

## ECONOMIC AND PRIVATE SECTOR

### PROFESSIONAL EVIDENCE AND APPLIED KNOWLEDGE SERVICES

TOPIC GUIDE

# Trade

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## Abbreviations

|           |  |
|-----------|--|
| ACP       | Africa, Caribbean and Pacific  |
| AfT       | Aid for Trade  |
| APEC      | Asia Pacific Economic Community  |
| ASEAN     | Association of South East Asian Nations  |
| CARICOM   | Caribbean Community  |
| CARIFORUM | Caribbean Forum  |
| CET       | Common External Tariff   |
| COMESA    | Common Market for Eastern and Southern Africa  |
| CPA       | Cotonou Partnership Agreement  |
| CSME      | CARICOM Single Market and Economy  |
| CU        | Customs Union  |
| EAC       | East African Community   |
| EBA       | Everything But Arms  |
| EPA       | Economic Partnership Agreement   |
| ECOWAS    | Economic Community of West African States  |
| EU        | European Union   |
| FTA       | Free Trade Agreement   |
| GATT      | General Agreement on Tariffs and Trade   |
| GDP       | Gross Domestic Product   |
| GSP       | Generalised System of Preferences  |
| GSP+      | (The EU's) Special Incentive Arrangement for Sustainable Development and Good Governance |
| GVC       | Global Value Chain   |
| IEPA      | Interim Economic Partnership Agreement   |
| LAC       | Latin America and the Caribbean  |
| LBE       | Learning by Exporting  |
| LDC       | Least Developed Country  |
| LIC       | Low-Income-Country   |
| LMIC      | Lower-Middle-Income-Country  |
| MENA      | Middle East and North Africa   |
| MFN       | Most Favoured Nation   |
| MNE       | Multi-National Enterprise  |
| NIC       | Newly Industrialised Country   |
| NTB       | Non-Tariff Barrier   |
| NTM       | Non-Tariff Measure   |
| OECD      | Organisation for Economic Cooperation and Development                                    |
| OECS      | Organisation of Eastern Caribbean States   |
| PPF       | Production Possibility Frontier  |
| PTA       | Preferential Trade Arrangement   |
| RCA       | Revealed Comparative Advantage   |
| REC       | Regional Economic Community  |
| RoO       | Rules of Origin  |
| R&D       | Research and Development   |
| RTA       | Regional Trade Agreement   |
| SAARC     | South Asian Association for Regional Cooperation   |
| SADC      | Southern African Development Community   |
| SAFTA     | South Asian Free Trade Agreement   |

|        |  |
|--------|--|
| SAPTA  | South Asian Preferential Trading Arrangement         |
| SAS    | South Asia   |
| SSA    | Sub-Saharan Africa                                   |
| TFP    | Total Factor Productivity                            |
| TNC    | Transnational Corporation                            |
| TTIP   | EU–US Transatlantic Trade and Investment Partnership |
| UMIC   | Upper-Middle-Income-Country                          |
| UN     | United Nations                                       |
| UNCTAD | United Nations Conference on Trade and Development   |
| US     | United States of America                             |
| WTO    | World Trade Organization                             |

# 1 Introduction

This Trade Topic Guide provides an overview of the key theoretical and practical issues relating to the role of trade in growth and development strategies. It is intended to assist economists working at the country level and on economic development programmes to become familiar with key concepts used in trade theory and trade policy circles. It also draws attention to some of the linkages between trade, growth and the achievement of structural transformation: the process which drives and sustains growth and poverty reduction strategies over time. It is important to note that this Guide is not intended to be exhaustive.

The Guide is organised as follows. Section 2 introduces some of the key concepts referred to in trade theory. We review two types of trade theory: neoclassical trade theory, based on perfect competition where gains from trade result from differences in terms of technology or factor endowments; and new trade theory and new economic geography where trade is based on economies of scale, agglomeration, and imperfect competition. In addition to potential welfare gains from trade, it is also recognised that there can be winners and losers from trade policy reform.

Section 3 discusses trends and patterns in global trade flows over recent years. This includes the increasing role of developing countries in global trade, increases in intermediate goods trade and services rather than finished final products. Over time global trade has become far more coordinated as countries have become more integrated within global value chains (GVCs) and production networks. This has in turn spurred the interest of policy makers in better understanding both the scope and extent of participation in this type of trade, and firms' relative position within GVCs. This heightened awareness has subsequently drawn policy makers' attention to the instruments available to assist firms in entering and securing their position at various stages of participation within GVCs, as well as participating more effectively.

Section 4 provides an overview of the outcomes from the most recent round of multilateral trade negotiations. We then discuss the next wave of mega-regional trade agreements (RTAs), plurilaterals, as well as other free trade agreements (FTAs) that are likely to shape the global trade policy landscape in the future. This is followed by a discussion of some of the risks and benefits associated with these agreements, including with regard to achieving deeper economic integration. This is with a view to informing decisions about trade policy, ensuring that the next wave of trade agreements serve as building rather than stumbling blocks for developing countries.

Section 5 introduces some of the key debates about the link between trade and development by reviewing empirical evidence. It highlights the complexity of the debate. Finally, in Section 5 we introduce the Aid for Trade (AFT) initiative and describe how it has evolved in recent years. We discuss evidence of its effectiveness and some of the key factors which influence this, according to experiences and assessments to date. We conclude with reference to the future directions of the AFT agenda.

## 2 Trade theory and trade policy

### Key messages

- Trade theory has evolved rapidly in recent years to acknowledge and explain intra-industry trade and trade between similar countries, and now focuses on the firm.
- Gains from trade can arise from allocative efficiency and scale effects, which are in turn affected by government policy.
- Regional integration has different trade effects from multilateral liberalisation, but can still be a stepping stone towards multilateralism.

The size of the welfare gains from trade and the mechanisms through which these occur are central to policy debates about trade policy reform and liberalisation. An understanding of the mechanisms behind the 'classic' and other trade theories is essential to the understanding not only of the current debate but also of the history of trade policies and negotiations. Generally we can differentiate between two waves of trade theory:

- neoclassical trade theory, which assumes perfect competition and according to which countries differ in terms of technology or production factor endowments;
- new trade theory and new economic geography, which takes into consideration economies of scale, agglomeration effects, and imperfect and monopolistic competition.

According to these theories, there are welfare gains to trade in aggregate. However there will also be winners and losers from any change in trade policy, requiring compensation mechanisms (embodied in the AFT concept of trade-related adjustment). The following two sub-sections outline, for each the two main schools of thought regarding trade theory in turn, why countries benefit from open trade.

### 2.1 Neoclassical trade theory

The static neoclassical theory of trade is based mainly on two models:

- the Ricardian model of trade (David Ricardo): countries have different technologies;
- the Heckscher-Ohlin-Samuelson model: countries have different factor endowments (labour, capital, human capital).

These theories are underpinned by the theory of comparative advantage, which is explained in Box 1. Gains from trade arise as soon as the relative price in the free trade scenario is different from the domestic relative price in autarky. Large differences between free trade and autarky relative prices imply larger gains from trade. Hence, traditional neoclassical trade theories predict that smaller countries gain more from the free trade because of relative price differences. In these models trade is inter-industry; in other words, exported goods are different from imported goods. This assumption is relaxed in new trade theory, which helps to explain intra-industry trade. The following sub-sections briefly introduce these two main neoclassical trade theories.

#### The Ricardian model of trade

In the Ricardian model, trade occurs because of differences in trading partners' production technologies. Production costs, and therefore prices, differ between countries.



As compared to Smith's absolute advantages (see Box 1), countries with an absolute disadvantage in the production of all goods will gain in free trade. Specialisation and trade will result from international differences in opportunity costs for the production of two different goods. This model has had an important impact on economic policy over the past two centuries and shaped the liberalisation agenda from 1947 until the Uruguay Round and the creation of the World Trade Organization (WTO) in 1994. Important to note is that the theory was developed at the end of the 18th/beginning of the 19th century, when the industrial revolution had widened the economic development gap between the most technologically advanced countries (such as England) and the rest of the world, explaining why Ricardo's reasoning focuses on differences in technology.

