and West Asian regions remained relatively stable over the period, whereas the African continent experienced a continuing decline in trade share over the entire period from 1980 to 2003. The developing country share of imports into high income countries is expected to increase from 15% in 1970 (40% today) to 65% by 2030, and the share of world trade is projected to be 45%.<sup>5</sup>

Many developing countries throughout Africa, the Middle East and Latin America rely on primary product exports (limited number of products). Of all LDCs, 35 receive at least 40% of their export earnings from one or two agricultural or non-fuel mineral products. Malawi (tobacco), Mozambique (fish, fruit) and Uganda (coffee) are among these. Some African countries continue to receive 3% or less of merchandise export earnings from manufacture (Mali, Niger and Rwanda). Primary products (non-mineral) have low income elasticity of demand compared to manufactured commodities. A 1% increase in developed country income raises imports of foodstuffs by 0.6%, petroleum products and other fuels by 0.5%, but manufactured goods by 1.9%. The low income elasticity of demand has caused the relative price of primary products to decline over time (0.6% annually since 1990). Thus the value of exports falls over time.

<sup>4</sup> Source: UNCTAD Handbook of statistics online, table 1.1 "Value and Shares of Merchandise Exports and Imports (1948-2004)": <http://www.unctad.org/Templates/Page.asp?intItemID=1890&lang=1>. West Asia: Bahrain, Iran, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, Turkey, United Arab Emirates, Yemen.

<sup>5</sup> WB (2007).

**Figure 2.2 Share of Merchandise Exports 2003<sup>6</sup>**

In poor countries where manufactures constitutes an important part of merchandise exports, they are often concentrated in specific sectors, such as textiles and clothing (Bangladesh, Pakistan, Mauritius, Sri Lanka). Even so, exports from developing countries have become more diversified over time,<sup>7</sup> and the share of manufactures in merchandise exports increased on average between 1996 and 2003.<sup>8</sup>

Trade in services has been growing. The share of services in exports has, though, kept relatively stable and only increased from 16 to 17.5 percent between 1984 and 2004. The largest contributors have been East Asia and the Pacific and Europe and Central Asia. Both exports and imports of services are, however, also important to countries such as Mozambique, Tanzania and Uganda.

**Table 2.1 Trade in Commercial Services as a Percentage of Total Trade<sup>9</sup>**

	Exports	Imports
Angola	2.9	46.4
Malawi	9.2	27.1
Mozambique	34	32.6
Tanzania	43.5	29.9
Uganda	31.4	32.5
Zambia	13.1	25

<sup>6</sup> WDI (2006).

<sup>7</sup> See Appendix 3a.

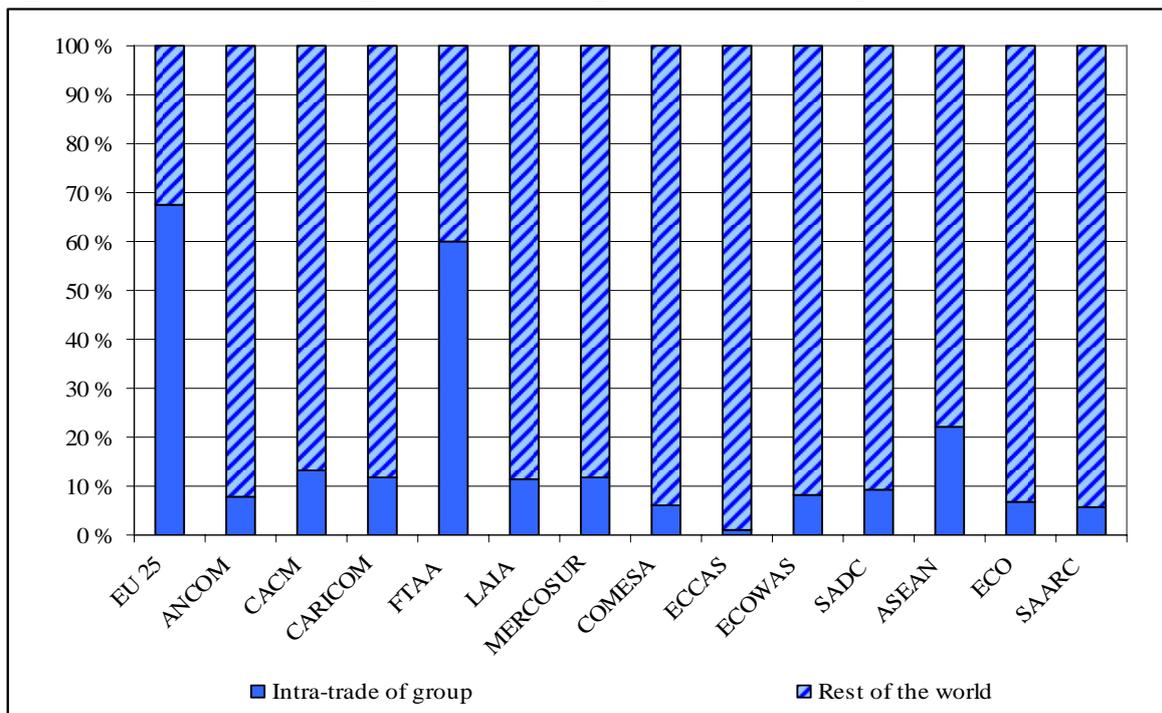
<sup>8</sup> See Appendix 3b for the composition of merchandise exports in 1996.

<sup>9</sup> Source: Jansen, 2006.

In the case of Tanzania and Uganda, more than 70 percent of exports in services are related to tourism and travel.

There is an increasing focus on the importance of regionalisation including South-South and intra-regional trade as an important source of economic growth, partly because of the deadlock in the Doha Round.

**Figure 2.3 Intra-Trade of Regional Trade Groups, Destination of Exports 2003<sup>10</sup>**



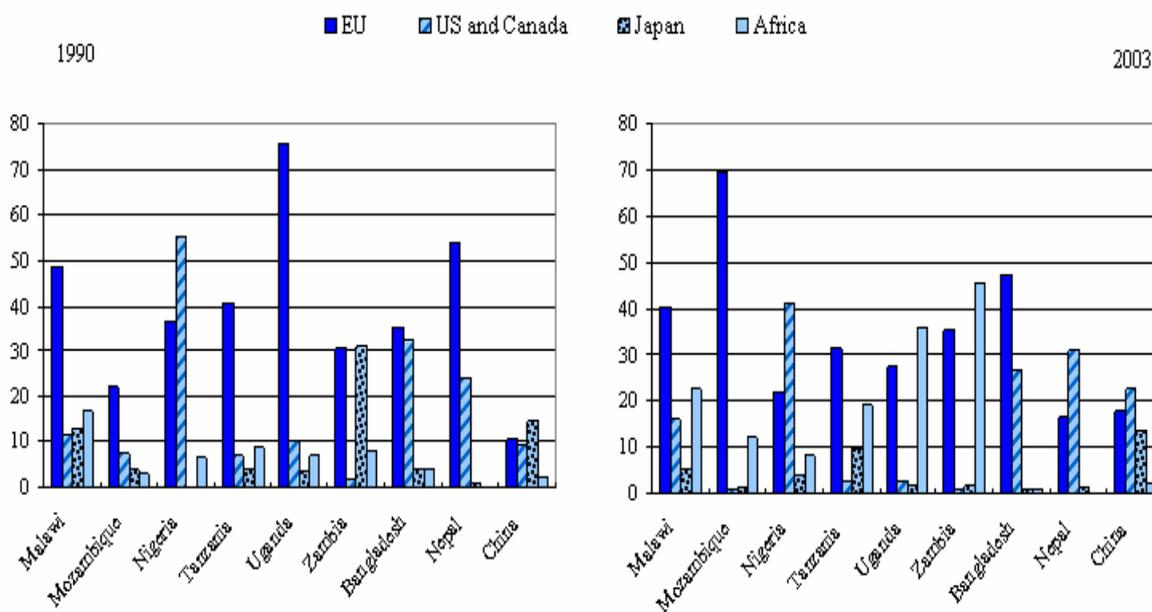
There are many trade agreements among developing countries as well as among developed countries and also between developed and developing countries. Some of these are more active than others. In figure 2.3, we compare the importance of intra-trade in a selection of regional trade groups. Even though intra-group trade has a limited share in some of the groups, a general trend is that the share of total trade that is either the group’s intra-trade or its trade with the rest of the geographical region has increased since 1980. The share of within-group exports has increased in the case of EU, ANCOM, CARICOM, FTAA, SADC and ASEAN. For some trade groups the share has remained relatively stable while it has been reduced for CACM. This again reflects the general trend of increasing trade between developing countries, and also indicates that ‘distance is not dead’ – countries are trading with their neighbours.<sup>11</sup> The tendency of increasing importance of intra-regional trade is also reflected when we consider the dispersion of exports from selected developing countries to the EU, US and Canada, Japan and Africa in figure 2.4. The general trend for the African countries is that the regional African market had become a more important market for exports by 2003 than it was in 1990, while in some cases the share going to the EU has been reduced. The share of exports going to the African market has increased noticeably in the cases of Malawi, Mozambique, Tanzania, Uganda and Zambia. In the case of Bangladesh and Nepal intra-regional trade is gaining momentum as imports from Asia increased more than 20% and 16% from

<sup>10</sup> UNCTAD Handbook of Trade Statistics online; table 1.4 “Intra-trade of Regional or Trade Groups (1970-2004)”; <http://www.unctad.org/Templates/Page.asp?intItemID=1890&lang=1>

<sup>11</sup> The data is reported in Appendix 4 for 1980 and 2003.

1990 to 2003 respectively. However, the share of intra-regional exports from Bangladesh and China was actually reduced, reflecting their position as exporters to high-income countries. The position of these two countries as importers of goods from developing countries and exporters to high-income countries might be a channel for other developing countries to reach the world market. Japan also has a relatively high share of imports from developing countries, at 62% in 2003. However, the increasing share of developing country imports to Bangladesh, China and Japan originates in developing Asia. The share of imports from Africa has remained stable at 1-2 % throughout the period.

**Figure 2.4 Exports by Market<sup>12</sup>**



## 2.2 Trade policy

We have restricted the overview to consideration of tariffs on agriculture and manufacturing. More information about the potential outcome of the Doha Round is given in section 4.

### Tariffs in agriculture and manufacturing

Exports from developing countries are hampered by high tariffs on agricultural products in both developed and developing countries, and by high tariffs on manufactured products in developing countries.

<sup>12</sup> Source: UNCTAD Handbook of statistics online, table 3.1 “Trade Structure by Main Region of Origin and Destination (1950-2004): <http://www.unctad.org/Templates/Page.asp?intItemID=1890&lang=1>

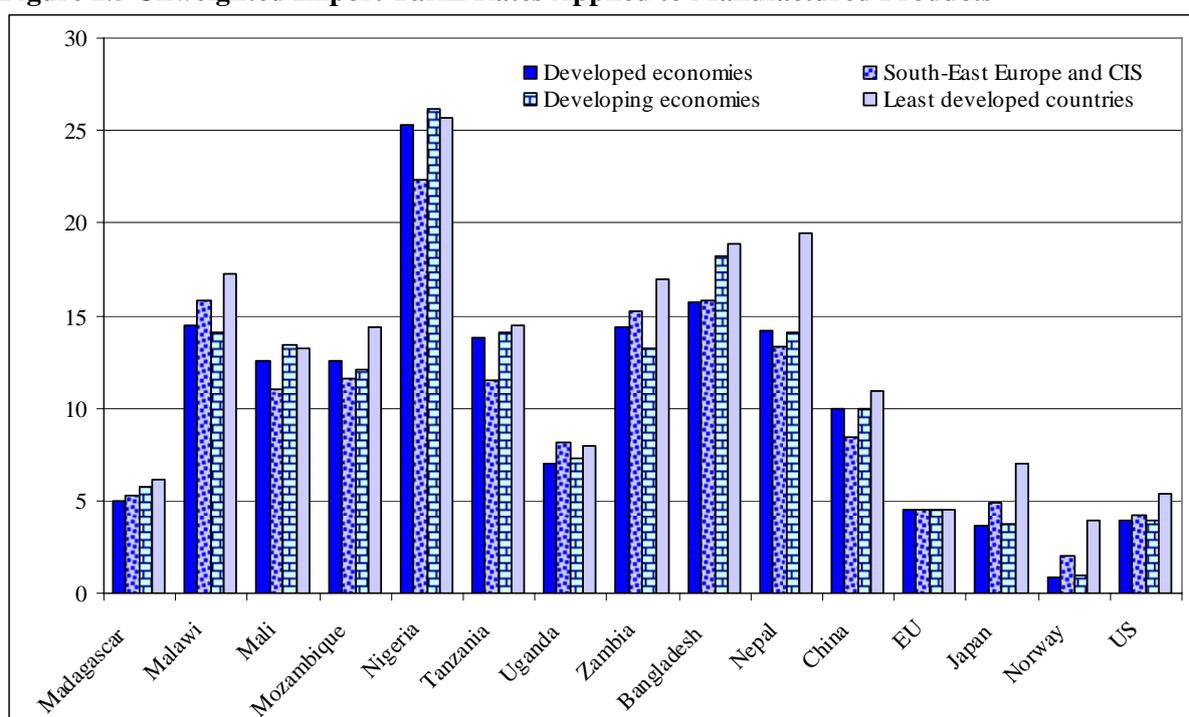
**Table 2.2 Weighted agricultural import tariffs, 2001<sup>13</sup>**

	Bound tariff	MFN applied tariff	Actual applied tariff
Developed countries	27	22	14
Developing countries	48	27	21
<i>Of which: LDCs</i>	78	14	13

Table 2.2 provides illustrative figures on tariff rates in the agricultural sector. The last column shows the actual applied tariffs when taking into account the use of trade preferences and in-quota tariff rates (TRQs). On average, the applied tariff rates are higher in developing countries than in developed countries, suggesting that developing countries are protecting their agricultural markets quite heavily. However, the lowest applied tariff rates are found in the poorest countries (LDCs), which reflect their higher dependency on agricultural imports for food security.

