Trade, Investment and People-Centered Growth

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Outline

• **Objective: link trade, growth and poverty reduction**

1. Trade Openness and Growth: theory and practice

2. Openness does not automatically lead to poverty reduction: Behind Border Issues

3. A framework of the Quality of Growth
   - Poor governance that hinders trade and investment
   - Underinvestment in human capital

4. People-centered growth: building a harmonious society
   - Open and develop the service sector
   - Improve governance and investment climate
   - Provide equitable education and job opportunities
   - Reform public Investment / transfer and labor market policies
I. Openness, Growth and Poverty

• Openness to trade and investment links with faster growth and poverty reduction: Theories and practices

• After years of openness and reforms, China has become one of the most open economies in the World

• WTO accession a main driver of reforms
The old and new trade theories

• Well-known trade models:
  – Ricardo (comparative advantage based on differences in productivity levels)
  – Heckscher-Ohlin (comparative advantage based on differences in factor endowments)
  – Krugman-Helpman (trade driven by economies of scale and consumers’ love of variety; explains intra-industry trade)
Growth models

• Neoclassical growth theory (Robert Solow)
  – Diminishing returns to accumulation of capital & labor
  – Sustained growth requires continuous technological progress (exogenous to the model)

• Endogenous growth theory (Paul Romer)
  – Technological progress within the system
  – Models incorporate R&D and technology diffusion

• Schumpeterian creative destruction (Aghion)
  – Firms are heterogeneous- entry & growth of more efficient firms raises productivity
The role of Entry and Exit

• Schumpeter’s idea of Creative Destruction (1942) stresses innovation/new products & new services
• New endogenous growth model stress vertical innovations generated by research (Aghion and Howitt 1992)
  – Monopoly rents provide the payoff/incentives for research
  – Better products/services render previous ones obsolete.
• New entrants with better products/services drive the old firms out--good for productivity.
• Implications for trade: Competition/entry and exit are good for productivity growth
  – process encourages innovation and reallocation of resources from inefficient ones to efficient one.

See also Melitz 2003.
Creative Destruction: Entry, Exit & competition raise productivity growth

- New Entrants with new tech
- Manufacturing firms become more productive
- Failed firms exit
- Spin-off services
- Deeper division of labor
- Reallocation

Trade Competition

Productivity Growth
After decades of reforms, China’s Exports and Global Market Share Have Risen Rapidly

Source: Will Martin 2004
Exports Have Been Transformed

Source: Will Martin, 2004
Trade in High-Tech Products rose

Sources: Chinese Ministry of Information Industries, China General Customs Administration
II. However, high trading cost prevented the poor from benefiting from trade, why?

- Trading cost:
- Domestic trade barriers are still high
- Transportation cost and transaction cost
- Many services are state monopoly: railways, airlines, telecom, ---lack of competition and lack of openness
- Other services are under-developed such as logistics, rural finance, rural health and education, rural roads, water, Ag R&D and rural extension services
Regional Trade Barriers are high

Figure 3 Sources of goods consumed in Chinese provinces 1987, 1992 and 1997 (percent)
Cost of Poor Infrastructure

- Inadequate road infrastructure imposes a high cost when moving goods from inland areas.
- Infrastructure quality accounts for 40% of the variation in cost in coastal countries and 60% in landlocked countries.
- 63% of the total cost of container transport from Chongqing to US West coast is land access to the port (compared to 21% for maritime transport).
- Significant prices differences of products between Ulaanbaatar and other outlying areas. 67% of the difference attributed to extra transport cost.
Importance of Infrastructure for Rural Connectivity

- Xiangxi County in Western Hunan Province is a producer of kiwis and tangerines.
- Due to the absence of high quality roads and the perishable nature of these products, they cannot reach large markets or ports in good condition.
- Inland provinces such as Inner Mongolia, Hunan and Yunnan where perishable goods constitute a large proportion of exports have inadequate cold chain facilities to maintain product freshness.
- Other provinces such as Gansu, Yunnan, Guizhou face shortage of containers.
Poverty decline has slowed since mid-1990s