### Box 1: The theory of comparative advantage: from Smith to Ricardo

#### Absolute advantage (Adam Smith, 1723–90)

A country has an absolute advantage when it produces a good at a lower cost than its trade partner. In other words, a country has an absolute advantage in the production of a good if its productivity is higher than other countries' productivity for the same good.

- A Swiss watch costs £100, an Indian one costs £20.
- A T-shirt produced in Switzerland costs £10, one produced in India costs £1.

India has an absolute advantage in the production of watches and T-shirts.

#### Comparative advantage (David Ricardo, 1772–1823)

A country produces a good at a lower cost at the expense of another good according to its resources allocation. In other words, a country has a comparative advantage in the production of a good if its productivity of this good relative to other goods is higher than in other countries. A comparative advantage also corresponds to a lower opportunity cost for the production of a good compared to another country.

- If Switzerland chooses to produce one watch, it chooses not to produce 10 T-shirts.
- If India chooses to produce one watch, it chooses not to produce 20 T-shirts.
- Switzerland has a comparative advantage in watch production.
- India has a comparative advantage in T-shirt production.

The opportunity cost for Switzerland of producing one watch is 10 T-shirts, whereas for India it is 20 T-shirts. Specialisation in the most efficient production can increase the availability of goods at the world level. If Switzerland stops producing T-shirts and specialises in the production of watches, and India stops producing watches and produces T-shirts, with the same resources the availability of both watches and T-shirts at the world level increases. As compared to Smith's theory, countries with an absolute disadvantage in the production of all goods will gain in free trade. The gains of free trade have two components:

- the gains of specialisation: scarce resources are used in the production of the good for which countries are the most efficient and as a result world production increases;
- gains from trade: the separation of production and consumption structures enables an increase in welfare as consumers can buy more goods.

Ricardo showed that while a country may be less efficient than its trading partners in the production of all goods, it may still gain from trade because of specialisation in goods according to relative rather than absolute advantages in production. The model presents an equilibrium resulting from the *producer problem* and the *consumer choice* and shows the change in welfare which results from moving from the autarky equilibrium to the free trade equilibrium. It requires consideration of the following:

- **the producer problem:** the production possibility frontier (PPF) is specific to the country's technology and shows the various combinations of quantities of two commodities that can be produced using a fixed amount of each's production factors;

- **consumer choice:** consumers are constrained by their budgets, and will try to maximise their utility accordingly (shown by the use of indifference curves);
- the combination of the PPF and the maximisation of consumer's utility according to budget constraints determines the equilibrium – when the domestic supply of goods is equal to domestic demand – under autarky.

In the autarky equilibrium with perfect competition, and free mobility of labour between sectors, relative prices are fully determined by relative productivity. Opening to trade leads to the equalisation of world relative prices. The gains from free trade come first from the gains from specialisation according to comparative advantage. Scarce resources are used for the production of the good for which countries are the most efficient, resulting in an increase in the availability of goods at the world level. Further gains from free trade result from the separation of production and consumption possibilities in each country which allows an increase in consumption possibilities for both countries, hence increasing welfare.

In the Ricardian model no country loses from opening up to trade (although the gains may not be equally shared between countries). Openness and specialisation redirect workers to the sector with higher relative productivity, resulting in an increase in production per worker and an increase in wealth (Gross Domestic Product (GDP)) *per capita* associated with specialisation. Therefore the Ricardian model predicts that greater trade openness should be associated with a more positive growth of GDP *per capita* in the long run.

### Heckscher-Ohlin-Samuelson model

The Ricardian model assumes comparative advantages, based on differences in technology. While this perspective may have been relevant during the industrial revolution – when growth was driven mainly by technological progress – how can we explain trade patterns in the late 19th and early 20th century? According to the Heckscher-Ohlin-Samuelson model of international trade, trade is motivated by differences in factor endowments (capital and labour) rather than differences in technology.

The Heckscher-Ohlin theory states that a country will export the commodity that uses relatively intensively the factor that country has in relative abundance, and will import the commodity that uses relatively intensively the factor that is relatively scarce in that country. If country A is relatively more endowed in capital than country B, this implies that the relative price of the capital-intensive good Y is lower in country A and that the relative price of the good that is more intensive in labour, X, is lower in country B. Therefore country A will export Y and import X and country B will export X and import Y. In free trade, a country exports the good using intensively the factor it has in relative abundance.

However it is important to note that there is no definite empirical validation of the Heckscher-Ohlin-Samuelson theorem. This is shown by the Leontief paradox (1953) – the analysis of which is underpinned by input:output analysis – which demonstrated that the United States' (US) exports should have been intensive in capital and its imports intensive in labour, but that in practice this is not the case. The country with the world's highest capital per worker was found to have a lower capital/labour ratio in exports than in imports. This result may be explained by the fact that the technology was not the same in the US and its trading partners. Others argue that factors such as demand may matter more than comparative advantage (the Linder hypothesis).

## Limitations of neoclassical trade theory

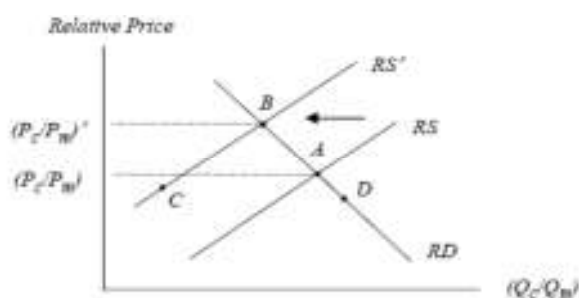
The neoclassical approaches that have been presented in the previous sub-sections explain the gains from trade liberalisation by comparative advantage owing to differences in technology (Ricardian model) or differences in resource endowments (Heckscher-Ohlin model). According to those trade theories, the gains from trade openness come from movement across the PPF. However, beside the specific modelling assumptions associated with each, there are three overall problems:

- no returns to scale – size does not matter either for specialisation or for the direction of trade;
- they assume perfect competition and that trade does not increase competition;
- they predict trade of two different perfectly homogeneous goods.

Various theories have looked more specifically at those issues. For example, Prebisch and Singer (1950) looked more closely at relative price movements and terms of trade because of their dissatisfaction with neoclassical trade theory in relation to trade *and development* (see Box 2). Their arguments helped to discredit the notion of free trade as necessarily leading to economic development. Moreover, their theorem helped substantiate the views of the Structuralists<sup>1</sup> that infant industry protection and import substitution might be a more effective trade policy for newly independent countries. New trade theories began to relax some of the main assumptions of the neoclassical models and introduced increasing returns to scale as a reason for trade, and explanations of intra-industry trade.

### Box 2: The Prebisch and Singer hypothesis

Prebisch-Singer analysed the relationship between international trade and the rise in *per capita* income gap between industrialised and developing countries. Their hypothesis refers to the idea that the relative price of primary commodities (exported by developing countries) compared to manufactures (exported by developed countries) shows a downward trend. The rationale is that international specialisation along the line of 'static' comparative advantage had prevented developing countries from benefiting from technical progress that enriched the industrialised world. The figure below, borrowed from Cuddington et al. (2002), describes a simple model of the world market for two goods, a primary commodity and a manufactured good, with the relative price of those two goods on the vertical axis and the relative quantity supplied on the horizontal axis. The world market equilibrium is set at the intersection of the relative demand (RD) and the relative supply (RS).



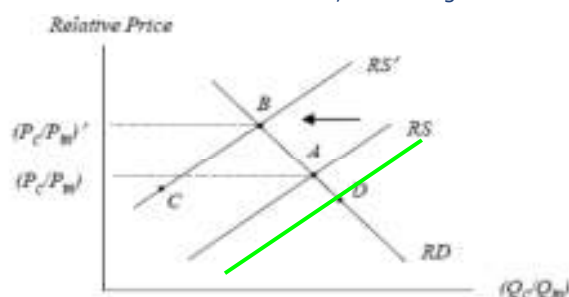
Source: Cuddington et al. (2002).