There are many products for which mean tariffs (bound MFN rates) are higher. In the case of the EU, the mean tariff on grains is 53, grain products 48, meat (fresh, frozen, other) 70, dairy 87 and sugar beet 349. France, Germany and the US are the top three producers of sugar beet in the world. For selected products tariffs are also high in North America. Access for the agricultural products of developing countries is impeded both by tariffs (for non LDCs) and by domestic subsidies allocated to the agricultural sector.

A number of developing countries enjoy preferential treatment in terms of either reduced tariff rates or no tariffs at all. The utilisation rate of these preferences varies. With respect to imports from LDCs, the utilisation rate of preferences is 77% in the US, 73% in Japan and 34% in the EU.<sup>14</sup>

**Figure 2.5 Unweighted Import Tariff Rates Applied to Manufactured Products<sup>15</sup>**

<sup>13</sup> Source: Jean, Laborde and Martin (2005), Table 4.2: Agricultural weighted average import tariffs, by region 2001.

<sup>14</sup> UNCTAD, 2001.

<sup>15</sup> Source: UNCTAD Handbook of International Trade Statistics, Table 8.4 "Average Applied Import Tariff Rates on Non-agricultural and Non-fuel Products (1988-2004)". Latest year available (2001-2004).

Figure 2.5 shows the tariff rates applied to manufactured products in selected countries of particular relevance for Norwegian policymakers. Tariffs on manufactured products are generally low in developed countries (<5%). Tariff rates are far higher in developing countries. (Note that figures are not comparable between table 2.2 and figure 2.5. In the agricultural sector, there are a large number of prohibitive tariff rates, which for that reason are not weighted in the aggregates presented in table 2.5).

From the figure we see that tariff rates on products from other developing countries are higher than tariffs on products imported from developed economies for most of the developing countries. This is an issue when we consider the growing importance of inter-regional South-South trade in volume and shares and in terms of developing countries reaping the potential gains from trade.

### 3. Trade, economic growth and poverty reduction

Do we know that international trade leads to income gains in the short run and economic growth in the long run? What is the empirical evidence on the relationship between trade, economic growth, distribution and poverty? Is the empirical evidence in accordance with predictions from theories of international trade? What are the policy consequences of this? These are the questions addressed in this section.

After a snapshot of the empirical relationship between trade and poverty, we provide an overview of traditional trade models based on comparative advantage and economies of scale and compare their predictions with trade flows. Against this background, we present the corresponding short-run impacts of trade on distribution and poverty. We will then proceed by analysing the long-term impacts of trade policy on economic growth and poverty. Each part will seek to integrate the relevant policy lessons that can be drawn.

Empirical evidence suggests that there are economic gains from trade. Appendix 5 provides a snapshot of the development in income (GDP), foreign trade and poverty at an aggregate level for low and middle income countries. The figure illustrates a tendency for poverty reduction, trade, and increasing income to be positively correlated. The same strong correlation is, however, not observed in Sub-Saharan Africa (Appendix 6). Anyway, it is not possible to say anything about the exact nature of distribution or the causal relationships on the basis of these data. A large literature discusses the relationship between trade and poverty in more detail (see Winters, McCulloch and McKay 2004; Tøndel and Wiig 2006).

#### 3.1 Trade theories, trade patterns and distribution: a general framework

According to the traditional explanation of international trade based on comparative advantage, countries participate in international trade because they are *different* from each other. Each nation can benefit from these differences by specialising in products and services that they are able to supply at relatively lower prices than other nations. Relative price differences may originate in different productivity levels or in availability of resources (e.g., labour and capital).<sup>16</sup> The larger the differences between countries, the larger the economic gains from trade and trade liberalisation.

To the extent that trade based on comparative advantage increases, who gains from this? The distributional impact of increasing trade is critically dependent on our assumptions regarding the flexibility of factor markets, i.e. the ability to reallocate production factors such as capital and labour between different sectors of the economy. Factors of production are less flexible in the short run than in the long run, and the flexibility of input markets varies across countries. While capital may move between sectors in the long run, it is attached to a given sector in the short run (sector-specific capital). With a flexible labour market, labour can move freely in the short run. The degree of flexibility in the labour market is important for determining whether particular groups of employees gain from trade liberalisation. The poverty impact of trade liberalisation is different in the short run than in the long run, when all factors are presumed to be flexible.

According to factor endowment theories of international trade, liberalisation will be pro-poor both in the short run and in the long run. In the short run, poverty will be reduced because the wages of unskilled labour will tend to increase. This happens because countries will tend to export commodities that are using abundant (and therefore relatively cheap) production factors intensively in the production process. This will drive up the demand for and therefore the price of the abundant factor. In the long run, when both capital and labour are mobile across sectors, this effect will be

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<sup>16</sup> Comparative advantages (relative price differences) can also arise from differences in demand patterns.

reinforced by reallocation of capital into labour intensive sectors. When a higher share of the capital stock is used in the labour intensive sectors, the scarcity of labour will increase even more, and so will the wages of unskilled labour.

Trade based on comparative advantage induces countries to specialise. A particular form of specialisation that has come to play an important role for developing countries is so-called “vertical” specialisation, i.e., specialisation in the production of intermediate products. When the production of final goods can be fragmented into several stages of production, we should find that some stages are capital-intensive but others are labour-intensive. Reduction in tariff barriers and technological innovation (lower costs of communication, information and transportation) encourage multinational companies to locate capital-intensive stages of production at home but labour-intensive stages of production in low-wage countries (see Lo 2005; Hummels et al. 2001). A product (say clothing) can be broken up into separate intermediate products (or tasks) where each task (say design and assembly) can be produced across multiple firms, countries and times. Each firm participating in the supply chain network specialises in tasks in which they produce most efficiently, and information technology is the glue that holds the different parts of the supply chain together. In this new global economy there are additional gains from specialisation as firms take advantage of differences in the cost of labour and skills across countries to allocate tasks in time and space (see WB 2007:111). Vertical specialisation and global outsourcing of intermediate products represents a growing export opportunity for developing countries.<sup>17</sup>

The above theories of comparative advantage may explain international trade patterns between countries that are different from each other – for instance, developed and developing countries – but can hardly explain the extensive trade between countries that are very similar. This brings us to a second explanation of trade: countries trade in order to achieve larger economies of scale in production. Trade expands the size of the market, making it possible to produce larger quantities of each good at a lower unit cost. Much of the trade between developed countries has the nature of trade in similar products between similar countries and is most naturally explained by economies of scale. The trend towards more vertical specialisation is an opportunity for developing countries also to share the benefits from these large trade flows.

## Theory, trade flows and some initial policy consequences

When comparing existing trading patterns as revealed in section 2 with predictions from theory, we will draw attention to two points that are relevant for resource allocation:

- Existing trade patterns for developing countries are more diversified than the prescribed logic of specialisation that follows from theories of comparative advantage (see Imbs and Wacziarg, 2003; Rodrik, 2003). As poor countries get richer, sectoral production and employment become less concentrated and more diversified. Countries with nearly identical resource and factor endowments specialise in very different types of product. China’s pattern of production and exports would have looked very different if it had specialised in labour-intensive products. Instead, China has ended up with an export basket that is significantly more sophisticated than what would normally be expected. The pattern is similar for other successful East Asian countries (see Rodrik 2006).
- An increasing share of international trade is based on vertical specialisation. Vertical specialisation accounts for more than 20% of US exports and 30% of the growth of exports (Hummels et al. 2001).

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<sup>17</sup> Vertical specialisation occurs when i) goods are produced in multiple, sequential stages; ii) two or more countries provide value added in the production process; iii) at least one country uses imported inputs in its stage of production process and some of the resulting output is exported.

Both points are extremely important when designing an industrial policy targeting exports from (or imports into) developing countries. The first illustrates that government policies matter for the development of comparative advantage. The second point illustrates the increasing importance of liberalising services and infrastructure development.

In a non-distorted economy, the potential for exports is highest in sectors with comparative advantages. If the firms know the cost structures and there are no market failures (e.g., externalities and information asymmetries) or government failures (e.g., macroeconomic instability, distorting government regulations or taxes, or corruption), there may be no reasons for the government or donor agencies to get involved. If there are market failures or government failures, one should focus on removing these failures. Targeting a specific sector requires that the policy maker is able to identify a country's comparative advantage. Such identification is difficult, particularly if existing trading patterns are distorted due to government interventions such as trade restrictions or because of other market failures.

In the literature, one common measure of (revealed) comparative advantage that has been applied for this identification is the ratio of a country's share in world exports of a particular product category to its share in world exports of all goods (see Balassa 1979:260). But this measure would, for instance, underestimate the potential for increasing exports of agricultural produce from developing to developed countries, since incentives for agricultural production are heavily distorted.

As many goods are not produced in developing countries in the first place, market prices and costs cannot reveal the profitability of resource allocation. The costs of producing new goods will depend on a number of factors such as factor endowments, the infrastructure of the country, the policy environment and the degree of technological success. Here, we will draw attention to two points that may stimulate special sectors or products.

The first is related to *information externalities*. For new products, technological success partly depends on the number of other investors making similar investments. The Dosh company of Bangladesh was the first exporter of clothing from Bangladesh and paid the burden of entry into a new market. Based on its experience, other clothing companies were established in Bangladesh that were able to penetrate new markets at lower cost. Without any entrepreneur taking the risk of producing new products, a country will not move up the quality ladder. Early entrants may therefore provide valuable information spillovers to the rest of the economy. This externality provides a rationale for government support in order to produce new goods that may improve productivity.

The other point is related to *coordination failures* induced by scale economies. The competitiveness of domestic industries can often be promoted through large investments in infrastructure and the like. Poor roads, port facilities and telecommunications are among the factors that impede exports from developing countries. To overcome these barriers, large investments are needed. While profitable for the country as a whole, these investments will normally not be profitable for any single investor. Hence, coordinated action is needed. Penetrating existing global supply chains based on vertical specialisation requires, for instance, timely delivery of high quality products. A concerted effort in many sectors at the same time may be necessary in order to participate in global outsourcing systems (Nordaas 2003).

The general policy conclusion from this is that specialisation patterns are partly indeterminate and the trick seems to be to acquire mastery over a diversified range of activities (Rodrik 2004). Industrial policies, including trade policies, may contribute to this diversification process.

### 3.2 Short-term impacts of trade liberalisation on poverty

McCulloch et al. (2001) identify a conceptual framework for analysing the linkages between trade, trade liberalisation and poverty (see Appendix 7). These include changes in the world market prices and availability of goods, changes in tariffs, export subsidies and government taxes, changes in

production and factor prices, and changes in income and employment, to mention the key mechanism in place in the short run.

Typically, the earnings-side impacts of trade reform predominate over the consumption-side effects. The importance of factor market effects is due to the fact that households tend to be much more specialised with regard to income sources than they are with regard to consumption. The poverty impacts of trade policy often hinge crucially on how well the increased demand for labour in one part of the economy is transmitted to the rest of the economy via raised wages, increased employment or both, and how changes in international prices are transmitted to domestic producers and consumers. From the perspective of the poor it is the markets for unskilled labour and agriculture that are most important.

In the short run, trade liberalisation or trade promotion changes the prices that the poor face both as producers and consumers. If the prices of goods they consume fall and the prices of goods they produce increase, then trade liberalisation will have a positive effect on poverty. If consumer and producer prices change in the same direction, the effect on poverty will depend on whether the poor are net consumers or net producers of the goods.

In the short run, the main impacts of a trade reform are through changes in commodity prices. If one seeks to liberalise or promote exports, it is therefore essential to identify sectors that increase (decrease) prices. Combining these price data with data on household consumption patterns and sources of income, one may find a first approximate measure of welfare changes (changes in price multiplied by budget share added over all commodities and households; see below for an elaboration).

For most developing countries, world prices of traded goods are normally given and independent of a unilateral trade reform. Liberalisation during the Doha Round would influence world market prices through worldwide changes in tariffs and domestic subsidies (see section 4). For instance, prices of agriculture products will increase if the EU and the US reduce their domestic agricultural support. This would give rising export opportunities in agricultural products for developing countries, but the flip side of the coin is that it might lead to an increase in consumer prices of food that would hurt consumers, particularly urban consumers. Net exporters will win from trade liberalisation of agriculture, while net importers will lose. For countries with preferential market access, a reduction in MFN tariffs will erode these preferences while other developing countries will receive higher prices for their exports. Unilateral liberalisation will have similar impacts on border prices (but not on world market prices as these are generally given for developing countries).

