

KNOWLEDGE IN DEVELOPMENT NOTES

Trade Policy for Development

International trade is one of the main vehicles of globalization, and rising trade flows are among the main drivers of development. Multilateral trade reforms and free trade agreements are attracting the most attention. But there is also a great deal of interest in outsourcing services, transferring technology, and networking production for the future geography of industrialization.

Trade policy reform is crucial for successful development and poverty reduction—so much so that no economy has ever developed without integrating with the world economy. Yet it is deeply controversial, partly because of pressures from special interests that benefit from trade barriers, and partly because of the complexity of the links between trade reform and economic development.

Developing countries have reformed their trade policies tremendously in recent years. Average tariffs in developing countries have fallen from over 30 percent to around 13 percent, and the use of nontariff barriers has greatly declined. This liberalization has transformed developing country trade—reducing their traditional dependence on commodity exports such that manufacturers now account for around 70 percent of their merchandise exports.

The key challenge for the Bank is to help countries use trade, as part of their overall development program, to promote economic development and poverty reduction. To do this, we try to influence policy decisions at national, regional, and multilateral levels.

What does past research tell us?

Trade policy is most potent when it complements other reforms

A recent Bank study found that excessively regulated economies did not seem to gain from more trade.¹ By contrast, a 10 percent increase in the trade-to-GDP ratio of well regulated economies resulted in a 4 percent gain in income.

If domestic policies are satisfactory, greater openness generally promotes development and poverty reduction by increasing efficiency and stimulating growth. More productive firms export more and export new products. Developing countries have been expanding the number of products they export by 12 percent a year in recent years, raising productivity by close to 2 percent a year.²

Unilateral policy decisions are central to successful policy reforms: multilateral and regional negotiations have had less development impact

Country decisions to reform their policies—with or without support from the World Bank and IMF—have been the most important source of liberalization, accounting for an

estimated two-thirds of the 20 percentage-point reduction in developing country tariffs over the past 20 years.³

Multilateral reforms contributed about a quarter of the reductions in developing country tariffs in the 1990s, and improved their access to markets in both north and south.

Regional trade arrangements are receiving enormous attention from developing country policymakers, who are involved in around 230 such agreements, up from 50 in 1990. But these arrangements have accounted for only around 10 percent of the reduction in developing country tariffs, and their benefits are diminished by product exclusions and the diversion of imports from the most efficient suppliers.

Despite considerable progress in recent decades, there are substantial barriers to developing countries seeking to use trade to promote development

Agricultural trade now accounts for less than 9 percent of global trade and 11 percent of developing country exports but for almost two-thirds of the cost of protection to developing countries.⁴ In the industrial countries, two-thirds of this protection comes from non-transparent specific tariffs. Agricultural protection in developing countries also remains too high, at 21 percent, seven percentage points above the industrial-country average.⁵

Tariff peaks in industrial countries pose major problems for developing countries—the highest tariffs in the Quad countries are 55 times the average—as against 12 times the average in developing countries—and these peak tariffs frequently apply to exports of interest to developing countries, such as clothing and footwear.

Exports of services have become more important with increases in the ability to trade many services across borders, allowing many developing countries to increase their exports of services by more than 20 percent a year. But there has been little progress in temporary movements of service providers (people)—the key area for developing countries.

Product standards can be a powerful force for trade expansion, but there is also potential for using them as trade barriers, as has sometimes been the case through restrictions on genetically modified products.⁶

Trade barriers associated with inefficient customs and other behind-the-border procedures have become much more important with the rise of global production sharing, where developing countries import inputs and export final products. Trade facilitation could greatly enhance developing country trade opportunities.

Foreign direct investment (FDI) can be a powerful source of productivity growth

Policymakers have become much more receptive to foreign direct investment because they believe it can help raise productivity. A recent Bank study⁷ finds that Indonesian plants acquired by foreign investors experienced 33 percentage point more productivity growth in three years. FDI also increases the share of output exported by 10-20 percentage points. It may also raise the productivity of domestic firms through backward linkages to local input suppliers, with a 1 percentage point increase in FDI producing a 3 percent increase in the productivity of input suppliers.⁸

The WTO has helped achieve substantial trade reforms in developing countries, especially the newly acceding countries.

WTO accession can be a major impetus to economic reforms—particularly in trade policies but also in reforming trade-related domestic policies and strengthening the legal system. Average tariffs in recently acceded countries—at around 7 percent—are substantially below those in comparable developing countries. And these tariffs are bound against future increases.