There are essentially two reasons why commodities might experience declining relative prices, other than differences in technology:

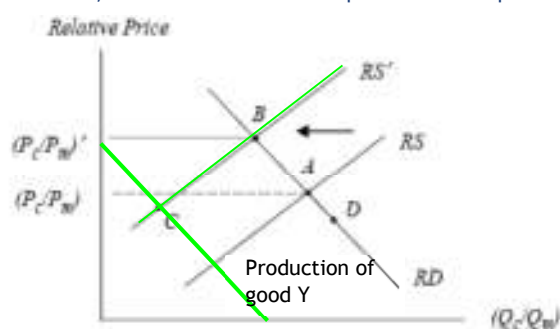
1. Prebisch offered a supply-side theory with the idea that something else may prevent the relative supply schedule RS from shifting to the left or even cause it to shift to the right. The latter would result in equilibrium at point D, with a lower relative commodity price. Such reasons can be

<sup>1</sup> Structuralist economists draw attention to specific market rigidities, as well as institutional and political factors that may influence economic outcomes adversely for developing countries, this includes for example, declining terms of trade for primary commodities compared to manufactured goods as described in Box 2.

rigidities in the North (unions, cartels etc.). As a result productivity increases in manufacturing translate into factor income, but for agriculture they mean falling prices.



2. Singer focused more on the demand side and suggested that something causes the relative demand schedule to shift to the left along with relative supply. If the shift in  $RD$  is greater than that of  $RS$ , the result would be equilibrium like point  $C$ , again with a lower relative commodity price.



Much like Prebisch, Singer argued that monopoly power in manufactures prevented the technical progress in that sector from lowering prices. But he also highlighted that this was also the result of a relatively low income-elasticity of demand for commodities (Engel's law). Finally, he argued that technical progress in manufacturing tended to be raw-material saving, with for instance the creation of synthetic substitutes for raw materials, thereby causing the demand for primary products to grow more slowly than that for manufactures, or even to decline.

## 2.2 New trade theory

The neoclassical Ricardo and Heckscher-Ohlin models essentially describe a world of inter-industry trade, whereas in practice we observe intra-industry trade. New trade theories, which began to be developed in the 1970s, apply industrial economics/imperfect competition models to international economics. Within these models the gains from trade depend on scale effects and pro-competitive effects, as well as rationalisation (inducing some firms to exit and others to enter the market) and variety effect (the production of goods within the same category). The two types of returns to scale can be defined as follows.

- **Internal returns to scale:** output increases more than proportionally with the quantity of inputs used, leading to imperfect competition.
- **External returns to scale or economies of agglomeration:** in such cases, economies of scale act at the level of the industry and not the firm. Therefore firms still have constant returns to scale but productivity depends upon a set of factors external to the firm. Firms still set their price at the apparent marginal cost, profits are null and firms still evolve in a perfect competition environment.

There are a number of new trade models which present gains from trade arising from these scale effects. The existence of returns to scale highlights new potential gains from trade. They can arise from a strategic choice of specialisation in an industry and dynamic

spill-over effect for the country; rents; and, finally, gains in terms of product variety availability. Box 3 summarises the models and literature which introduce external returns to scale with perfect competition; the relationship between trade liberalisation, returns to scale and imperfect competition; and finally monopolistic competition and heterogeneous goods.

### **Box 3: Summary of key new trade models**

#### **External returns to scale and perfect competition: explaining trade between similar countries**

There exist different types of external economies of scale (Marshall, 1890). They can arise from a local specialised skilled labour force, the existence of technological spill-overs or from pecuniary externalities linking suppliers and sellers of intermediate products, final goods and services. In all cases, the size of market influences firms' performance through its impact on productivity and/or production costs. There are two consequences of the existence of external returns to scale associated with perfect competition: larger gains from trade and the possibility of 'strategic' behaviour from governments.

With the existence of external economies of scale, engaging in international trade increases the market size and provides the opportunity to increase output, further reducing costs for the whole industry (and not only for a selection of firms) and increasing gains to trade.

#### **Increasing returns to scale and imperfect competition with homogeneous goods**

According to neoclassical trade theories, intra-industry trade is an inefficient outcome. But with the introduction of increasing returns intra-firm trade becomes efficient, as it will have a positive effect via increases in competition. In this context, there are two main sources of gains to trade liberalisation. The first is associated with pro-competitive effects, the second with a more ambiguous impact on competition. The pro-competitive effect is the result of the increase in production as a result of liberalisation. When two identical countries open up to trade the size of market as well as the number of firms doubles. This therefore increases the number of competitors and each firm has a smaller market share than in the autarkic situation. As a result consumers benefit from lower prices and an increase in available varieties, and firms from a more efficient scale of operation. The least efficient firms exit.

#### **Monopolistic competition: increasing returns and differentiated goods**

Monopolistic competition occurs when for one good several differentiated varieties exist. The production of this variety presents internal increasing returns and each producer has a monopoly on its own variety. In monopolistic competition models there is free entry into the industry, since as long as there are profits firms will produce new varieties. The long-run equilibrium is therefore close to perfect competition with a large number of firms, each making zero profits. However, prices are higher than marginal cost. Consumers benefit from increased variety (Krugman, 1980; Helpman and Krugman, 1985). Opening to trade yields gains from an increase in variety for the consumers and allows intra-industry trade. Trade liberalisation results in an increased availability and variety of goods.

Essentially, new trade theory is part of economic theory which includes new growth theory, new economic geography, and new institutionalism. It emphasises certain variables that traditional trade theories had simply played down or taken as a given (such as geographical location and the free flow of knowledge and technology). It has been informed by the experiences of the East Asian Newly Industrialised Countries (NICs) and more recently China, with their trade-induced growth strategies and the pursuit of an export-oriented, as opposed to import-substituting, strategy. Their development experience has served both to support and undermine traditional *theories* of trade-induced growth as well as the associated *policy* prescriptions.

During the 1980s there was a tendency for trade policy issues to be seen in black and white, 'market versus state' terms. This approach has softened since then, and during the 1990s there was greater recognition of market as well as government failures. Hence

the case now for providing special support to infant industries (and firms) goes beyond the traditional **Structuralist** case which supported import-substitution industrialisation, so as to assist countries in moving out of primary commodity specialisation (which were posited to have adverse terms of trade relative to imported manufactured goods). Instead it is recognised that firms may need support in order to penetrate export markets.

There is a broad consensus on the importance in both determining and sustaining growth of fundamentals such as the role of human capital, learning and processes of technological upgrading. These processes may create a self-reinforcing dynamic. Hence sustaining dynamic trade-induced growth requires the development of technological capabilities and the maximising of potential knowledge spill-overs from lead firms to others (Lall, 1993 and 2000). The importance of geography and the location of firms (and labour) are increasingly recognised. The clustering and agglomeration of some activities for export and development of linkages backwards and forwards to a particular firm's suppliers and industrial consumers may serve to increase competitiveness. The ways in which firms access export markets and interact within the value chains in which they trade may also determine their ability to acquire information about new skills and technologies.

### Moving from new trade theory to *new new* trade theory: firm-based trade theory

*New new* trade theory is distinguished from (old) new trade theory by its focus on the firm as opposed to the industry; it focuses more on internal economies of scale to the firm than external economies to the industry which may result from the clustering of firms (for example, as in new economic geography models). That is, it is more in line with models of monopolistic competition that incorporate heterogeneous firms and the theory of the multinational enterprise. However, rather than considering all firms as homogeneous exporters it introduces firm heterogeneity: some firms export, others do not; some firms are larger and more productive than others.<sup>2</sup>

According to new international trade theories of firm heterogeneity developed by Melitz (2003) and extended by Helpman et al. (2008) and Chaney (2008), a country's capacity to engage in trade depends on both variable and fixed (sunk) costs to trade, such as distance to markets, as well as on firms' productivity. Accordingly, all other things being equal, only the more productive firms – i.e. those producing at the lower variable costs – can export. This approach emphasises the importance of differences in firms' productivities in their capacity and decision to trade. The capacity to export is defined by a productivity threshold above which firms will be able to export to distant markets.