From a policy perspective it is therefore of the utmost importance to identify which sectors will receive higher (lower) producer and consumer prices and explore to what extent the poor, women or vulnerable groups are involved in these sectors. Based on the assumed changes in prices, one may combine this with household data on consumption patterns and income sources. For instance, in the easiest example where liberalisation takes place in one sector, Balat and Porto (2006) found that cotton prices would increase by 12% in Zambia. From household data, they also found that the average income share from cotton was only 8%, leading to a modest change in real income (one percent). They did similar calculations for different groups of households, and this approach is useful for assessing the impacts on vulnerable groups.

Nordås (2003) studies the impact of trade liberalisation on women. Based on case studies from five different developing countries (Mauritius, Mexico, Peru, the Philippines and Sri Lanka), she finds that trade liberalisation is likely to create jobs for women and increase their relative wages over time. In the five case studies, exporting industries tended to employ relatively high proportions of women. There is a positive and statistically significant relationship between exports and women's share in employment. There is a statistically significant and negative correlation between women's share in employment and imports.

## Price transmission and household responses

If a trade reform does not change the farm gate prices received by the producers, it will have no impacts on the producers in the short run. In many markets, there are huge marketing wedges between the prices received by the producer and the consumer, indicating that there are transaction costs. These differences vary across locations in a country (see Nicita 2006, Arndt 2006).<sup>18</sup> A change in border prices does not always therefore transmit to a price change for a rural producer. There are at least four mechanisms that may prevent price signals being transmitted all the way to the producer.

*First*, high fixed transaction costs (high transport costs, other distribution costs, land infrastructure facilities such as telecommunications) may isolate producers from trade. In these cases the marketing margin is so huge that market participation does not take place. Lack of infrastructure in remote areas leads in many cases to the isolation of farmers from a modern cash economy (they rather consume their produce). More generally, in the absence of appropriate roads, port facilities, or slaughterhouses with an approved sanitary standard, a change in the world market prices of an export commodity will have no impact on the individual producer. Unless complementary policies addressing transport issues are in place, producers in land-locked countries will not experience any impact from liberalisation. Similarly, changes in the international price of beef will have limited impact on beef production in a country that does not comply with international standards. Finally, without access to information and communication technology, a country will hardly be able to source modern supply chains in spite of competitive wages. If potential producers are isolated from trade in the first place due to high transaction costs, one would expect that border prices would need to increase significantly or transaction costs to reduce if the liberalisation were to have any impact. For a lower level of transaction cost, it is more likely that liberalisation may influence producer prices.

*Second*, transaction costs provide natural protection to local producers of products competing with imports, but such costs also tax prospective purchasers of imports (producers and consumers) and prospective suppliers of exports. Changes in export prices will be expanded while import prices will be neutralised. Arndt (2006) provides the following illustrative example. Consider a good with an export price at the border of 100 and a marketing wedge between the border and the farm/factory gate of 50. If the FOB price increases by 10 percent to 110 and the marketing wedge remains, the farm price increases by 10 to 60 (or 20%). Consider an imported good that is available at the border for a price of 50. Marketing costs of 50 are incurred to get the product to the point of final consumption. If the border price increases by 10 percent and marketing costs remain constant, then the price of the imported good at the point of consumption increases by only five percent (to 105).

*Third*, an overvalued exchange rate offsets the impact of higher border prices. On the other hand, if a trade reform is combined with the correction of an overvalued exchange rate through a currency devaluation, this increases the profitability of tradable activities. *Finally*, changes in border prices can be offset or exacerbated by changes in transaction costs. For instance, if the power of marketing boards dealing with exports of agricultural products is reduced, the likelihood is increased that producers may reap a higher share of the increase in border prices.

When price signals transmit to the poor, there is first a direct impact on their welfare (positive or negative). Secondly, the impact of positive price signals may be reinforced if the poor increase their production volumes. Their ability to do so depends on the availability of the inputs needed to expand production. In general, poor people will have more limited access to credit and thus to capital investments than those with higher levels of income. Hence, larger farmers are often better placed to take advantage of the trade opportunities. In some cases, households for various

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<sup>18</sup> Nicita (2006) finds that for manufactured goods, about two thirds of the international price change passes through to the domestic market, whereas the comparable figure for agriculture is just one-quarter. In the more remote, rural regions of Mexico, very little of the international price changes will be felt – particularly in the case of agricultural products. Indeed, about one third of rural households are unaffected by the Doha scenario. Arndt (2006) draws a similar conclusion.

reasons do not seem to respond to market opportunities. It is, for instance, a puzzle that Namibian subsistence farmers are not fully utilising their commercial opportunities.<sup>19</sup>

The general policy conclusion from this subsection is that there are winners and losers from trade liberalisation. In many cases the poor are not able in the short run to take advantage of the opportunities that may follow from liberalisation. There is therefore an important role for complementary policies to help the poor. Again, support to infrastructure seems relevant.

### 3.3 Long-term effects of trade on growth

There are several reasons why one should assess the possible impacts of liberalisation on growth and poverty in a long-term perspective, say, in 10-15 years' time, or between generations. First and foremost, entrepreneurs and people may need time in order to take advantage of new opportunities created by access to international markets. Taking advantage of new market opportunities is easier in the long run, since companies can respond to new profitable markets by investing in new factories to produce more to serve the new demand and people can educate themselves to enter into growth sectors. Moreover, it may take quite some time before new technologies are actually brought into use in a poor country, even though they may be available on the world market. Finally, demand patterns may change slowly and may take a generation to be altered. Hence, the full impact on the economy of initial changes in prices will only be evident once the consumers have substituted away from the more expensive goods and towards the less costly goods. It is important for policy makers to be aware of the fact that liberalising may give short-term losses and hence be unpopular with their constituencies, while the benefits come in the longer run after the companies, entrepreneurs and households have adapted to the change.

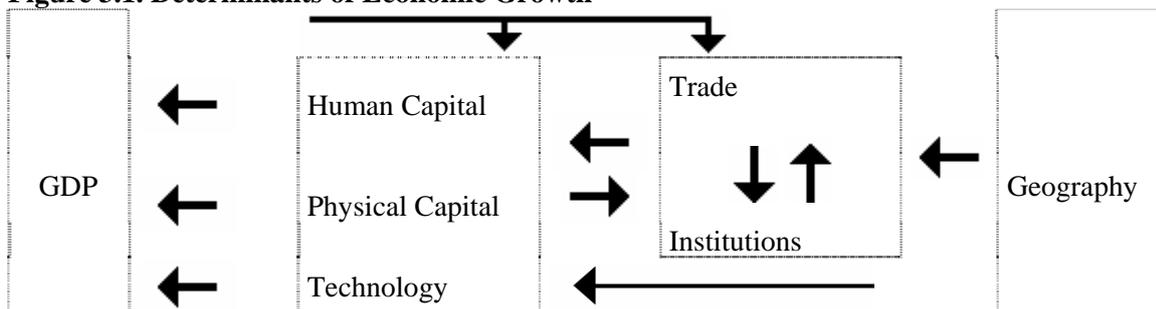
#### Trade increases growth: the mechanisms

We have already discussed how differences in factor endowment may lead to trade, which in turn leads to increasing income. Specialisation in turn may lead to technology improvement and economic growth. Another factor usually highlighted as a source of growth from trade liberalisation is that openness to imports promotes *competition* in the domestic markets. Competition increases the pressure on firms to be innovative and provide consumers with a wider choice, ideally at lower prices. However, increased competition can be a double-edged sword if the domestic companies are not allowed the time to adjust to the new competitors. If full liberalisation is implemented in the short run, then domestic companies could be forced out of business even if they would have been able to meet the competition if the liberalisation had been phased in over a longer time span. Again, it takes time to upgrade the business with new technology and know-how.

Taken together, trade may influence economic growth through each of the three main inputs needed to create growth. The first input necessary to create long-term economic growth is increased investment in physical capital (machinery and buildings), the second is increased education, and the third is technological development. However, it is important to keep in mind that other factors, such as institutions, infrastructure and geography, may influence both the trade patterns and the growth performance of a country, and such factors may also act as barriers to economic growth. Hence, with poorly functioning institutions there is little hope of generating very much growth at all. Figure 3.1 illustrates these interlinkages and underscores that such factors must be taken into account when developing trade policies for a particular country.

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<sup>19</sup>The 'cattle complex argument' – i.e. farmers have a preference for holding cattle partly for reasons of prestige (livestock are important in supporting social relationships) – is pointed to as one (but disputed) explanation.

**Figure 3.1. Determinants of Economic Growth**

Maintaining long-term economic growth is a very difficult task that requires knowledge of the particular challenges in the particular country. From the basic growth framework we can nevertheless extract some general necessary conditions for making trade increase growth.

First, it is important that the government provide the population with a *minimum level of quality education* in order to enable workers to take advantage of new work opportunities. In other words, when the investment decisions are taken the investors need to be confident that there are workers with the skills necessary for entering that particular production process. This was one clear advantage of many of the Asian countries that performed well over a long time span – they educated their entire population, and increased the educational levels step by step. Taiwan is illustrative in this respect since it has one of the most impressive growth successes in history – achieving 10% annual growth from 1965 to 1980 and 7% from 1960 to 2000. It made six years of education compulsory in 1950, and had a 90% (96%) enrolment rate for girls (boys) in 1956, expanded to nine years in 1968, and is now considering 12 years of compulsory schooling. Several features of the Taiwanese schooling system ensured that the education was of high quality and had close relationships with the private sector. This, in combination with broad coverage of the population, has been of major importance in making the growth miracle possible. The policy issue to take home is that the early experiences and achievements of Taiwan on education can be useful for poor countries in generating economic growth, including making trade increase growth.

The second condition for making trade increase growth is to create a domestic investment climate conducive for entrepreneurial activities directed towards international markets. Increased investment is crucial for fostering growth. Due to the scarcity of capital in the poorest countries, their returns to capital tend to be rather high, so there seem to be profitable opportunities for investors. However, the economic risks, lack of business infrastructure and poorly functioning institutions constitute major obstacles to increased investment. Reducing barriers to trade nevertheless increases the attractiveness to both foreign and domestic entrepreneurs of investing in the country since they can produce for a larger market.

The third condition for making trade increase growth is to take advantage of the technological development that is made available by international markets through inputs, intermediates and production knowledge. Domestic entrepreneurs need to absorb the commercial ideas that are available in developed countries, and to adapt them to fit the production conditions in their own country. To be successful, however, may require both managerial skills and technical know-how at rather advanced levels. So if domestic companies are not able to take advantage of the technological opportunities created by international markets, then the government or donors can play a role in identifying the barriers and contributing towards their removal. China's active role along these lines may provide important insight into the requirements for success in using new technologies that are made available on the world market.

The trade and growth theories are simple in nature and apply quite restrictive assumptions, which in turn have spurred a range of critiques of the different models. Moreover, many scholars point out that most of the trade takes place between countries that are not very different in terms of factor endowments and economic structure. Nevertheless, the theoretical linkages depicted above

will probably give useful advice on how to take advantage of trade opportunities within a certain country. Laissez-faire has proven to be a failure for poor countries wanting to take advantage of their low labour costs. When aggressive utilisation of trade advantages is pursued in close cooperation with the private sector, then trade can be a powerful tool for rapid economic growth, as we will see below. It is important to see that it can be difficult for policy makers to assess market opportunities. Hence, it is important that the private sector acts as a guide on profitability, and needs to be included in the decision making on what trade policies should be pursued.

## Empirical evidence on the impact of trade on growth

There are many studies that attempt to evaluate the possible impacts of trade on economic growth, from which a consensus seems to emerge on two main issues.<sup>20</sup> First, empirical research tends more often than not to show that increased openness is conducive to economic growth. Second, quantifying these impacts is inherently difficult and one should avoid strong conclusions based on the figures presented. Three main problems are evident from trade-growth studies. First, trade reforms are usually part of a larger “package” of reforms that include institutional improvements. So when the quality of institutions is important to growth, it is difficult to separate out the impact of the trade policies. Second, the causality may go the other way around so that trade is increasing because countries get richer and want to purchase more goods from abroad. If this is the case, increasing trade will have no effect on growth. Finally, there are deep problems with measuring openness, and the literature does not agree on a single measure.

Keeping the pitfalls in mind, we bring a couple of examples of the probable impacts of openness on growth. Annabi et al’s (2006) study of Bangladesh estimates that in the long run, i.e. after 15 years, its GDP would be 1.4 % higher with full world trade liberalisation, as compared to a status quo scenario. This amounts to an annual extra growth of 0.1 percentage points, which is below the usual error margins in long-term predictions. Berg and Kreuger (2003) refer to a more impressive result in which the growth spells over two decades for a sample of 100 countries were evaluated statistically. This study indicated that doubling the trade as a share of GDP from 20 to 40 % would raise GDP by 10% over 10 years. If we take the result at face value, it is still a very large task to double the trade share as suggested, and not a very impressive result to have less than one percent extra growth annually.

