SUPPORTING ECONOMIC TRANSFORMATION

TRADE AND ECONOMIC TRANSFORMATION SESSION AT TRADE AND DEVELOPMENT SYMPOSIUM 2015

Event Report

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INTRODUCTION

On 14th-17th December 2015, the International Centre for Trade and Sustainable Development (ICTSD) hosted the Trade and Development Symposium (TDS) alongside the Tenth World Trade Organization Ministerial Conference in Nairobi. The Supporting Economic Transformation programme (SET) held a panel session at the TDS on the 17th December to discuss trade and economic transformation. The TDS was attended by global thought leaders, key private sector actors, active civil society groups, as well as high-level governmental and intergovernmental organisation representatives.

Dr Dirk Willem te Velde (Head of the International Economic Development Group, ODI and Director of the SET programme) chaired the event. He provided introductory comments to open the discussion:

It is well known that in recent years there has been growth in developing countries, but little diversification which is essential for high quality growth. In November 2014 the SET programme was launched as a response to this. Two issues have come out from the programme so far: (i) ideas matter in the debate on trade and economic transformation, e.g. countries can only transform by focusing on competitiveness and using trade; and (ii) implementation matters – countries that have developed have used a range of co-ordinated policies but developing countries may need to start small. The panel at this session will discuss the importance of trade and economic transformation.

UKaid from the British people

Key Points from Session

- Trade is the single most powerful mechanism to reduce poverty and promote development.
- Trade supports economic transformation and high quality growth. Economic transformation implies both moving resources between sectors (for example, from agriculture to manufacturing) known as structural change and also improving productivity within sectors (for example, from subsistence agriculture to high-value crops). Thus economic transformation includes, but is more than, industrialisation.
- Ideas matter in the debate on trade and economic transformation. Countries have not been able to transform economically without focusing on trade and competitiveness and there is no role for concepts such as infant industry protection.
- There has been a negative perception on the role of services in economic transformation, but recent data suggest that services are a major contributor to employment. Exports of services have grown faster than exports of goods, and services from developing countries are increasingly becoming intermediates. In many countries value addition from services in goods exports is greater than exports of services.
- There is a robust relationship between services productivity and performance of manufacturing and merchandise trade.

CHRIS BARTON – DIRECTOR OF INTERNATIONAL AFFAIRS, TRADE POLICY & EXPORT CONTROL (ITEC), UK'S DEPARTMENT FOR BUSINESS, INNOVATION AND SKILLS (BIS)

Chris Barton is a director in the UK's Department for Business, Innovation and Skills which also works with the Department for International Development (DFID – the funders of the SET programme) and the Foreign & Commonwealth Office (FCO).

He made four propositions to open the discussion:

1) Trade is the single most powerful mechanism to reduce poverty and promote development. Examples of this include South Korea, which opened up for trade and embraced reform, grew enormously and is now a G20 member, as opposed to North Korea which closed its borders and is now one of the poorest countries. Often in trade and development debates those who speak out for the poorest in society tend to be suspicious of trade as something 'being done' by rich counties against poor countries – this is profoundly wrong.
2) Trade can be the ultimate win-win in any deal. This is important in the context of current WTO discussions. When richer countries opened up their markets for trade – the most benefit was to the developed countries themselves through greater competition, choice etc. Opening up markets for developing countries can also help them. It is one of the most misunderstood parts of economic theory (comparative advantage).
3) The Doha development agenda is a powerful pro-development deal. Many criticise the deal and agenda and Chris disagrees with those who think it has failed. If we have agreement on the things we are looking for it would benefit developing countries in two ways – the development aspects (reducing barriers for exports) and agricultural aspects (reducing unfair international competition for domestic markets in developing countries). In addition, when the Bali trade facilitation agreement is implemented, it has the potential to be really transformational.
4) We need to do more for trade liberalisation but Chris also believes the removal of barriers to trade are necessary (but not sufficient) for development. The UK government believes in aid for trade

both on the negotiation side and practical assistance for trade facilitation. To see real economic growth we need a stable regulatory environment, domestic trade, investment, education etc. Trade should be celebrated but we must remember it is part of a broader package.