Liberalisation induces the smallest or least productive firms to exit, as market shares are further allocated to larger more productive exporters (Melitz, 2003). The *new new* trade literature emphasises productivity differences between firms that export within industries, which inform decisions to export. Only a few large firms are really productive within a given industry, and these are also the firms that export and have a higher probability of being foreign owned.

Because of these theoretical developments, some see GVC analysis as a logical progression from *new*, and *new new*, trade theory. Although the extent to which these strands of thought (informed by empirical analysis) can be considered synonymous is largely an academic debate, it is fair to say that both share the focus on the firm, and explore how, and why, firms engage with global markets.

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<sup>2</sup> As summarised by Greenaway and Kneller (2007). Krugman (1979) builds on a Dixit-Stiglitz monopolistic model in which all firms export because each produces a unique variety that consumers, who have a love of variety, want.

## Global value chain analysis

GVCs are not a new phenomenon, but they have increasingly been used to describe and explain trade. Sector studies have been motivated by the need to better understand how producers engage with the process of globalisation, and the resultant implications for the development of productive capacity and capabilities. A number of value chain studies across sectors, including agriculture and light manufacturing, have acknowledged and discussed changes in global production and methods of coordination and explored what this means for firms, and employees (see Box 4).<sup>3</sup>

### Box 4: Value chain handbook

In the handbook developed by Kaplinsky and Morris (2001), a value chain was defined as: the full range of activities which are required to bring a product or service from conception, through the different phases of production (involving a combination of physical transformation and the input of various producer services), delivery to final consumers, and final disposal after use. GVCs are defined in the same way, but with the activities spread across countries. The GVC literature became prominent during the 1990s as product- and sector-specific studies were published, motivated by the need to better understand how producers engaged with the most recent process of globalisation and the implications for the development of productive capacity and capabilities.

The literature continues to develop, both conceptually (e.g. by recognising global production networks) and empirically (e.g. by employing more robust research methods). However, the building blocks of the methodology generally remain the same, and consist of an understanding of the appropriation of rents within a given chain, as an indicator of power, and the governance structures that surround trade, which help to secure them. At the core of GVC analysis is the notion of governance which helps to explain the organisation of the production and marketing of goods and services globally.

## 2.3 The basics of trade policy

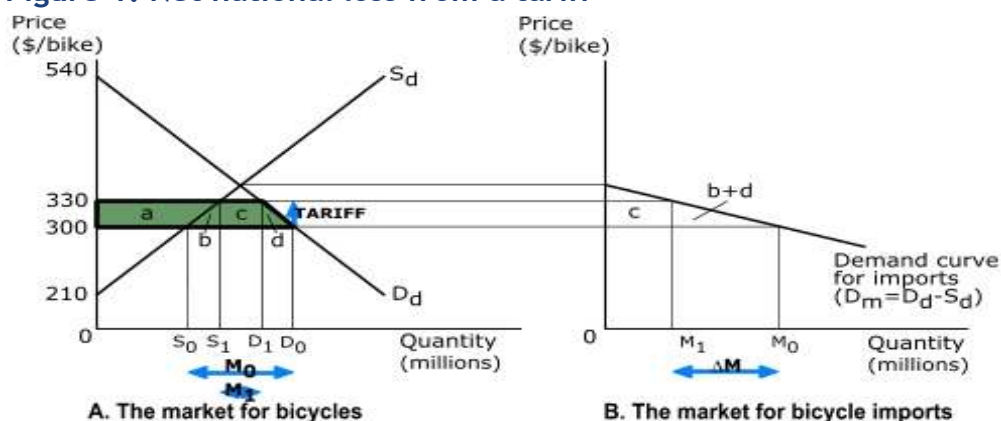
### The impact of levying a tariff

Because countries are different in terms of their economic size it is important to make the distinction between a small and a large country. The assumption is that a small country's imports are small enough to not affect the world market or the world price. This is why we say a small country is a price taker: the price is a given for such a country (conversely, if the importing country is large it will be price maker: its share in the world market will impact the world price if its demand changes).

Figure 1 presents an overview of the net national loss from a tariff on bicycle imports. Following the implementation of a tariff by a small country the world price remains unaffected, but the domestic price increases by the amount of the tariff. This increase in price will increase domestic supply (area *a* in Figure 1 is the increased producer surplus) and decrease domestic demand (area *d* in Figure 1 is the consumption effect). Since imports are the difference between demand and supply, they are reduced by both of these changes. The rise in price will benefit domestic suppliers (unless they are processors of imported goods), but it will discourage consumers. The government will gain from the tariff by the amount of tax levied (area *c* in Figure 1). The net impact when aggregated across all actors will always be a loss, since the loss of the consumers will always outweigh the gains by the producers and the government; this is what is called the dead-weight loss of a tariff, and is shown by areas *a* + *b* in Figure 1.

<sup>3</sup> See Milberg and Winkler (2011).

Figure 1: Net national loss from a tariff



Source: Pugel (2012).

### Trade policy instruments

Trade policy is defined as the set of rules and regulatory instruments related to the exchange of goods or services involved in international trade. Trade policies are set up by governments for the purpose of controlling both the export and import of goods and services. Tariffs are the most common form of trade policy instrument. A tariff is a discriminatory tax that applies only to imported goods, thereby creating a distortion in price between the imported good and the same product produced domestically. Tariffs are usually employed to protect the domestic market from the competition of foreign countries' products, or as a source of government revenue (which can be substantial for poor countries). Non-tariff measures (NTMs) can include other restrictions on imports (or exports) such as quotas and quantitative restrictions – although these measures are restricted by the WTO. All countries can use NTMs to protect the environment or public health. Table 1 provides a brief taxonomy of tariffs, quotas and subsidies, and other NTMs.

Table 1: Taxonomy of tariffs, quotas and subsidies

|                     | Imports   | Exports  |
|---------------------|---|--|
| Tariffs             | <p>Ad valorem: calculated as a percentage of the price of the imported good.</p> <p>Specific: specified as an amount of currency per unit of the good.</p> <p>Mixed: an ad hoc combination of ad valorem and specific tariffs</p>   |  |
| Quotas              | <p>Import quota:<br/>Specifies the maximum amount of an import per year, typically administered with import licences that may be sold or directly allocated, to individuals or firms, domestic or foreign. May be global, bilateral, or by country.</p> <p>Tariff rate quota:<br/>A combination of an import tariff and an import quota in which imports below a specified quantity enter at a low (or zero) tariff and imports above that quantity enter at a higher tariff. Also called a tariff quota.</p> |  |
| Subsidies           |   | <p>A payment by government, perhaps implicit, to the private sector in return for some activity that it wants to reward, encourage, or assist.</p> |
| Non-tariff measures | <p>Standards, such as those required for public health, or technical requirements.</p>  | <p>Customs procedures.</p>   |

Source: Adapted from Deardorff's Glossary of International Economics



The access of products from developing countries to the markets of developed countries has traditionally been promoted by reducing traditional barriers to trade (e.g. tariffs and quantitative restrictions). But tariffs are only part of the challenge, as NTMs may serve to prevent rather than facilitate the exports of many developing countries to developed country markets.

It is worth distinguishing between NTMs and non-tariff barriers (NTBs). The former are intended to address health and security objectives. Their purpose is to address market failures and asymmetric information and thereby to improve the functioning of markets. They are not necessarily protectionist in intent. In practice, however, they may be. NTBs are defined by the WTO as NTMs not implemented in the 'least trade-restrictive' way. An NTM may become an NTB if suppliers are unable to meet its requirements because of technical or financial barriers.<sup>4</sup> For example, certain product standards required in the domestic market may be challenging for imported products to meet because of certain minimum requirements, e.g. fruit and vegetables must be straight, or exporters must prove minimal pesticide residues.