Source: Martin Ravallion and Shaohua Chen 2004
... while inequality has risen sharply
Regional income disparities, 1978-2001

Standard Deviation of Log of Per Capita Income

Coast versus Interior

All Provinces

Intra-coast

Intra-Interior

Poverty is higher in the West

Poverty rates (percent of the population)

Coastal: 6.3%
Northeast: 6.6%
Center: 13.0%
Southwest: 20.7%
Northwest: 28.6%

Distribution of poverty in China, 2003

- Southwest: 31.0%
- Center: 28.0%
- Coastal: 16.8%
- Northeast: 4.2%
- Northwest: 20.0%

Most common characteristics of poor households

• Low education level of adults

• No migrant worker in the household

III. A Framework for more balanced and equitable growth

- A country needs at least 3 types of capital for income growth and welfare: physical, human and natural capital
- Investing in H raises the productivity of FDI and other investment, but currently there is an under-investment in H
- Investing in Natural capital (R) and protecting the environment contribute to growth as well as welfare, but currently there is an overexploitation of natural capital
- Opening to trade and foreign investment would raise the productivity of K, and H
- Improving governance would raise the productivity of all three capital, K, H, and R, and promote growth and poverty reduction
A Framework

- Opening to trade and investment
- Improving investment climate
- Providing sound macro policy
- Correcting market failures hurting H and R
- Good governance to ensure policy consistency

Policy Implication 1: further opening and reform, especially in the Service sector

- China is lagging behind others in the service sector development [it accounts for 40% of the economy]
- Services as engine of growth: since deeper division of labor and specialization contribute to competitiveness and higher productivity
- Liberalization in service may generate sizable gains
  - A) Standard gains from trade and specialization;
  - B) Services as intermediate input—better services for the goods sector;
  - C) Gains from FDI as a means for trade -- learning-by-doing.
Service Sector as a Percentage of GDP (Year 2003)

Source: WDI 2005, China 2004 Service data: NBS
Sectoral composition of FDI stock in China: why so much concentration?

• **Cost of not opening:**
  • Lack of openness in many service sectors
    Ex: financial/banking sector, education and health
  • In banking, market access was not allowed to the domestic private sector, nor to foreign banks. The poor suffers from lack of access to rural / micro finance.

**Policy 2: Improve Governance**

• Improve governance — anti-corruption issues.

• Voice of the poor, and empowerment of the poor
Policy 2: improve investment climate and governance

- Improving investment climate by reducing red tapes, encouraging FDI and private sector development
- It would encourage investment in infrastructure, reduce trade cost and facilitate trade.
- It would also promote productivity growth, and create more jobs, as shown below.
Share of firms needing informal payment to secure bank loans

Source: Dollar et al. 2003
Firms making informal payments to secure bank loan

Southeast
Bohai cluster
Northeast
Southwest
Center
Northwest

Source: Dollar et al. 2006
Days needed for clearing Customs for exports

Southeast
Bohai cluster
Northeast
Southwest
Center
Northwest

Source: Dollar et al. 2006
Transport and factor costs, inland and coast regions

Source: Dollar et al. 2006
Policy 3: invest in the poor’s human capital

• Distribution of opportunities Key:
• There are large rural/urban disparities in education and health
• School enrollment and attainment have risen but disparities are high
• Schooling is 2-3 years longer in urban areas than rural
• Enrollment in high school was 34% in west China, 50% in East China
• Infant mortality was 37 per 1000 in rural China, 12 in urban China in 2000.
Access to schooling has remained unequal

Average years of schooling, 2000

Government spending on education per student, 1990s (% of GNP per capita)

Reasons? Low level of public spending and inadequate attention to the poor regions

Government Budgetary Spending on Education by Province (China, 2003)

Source: China Statistical Year Book (2005 and 2004)
Note: Beijing, Shanghai, and Tianjin are not shown under the current scale, as outliers, they stay at the upper right side of Zhejiang and Guangdong.
Policy 4: Reform the fiscal transfer system which is regressive: the rich get more