MAXIMILIANO MENDEZ-PARRA - RESEARCH FELLOW, ODI/SET

Max Mendez-Parra has been working on the SET programme at ODI and presented some of the research so far on trade in services and economic transformation (ET).

He began by defining economic transformation: the movement of factors of production (labour, capital and land) from lower to higher productivity activities. This implies both moving resources between sectors (for example, from agriculture to manufacturing) known as structural change and also improving productivity within sectors (for example, from subsistence agriculture to high-value crops). Analysing ET involves understanding the determinants of growth and productivity at the micro, sectoral and macro levels. It also includes understanding how resources move to higher-value uses and the role played by diversification in production and trade.

STRUCTURAL CHANGE AND WITHIN SECTOR PRODUCTIVITY

In poor countries the agricultural sector has lower productivity than in rich countries and makes up a large share of the labour force. Labour productivity in manufacturing and services also tends to be lower than in rich countries although the gap is smaller. Evidence suggests that structural change plays a key role in the productivity catch-up with developed countries. In addition, there is a high degree of heterogeneity in firm productivity within sectors and these gaps tend to be bigger in poor countries.

Therefore, within-sector productivity growth implies the reallocation of resources from low to high productivity productive units within a sector. This in turn implies the exit of low productivity units, the movement of resources to those most productive and the entry of new more productive firms. Within sector productivity growth is also achieved by increasing efficiency through upgrading the existing firms.

ECONOMIC TRANSFORMATION AND TRADE

In developing countries, domestic markets are often not large enough to provide the required size and diversification of demand. They also do not provide enough competition for the provision of efficient and cost effective inputs necessary to increase productivity. Therefore, it can be said that ET and trade are intimately linked:

- Trade provides opportunities for diversification in production
- Trade supports the discovery and development of new productive capabilities
- Trade also helps to create higher domestic value added in trade.

At the same time, there is a simultaneity in the relationship. If ET has been successful we should observe a more diversified production and export structure as well as higher domestic value added in output and trade. Finally it is important to note that global competitiveness, even in large economies, is key in achieving ET. Market size matters but market discipline and other competitive effects are also important.

SERVICES AND ECONOMIC TRANSFORMATION

Services share in employment and output is growing in all countries; in South East Asia we see the reversion of the previous industrialisation process and in Africa, there is a movement of resources from agriculture into services.

We can distinguish two types of services:

- **Modern services** which can be traded with important productivity growth. These services mostly employ skilled workers and therefore often it is easier for middle-income countries to step into them.
- **Traditional services** are normally non-tradable and have marginal productivity growth. These services usually employ unskilled workers and are often seen in Africa.

There is often a pessimistic view of the role of services; the movement of resources from agriculture to traditional services keep resources in low productivity activities and services tend to be mostly non-tradable.

However, recent evidence indicates that there is an important contribution from services to productivity growth. Exports of services from many Least Developed Countries (LDCs) have grown faster than trade in goods in the last 20 years and services value added is increasingly embedded in other products/exports.

Nevertheless, services are highly protected (more than agriculture) around the world, especially in LDCs. For example, financial regulations are blocking the expansion of mobile financial services in the East African Community (EAC). Services provided under Mode 4 (the movement of natural persons) remain the most restricted (only 0.5% of US imports of services are Mode 4).

SELECTED FINDINGS FROM RESEARCH TO DATE

Figure 1 shows that in many LDCs, services are a major contributor to the growth of labour productivity and therefore explain much of the productivity growth in developing countries

