SET SUPPORTING ECONOMIC TRANSFORMATION

Realising the potential of trade in economic transformation

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Promoting quality growth and economic transformation is crucial to sustained progress and job creation. Trade plays a special role in this process but unfortunately this is not always acknowledged in policy design or realised in practice. New ideas in trade related to identifying niches in value chains, nudging firms towards exporting or facilitating services trade fail to make it onto the radar screen of policymakers, who may instead choose to stick with unrealistic targets for old-style full-blown industrialisation. It requires hard work to embed new thinking on trade in the mind set of policy makers.

Although many African countries have enjoyed fast economic growth over the past two decades, the **growth has been low in quality** and accompanied by little economic transformation. Witness, for example, the lack of significant structural shifts in production and employment (declining shares of manufacturing in gross domestic product (GDP) in Africa); weak levels of and growth in (labour) productivity within sectors; concentrated export baskets and lack of diversification into complex products; and substantial differences in productivity levels among firms, sectors and locations, suggesting scope for the enhancement of productivity. A change towards higher-quality growth is sorely needed now commodity prices have plummeted.[2]

Trade plays a special role in promoting economic transformation. One lesson that emerges clearly from the experiences of **countries that have achieved economic transformation is the importance of emphasising global competitiveness,** even in a large economy with a growing domestic market.[3] A number of successful economic developers, many in East Asia, have benchmarked their performance to global standards, whether by exporting or by opening their national economies to external competition so as to drive out unproductive firms in favour of productive ones. In Korea, allocating credit selectively to productive firms has played a key role alongside the use of performance criteria to provide time-bound incentives.

International competitiveness (through openness, skills and infrastructure development) has to be the yardstick of success if the productivity gains of trade and economic transformation are to be realised. It is tempting to regard the domestic market as a sufficient basis for transformation but in practice this has weakened the industrial performance of economies like Argentina and Brazil. In those countries, domestic firms protected by high tariff barriers have had little incentive to upgrade, leading to a failure of industrial transformation. Trade helps countries move towards higher-productivity sectors, raise within-sector productivity through entry and exit and facilitate upgrading in value chains.[4] A range of **carefully targeted but realistic and politically feasible policies around stimulating exports and attracting foreign direct investment** (FDI) can complement the

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[1] Note to guide the SET workshop on trade and economic transformation on 17 December in Nairobi http://set.odi.org/17-december-2015-trade-session-at-trade-and-development-symposium-wto-mc10/

[2] McMillan, M., Page, J. and te Velde, D.W. (2015) 'Supporting Economic Transformation'. Draft. London: SET Programme, ODI http://set.odi.org/17-december-2015-trade-session-at-trade-and-development-symposium-wto-mc10/

[3] Leipziger, D. (2015) 'Economic Transformation Lessons from Large Developing Countries'. London: SET Programme, ODI. http://set.odi.org/economic-transformation-lessons-from-large-developing-countries/

[4] Jouanjean, M.A., Mendez-Parra, M. and te Velde, D.W. (2015) 'Linking Trade Policy and Economic Transformation'. London: Set Programme, ODI. http://set.odi.org/trade-policy-and-economic-transformation/

emphasis on competitiveness. These policies need to be well thought-out within country-specific institutional frameworks. For example, special economic zones (SEZs) that fit within a wider industrial strategy, target appropriate geographical and sectoral areas and are run competently have greater success in terms of achieving transformation. Achieving this is a tall order. Whereas Asian countries have long used SEZs successfully, African countries have a much weaker record (e.g. around preference-dependent garments), although Chinese firms have recently set up manufacturing in African SEZs[5] .

Such demonstration projects that combine public and private sector actions can show export-oriented industrial policy is possible. They provide an answer to the observation that manufacturing share in GDP in Sub-Saharan Africa has fallen in recent decades to 11%. There are other promising signs. Data from the World Development Indicators show that, over 1997-2012, although manufacturing production increased on average by 2.3% annually across the world, it increased by 3.4% annually in Sub-Saharan Africa, with examples such as Tanzania growing 7.9% annually. Overall, the share of Sub-Saharan Africa in world manufacturing *increased* from 0.9% in 2000 to 1.1% in 2012.

At the same time, services have long been ignored in debates on economic transformation. Services used to be seen as following economic transformation, with demand increasing as incomes rise and the sector being endogenous to a country's structural position. However, **a more comprehensive and balanced view is warranted, one that includes a supply-side view, whereby services can lead economic transformation through direct, indirect, induced and second-order/productivity effects, depending on the specific subsector.** IT-enabled services can be modest escalators for economic transformation; efficient financial, energy and logistics services raise the productivity of goods and diversify exports;[6] and tourism is already a major export earner and job creator in countries such as Tanzania.

Whereas agriculture tends to contribute a significant part of labour productivity change at low-income levels, the manufacturing sector begins to contributes more at slightly higher levels of income, but **services contributed more than half of productivity change over 1991-2013 in developing countries**.[7] Countries gain significant increases in labour productivity through changes *between* sectors (structural change towards higher-productivity sectors), although recently there has also been premature deindustrialisation and movements towards low-productivity services (e.g. retail). We find that, over time, the *within*-service sector change in productivity has the greatest contribution to overall productivity change. In general, countries with a high contribution of manufacturing (within and between) to productivity change also have a high contribution of services (within and between) to productivity changes, which points to the need for a balanced trade and growth strategy.

These considerations have significant **implications for trade policy design and practice.** Countries need to embrace competitiveness and begin implementing this throughout government policy. This means encouraging firms to export, promoting zones and developing joint manufacturing and service clusters. It also means avoiding past mistakes, whereby ambitious targets for old-style industrialisation were not implemented, in favour of a more pragmatic approach by putting in place demonstration projects that show new trade ideas can work. It further entails adopting a more aggressive approach in negotiating better conditions for trade in goods and services at home and abroad.

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[5] Xiaoyang, T. (2015) 'How Do Chinese "Special Economic Zones" Support Economic Transformation in Africa?' London: SET Programme, ODI. http://set.odi.org/chinese-special-economic-zones-in-africa/

[6] Khanna, A., Tyson, J. and te Velde, D.W. (2015) 'The Role of Services in Economic Transformation – With an Application to Kenya'. Draft. London: SET Programme, ODI. http://set.odi.org/kenya-as-a-services-hub-the-role-of-services-in-economic-transformation-2/

[7] Ongoing SET work on trade in services.