Fiscal transfers and provincial GDP per capita, 2000 (RMB)
Public Investment should be in areas of higher returns: Investment returns in China

<table>
<thead>
<tr>
<th></th>
<th>Coastal</th>
<th>Central</th>
<th>Western</th>
<th>Average</th>
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<tbody>
<tr>
<td><strong>Returns to Agricultural GDP</strong></td>
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<tr>
<td>R&amp;D</td>
<td>8.6</td>
<td>10.02</td>
<td>12.69</td>
<td>9.59</td>
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<tr>
<td>Irrigation</td>
<td>2.39</td>
<td>1.75</td>
<td>1.56</td>
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<tr>
<td>Roads</td>
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<td>3.84</td>
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<td>Education</td>
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<td>3.28</td>
<td>3.71</td>
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<td>Electricity</td>
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<td>0.63</td>
<td>0.4</td>
<td>0.54</td>
</tr>
<tr>
<td>Telephone</td>
<td>1.58</td>
<td>2.64</td>
<td>1.99</td>
<td>1.91</td>
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| **Returns to poverty reduction** |         |         |         |         |
| R&D                                | 1.99    | 4.4     | 33.12   | 6.79    |
| Irrigation                         | 0.55    | 0.77    | 4.06    | 1.33    |
| Roads                              | 0.83    | 3.61    | 10.73   | 3.22    |
| Education                          | 2.73    | 5.38    | 28.66   | 8.8     |
| Electricity                        | 0.76    | 1.65    | 6.17    | 2.27    |
| Telephone                          | 0.6     | 1.9     | 8.51    | 2.21    |
| Poverty loan                       | 0.88    | 0.75    | 1.49    | 1.13    |

Source: Fan, Shenggen. 2004. Investment and Subsidies in Rural India and Implications for China
Policy 5: migration and labor markets are critical for equitable growth

- Trade reform & China’s growth & development require massive movements of workers
- Many barriers to mobility between agriculture & other sectors
  - Poor education, lack of experience, inability to sell land use rights, formal barriers (eg hukou) all limit mobility
  - Causes rural incomes to fall behind urban
- *Hukou* system less restrictive than previously, but still an important barrier
An example: Labor Mobility Component Of Southwest Poverty Reduction Project

- SWPR Project areas
  - 3 provinces (region)
  - 35 counties
  - 291 townships
  - 1798 administrative villages
  - Agricultural population 4.448 million,
  - 2.235 million laborers
  - 0.73 million surplus laborers

- 0.28 million laborers were relocated in coastal regions and found jobs, of which, 68% male and 32% female.

- Actual investment was 490 million yuan.
Openness and poverty reduction

• Directly increased income
  – It was shown in the sample survey, of laborers sent out from 1995 to 2000: The remittance amounted to 1.338 bn yuan, the goods purchased valued to 0.25 bn yuan, totaling 1.59 bn yuan.

• The production and living condition of project farmers were improved by the remittance:
  To invest in agricultural production
    To build houses
  To pay off the debts
  To pay the education fees
  To pay for health
Summary: People-centered growth is achievable

- Openness to trade and investment has led to rapid growth, which has helped poverty reduction, but rising inequality increased the poverty.

- Focus on pro-poor / quality growth: a growth that provide equal opportunities to the poor, a growth that is based on productivity, not on resources; a growth that is equitable, stable and sustainable over time.

- Invest in human capital, and focus on rural-urban migration and equal education /job opportunities.
People-centered growth and building a harmonious society

• Public investment would be more effective if it focuses on Agricultural R&D, roads, water, and rural infrastructure, and education.

• Fiscal transfers should be reformed to better protect the poor, the elderly and the vulnerable.

• Targeted Programs /conditional cash transfers such as Mexico’s oportunidades may be considered.
References:

- World Bank. 2000. The Quality of Growth. In particular, Chapter 3 on “Improving the distribution of opportunities”.
See our website, trade and poverty

China: WTO and Development -- Policy Reform and strategy in the Post-WTO Era

www.worldbank.org/trade/China-WTO

www.reducingpoverty.org