Note also that the composition of exports is found to matter for economic growth, especially for poor countries relying on a few primary export products. The low income elasticity of demand for the primary agricultural products and other goods often exported by poor countries plays an important role in the long run. The implication of this is that the percentage increase in quantity demanded of primary products is rising less than the increase in their incomes. Hence, as the world becomes richer, less is spent on the export goods from poor countries. This has contributed to a decline in the relative price of primary products, which in turn has implied that a country relying on the export of such agricultural products can import fewer goods for the same quantity of exports. In combination with the volatility in the prices of primary products, which is perhaps best illustrated by the large swings in coffee prices, this has resulted in export earnings instability that in turn has been shown to lead to lower and less predictable rates of economic growth. Moreover, Hausmann, Hwang, and Rodrik (2005:2) use different arguments for the claim that specialising in some goods creates larger economic growth than specialising in others:

“An entrepreneur who attempts to produce a good for the first time in a developing economy necessarily faces considerable cost uncertainty. Even if the good comes with a standard technology (“blueprint”), domestic factor endowments and institutional realities will require tinkering and local adaptation. What the entrepreneur effectively does is to explore the

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<sup>20</sup> See, for example, the literature review in Berg and Kreuger (2003). See also the seminal papers by Dollar and Kraay 2001; 2004 and Frankel and Romer 1999.

underlying cost structure of the economy. This process is one with considerable positive externalities for other entrepreneurs. If the project is successful, other entrepreneurs learn that the product in question can be profitably produced and emulate the incumbent. In this way, the returns to the pioneer investor's cost discovery become socialized. If the incumbent ends up with failure, on the other hand, the losses remain private. This knowledge externality implies that investment levels in cost discovery are sub-optimal unless the industry or the government find some way in which the externality can be internalized.”

Hence, countries that go through this process with many entrepreneurs will eventually end up producing higher productivity goods and thereby achieve higher economic growth than countries that do not go through this process. The policy implications for both the above arguments are alike, however, in that the government has an important positive role in shaping the production structure.

Finally, history has shown that trade *can be* an important stimulus to rapid economic growth, which is best exemplified by the success stories of China, Malaysia, Thailand, Brazil, Chile, Taiwan, Singapore and South Korea. However, in order to be successful, it is necessary for the government to be competent in its interventions in the economy.

### Empirical evidence on the impact of trade on poverty

It is difficult to assess the magnitudes of implementing different trade policies in the short run, but almost impossible to assess the impacts in the long run since there are so many routes an economy could go to capture the advantages of new market opportunities and the improved availability of inputs and goods. Take the IT industry in India, for example – would anyone 20 years ago have predicted this development? A few figures from one of the latest World Bank studies<sup>21</sup> nevertheless underline one main point, that it is far from sufficient to rely solely on passive trade liberalisation to eradicate poverty.

Annabi et al's (2006) study of Bangladesh estimates that an unchanged trade regime would cause a decline in poverty from 46 % to 22 % in rural Bangladesh during the next 15 years, and a reduction in urban poverty from 36 % to 19 %. However, if the world liberalised 100%, then the price of investment goods would decline more so that there would be increased investment in competitive sectors. In the same 15 years' time, then this would reduce rural poverty from 46% to 18 % and urban poverty from 36% to 15 %. Hence, the effect of a full world trade liberalisation is quite modest for Bangladesh. Poverty would be reduced by 1.5 (1.1) percentage points annually in the rural (urban) areas without any changes in current trade policies, while it would be reduced by 1.8 (1.4) percentage points annually under the full liberalisation scenario. It is important to notice also that poverty would increase in the short run under the liberalisation process.

Similar results from long-run scenarios are obtained from relatively better-off developing countries. It is found that Brazil would reduce its poverty rate by around 3 % in the event of full goods trade liberalisation, a reduction that would stem mainly from increased agricultural production in regions with high poverty rates. Similar results are found for China. Poverty would be reduced under full liberalisation by 2.7 % due to increased exports of agricultural products to highly protected markets in East Asia. Attempts to quantify the long-term (15-year) impacts of full liberalisation on world poverty also indicate that such policies would cause minor reductions. The US \$ 1 a day poverty measure would decline by 5 percentage points, while the US \$ 2 a day measure would be reduced by 3 percentage points. Even if these figures were a couple of percentage points higher with productivity effects added, trade liberalisation in itself is clearly not the tool that will eradicate poverty.

The evidence indicates that trade liberalisation may bring important gains to some countries, and also bring about modest reductions in poverty. In order to contribute more to poverty

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<sup>21</sup> Hertel and Winters, (2006)

reduction, however, redistributive policies are necessary. A more equal distribution of wealth and income in a society will imply a larger poverty reduction for the same poverty-reducing policies, which is the topic of the next section.

### 3.4 The importance of inequality to poverty in a trade perspective

Do the incomes of the poor increase proportionally to other income groups when the economy is growing? Many studies find that there is no correlation between economic growth and changes in inequality.<sup>22</sup> Thus, on average across a large sample of countries growth tends to be distribution neutral. However, the important issue for the policy makers is whether the economic growth in their own country changes the income distribution, and what to do if the incomes of the poor grow more slowly than in other groups. An important point to notice in this respect is that *both initial inequality and change in inequality seem to matter for the effect of growth on poverty*. The higher the initial inequality in a country, the less the gains from growth tend to reach the poor (Ravallion 2001, 2004, 2006). Ravallion (2001) finds that among the growing economies the median decline in poverty (\$1 a day) is 10% in countries where inequality also declined, and only 1% in countries where growth was accompanied by rising inequality.

It is also interesting to note that poverty reduction differs according to which sector is growing. Agriculture is the main income source for the majority of the world's poor people, which hence makes this sector particularly important to poverty reduction. Ravallion (2006) and Chen and Ravallion (2004) find that in China the impact of growth on poverty is sector specific. Growth in agriculture was found to have a significant impact on poverty. They found a four times higher poverty impact from growth in the primary sector than from growth in the secondary and tertiary sectors. Only rural economic growth had a significant effect on poverty reduction. Ravallion, however, warns against making the conclusion that the reduction of poverty in China stems from trade liberalisation. Most of the poverty reduction in China arose before China made any progress in world trade, partly due to agricultural reforms.

Whether a country is a net importer/exporter matters for whether liberalisation achieves a net gain. Liberalisation might hurt import-competitive sectors when the labour market does not adjust to expanding export opportunities.

Summing up what we know and what we do not know about pro-poor growth, Lopez (2005) concludes that (i) growth is fundamental to poverty reduction and does not appear to affect (relative) inequality; (ii) growth in combination with progressive distributional change is better than growth alone; (iii) high initial inequality hampers poverty reduction; (iv) poverty is in itself a barrier to poverty reduction; (v) inequality in terms of asset holding predicts lower future growth rates; and (vi) education, infrastructure and macroeconomic stability have a positive effect on both growth and distribution.

The literature seems to be somewhat inconclusive on whether increased trade leads to increased inequality. Dollar and Kraay (2004) examine the trade, growth and poverty relationship and conclude that there is no significant relationship between changes in inequality and changes in trade volumes. They find that more open countries do not have rising income inequality on average. However, they do agree that there are distributional conflicts from increased liberalisation, but maintain that the poor are not systematically losers from trade openness. Other researchers come to opposite conclusions. Easterly (2006) and Milanovic and Squire (2006) both suggest that globalisation has been accompanied by increasing inequality in poor countries.

Again, the studies of large samples of countries may give important insights into the mechanisms at play, but may also hide important country-specific patterns. The important issue is whether the increased trade impacts on the income distribution in the country of interest, and how to make the trade pattern more pro-poor. It is important to acknowledge that if the growth effects are small and there are negative distributional consequences from the liberalisation, trade-induced

<sup>22</sup> Ravallion (2001), Dollar and Kray (2002, 2004).

growth could actually be associated with a lower income for the poor. Hence, trade liberalisation may work against important goals of the national development agenda. In order to study the direct linkages between trade and poverty we need to look at country case studies at the microeconomic level.

Finally, some groups are more vulnerable than others, and some have larger difficulties than others in sharing the benefits that could be created by trade and growth. Generally, we find that the poor are disproportionately located in rural areas, making it more difficult to provide public services to them. Moreover, most of these people make a living out of subsistence farming or as low-paid farm workers, while the rest tend to be engaged in rural petty services or in the fringes and marginal areas of urban centres as street-hawkers and small traders. The poor are more likely to be women and children than adult males, and we find more poor among indigenous people and minority groups. Each country should analyse the conditions for enabling the poor and marginalised to take part in growth opportunities. However, the development of the agricultural sector in rural areas and the availability of better-paid wage labour in urban areas seem to be the first steps for many of the poorest countries.

### 3.5 Trade and the environment

The gains from trade can be undermined and even outweighed by their environmental side effects of increased economic activity. Expansion of production may lead to increasing levels of pollution, more intensive harvesting of fishery and forestry resources, as well as to a more rapid exhaustion of non-renewable resources such as oil and diamonds. Moreover, increased trade usually implies more transport of goods, which in turn creates environmental challenges.

Textbook explorations of the welfare economics of trade expansion are usually based on the assumption that resource scarcities are appropriately reflected in market prices. This is sometimes not the case, in particular when natural resources are being used in the production process. Natural resources may sometimes appear as “free”, although they of course have valuable alternative uses. As a result, a trade expansion that is based on the utilisation of “underpriced” natural resources may actually reduce social welfare, despite the benefits involved for the trading partners.

It is not difficult to come by examples of a potential conflict between trade expansion and environmental protection. International trade in tropical timber has been claimed to be a reason for tropical deforestation in Asia. Several of the world’s fisheries are threatened by stock depletion, partly due to increasing international trade. Expansion of trade and transport is also a direct source of increased emissions of climate-affecting gases. But the opposite may, of course, also be the case. Higher emissions from transport may be more than outweighed by less energy-intensive production processes as agricultural production is moved from the North to the South. And if export growth takes place in sectors that are relatively environmentally friendly, the polluting sectors may experience a decline in profitability and output as capital and labour are reallocated towards the expanding sectors.

Conflicts between trade expansion and environmental protection do not necessarily imply that trade should not be stimulated. When the goal is to improve the welfare of the population, the key will be to strike the right balance between trade expansion (income growth) on the one hand and the use, and possibly the degradation, of the environment on the other. If appropriate environmental regulations, such as environmental taxes or quotas, are implemented, economic agents will receive the signals they need in order to strike this balance in a way that maximises the aggregate economic surplus. In that case, exports can be promoted without being concerned about the environmental consequences. In this context it is important to underscore that the definition of “appropriate” environmental regulations may differ between countries, depending on local circumstances and income levels. Poor people will most likely put less weight on environmental protection relative to income compared with wealthier people.

There may be reason for concern about the welfare implications of trade expansion when environmental regulations are weak or non-existent, as is usually the case in developing countries. The non-participation of developing countries in certain international environmental agreements (e.g., the Kyoto Protocol) is also an issue that needs careful attention. Trade-promoting activities in developing countries should therefore usually involve assessments of potential environmental side-effects. This is of course not to say that trade promotion should be avoided whenever negative environmental consequences can be envisaged; it is legitimate to make trade-offs here as elsewhere. But trade promotion should not be as strong as it otherwise would be, for as long as appropriate environmental regulations are not put in place.

## 4. Multilateral trade liberalisation and developing countries

At the WTO Ministerial Meeting in November 2001, the Doha Round of multilateral trade negotiations was launched, promising a strong focus on development issues. However, these negotiations have proven to be extremely difficult due to the different priorities of developing and developed countries.<sup>23</sup> In this chapter we discuss which are the potential gains from further liberalisations and identify what challenges the developing countries face. The estimates on gains from liberalisations have varied widely depending both on what models are being employed and how extensive one expects liberalisation to be. We also provide a short introduction to the elements of the GATS agreement that are of special interest to developing countries.

### 4.1 The Doha Round Negotiations

The agricultural sector, which was characterised by high prevailing tariffs and domestic subsidies in developed countries, has received most attention in these negotiations. The textile and clothing industry was the runner-up. These are two sectors where several developing countries do have an export potential.

There is a wide range of studies assessing the potential effects of different Doha Round outcomes. Results differ somewhat; however, there are certain trends worth noticing. The main findings with respect to welfare gains from two separate studies assessing different scenarios (the Doha and Hong Kong scenarios) are compared in table 4.1.

**Table 4.1 Welfare Gains from Partial Trade Liberalisation (billions of US\$)**

	World Bank Doha scenario*			CEIP Hong Kong Scenario**		
	Manufacturing	Agricultural	Total	Manufacturing	Agricultural	Total
High Income Countries	13.6	18.1	31.7	16.4	5.5	21.9
Developing Countries	7.1	-0.4	6.7	21.7	-0.06	21.5
Brazil	0.3	1.1	1.4	0.8	0.3	1.1
India	2.0	0.2	2.2	2.3	-0.04	2.3
China	2.2	-1.5	0.7	10.6	-0.3	10.3
Argentina	0.3	1.0	1.3	0.2	0.4	0.6
Bangladesh	0.1	0.0	0.1	-0.03	-0.02	-0.05
Vietnam	0.4	0.0	0.4	1.8	-0.2	1.6
South Africa	0.3	0.3	0.6	0.3	0.06	0.3
Sub-Saharan Africa	0.6	-0.3	0.3	-0.08	-0.11	-0.19
World Total	20.7	17.7	38.4	38.1	5.4	43.4

\*Anderson and Martin (2005), "Agricultural Trade Reform and the Doha Development Agenda", World Bank Table 12.14 Scenario 7 (SPSS)

\*\*Polanski (2006), "Winners and Losers: Impact of the Doha Round on Developing Countries" CEIP, Figures 3.1,3.3,3.5,3.8.