### The economics of regional integration

Viner (1950) was one of the first to ask whether the elimination of a tariff, particularly in a discriminatory manner, is always beneficial. In other words, could an RTA improve well-being for each member country, and for the rest of the world? The outcome depends on the balance between the **trade creation** and **trade diversion** resulting from the implementation of the regional integration agreement.

- **Trade creation** increases welfare by replacing domestic supply by imports from a partner whose production costs are lower (more efficient) but who was previously excluded by tariffs (artificially inefficient compared to domestic producers). It occurs when consumption shifts from a high-cost producer to a lower-cost one. The reduction in tariffs between trading partners in the RTA increases the consumer surplus, and hence welfare. The effect on domestic producers is not explored.
- **Trade diversion** occurs when the impact of the regional agreement is the replacement of imports from an efficient country by imports from a less efficient partner country which became artificially competitive thanks to the discriminatory removal of tariffs. For example, the removal of tariffs between partners and the imposition of a common external tariff (CET) under a customs union (CU) may mean that regional suppliers become more competitive than third-party suppliers; this is because of the price differential which arises as a result of the CET. The price consumers pay for the product may not have been lowered.

Viner shows that regional integration has different trade effects from multilateral liberalisation. If trade diversion is greater than trade creation, the agreement is considered to be welfare decreasing. If trade creation is larger than trade diversion, a regional agreement improves welfare. It can be seen as a first step towards comprehensive liberalisation at a multilateral level.

Developing economies of scale, and scope, are now some of the main objectives of regional integration. This is because regional integration can attract investment because of the harmonisation of procedures across countries, as well as other dynamic effects. This depends on the level of integration sought between countries, which different types of agreement, listed below, can facilitate.

- **Free trade area (FTA):** Elimination of internal tariffs or other measures without common commercial policy, e.g. the North American Free Trade

<sup>4</sup> See Keane et al. (2010) for a recent study on NTBs in sub-Saharan Africa.

Agreement. The non-existence of a common trade policy requires the implementation of rules of origin (RoO) or other measures with the aim of avoiding 'deflection' of trade – in other words the possibility of firms producing in non-member countries using one member country as their exporting base so as to take advantage of the lowest barriers.

- **Customs union (CU):** Elimination of tariffs and other trade restrictions between members of the agreement. In addition, CUs develop a common trade policy and apply a CET with respect to countries outside the agreement, e.g. the European Economic Community.
- **Common market:** Member countries also liberalise the movement of factors of production such as capital and labour. They turn gradually towards an integrated market if members also eliminate other types of barrier to trade from different national policies, e.g. the European Union (EU).
- **Economic union:** An extension of the common market with harmonisation of institutional framework on competition policy, etc. The countries often share a common currency, e.g. the euro zone.

# 3 Trends and patterns in trade flows since 2000

## Key messages

- Developing countries now account for around half of global trade flows. Around 80% of all trade takes place within the international production networks of transnational corporations (TNCs); trade in commercial services is increasing rapidly from a small base.
- Because global trade patterns have evolved so rapidly in recent years, there may be new opportunities to engage with new types of trade being driven by the emerging powers such as China.
- As well as considering entry into new GVCs, it is important to understand producers' relative position within existing value chains, and then how to improve outcomes over time. This increasingly means adopting a 'whole of supply chain' approach, considering the role of services, as well as the regulatory environment more broadly. The GVC methodology can help to identify and articulate these linkages.

The WTO's most recent *World Trade Report* (2013) shows that there have been significant changes in patterns of global trade since the 1980s, in terms both of the relative growth of trade in goods and services and the entrance of new countries as major players and the exit of others. This section highlights recent trends and patterns in global trade flows. It begins with a brief overview of recent trends and patterns in global trade in goods and services. It then presents shares of global value added, and discusses why recent trends and patterns highlight that not only *what* you export matters, but also *how* and *where*, in terms of influencing upgrading trajectories for firms.

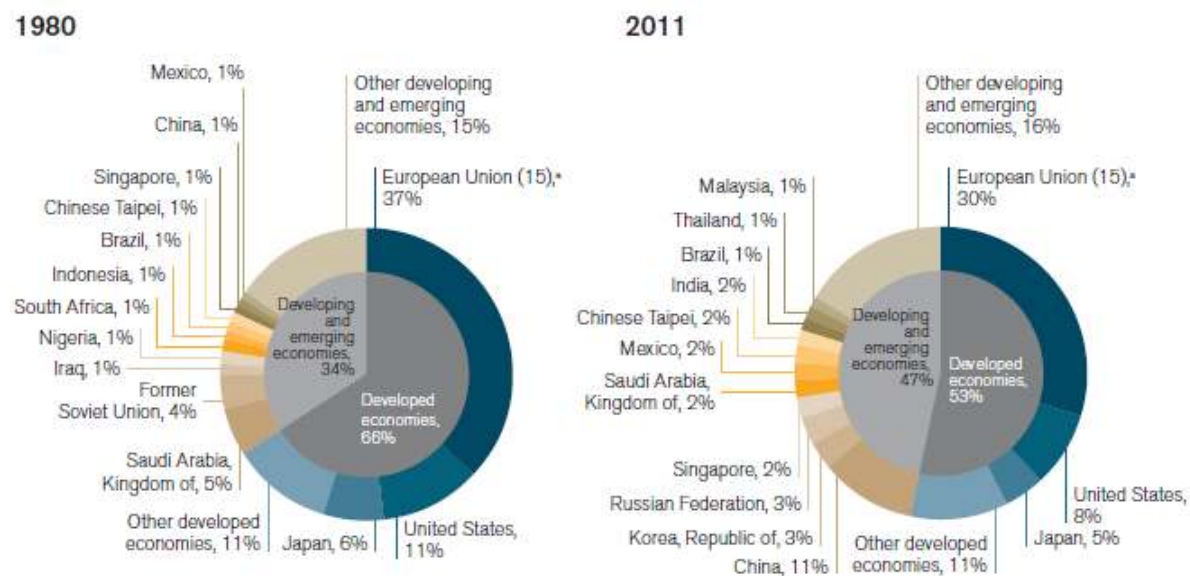
## 3.1 Recent trends and patterns in global trade

The value of world merchandise trade increased by more than 7% per year on average between 1980 and 2011 (when it reached US\$18 trillion), and trade in commercial services has grown even faster – at roughly 8% per year on average (amounting to US\$4 trillion in 2011) (WTO, 2013). As shown in Figure 2, developing economies accounted for only 34% of world merchandise exports in 1980 but by 2011 their share had risen to 47%, or nearly half of the total.

At the same time, the share of developed economies in world merchandise trade dropped from 66% to 53%. Other countries which were major players in terms of world merchandise exports in 1980 no longer feature in 2011 (for example Nigeria and South Africa). Instead there are new players which include some of the East Asian NICs such as South Korea, Thailand and Malaysia. South–South trade flows are growing rapidly, albeit from a low base (Figure 3)