Figure 1: Annualised labour productivity growth 1991-2013

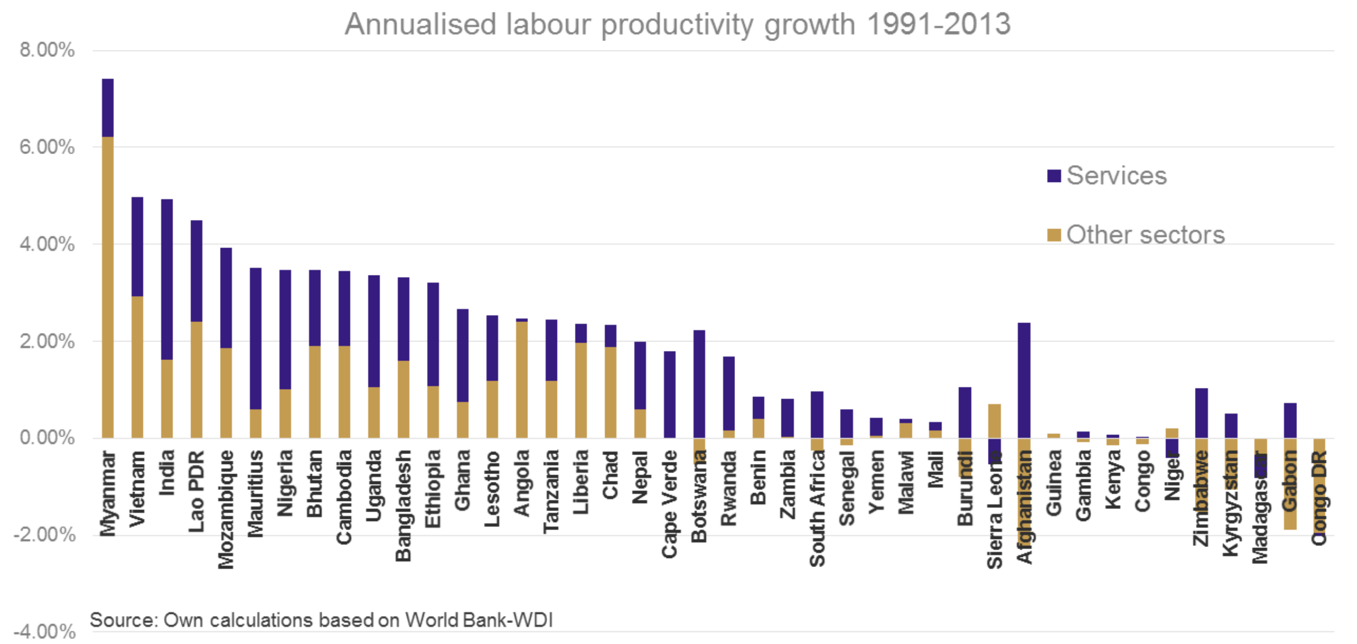
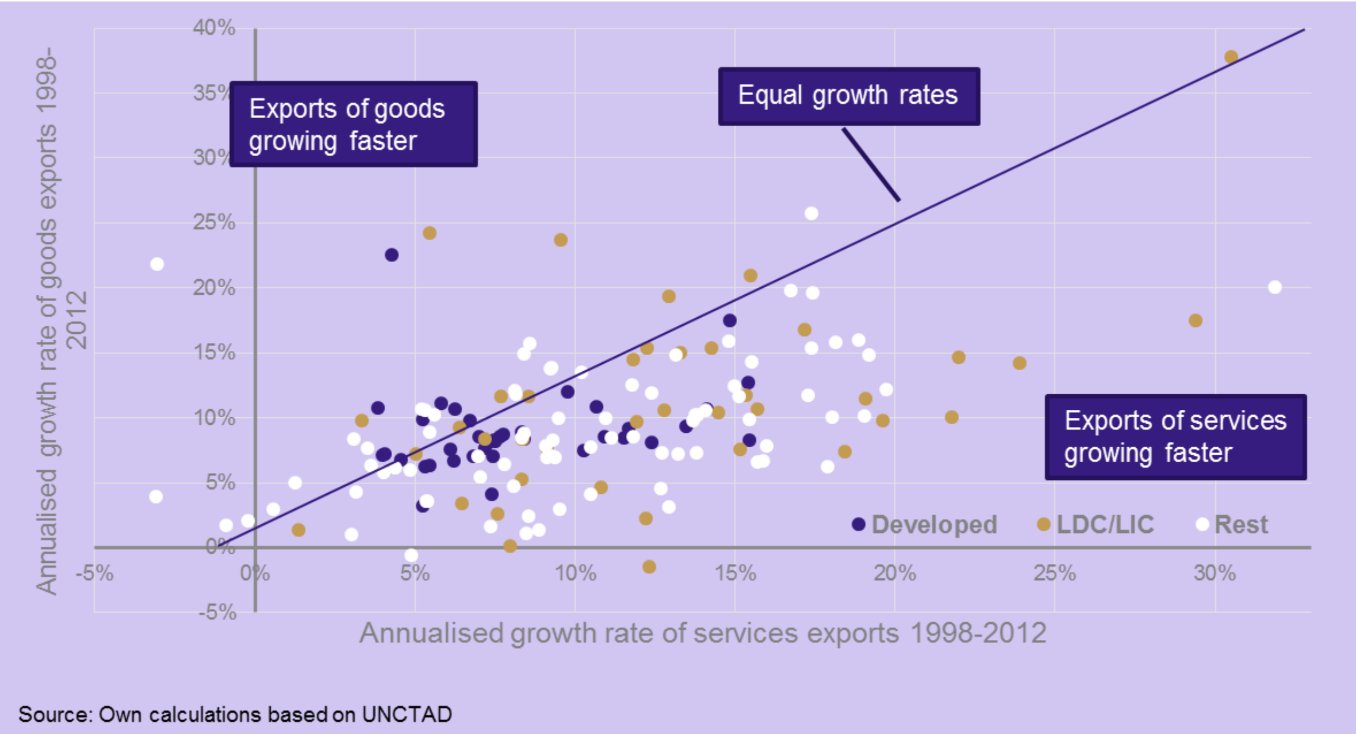