There are two main reasons why results differ in these studies. First they employ different models. Anderson and Martin (2005) employ the World Bank Linkage model whereas Polanski (2006) employ the Carnegie model allowing for there to be unemployment in the economy. Second, the

<sup>23</sup> Polanski (2006).

Hong Kong Scenario assumes the same level of tariff cuts in both the agricultural and manufacturing sector whereas the Doha Scenario allows for more reduction of tariffs in the manufacturing sector.

What we can conclude from table 4.1 is that there are winners and losers in both scenarios. Both gains and losses are estimated to be larger with the World Bank Model and Doha Scenario. However, in both scenarios the main beneficiaries from liberalisation in agriculture would be the competitive exporters Australia, New Zealand, Brazil, Argentina and Thailand – in addition to consumers in developed countries that liberalise their agricultural trade. The poorest countries, such as Sub-Saharan Africa and Bangladesh, are among the potential losers. In the Hong Kong Scenario, Sub-Saharan Africa will experience an overall loss whereas gains and losses in the manufacturing and agricultural sector more or less level each other out in the Doha Scenario. Bangladesh also loses out in the Hong Kong Scenario with less liberalisation in the manufacturing sector, whereas it is estimated to experience a small gain in the Doha Scenario.

It is also worth noting that the initially predicted gains for developing countries at \$500 billion have been drastically reduced, and the more recent estimations suggest a global income gain at less than \$60 billion under any realistic scenario.<sup>24</sup> This is equivalent to 0.146% of current global GDP. A second note should be that the models used to estimate gains and losses from liberalisation only pay attention to tariffs. Anderson and Wincoop (2004) suggest that policies related to transport and infrastructural investment, law enforcement, the existence and quality of property rights institutions and so forth are more important than tariffs in terms of accessing the world market and providing new trading opportunities for developing countries.

In the next section, we address more closely the challenges faced by developing countries in engaging with liberalisation.

## 4.2 Challenges for developing countries

There are many challenges faced by developing countries. We first consider those captured in the models estimating liberalisation outcomes before addressing elements that are not captured in these impact studies.

There are three main factors that explain why some poor countries may experience small gains or even a loss from multilateral trade liberalisation in these impact studies; their own liberalisation, terms of trade for food-importing poor countries, and preference erosion.

First, as long as these countries do not themselves reduce their import tariffs, their gains will be reduced. The idea is that a more open domestic market would give domestic producers access to less expensive inputs, which again would enable them to take advantage of new market opportunities abroad.

Second, multilateral liberalisation might have unfavourable terms of trade effects for food-importing countries. Reduction of agricultural tariffs and subsidies will raise world market prices of these products and raise the import bill of food-importing countries. However, even if aggregate welfare in the food-importing country may be negative, the impact on poverty is more ambiguous. If poor households are net sellers of food, multilateral trade liberalisation might actually favour the poor.

And lastly, the benefits that poor countries currently enjoy from preferential trade arrangements will be eroded by multilateral liberalisation, because other countries will become more competitive and thus may reap market shares from the poorest countries. On the other hand, preference erosion is not necessarily bad. The OECD's protection might have a depressing effect on the price of a good sold under a preferential agreement. The exporting country might have achieved a higher price without it. In addition, preferences create disagreements between developing countries and prevent them from cooperating as one group. If these preferences had not been offered, developing countries might have negotiated more vigorously in previous GATT rounds.

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<sup>24</sup> Polanski (2006).

These arguments notwithstanding, there will still be countries that experience a loss in export market shares due to preference erosion.

Issues not accounted for in the impact studies include the threat of deindustrialisation, problems associated with SPS and loss of tax revenues.

Shafaeddin (2005) studies the effect of trade liberalisation and structural reform since the 1980s in a sample of 46 developing countries. Several East Asian countries achieved the goal of rapid expansion of exports and diversification in favour of the manufacturing sector. Thus rapid export growth was accompanied by expansion of industrial supply capacity and upgrading. However, nearly half the countries in the sample (African and Latin American) faced deindustrialisation. In these countries trade liberalisation lead to the development and reorientation of the industrial sector in accordance with static comparative advantage (Shafaeddin 2005). Thus low income countries will be locked into the production and export of primary commodities, simple processing and at best assembly operation or other labour-intensive activities.

Developing countries are also concerned that the SPS Sanitary and Phytosanitary Standards will be too difficult or costly to comply with. As developing countries do not have the resources needed to upgrade their sanitary capacity to meet the SPS requirements, development (technical) assistance is a possible solution.

Import duties are an important share of tax revenues in some developing countries. There is therefore concern that drastic trade liberalisation (through a reduction in import tariffs) could mean a loss of tariff revenue and thus fiscal deficits. From table 4.2 we see that in 2001 Swaziland and Uganda collected more than 50% of total tax revenue from import duties.

**Table 4.2 Import Duties as a Share of Total Tax Revenue 2001<sup>25</sup>**

Country	Share	Country	Share
Algeria	12.1	Morocco	18.8
Bangladesh	30	Nepal	30.9
Burundi	16.4	Oman	10.3
Cameroon	31.6	Pakistan	15.4
Congo DR	33.7	Papua New Guinea	24.2
Congo	23.2	Paraguay	17.5
Côte d'Ivoire	27.6	Peru	10.5
Dominican Republic	44.1	Philippines	19.6
Ethiopia	26.3	Sierra Leone	49.8
Guinea	42.9	Sri Lanka	27.4
India	24.1	Swaziland	54.7
Iran	14.4	Syria	11.7
Jordan	20.4	Thailand	12.3
Lebanon	39	Tunisia	12.5
Madagascar	53.5	Uganda	50.3
Mauritius	29.3	Venezuela	12.1

### 4.3 GATS

Services are a diverse group of economic activities distinct from manufacturing, mining and agriculture. The term covers a wide range of industries that provide the basic economic infrastructure (transport, communications, distribution, energy-related services, construction, water supply, sanitation and sewerage services, waste collection and disposal), financial infrastructure (banking, insurance, financial markets), support to business (advertising, marketing, computer services, professional services), or needed social infrastructure (education, health and social services).

In 2001, service sectors accounted for 45% of GDP in low income economies. Service activities in low and middle income countries have been expanding faster than GDP for the last two decades. However, trade in services has remained stable at around 16-17 %.

The GATS agreement covers trade in services and includes both traditional forms of supplying services (e.g. cross-border) and supply through the commercial presence of juridical persons (mode 3) and the movement of natural persons (mode 4).

Liberalisation in the service sector implies reduction in barriers that affect the services and the service-providing firms, such as restrictions on entry, legally established monopolies or oligopolistic market structures, discriminatory taxation, and limits on foreign investment and on the movement of persons.

Developing countries resist binding their offers and have not been as active in negotiation on services as on commodities.<sup>26</sup> After long resistance, developing countries are no longer opposing the GATS agreement, partly because it is extremely flexible. Governments can decide the level, scope and time frame of their commitments.

Developing countries' interests seem to be concentrated on mode 4, movement of natural persons. A number of developing countries seems to have developed a genuine interest in the expansion of commitments on cross-border trade (mode 1) in services related to vertical trade (outsourcing of accounting, payroll systems, billing systems etc).

The productivity gains in the final goods sector from liberalising the access of firms to foreign – and more efficient – intermediate services may be substantial.. Furthermore, we have

<sup>25</sup> South Centre, Oxfam Table 1 p. 17.

<sup>26</sup> Marchetti (2004)

observed a significant increase in vertical trade. Services, including infrastructure, play an important role in supporting participation in vertical trade.

## 5. Aid for Trade

In the Hong Kong Declaration, the WTO has for the first time in its history recognised the necessity of Aid for Trade in the economic adjustment process of developing countries moving towards liberalisation:

“Aid for Trade should aim to help developing countries, particularly LDCs, to build the supply-side capacity and trade-related infrastructure that they need to assist them to implement and benefit from WTO Agreements and more broadly to expand their trade. Aid for Trade cannot be a substitute for the development benefits that will result from a successful conclusion to the DDA, particularly on market access. However, it can be a valuable complement to the DDA.”

Source: [http://www.wto.org/English/thewto\\_e/minist\\_e/min05\\_e/final\\_text\\_e.doc](http://www.wto.org/English/thewto_e/minist_e/min05_e/final_text_e.doc) §57

Politically, Aid for Trade has represented a type of side payment in order to keep developing countries at the negotiating table in WTO. Comparing Aid for Trade with other aid initiatives, more emphasis is put on private sector development while traditionally aid has been targeted on the public sector. Including infrastructural support under the umbrella of Aid for Trade, the borders between Aid for Trade and other aid mechanisms has diminished. Recent and future initiatives need to be seen in light of this political context, and, like other types of foreign aid, without proper *needs assessment and implementing capacity* they may lead to inefficient use of aid funds.

Since the Doha Ministerial Declaration in 2001, total assistance to trade capacity building has increased by 50%, indicating that donors have put more weight on providing Aid for Trade. G-7 countries have pledged to double Aid for Trade by 2010 (to US\$12 billion). The EU has, for instance, recently pledged €1 billion to trade-related assistance, bringing it on par with the US.<sup>27</sup> Multilateral donors have also scaled up their activities. These include the Integrated Framework for Trade Related Assistance (IF), the IMF’s Trade Integration Mechanism (TIM) and the World Bank.<sup>28</sup> The *scaling up* has been linked to the Doha outcome, but the delivery of Aid for Trade is generally presumed to be the *responsibility* of aid and finance ministries and international agencies – not the WTO (see Stiglitz and Charlton, 2006 for an opposing view). One fourth of the assistance is provided to LDCs.

Trade-related assistance (TRA) can be divided into three *types* of aid policy.<sup>29</sup> The first is *trade policy and regulations* (assistance to trade facilitation and to achieve appropriate veterinary standards are examples). The second is *trade development* (export promotion and support to e-commerce are examples). Together these constituted 4.4% of total world aid commitments in 2003.<sup>30</sup> The third and largest category of TRA is *infrastructural support* to reduce supply constraints. Infrastructural support constitutes around 25% of total aid commitments. For Norwegian aid, the corresponding figures are slightly lower (see Appendix 8). The increasing role of aid to infrastructural development is partly related to the donor communities’ awareness of the

<sup>27</sup> See Velde et al, 2006 at [http://www.odi.org.uk/IEDG/Projects/TRA\\_Final\\_Draft\\_ODI.pdf](http://www.odi.org.uk/IEDG/Projects/TRA_Final_Draft_ODI.pdf)

<sup>28</sup> The World Bank has just recently completed an overview and assessment of its trade for aid activities <http://www.globalpolicy.org/soecon/bwi-wto/wbank/2006/06tradeevaluation.pdf>.

<sup>29</sup> *Trade policy and regulations* covers support to aid recipients’ effective participation in multilateral trade negotiations, analysis and implementation of multilateral trade agreements, trade policy mainstreaming and technical standards, trade facilitation including tariff structures and customs regimes, support to regional trade arrangements and human resources development in trade.

*Trade development* covers business development and activities aimed at improving the business climate, access to trade finance, and trade promotion in the productive sectors (agriculture, forestry, fishing, industry, mining, tourism, services), including at the institutional and enterprise level.

All aid to infrastructure (transport, storage, communications and energy) is categorised as assisting international trade. See <http://tcbdb.wto.org/publish/2005%20Report-Final.pdf>

<sup>30</sup> [http://www.wto.org/english/news\\_e/pres05\\_e/pr427\\_e.htm](http://www.wto.org/english/news_e/pres05_e/pr427_e.htm) and <http://tcbdb.wto.org/publish/2005%20Report-Final.pdf>

role that infrastructure plays in generating trade and foreign direct investment, and may also partly reflect a renaming of traditional aid categories (Melchior, 2007).

## 5.1 Motivation: public good and complementarities

In section 4 we showed various estimates of the global welfare gain from trade liberalisation. To achieve these potential gains there is a need for tariff reduction. Participation in WTO negotiations, the implementation of WTO rules (for instance, rules on veterinary standards) and the reduction of MFN tariff rates have some of the characteristics of a *public good*. Trade policy reform has positive external effects that are not appropriately internalised by member countries, for instance on technology, human skills and the quality of institutions in a country and on other countries. Thus, benefits from liberalisation are not sufficiently internalised by individual countries, leading to underinvestment in trade reform. Aid for Trade increases the incentives for developing countries to participate in and enhance the world trading system.