But WTO commitments have done little to reduce developing country protection and its instability. Much of the current flexibility given to WTO members under Special and Differential Treatment is unhelpful to development—particularly the right to make smaller liberalization commitments. By contrast, where reforms involve costly commitments to strengthen institutions, current WTO rules are not responsive enough to developing country constraints.⁹

Trade reform and supporting policies are vital for long-term poverty reduction

A recent study of trade reform and poverty finds that the Doha Development Agenda outcome would have to be very ambitious to reduce poverty substantially. To have a significant short-term impact on poverty, complementary policies, such as improvements in rural education, are needed. But sustained long-term poverty reductions depend on stimulating economic growth.¹⁰

Country studies provide important findings. Liberalization of world sugar markets would reduce poverty in Brazil, rather than merely raise incomes of the wealthy. Trade reform in Madagascar would help a small number of farmers move out of poverty, while specific poverty-reducing policies, such as improving education, would be much more effective. Improving rural education in China strongly complements attempts to improve access to protected agricultural markets by increasing workers' productivity and their mobility.

The current research agenda

Much trade research is conducted worldwide. The World Bank, through its acknowledged leadership in the area, is able to influence the agenda strongly. For research within the Bank we identify three critical areas.

Designing trade policy reforms that work

A precursor to advising on policy reform is assessing the impact of trade reforms on trade opportunities. This is much more difficult than it appears, since high protection reduces the value of trade normally used to indicate the importance of particular traded items. New work on the Bank's Overall Trade Restrictiveness overcomes this problem using state-of-the-art measurement techniques.

A tentative finding from our quantitative assessment of the Doha Agenda is that reforms will need to be much deeper, and with much less "flexibility" than currently envisaged if they are to provide substantial benefits to developing countries. A key need identified in this work is to improve our understanding of the determinants of developing country agricultural policies. We need to know what causes countries to choose high protection in some industries and to have low protection in others, and why agricultural protection tends to rise when countries get beyond middle-income status. A major series of developing country studies is under way to understand the evolution of distortions to agricultural incentives and to help guide reforms in the face of strong pressures to restrict trade.

Also important is the impact of the liberalization of textiles and clothing under the WTO's Uruguay Round agreement. A major challenge is to see what can be done to help countries adjust to the profound changes in the competitive environment associated with these reforms, including how costly—and how effective—the widespread imposition of safeguards against China's exports would be in reducing adjustment costs.

WTO rules on antidumping duties are too permissive, and developing countries have become major users of these restrictions. Lessons are being drawn to see how to make these policies less costly.

Services trade has great potential to promote development, through the WTO's General Agreement on Trade in Services (GATS) and through unilateral reforms. But numerous domestic reforms, such as improvements in regulation, are required for this to have greater impact. Research is under way to examine greater progress in expanding exports of services for developing country suppliers (Mode 4).

Negotiations on Trade Facilitation are on the Doha Agenda. To reduce trade costs, we need to explore the gaps in current trade policies that add most to the costs of trade, and how reform might reduce these costs. Our research will also examine how WTO negotiations might contribute to achieving these goals at the national level.

Using trade to boost technical change and growth

We are currently exploring how such poor developing countries as Bangladesh can reform their trade and related policies to best take advantage of the productivity-enhancing effects of greater trade integration. In particular, we are seeking to identify the key linkages

between trade reform and growth—such as improving process technology, producing new varieties, and lifting the quality of producer services.

An important source of growth is foreign direct investment. We are examining how countries can make better use of FDI to promote modernization and development. In particular, we are looking at policies that attract foreign investment and do not lead to economic distortions, such as those associated with now-outlawed trade-related investment measures or to excessive payments to foreign investors.

Also under way is further empirical research on who gains and who loses among developing countries from current or prospective agricultural biotechnology policies, particularly in the presence of trade bans or strict labeling regulations on transgenic food. Initial results suggest that many developing countries—and especially their poorest households—would benefit from adopting genetically modified varieties of food crops, even if sales of those foods to Europe were curtailed.

Designing trade reforms to reduce poverty

Special and differential treatment provisions in international trade agreements need to be more supportive of development. New ways need to be found for industrial countries to help poorer developing countries overcome the transition costs of trade reforms. One unresolved question is whether some disciplines should be conditional on the capability of poorer members, rather than be available to all WTO member countries self-selecting as “developing.”

More work is needed to understand how trade policy reforms can reduce poverty. We need to go beyond estimating the impact of reform to examining complementary policy measures that could reduce poverty more by reducing costs to access markets. Understanding how trade reform can best stimulate the economic growth that reduces poverty is especially important. Only with this understanding can policies maximize the role of trade in achieving the sustained reduction in poverty central to the efforts of the World Bank and the international development community.

Contact: Will Martin, Wmartin1@worldbank.org, 202-473-3853

DECRG website: <http://econ.worldbank.org/research>

Endnotes

Most Bank documents cited in this summary are available through the documents and reports portal of the World Bank <http://www-wds.worldbank.org/>. The word “processed” describes informally reproduced works that may not be commonly available through library systems.

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