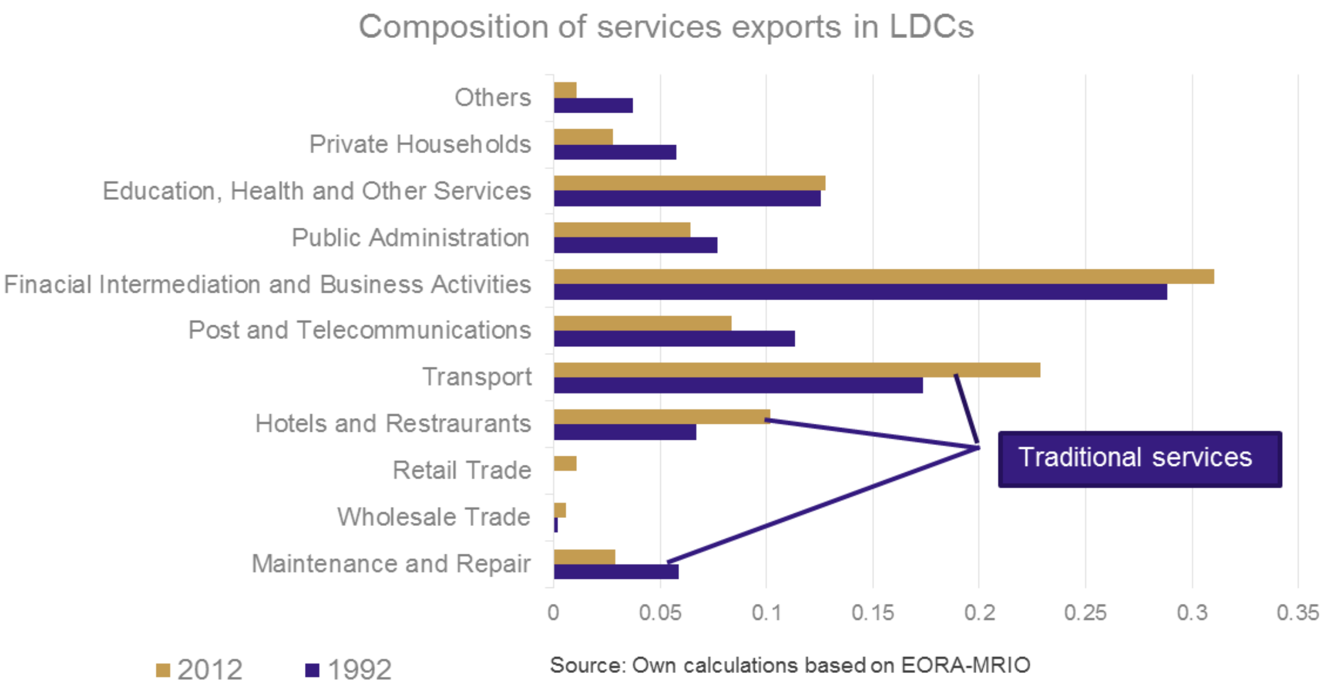
Figure 2 shows that in several LDCs, exports of services have grown faster than trade in goods. For LDCs we can see the growth of services is very fast (below the 45 degree line).