The policy consequence of the public good perspective is an increase in aid for *trade development*. The world's welfare gain of liberalisation provides room for increasing aid and aid should be used for i) integrating developing countries into the WTO; ii) compensating those who lose from liberalisation. The first principle is acknowledged in Aid for Trade and is covered under the umbrella *aid to trade development* (see above), while regarding the second principle there is so far no common agreement. Countries are as yet not being compensated for their loss from liberalisation.

From a public good perspective, those countries bearing the costs but achieving minor gains should be *compensated* (see section 4 for a discussion about winners and losers). As has been pointed out both in empirical studies and predictions of Doha effects, trade liberalisation has *adjustment costs*. Adjustment costs are related to preference erosion, tax erosion and the loss of jobs in some parts of the economy. It might be that those sectors adversely affected by trade liberalisation are also the ones that employ poor (unskilled) people. A loss of tax revenue from international trade might be particularly harmful for poor countries as tariffs constitute a significant and reliable source of government revenue and it takes a long time to develop an ordinary taxation system (based on taxing firms' profits and households' income). Developing countries with preferences will lose their preference margins and trade-related aid may compensate for this.<sup>31</sup>

In addition to the (international) public good argument, another motivation for Aid for Trade is that of *government and market failures*. Market access is not a panacea for export growth. Government and market failures make it difficult to reap the benefits of freer trade. Investment in potential new export products requires a 'good' investment climate characterised by a flexible labour market, a competitive product market, a low tax burden, non-arbitrary regulations and licensing procedures and lack of corruption. The absence of these qualities is frequently pointed to as instances of government failure, restricting investment opportunities. Foreign aid agencies lack power to influence these government failures apart from underlining the *importance good governance* plays for business activities. The situation is different for market failures. We have already mentioned market failures related to information asymmetries in export markets and increasing returns to scale in production.

The International Trade Centre was established in order to help developing countries to increase trade (*to stimulate trade development*), partly based on the perspective of overcoming market failures. Export promotion agencies in developing countries have been put in place for some of the same reasons. The experiences from these activities are mixed but give important insights into targeting exports from developing countries. Lederman et al (2006) found that there are some characteristics that are particularly important for export promotion agencies (EPA) in developing countries. They are more efficient when the export promotion activities are shared with other

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<sup>31</sup> Trade preferences were originally given as an aid mechanism (trade as aid), while the argument has now been turned on its head (aid for lost trade). See Hoekman and Prowse 2005.

activities such as investment promotion and export financing. Their onshore export support services (exporter training, technical assistance, capacity building, including regulatory compliance, information on trade finance, logistics, customs, packaging, pricing) are more important than country image, marketing and market research activities. Finally, the presence of EPAs' offices in foreign markets does not appear to help exports from developing countries. They also find that for the median agency, \$1 of export promotion creates \$300 of exports. For every \$1 in the EPA budget there is an additional \$490 dollars of exports in Latin America, \$227 in Asia and \$137 in SSA. These figures are quite impressive and are supported by others. Rose (2005) found that for each additional consulate abroad, exports increase by 6 to 10 percent.

The policy prescription of market failure is, however, not to support specific sectors as is the most common applied approach, but to deal directly with the activity that creates the externality (such as the information externality mentioned above). Furthermore, it is not clear cut that the externality is related to exports only, as it may also be a common phenomenon in an industry or a country. This highlights the need for trade support to be seen in light of a country's general industrial policy.

Another market failure is related to infrastructural development. A high proportion of poor countries are landlocked, with small markets and low-skilled labour forces; moreover, they are surrounded by similar countries. Previous studies that looked at the relationship between trade and infrastructure have found a positive and significant impact of quality of infrastructure on trade (Clark et al. 2004; Wilson et al. 2003). Recent research by UNCTAD, for example, estimates that the share of import value accounted for by international transport costs is 20.7% for landlocked African countries against a 12.7% average for African countries and a world average of 5.1% (see Stevens and Kennan 2006).<sup>32</sup> Similar proportions are likely for their exports. Several empirical studies have also shown that *trade facilitation measures*, such as reducing the costs of logistics, inventory and customs clearance, are significant, and in many cases more important, ways of reducing barriers for developing countries than lowering tariffs (e.g., Wilson et al. 2003; Rauch, 2001). Aid for Trade may have a role to play in easing these constraints. Of particular importance are public investments in *infrastructure and institutions* that *crowd in* (attract) private investments. Again, these problems with infrastructure are not only related to firms or sectors dealing with a country's international trade, but to its trade and industrial development in general.

In section 3, we discussed the importance export patterns play in productivity growth. The successful development of East Asian countries indicates that what is exported may have a spillover impact on overall economic growth and that in order to produce goods with spillover impacts, government targeting and infrastructural investment play an important role. That said, spillover impacts do not arise only from exports. Again, trade support must be seen in light of the overall industrial policy of the country concerned.

In Appendix 9, we have provided an overview of key policies that have been applied to stimulate trade development, partly based on external effects motivations. One discernible problem is, however, that, policies are geared towards *sectors*, while externalities in many cases are related to specific activities across sectors (learning spillovers). One technological spillover is related to infrastructure.

One of the weaknesses of past initiatives for promoting trade liberalisation is the lack of investment in complementary initiatives (see, for instance, the evaluation of past trade for aid initiatives by the World Bank).<sup>33</sup> That said, one problem with the argument for complementarities is finding the right mix of complementary investments (in telecommunications, roads, port facilities, energy, and also in human capital) and governance conditions that facilitates trade and exploits complementarities. These investments will vary across countries and sectors and require in-depth, case-specific competence, including competence on governance issues.

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<sup>32</sup> [http://www.saldru.uct.ac.za/trade/trade\\_stevens&kenman.pdf](http://www.saldru.uct.ac.za/trade/trade_stevens&kenman.pdf)

<sup>33</sup> World Bank. Assessing World Bank Support for Trade, 1987–2004. An IEG Evaluation. 2006.

A final argument for providing Aid for Trade is related to poverty concerns. While one needs to analyse the poverty impact of, say, a trade promotion initiative, one should keep in mind that trade policy is not a well suited policy tool for poverty reduction as there are many filters between trade policy and poverty reduction. Overcoming market failures is therefore a key motivation for providing Aid for Trade.

## 5.2 Principles and challenges for NORAD's action plan

There are some key *principles* that should guide a potential expansion of the Aid for Trade system in an effective direction:

- *Ownership.* Trade for aid must be intertwined with the national development strategy of the recipient country, including its industrial policy and its poverty reduction strategy. The main policy challenge is to link Aid for Trade with broader national development programmes through a dialogue with the recipient (for instance, through the PRSP process).
- *Coherence.* Donors need to coordinate and harmonise their efforts. The main policy challenge is which forum to apply. Currently, coherence is managed by the Integrated Framework.
- *Economic growth and poverty reduction.* A strategy for trade-related aid needs to be based on a country's overall aid strategy. The general motivation is to promote increasing trade as part of a general strategy for economic development and poverty reduction. The general motivation for trade-inducing aid is mainly the same as for other types of aid: to reduce poverty. The specific concerns of Aid for Trade are to facilitate the exploration of trade openness for developing countries (supporting implementation measures, removing institutional constraints, reducing market failures and facilitating export promotion) and to alleviate the negative distributional impacts of trade openness. Aid for Trade should accordingly be given to low income countries with an unexploited potential for increasing trade (due to factors mentioned above) and/or to countries with high adjustment or implementation costs. Different types of Aid for Trade should be channelled to different countries according to a needs assessment of whether or not there are market failures in trade and whether the aid policy will influence trading patterns. The main policy challenges from this are that in the countries where poverty is most widespread, trade promotion is probably not the most efficient policy. For Sub-Saharan Africa there might be other types of market and political failure that are more prevalent than those in international trade.
- *Efficiency.* Assistance to developing countries should be based on relevant data and comparisons of the benefits and costs of different kinds of trade support (including the costs of market failure and potential spillover impacts). There should be clear benchmarks/criteria for success and failure and built-in sunset clauses (support will be withdrawn at particular points in time). The target of support should be activities rather than sectors unless market failures are clearly related to sectors. Activities should be sought that may have spillover impacts. It seems that support within the recipient country pays off better than marketing support. One important policy challenge is to assemble appropriate data and provide estimates of costs and benefits. NORAD should consider financing trade diagnostic studies of some of our main cooperating partners.
- *Competence.* In its bilateral Aid for Trade programme, NORAD should build upon synergies in countries and activities where it already has experience. For instance, the focus on governance issues related to natural resource management is a key pillar in the

Norwegian aid strategy and this experience may also play an important role in identifying institutional constraints on facilitating trade in low income countries. Another area where NORAD has long experience is the promotion of sanitary standards. NORAD has already been involved in several implementation projects that assist developing countries to comply with *SPS standards*. *NORAD probably has a comparative advantage within areas in which it has already gained some experience.*

## 6. Conclusion

Developing countries are generally more dependent on trade than developed countries. Their share of world trade as well as South-South trade is increasing.

This trade is concentrated on a limited number of products and sectors and increases the vulnerability of the poor. More than two out of three LDCs receive at least 40% of their export earnings from one or two agricultural or non-fuel mineral products.

Still, trade patterns for developing countries are becoming increasingly diversified. Furthermore, an increasing share of international trade is based on vertical specialisation (for instance, outsourcing).

On average, the weighted applied tariff rates for agricultural products are higher in developing countries than in developed countries. This suggests that both types of country protect their agricultural markets quite heavily. There are tariff peaks for certain commodities. In the case of the EU, the mean tariff on grains is 53, grain products 48, meat (fresh, frozen, other) 70, dairy 87 and sugar beet 349. Tariffs on manufactured products are generally low in developed countries (<5%). Tariff rates are much higher in developing countries.

Opening up an economy to international trade increases the income of that country. However, whether trade liberalisation increases long-term economic growth, or whether more open countries achieve higher growth than other countries, is more disputed in the literature. It is likely, nevertheless, that governments can use trade to increase growth and reduce poverty if they design appropriate domestic policies for stimulating entrepreneurs to take advantage of trade opportunities. Nevertheless, if poverty reduction is the main aim, then it is clear that trade policy is not a main vehicle for improving the situation of the poor.

One of the main arguments for trade liberalisation being pro-poor is that the incomes of the poor and unskilled will rise as a result of increased trade. Several country case studies assessing the direct effects of trade on poverty show that the wages of the unskilled poor do not always increase following liberalisation. Government policies to enable workers to acquire the skills to enter the growing sectors are crucial in order to avoid short-term losses from trade liberalisation.

In the long run, trade tends to have a larger impact on growth and poverty reduction than may be immediately apparent after liberalisation. The impacts of a trade reform do not always manifest themselves immediately when input markets are inflexible, the price transmission mechanism does not work or households do not respond to price changes. All these features are widespread in many of the poorest countries and need to be analysed and addressed.

One of the most important conditions for maintaining long-term growth is to ensure the development of an education system of high quality. This should be pursued in close collaboration with the private sector and cover the entire population. Another is to encourage entrepreneurs to respond to the new market opportunities, to invest in production capacity, and to take advantage of the technological development that is made available by international markets through inputs, intermediates and production knowledge. History suggests that aggressive utilisation of trade advantages pursued in close cooperation with the private sector can make trade a powerful tool for rapid economic growth and poverty reduction.

In many of the trade success stories, the government has played a key role in promoting exports and reaping the benefits from importing new technologies and cheap consumer goods. The government can stimulate early entrants into different markets in order to provide valuable information spillovers to the rest of the economy. Such externalities provide a rationale for government support in order to produce new goods that may improve productivity. An interventionist government nevertheless requires competent government agencies to carry out the analysis and to develop the action plans.

What is exported from poor countries partly reflects comparative advantage, but it also reflects the industrial policies under which trade takes place. It is important for policy makers to

note that the composition of exports is found to matter for economic growth and poverty reduction. Hence, it can be important to develop policies for promoting products that will be more profitable to export, and that will generate more jobs and reduce poverty.

In this setting there is a clear danger with the current WTO initiatives, particularly on constraining export subsidies. This will most likely make it more difficult to undertake an industrial policy targeting particular sectors or activities.

The specific requirements for success in making trade and growth a tool for poverty reduction must be analysed for each country, and this analysis must identify vulnerable groups such as women, children, minorities, the rural population and indigenous people. Local political, cultural and economic conditions matter for achieving success. Just as there are no blueprints for development, there are no blueprints for trade promotion and export-based growth. The policy framework has varied a lot across countries that have previously experienced success from globalisation.

NORAD may wish to consider undertaking a trade diagnostic study in one of its co-operating countries.

When the Doha Round Negotiations were launched in November 2001, the focus was on the agricultural sector and the textile and clothing industries as these hold most potential for export expansion in developing countries. It is hard to assess what will be the results from the Doha Round negotiations as countries still have to reach a consensus on what the outcome should be. Nevertheless, assessments of different scenarios suggest that the gains from liberalisation might not be as significant as was concluded during early optimism.