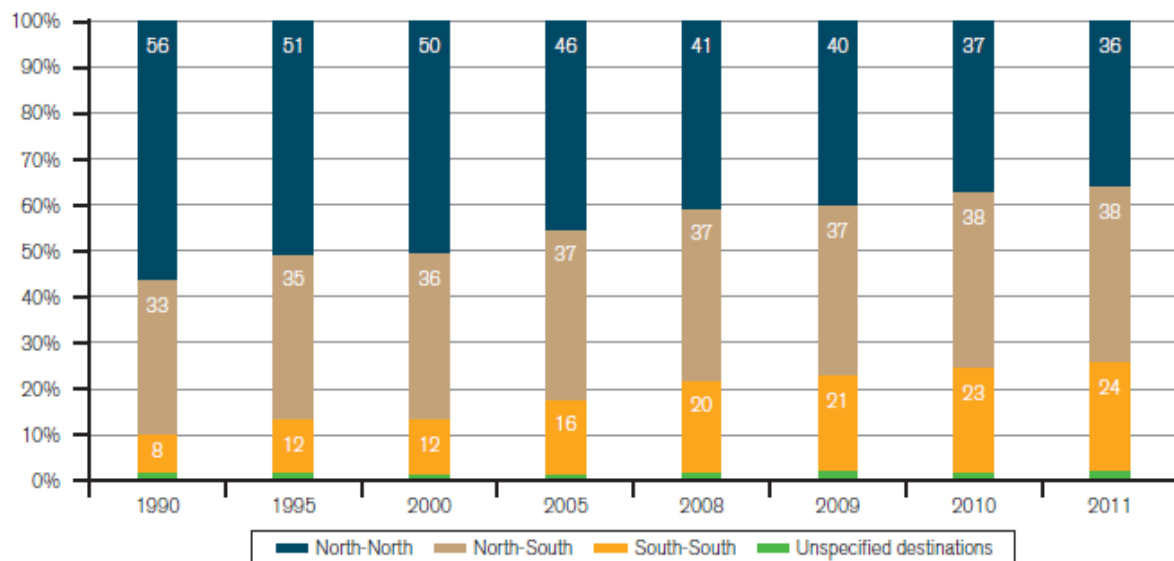
Just as the relative importance of countries in international trade has shifted over time, so has the mix of traded goods and services (Figure 4). Commercial services trade has increased with trade in goods, and both are becoming more interdependent (the offshoring of manufacturing activities requires related services to facilitate trade, such as finance, and logistics). This is because services such as logistics and transportation are integral to countries' connection to external markets and to their participation in value chains (regional or global), which we elaborate upon in the following sub-sections.

**Figure 2: Shares of selected economies in world merchandise exports by level of development**

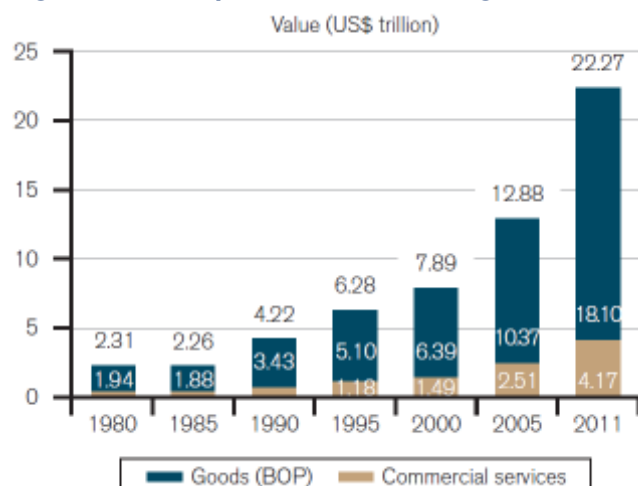


Note:  
 (a) Includes intra-EU trade.  
 Source: WTO (2013).

**Figure 3: Shares of North-North, North-South and South-South trade in world merchandise exports**



Note: South includes Central and Eastern Europe before 2000, equal to 1.6% of world trade in 1995.  
 Source: WTO (2013).

**Figure 4: Composition of world goods and commercial services exports**

Source: WTO (2013).

However, despite the optimism which may be generated from a review of the aggregate global trade picture, for most of the poorest countries and regions where DFID works there have not been substantial changes in trade patterns (see Box 5). The supply-side responses from trade liberalisation have not been as extensive as expected in many instances, e.g. the removal of tariffs has not always resulted in increased trade because of other capacity constraints. Increases in trade flows have often followed countries' existing comparative advantages. For example, although the range of new trading partners has increased over time, particularly in the case of commodity exporters (discussed in the following sub-section), progress in terms of structural change and export diversification, and movement across the extensive margin of trade (into new products) as well as across the intensive margin (upgrading within existing product categories), has been limited. Countries such as Nigeria may be supplying oil to more trading partners, but are not moving into the production of other goods and services which may contribute to structural change and more broad-based growth through providing more employment opportunities and hence helping to reduce poverty.

### Box 5: Regional patterns and trends in flows

**Sub-Saharan Africa (SSA):** Despite efforts made over the last 25 years to remove many of the policy barriers considered to impede export performance and inhibit diversification, the composition of SSA's exports has not changed substantially.

- Although a very small number of countries have been able to diversify significantly into manufactures (Mauritius, for example, has achieved fairly steady manufactures growth), for most SSA states manufactured goods exports remain low.
- The continent as a whole remains the most dependent on primary commodity exports as a proportion of total exports in the world.
- More seriously, for most countries the dependence is on a very small number of primaries.
- There has been more progress in diversifying markets than products, because of new demand from emerging markets. But unless the revenue is used to finance the development of new products, efforts to diversify export baskets will be hindered.

**South Asia:** Apart from India and Nepal, the merchandise exports of all the countries of the region are concentrated on a narrow range of goods such as textiles. For most countries in the region there is also a concentration on a small number of markets for their exports. As the largest country in the region, India's exports dwarf those of its neighbours.

**Pacific:** At the time of writing there is a lack of recent trade data analyses for the Pacific (although 2011 and 2012 data for several Pacific countries have recently become available in the United Nation's (UN) COMTRADE database). When we last explored export patterns, they generally included goods that are imported in bulk and then exported (possibly with some processing) to neighbours. Almost one-quarter of Fiji's exports in the most recent three years, for example, have been of fuel.

**Caribbean:** The export basket of this region is dominated by a small number of primary products, with fuel accounting for almost two-thirds of the total in 2006 (e.g. from Trinidad and Tobago) and food for one-twelfth (World Bank, 2009). Manufactures accounted for some 27% of exports in 2006, but they were dominated by low and intermediate technology products. Hi-tech goods accounted for only 1.4% of merchandise exports in 2000 (World Bank, 2009). Moreover, this picture has not changed much in recent decades. Nor has there been much change in the direction of goods exports: the US and Canada absorb over half of the total. Most of the growth in intra-Caribbean Community (CARICOM) trade is attributed to exports from Trinidad and Tobago (of natural gas and oil). In many countries services exports now greatly exceed those of goods. Within the services sectors tourism is overwhelmingly the most important, accounting for almost 69% of CARICOM's services export revenue in 2005 (CARICOM, 2008). Although tourism has allowed countries to diversify from their previous dependence on goods exports, the high share of export revenue derived from a single sector shows that diversification still has some way to go; its share has remained steady in recent years at around 70%.<sup>5</sup> Migrant remittances are also a very important source of revenue in many countries.

## 3.2 The role in, and effect on, global trade patterns of new players

Emerging powers such as China have begun to account not only for a larger share of global GDP but also for increasing shares of global manufacturing trade and global investment as they have been increasingly integrated into the global economy (Box 6 discusses the de-coupling hypothesis which was popular prior to the global financial crisis, and has since been challenged). The world's largest exporter, China, has been systematically integrated into the global trading system since its accession to the WTO in 2001, and essentially represents the assembling tip of a series of East Asian regional value chains (Kaplinsky and Messner, 2008). Its economic ascendance has generated ripple effects in the world economy.

### Box 6: De-coupling hypothesis - tried and tested?

Towards the mid-2000s there was increasing speculation over the decoupling hypothesis: that growth of the Asian economies was becoming increasingly detached from that of the developed countries, as their growth trajectory shifted towards being driven by internal consumption. The ramifications of the global financial crisis since 2008 have challenged these suggestions. Closer analysis of Chinese trade shows that it features high levels of two-way intra-industry trade reflecting cross-border production networks (Venables and Yueh, 2006). The decline in commodity prices and synchronised global slow-down in manufactured goods trade was unprecedented and indicated the extent to which countries are independent rather than de-coupled.<sup>6</sup>

<sup>5</sup> See CARICOM (2002 and 2008).