Figure 2: Exports of goods and services



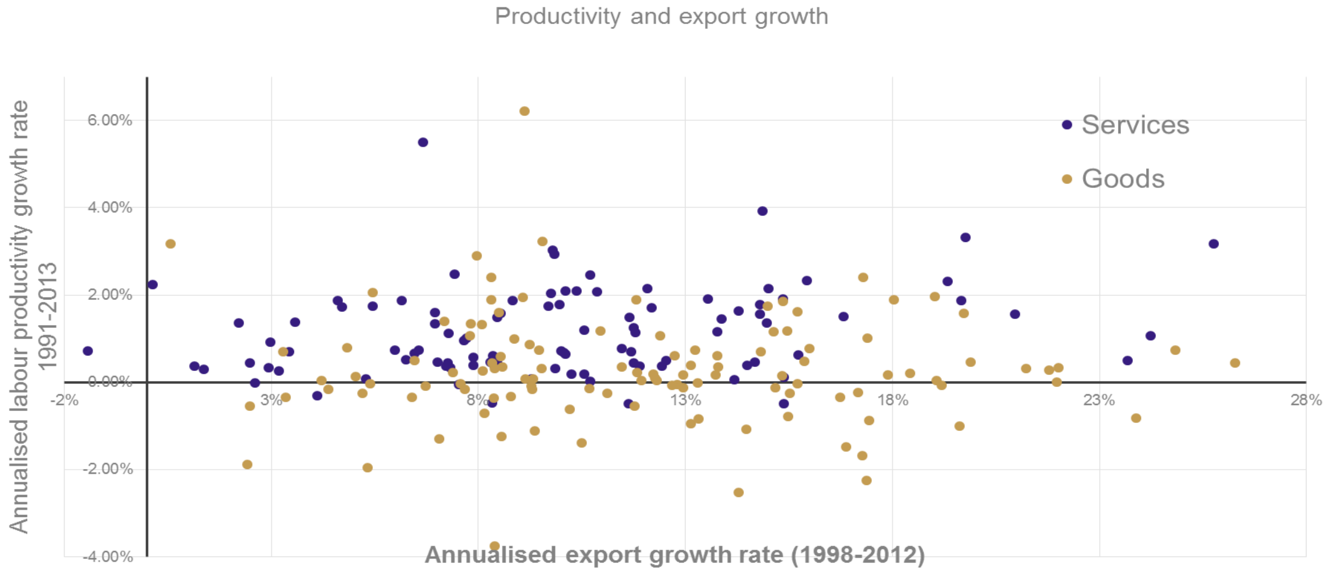
On the structure of services exports (Figure 3), the importance of exports of traditional services in LDCs shows some traditional services plus transport have not only grown, but are important in the export of services (tradable). This can motivate economic transformation.