The overall results seem to suggest that developing countries as a group will indeed benefit from liberalisation but that those benefits will be unevenly spread and that some countries will lose out. Brazil, Argentina and Thailand are among the “winners” while countries such as Bangladesh and those in Sub-Saharan Africa will suffer welfare losses. The gains from liberalisation will be greater following domestic liberalisation, and the need for trade between developing countries is stressed. The cost of liberalisation is associated with preference erosion, loss of tariff revenue (own liberalisation) and increased competition. Net food importers worry that increased world food prices might simply increase the import bill and induce a welfare loss for their countries. Developing countries also air concerns that trade liberalisation and exploitation of comparative advantage might lead to deindustrialisation as developing countries become locked into the production and export of primary products and simple processing.

There is a need for complementary policies for the poor to gain from liberalisation. The WTO has recognised that there is a need for “Aid for Trade” that helps developing countries promote aid and build trade-related infrastructure. One of the weaknesses with past initiatives for promoting trade liberalisation is the lack of investment in complementary initiatives. That said, one problem with the argument for complementarities is finding the right mix of complementary investments (in telecommunications, roads, port facilities, energy, and also in human capital) and governance conditions that facilitates trade and exploits complementarities. These investments will vary across countries and sectors and require in-depth, case-specific competence, including competence in governance issues.

We suggest that Norway should target its Aid for Trade towards Norwegian co-operating partners that are committed to making trade a vehicle for poverty reduction and growth promotion. Moreover, this aid-for-trade strategy should be an integrated part of the overall aid strategy in the country, and aligned with its national development strategies.

Finally, market access is a core precondition for increasing exports from developing countries. Hence, Aid for Trade and many of the other efforts proposed will not be beneficial to the poor countries if the rich countries continue to apply trade restrictions. Notice should be taken of the strong statement by the WTO Director-General Pascal Lamy in his speech on 4 January 2007 at NHO: “The EU and the G-10 (to which Norway belongs, alongside Japan, Switzerland and others) have to agree to greater cuts in agriculture tariffs beyond their current position.”

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## Appendix 1. TOR

### OPPDRAGSBESKRIVELSE

For CMI v/Arne Wiig og Espen Villanger

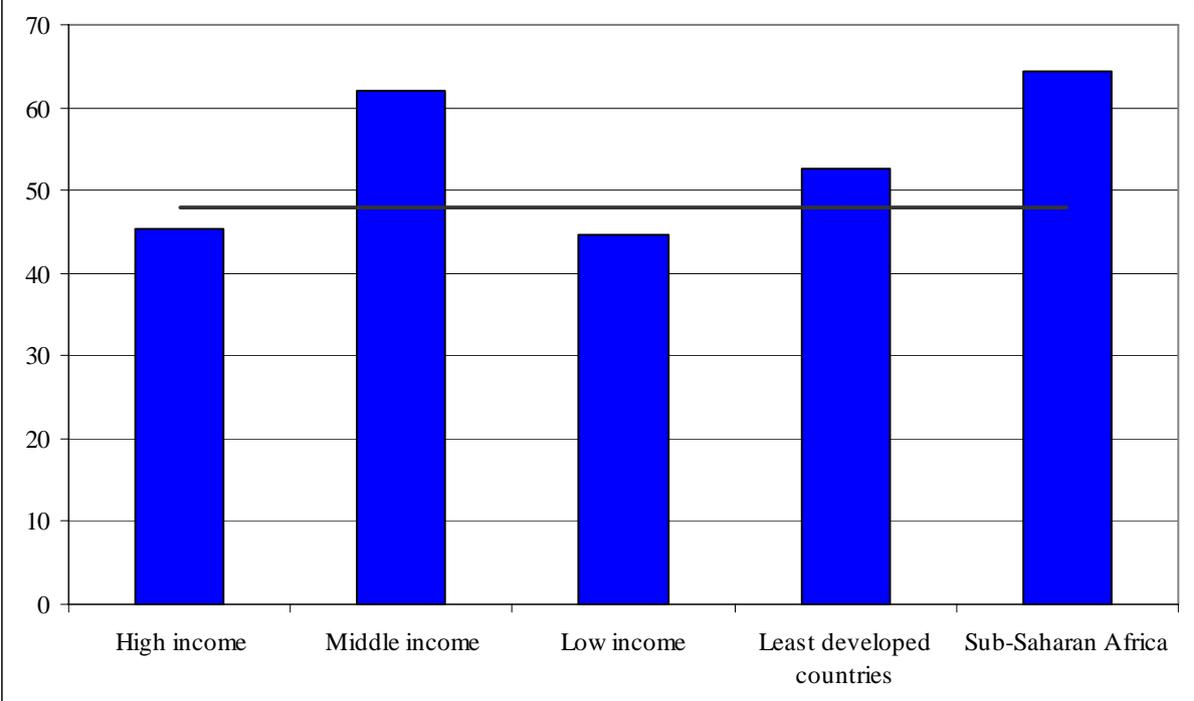
#### *Handelsdokument*

Det er besluttet at det skal utarbeides en handlingsplan for handelsrettet utviklingssamarbeid. UDs prosjektgruppe for handelsrelatert bistand, hvor også Norad deltar, skal selv skrive planen som skal være kort og oversiktlig. I denne prosessen vil det være nyttig med et bakgrunnsdokument - max 20 sider - som kan gi en introduksjon av *hovedutfordringene innen handel og utvikling og utviklingssamarbeidets rolle på dette området*. Dokumentet skal ikke gi et komplett bilde av alle utfordringer innen handel, men bl.a. fokusere på

- handel, vekst og fattigdomsreduksjon, inkl. den nasjonal utviklingsagenda, sårbare grupper/kjønnsdimensjon, miljø
- utviklingslandenes rolle i verdenshandelen, deres handelspolitikk og praksis, (inkl tollreform, standarder, GATS/TRIPS, rettferdig/etisk handel.) Den regionale dimensjon/handelsavtaler.
- multilateral handelspolitikk og utviklingsland, inkl. fordeler/ulempes og utfordringer sett fra et sør perspektiv. "Aid for trade".
- eksemplifisere hva en handelsplan bør/kan inneholde i et samarbeidsland CMI kjenner godt (for eksempel BGD, UGA eller SRV).

Dokumentet skal være overlevert Norad innen 8.1.07.

### Appendix 2. Trade as Share of GDP, 2003

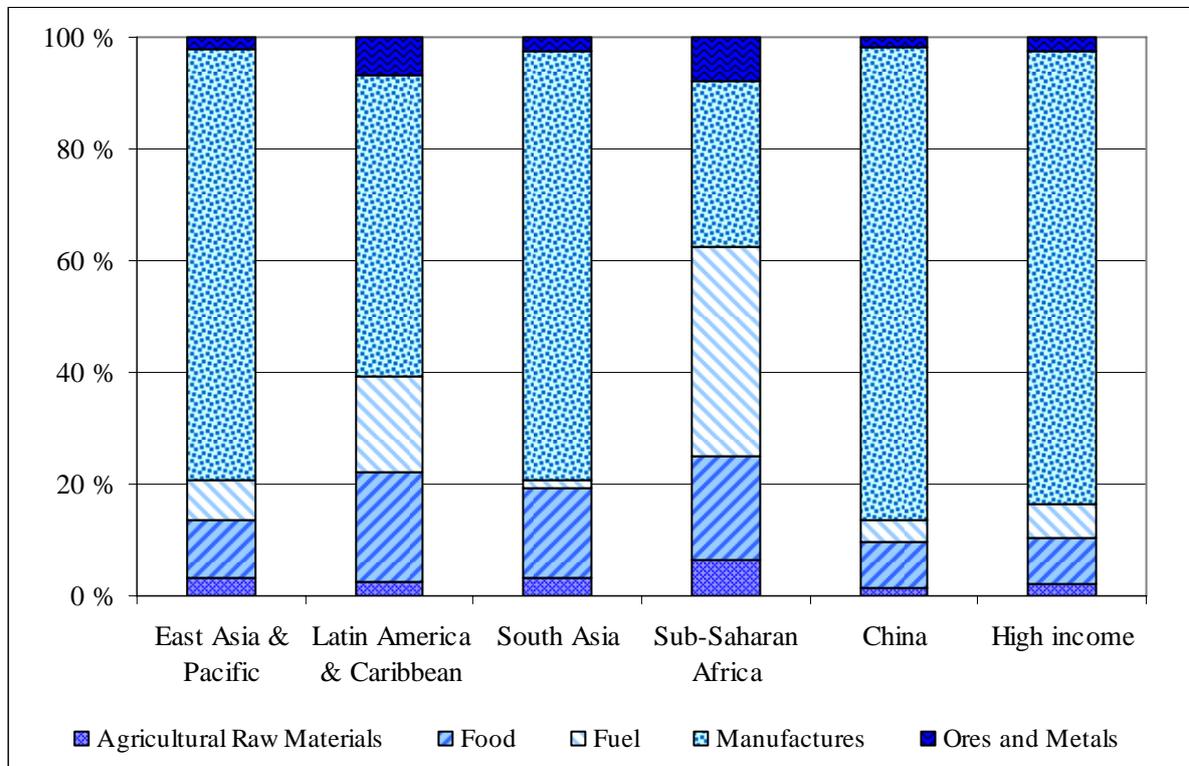


Source: WDI (2006)

## Appendix 3a. The Number of Commodities Exported and Imported

	Exported			Imported		
	1980	1990	2003	1980	1990	2003
Developed economies	229	231	232	234	235	235
Developing economies	167	190	211	215	218	226
Africa	138	115	129	207	200	209
Asia	178	205	218	219	223	229
Least Developed Countries	48	37	73	166	165	184

## Appendix 3b. Share of Merchandise Exports, 1996



Source: UNCTAD Handbook of statistics online, table 1.1 “Value and Shares of Merchandise Exports and Imports (1948-2004)”:

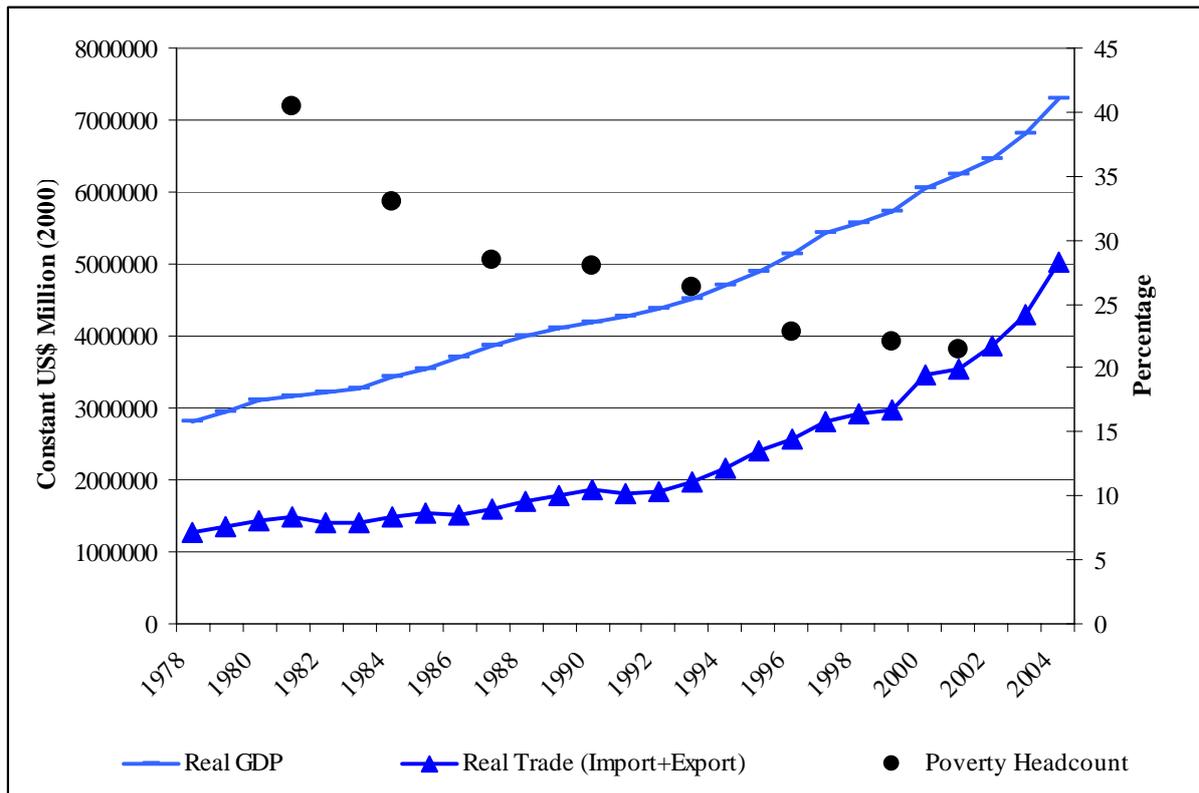
<http://www.unctad.org/Templates/Page.asp?intItemID=1890&lang=1>