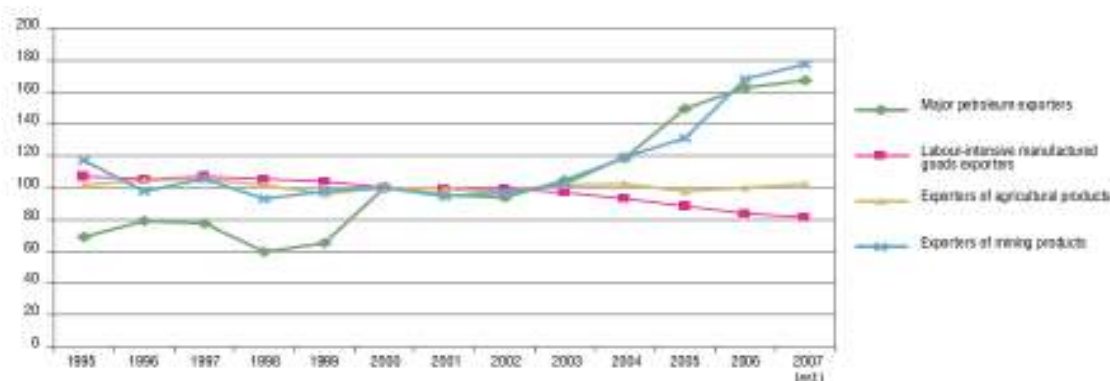
<sup>6</sup> For example, Dooley and Hutchinson (2009) find that emerging markets appeared to be somewhat insulated from developments in US financial markets from early 2007 to summer 2008. From that point on, however, emerging markets responded very strongly to the deteriorating situation in the US financial system and real economy. Policy measures taken in emerging markets to insulate themselves from global financial developments proved inadequate in the face of the credit crunch and decline in international trade that followed the Lehman bankruptcy in September 2008.

Prior to the global financial crisis of 2008, and subsequent euro zone crisis, there was much discussion of the 'China effect' and the impact of the Asian drivers on global trade patterns, including shifts in the terms of trade between commodities and manufactures (Kaplinsky and Messner, 2008; Venables and Yueh, 2006; Zafar, 2007). The commodity price boom which occurred from the early 2000s, and the secular decline in the terms of trade for manufactures, challenged traditional trade theories such as the Prebisch and Singer hypothesis (see Box 7).

### Box 7: Changing terms of trade

In the period since 1995 exporters of labour-intensive manufactures experienced a more unfavourable movement in their terms of trade than any of the other four groups of exporters covered in Figure 5. The terms of trade for agricultural exporters did not improve significantly in the period analysed, but neither did they deteriorate.

**Figure 5: Terms of trade indices of selected developing country groups (2000=100)**



Source: UNCTAD (2008).

Countries endowed with oil and minerals have seen the largest rise in their terms of trade. This poses management issues. The net effect of a booming (often mineral) export that is not well managed can be to reduce the competitive-ness of other productive activities through exchange rate movements, which in turn can hinder export diversification efforts.

Demand from China throughout the 2000s and prior to the global financial crisis increased commodity prices, particularly for oil and metals from Africa, and has given a boost to real GDP in SSA (Zafar, 2007). Although this new major source of demand represents an opportunity for commodity exporters, there are also new challenges for those countries that seek to diversify their economies and avoid some of the economic risks associated with an over-dependency on commodity exports (Nissanke and Kuleshov, 2012). These patterns in global trade were a cause for concern because of their effect on trade, growth and industrialisation strategies for countries in SSA. Box 8 discusses some of the recent patterns in global commodity trade.

The relative merits of exporting commodities and manufactures came under increasing scrutiny as the weight of the Asian drivers, or 'Factory Asia' (Baldwin, 2006; Baldwin and Forslid, 2013), began to be felt in two ways: first, in the form of dramatic increases in commodity prices because of the shift in demand; second, in terms of reduced prices of manufactured goods as a result of supply increases.<sup>7</sup> This drew attention to why *what* countries export matters, as well as *where*. For example, Kaplinsky and Messner (2008)

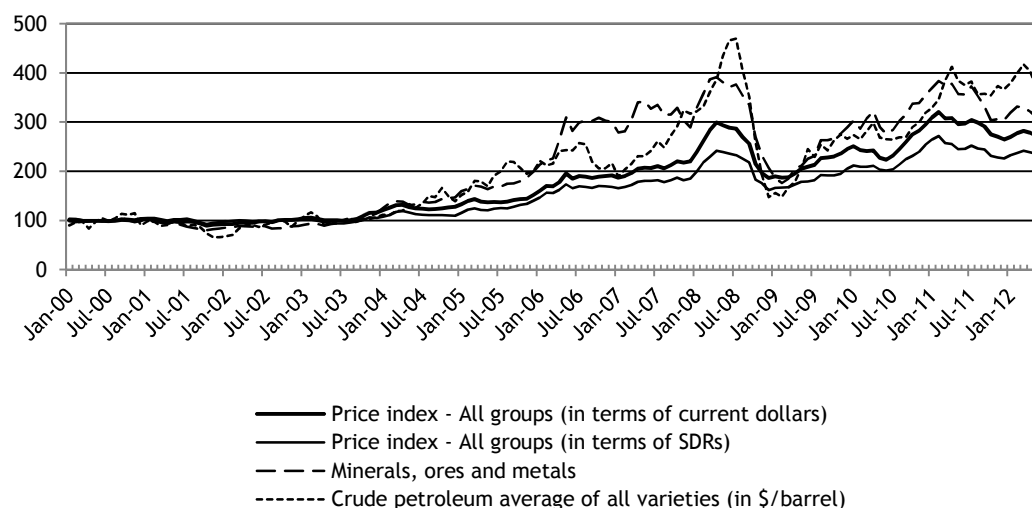
<sup>7</sup> As noted by Baldwin and Forslid (2013:1): 'Like a gigantic, impossibly complex but wonderfully efficient factory, East Asia churns out a vast array of manufactured goods with world-beating price-quality ratios. But this is not a series of national efforts. Manufacturing processes that used to be performed in single factories (mostly in Japan and Korea) have been fractionalised and dispersed across the region – creating what Baldwin (2006) called "Factory Asia".'

concluded that SSA clothing and textile exporters cannot compete with Asian producers in general, and Chinese exporters in particular. Moreover, they note that there are compelling reasons to believe that the prospects facing large parts of Latin American and Caribbean industry are not dissimilar to those confronting SSA (Kaplinsky, 2005; Jenkins and Dusserl Peters, 2006).

### Box 8: Commodity price trends

Commodity prices are driven by multiple forces and characterised by very long-term trends and shorter-run cycles of varying durations. The rise of new global economic players such as China and India put upward pressure on commodity prices during the 2000s (see Figure 6). The role of new actors driving commodity prices, as a result of the 'financialisation' of commodity markets – commodities being considered by financial investors as a distinct asset class – is under increasing scrutiny. This is because financialisation opens up the possibility for noise trading and momentum strategies to affect prices; greater participation by financial investors in commodity futures markets raises co-movement between commodities and equities returns. The evidence supports the hypothesis that commodities are increasingly considered as an asset class on their own alongside equities.

**Figure 6: Monthly commodity price indices by commodity group (2000=100)**



Source: Adapted from Arezki et al. (2013); Nissanke and Kuleshov (2012).

Despite this rather pessimistic view, there may be new opportunities to engage with new types of trade emerging from new major players in global trade such as China, as well as the Asian NICs more broadly. Much of the existing literature describes China as an importer of primary products through GVCs in which price is the main focus, and as a supplier of consumer goods (ECA, 2013; Morris et al., 2012). However, as China's growth pattern shifts towards domestic consumption and as labour costs rise, trading patterns are likely to change. Although there are concerns by some observers that Chinese import competition may undermine Africa's (as well as other regions') existing manufacturing base, imports of intermediate goods and services, plus Chinese investment may conversely help to improve the competitiveness of other sectors. The ability to tap into these new trade opportunities, as we argue in the following section, depends on how the integration with new GVCs takes place, as well as upgrading within existing ones.