Figure 3: Composition of services exports in LDCs



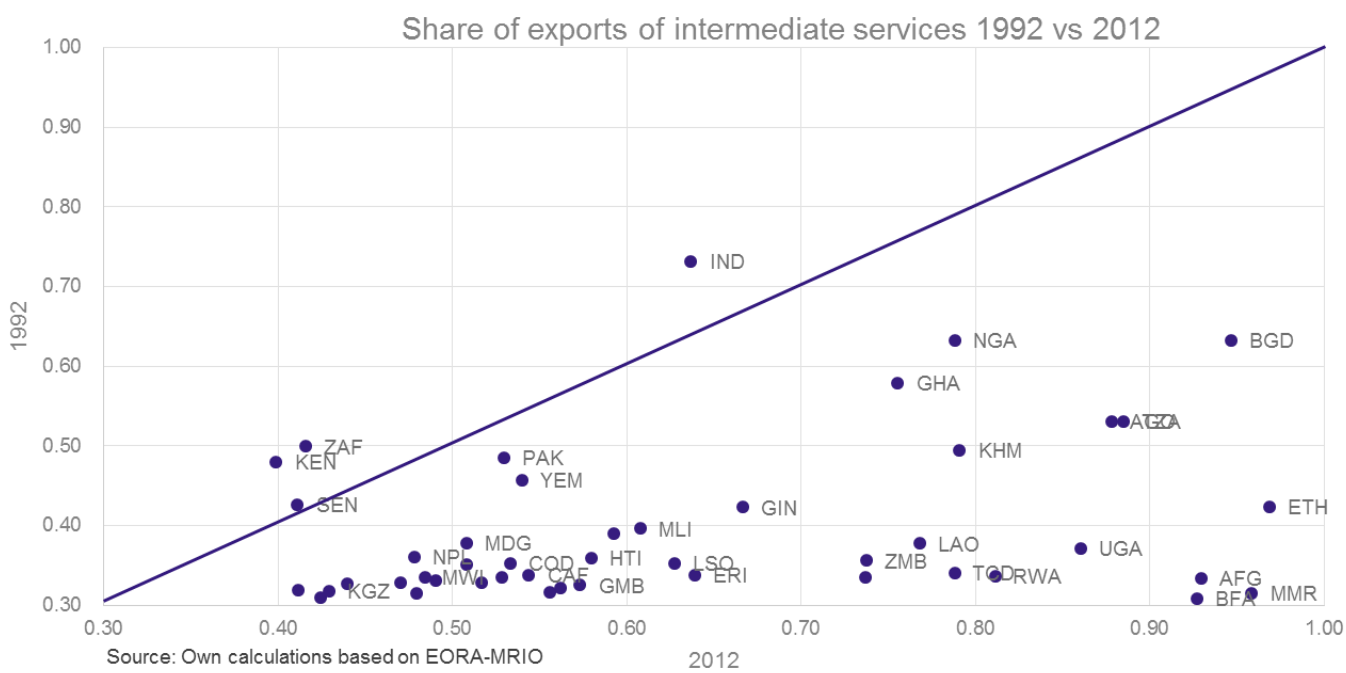
Labour productivity growth and services export growth are mostly positively associated in mostly all countries (Figure 4). The link/causality needs to be defined, but the association is visible.

Figure 4: Productivity and export growth



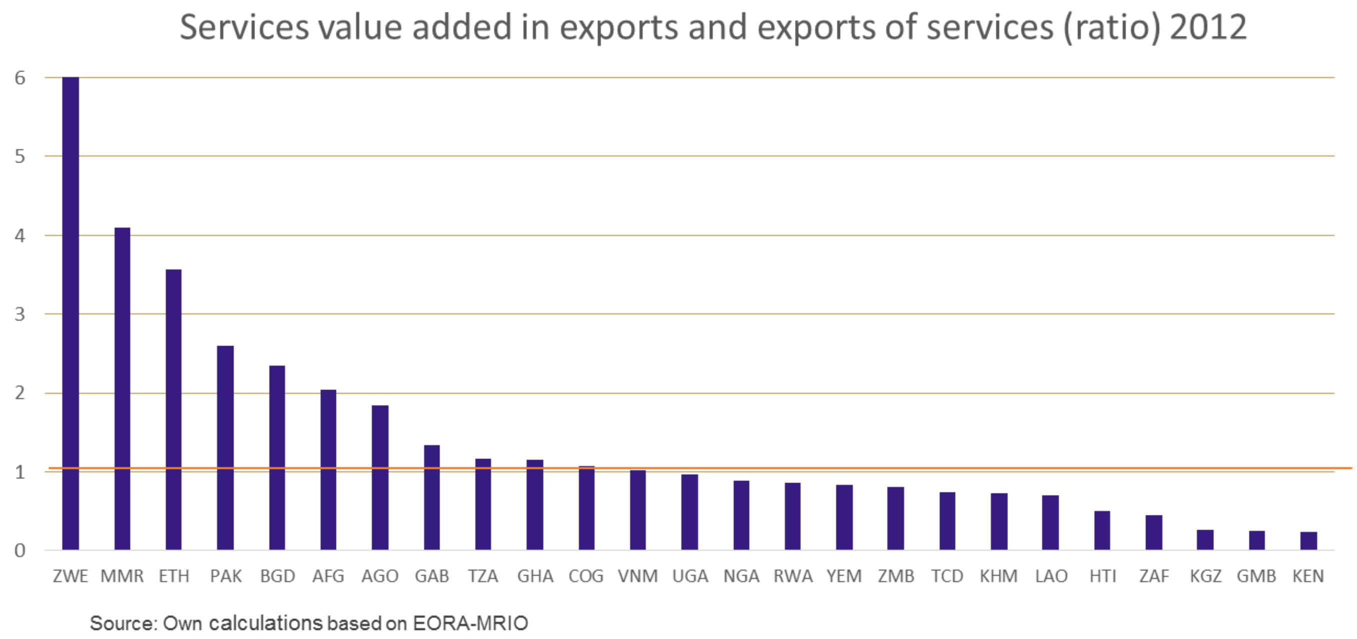
Services exported from developing countries are becoming intermediate services. We have identified where the services are being used – households or other firms in other countries. In Figure 5 we can see almost all countries have increased their exports of intermediate services. The cause is still to be defined – it may be because countries are being more productive in the production of these services or it could be because services in general have become a more intermediate good.