## Appendix 4. Intra-trade of regional or trade groups, 1980 and 2003

1980	Group	Region	Other		2003	Group	Region	Other
EU 25	60,9	10,6	39,1		EU 25	67,6	6,9	32,4
ANCOM	3,8	62,2	96,2		ANCOM	7,8	63,4	92,2
CACM	24,4	41,2	75,6		CACM	13,0	53,7	87,0
CARICOM	5,4	66,0	94,6		CARICOM	11,8	60,9	88,2
FTAA	43,4	1,6	56,6		FTAA	60,1	0,4	39,9
LAIA	13,9	40,9	86,1		LAIA	11,4	60,2	88,6
MERCOSUR	11,6	24,9	88,4		MERCOSUR	11,9	34,5	88,1
COMESA	5,7	1,6	94,3		COMESA	6,2	5,2	93,8
ECCAS	1,4	1,5	98,6		ECCAS	1,1	2,0	98,9
ECOWAS	9,6	3,5	90,4		ECOWAS	8,3	4,3	91,7
SADC	0,4	0,3	99,6		SADC	9,1	3,4	90,9
ASEAN	17,4	42,5	82,6		ASEAN	22,0	39,0	78,0
ECO	6,3	30,5	93,7		ECO	6,7	25,8	93,3
SAARC	4,8	34,2	95,2		SAARC	5,6	34,9	94,4

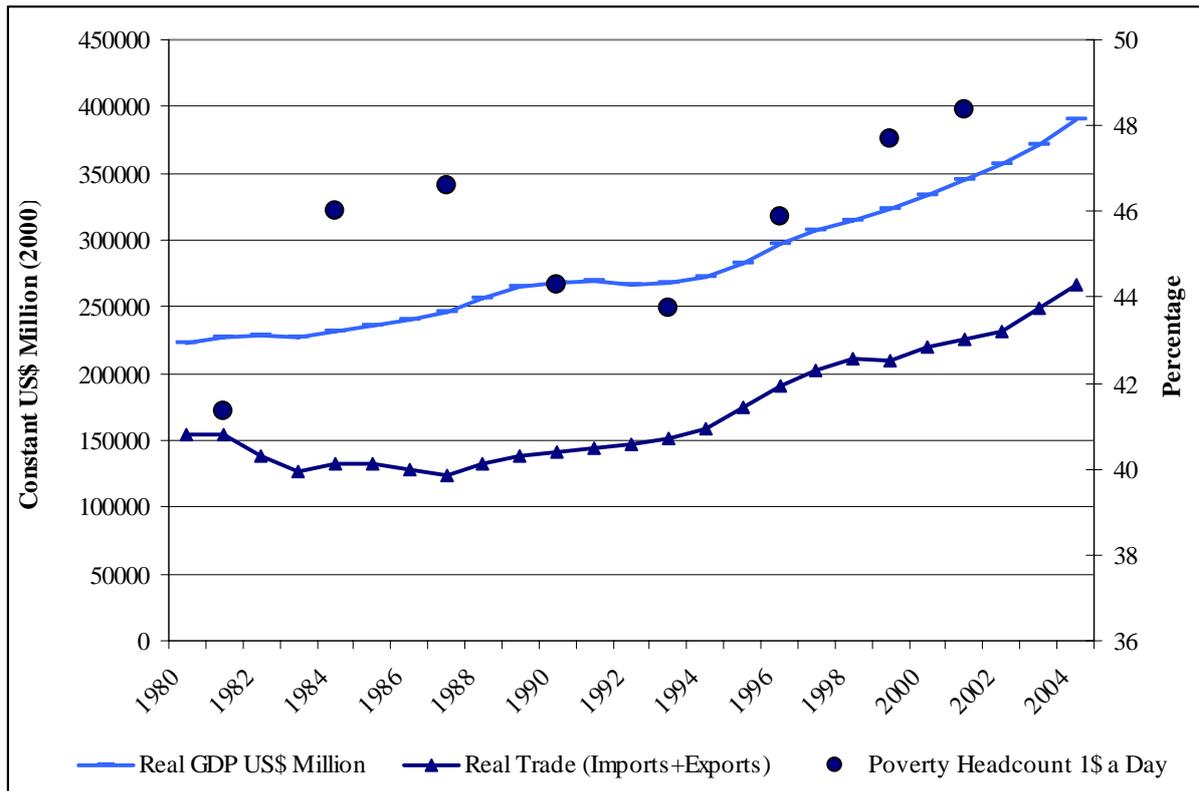
Source: UNCTAD Handbook of Statistics online; Table 1.4 "Intra-trade of regional or trade groups (1970-2004)" <http://www.unctad.org/Templates/Page.asp?intItemID=1890&lang=1>

## Appendix 5. Development in GDP, Trade and Poverty in Low and Middle Income Countries<sup>34</sup>

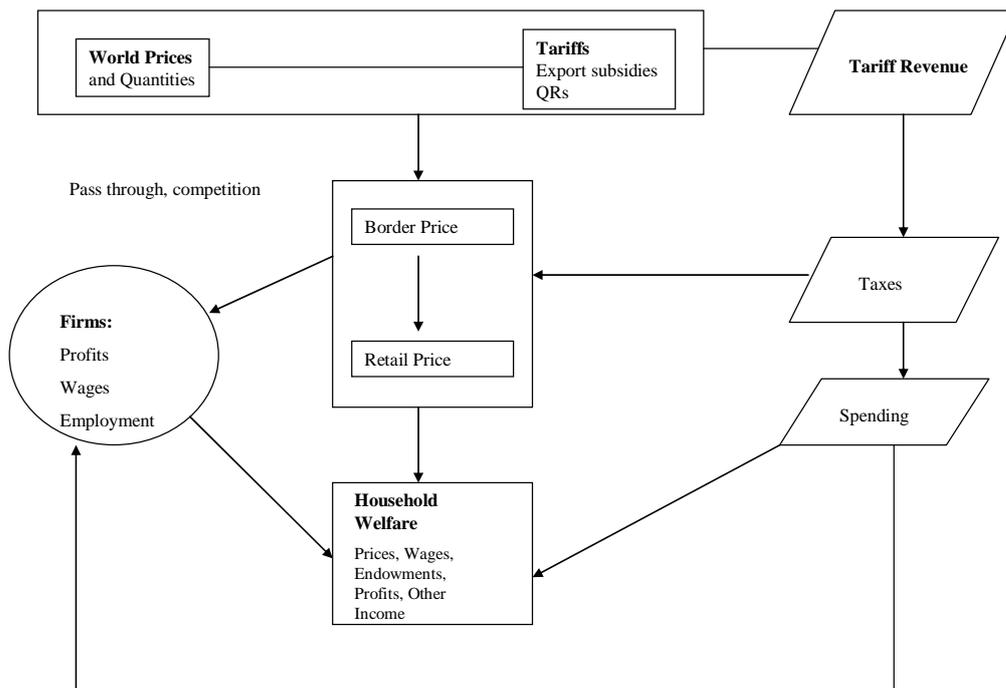


<sup>34</sup>Source: WDI 2006, Poverty Headcount: <http://iresearch.worldbank.org/PovcalNet/jsp/index.jsp>

## Appendix 6. Development in GDP, Trade and Poverty in Sub Saharan Africa



# Appendix 7. Trade policy and poverty: conceptual framework



Appendix 8. Norwegian Aid for Trade

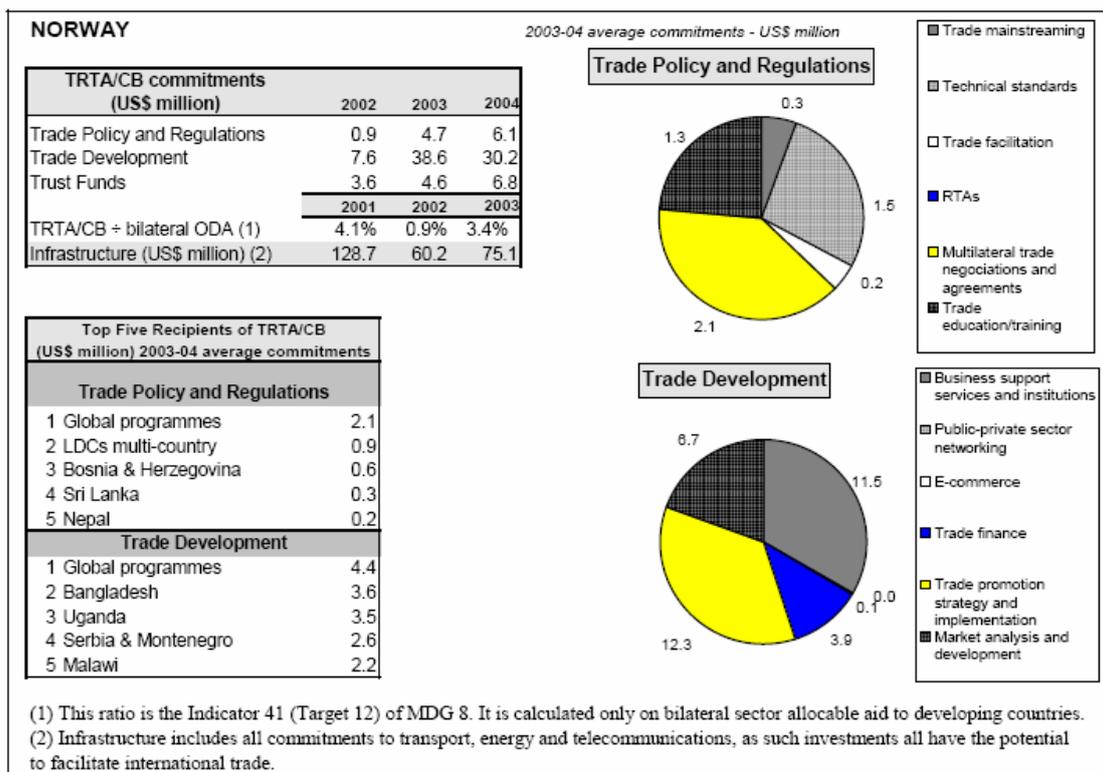
**Strategy and objectives:** Norwegian TRTA/CB aims to assist developing countries in strengthening their participation in the international trading system and in international trade, and thereby contribute to economic growth and poverty reduction. Budget allocations for such assistance have been increased during the last years. The main objectives are:

- To assist developing countries and in particular the LDCs in their efforts to promote their interests through active participation in trade negotiations and in the rules based international trade system.
- To support the efforts that are made in integrating trade related aspects into national development plans
- To contribute to increased participation of developing countries in international trade by improving their supply side capacity and promoting investment, private sector development and exports.

**Priority areas:** Norway’s TRTA/CB has a particular focus on **LDCs and Africa**.

Priority is given to the development of efficient and coordinated **multilateral** channels for TRTA/CB, and in particular to the Integrated Framework (IF) and the efforts to integrate trade concerns into national development strategies. Priority is also given to facilitate LDC participation in trade negotiations..

Norway’s **bilateral** TRTA/CB focuses on private sector development and supply side capacity. Emphasis is given to the development of the agricultural sector. Efforts are made to help improve product quality and develop control mechanisms (including compliance with SPS/TBT). A specific *Strategy for Support for Private Sector Development in Developing Countries* includes important trade related elements. Norwegian companies are encouraged to engage in commercial activities in developing countries. A special unit is established to offer information on market access and regulations in Norway as well as a company matching database.



Source:

WTO: 2005 Joint WTO/OECD Report on Trade-Related Technical Assistance and Capacity Building

## Appendix 9. Trade development. Main categories and description

Business support services and institutions		Support to trade and business associations, chambers of commerce; legal and regulatory reform aimed at improving business and investment climate; private sector institution capacity building and advice; trade information (sector unspecified).
Public-private sector networking		Tools and mechanisms for improved dialogue and resource sharing between public and private sector (and within the private sector) at the national, regional and global levels, including trade fairs (sector unspecified).
E-commerce		Promotion of information communication technologies for enhancing trade; training and provision of software and hardware to improve e-commerce capability.
Banking and finance	Trade finance	Access to trade finance; reform of financial systems, banking and securities markets to facilitate trade; laws and regulations that protect and promote trade-related investment.
Agriculture Forestry Fishing Industry Mining Tourism Services Multisector / general	Trade promotion strategy and implementation	Development of a national sector-level trade strategy; workforce development in export industries; implementation of sector-specific strategies in agriculture, forestry, fishing, industry, mining, tourism, and services including "fair trade programmes".
Agriculture Forestry Fishing Industry Mining Tourism Services Multisector / general	Market analysis and development	Access to market information; advice on standards, packaging, quality control, marketing and distribution channels in agriculture, forestry, fishing, industry, mining, tourism and service

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## SUMMARY

NORAD is currently developing a trade strategy towards developing countries. This background note presents a review of the current literature and empirical findings on the relationship between trade, growth and poverty reduction. There is also a review of the Aid for Trade debate.

Opening up an economy to international trade increases the income of that country. Whether trade liberalisation increases long-term economic growth and more open countries achieve higher growth than other countries is more disputed in the literature. The overall results seem to suggest that developing countries as a group will benefit from liberalisation but that those benefits will be uneven. Some countries will lose out. If poverty reduction is the main goal, trade policy cannot be a main vehicle for improving the situation of the poor.

Specific requirements for success in making trade and growth a tool for poverty reduction must be tailored to each country. Just as there are no blueprints for development, there are no blueprints for trade promotion and export-based growth.

Finally, market access is a core precondition for increasing exports from developing countries. Hence, Aid for Trade and many of the other efforts proposed will not be beneficial to poor countries if rich countries continue to apply trade restrictions (as Norway does on agriculture).

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