Figure 5: Share of exports of intermediate services



Finally, Figure 6 below shows that value added from services are greater than exports of services in some developing countries. We should also consider how the export of services are being used by goods, and other services in their exports.

Figure 6: Services value added in exports and exports of services (ratio) 2012



FINAL COMMENTS

- Productivity growth is essential in ET – countries can jump towards higher productivity sectors or increase productivity within sectors.
- Manufacturing is generally regarded as the most transformative sector; however, not all manufactures provide the best opportunities for LDCs.
- Although traditional services generally provide weaker links to ET, evidence indicates that they are traded in developing countries and they might have important productivity effects.
- The potential for ET and trade in services is stronger when seen under the light of trade in value added.
- Services are highly protected. This limits the possibilities to Mode 2 (consumption abroad) provision and through value added in exports. More and deeper preferences may be needed for LDCs – the current waiver is not suited for LDCs capabilities. There is also scope for more services chapters in regional trade agreements, particularly those involving LDCs.
- More open services sectors in LDCs can contribute to both productivity in the services sector and in the other sectors too.

BERNARD HOEKMAN - DIRECTOR OF GLOBAL ECONOMICS, ROBERT SCHUMAN CENTRE FOR ADVANCED STUDIES

Professor Hoekman began by stating that many people associate economic transformation as increasing manufacturing and industrialisation. He argues that this is a misconception – you must think in terms of productivity and employment (even if it is relatively low productivity).

Manufacturing is just one aspect – trade in services can be direct or indirect. The SET programme is looking at direct exports of services, but indirect services are equally important from a productivity aspect as most firms rely heavily on services to produce their goods or services. We know higher productivity firms tend to export more and there is a relationship between the productivity of the service sector and the countries' ability to export.

Work done by Professor Hoekman with the International Growth Centre shows a robust relationship between services productivity and performance of manufacturing and merchandise trade. The evidence is statistically robust but there are data issues with measuring services in firm level surveys/data. It also shows a strong relationship between lower barriers to trade and higher productivity – more barriers hamper export performance. Relationships between high barriers to services and the consequence on productivity is conditional with the business environment and simply lowering trade barriers is not sufficient – you also need a good investment climate. For example, Rwanda has good economic governance but high barriers – so you would expect to see good results if they reduce barriers.

More generally, many countries in this region (Africa) have high barriers to trade in services. If you can identify which sectors matter the most, you could potentially have a big impact. The big challenge, and information that is needed, is identifying which policies matter most - *where* do we need policy and *what* policy is needed?

ARANCHA GONZALEZ - EXECUTIVE DIRECTOR, INTERNATIONAL TRADE CENTRE (ITC)

Arancha Gonzalez offered the perspectives from the ITC. She began by stating: "We need to ban two words – industrialisation and exports. The former is ET and the latter is trade. More accurately it would be internationalisation – putting together trade and investment."

ET is about increasing productivity of factors of production and when thinking of trade we need to think about – how to make it *possible* and how to make it *happen*.

In making it possible, we need to look at small and medium enterprises (SMEs) which are less productive and pay lower wages. A big task is to narrow the productivity gap for SMEs – through this SMEs can contribute more to growth economy, higher wages and more inclusive growth. The ITC has found a relationship between internationalisation of SMEs and productivity (and higher wages). To make trade possible we need robust public private dialogue.

In order to make trade happen – we need to understand how we can support SMEs:

1) Trade and market intelligence for SMEs with regards to internationalisation.
2) 'Nuts and bolts' of competitiveness – improving quality of product or service, labelling, marketing etc. to make an internationally demanded product.
3) Trade and investment institutions need to support SMEs.
4) Access to credit – essential in moving from informal to informal sector.
5) Connecting SMEs to markets. E-commerce particularly suffers from hardware limitation and regulatory frameworks which limits SMEs from a vehicle to internationalise.

ITC supports call to work on better regulated services – whether agriculture or services or manufacturing.

FRANK MATSAERT - CHIEF EXECUTIVE OFFICER, TRADEMARK EAST AFRICA

Frank Matsaert added that there is a need to think regionally and integrate markets *within* the region. Market size is important but you need to be able to move goods across borders and there are many hurdles. There is a large range of services and transport and logistics are the nuts and bolts of trade. He also stated that services are an enabler of transformation and must be liberalised.

Finally, services cover a broad range of areas and play an important role in trade facilitation. The importance of services is critical, and as Arancha Gonzalez suggested, so is the trade and market intelligence to move services across borders.

DISCUSSION

Jodie Keane from Commonwealth Secretariat: Qualitative research looks at value chain governance structures and some upgrading routes are no longer available. Why have you not looked at manufacturing? On the high amount of firm level heterogeneity – you mentioned it is higher for developing countries – but what is this compared to? The literature suggests most productive firms are foreign owned and integrating. Important to consider this project within a global value chain context.

Chris Roggie from University of Northern Iowa: We know SMEs are not necessarily entrepreneurial but rather are survival entrepreneurs. Will they really be excited by aspects of trade?

William Davies from UNECA: We all recognise role of trade, but our report looks at infant industry protection. If we follow neo-classical economics this would not be necessary, however we don't expect that to happen in Africa – due to barriers to foreign investment, lack of knowledge etc. We know Import Substitution Industrialisation project failed to deliver – what do we do differently so that infant industry protection is no longer necessary? Our other work we have done suggests:

1) Dynamic industrial policy with private sector
2) Highly selective trade policy linked to industrial policy
3) Support measures for strategic sectors – need to be contingent on increasing productivity.

Nick Charalambides from Imani Development: We did work on Rwanda which showed the link of trade in goods and services. In growth of telecoms – tariffs were punishing new entrants and are currently dealt with by exemption.

Richard Newfarmer from IGC: When economies are exposed to trade in manufacturing, you see a narrowing of dispersion around average productivity. Average productivity goes up because of competition. Also a point on the 'Rodrik puzzle' - why in the aggregate level do we see movement of labour from high productivity manufacturing sectors to low productivity services? It may be that low productivity workers in manufacturing are moving to high productivity services firms.

RESPONSES

Maximiliano Mendez-Parra: We have not downplayed manufacturing but want to understand alternatives to manufacturing. We found that in LDCs productivity within firms in sectors tend to be bigger and is associated within sector productivity change. We have found exceptions. Heterogeneity is also between sectors, across locations within country, across sectors etc.

Arancha Gonzalez: On the point of survival entrepreneurs (in informal sectors) vs professional entrepreneurs. My view is that a large number of survival entrepreneurs make up the informal sector – this is large due to low skills, red tape and taxation systems. Risk taking is a part of entrepreneurship – my view is that it is not the instincts of the entrepreneur that matters but the appetite to move from informal to formal, from small to medium etc. On the comment on infant industry protection – are you looking at per country or per region? Is it going to be conducive to emergence of value chains? We should not have trade drive business environment – rather we should be working on infrastructure, rule of law, and make sure trade policy is conducive.

Bernard Hoekman: Good question on governance - competition issues are important. We have not focussed on this at all. On survival question, there is lots of literature on this. Putting in infant industry protection will kill this idea. Rather we need to ask what is the market failure and how can we address it? Yes we need government support for particular activities but need to be clear what it is.

Frank Matsaert: Competition policy plays an important role, especially in transport. Many sectors here are dominated by informal sectors. We also have problem with dual labour markets – this creates expensive informal sectors. We need to drive competitiveness – and you cannot do this under infant industry protection – so the question is how do you phase protection out?

PHOTOS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