### 3.3 Engaging with and upgrading within global value chains and emerging production networks

Since 1980 world trade has grown on average nearly twice as fast as world production; this reflects the increasing prominence of international supply chains, or GVCs (WTO, 2013). The latest phase of globalisation is characterised by the great ‘unbundling’ of global production and its fragmentation across countries.<sup>8</sup> As discussed by Grossman and Rossi-Hansberg (2006, 2008), trade has traditionally entailed mostly an exchange of *goods*. Now it increasingly involves value being added in many different locations, or what might be called *trade in tasks*. Revolutionary advances in transportation and communications technology have weakened the link between labour specialisation and geographic concentration, making it increasingly viable to separate tasks in time and space.

The result has been a boom in ‘offshoring’ of both manufacturing tasks and other business functions, as well as outsourcing of production where capabilities in host countries already exist (Grossman and Rossi-Hansberg, 2008). This unbundling process, which has gathered pace with globalisation and the scale of economic integration through trade and finance, has subsequently shifted from sectors towards stages of production. The economics of this change according to Baldwin (2013) is best examined by deconstructing it into two phenomena – fractionalisation and dispersion:

- fractionalisation concerns the unbundling of supply chains into finer stages of production;
- dispersion concerns the geographic unbundling of stages.

The two phenomena are linked in so far as the organisation of stages may be crafted with dispersion, i.e. offshoring, in mind. Hence, the production of a final good (or indeed service) can take place across several firms located in different countries, with each one undertaking what is better described as ‘a task’ in the overall process. Whilst global production has become dispersed across countries, it has also become increasingly coordinated by the lead firms that govern GVCs. Although estimates vary, it is generally acknowledged that since the latest phase of globalisation, which began in the 1980s, the proportion of trade that takes place on an intra- rather than inter-firm basis, or within firm as opposed to between firms, has been increasing. The latest estimates made by the United Nations Conference on Trade and Development (UNCTAD, 2013) suggest that 80% of all trade takes place within the international production networks of TNCs; 60% of all global trade is now in intermediate goods (see Figure 7).<sup>9</sup>

These types of value chain are replacing spot market deals and are thus reshaping the global organisation of production and trade relations. This process applies equally to countries exporting manufactured goods and those exporting commodities. This means that instead of dealing with developing country firms under arms-length and contractual arrangements, increasingly trade is occurring between firms owned by the same company (intra-firm) – typically a subsidiary of a multi-national enterprise (MNE). This may mean that backward (and forward) linkages to the domestic economy may be rather limited unless efforts are made to learn from MNEs and develop relationships (including contractual) with the domestic private sector. MNE firms may employ workers and pay higher wages than domestic firms, but the ability of local firms to benefit from

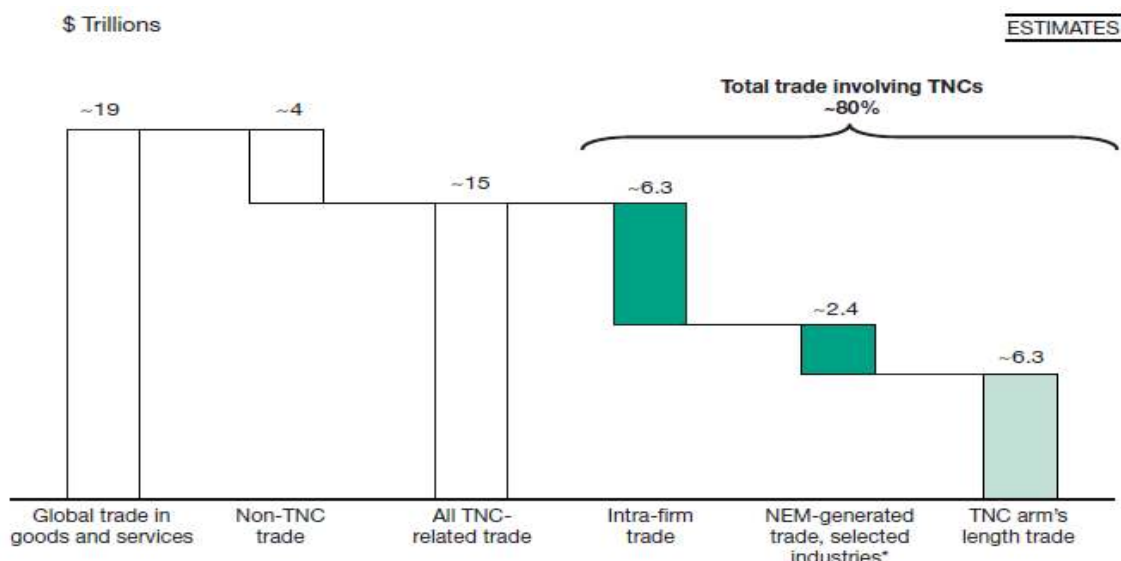
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<sup>8</sup> The global fragmentation of production and increasingly coordinated trade has been an integral part of the financialisation process which is so characteristic of the contemporary phase of globalisation.

<sup>9</sup> As far back as the 1990s, UNCTAD had already distinguished between TNC-initiated trade, intra-firm and arm’s-length trade, and estimated at that time that TNCs accounted for two-thirds of world trade, half of which was intra-firm trade; the other half being organised within global supply chains (through outsourcing and inter-firm trade).

technology spill-overs may be limited unless purposive actions are taken. Hence, how countries export increasingly matters.

**Figure 7: Global trade by type of TNC involvement**



Note: \* including contract manufacturing in electronics, automotive components, pharmaceuticals, garments, footwear, toys; and IT services and business process outsourcing (see WIR11). TNC arm's length trade may include other NEM trade.  
Source: UNCTAD (2013).

The increased consolidation of marketing and retailing nodes of GVCs that has occurred in recent years means commonly that large, oligopolistic lead firms from industrialised countries enjoy considerable economic power within their value chains; this means that they are able to capture most of the value created in the chain; buyer-supplier contracts are negotiated and lead firms with a multitude of potential suppliers are in strong positions to dictate the terms of the supply (Mayer and Milberg, 2013: 4). The choice of suppliers may be more limited in the case of some types of commodity exporters, but the broader point is that export markets in the developed world are tightly controlled by a few major traders, and buyers. Much attention in the literature has been given to the link between these shifts in the pattern of global trade and qualitative changes in the governance structures of GVCs, which seem to have become more hierarchical over time as shares of intra-firm trade have increased (Keane, 2012).

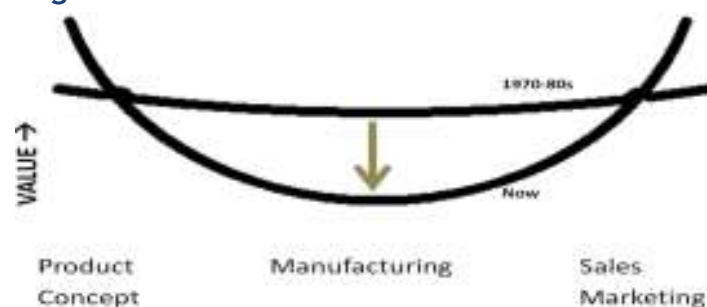
- On the one hand, Gibbon and Ponte (2005) argue that the increased consolidation of marketing and retailing nodes in developed countries has resulted in African producers trading down rather than up in GVCs. This is through increasing producer specialisation within the lower-value-added nodes of a given value chain rather than facilitating movement up towards higher-value-added nodes such as processing, retailing and marketing.
- On the other, it must be recognised that increased fragmentation of production can also create new trade opportunities for least developed countries (LDCs). For example, movement into the modern export sector and the production of high-value agriculture and ready-made garments has been driven by the increasing integration of LDCs into global GVCs. Within the agricultural sector, contract farming is a form of vertical integration between LDC agricultural producers and global buyers (Oya, 2012).<sup>10</sup>

Essentially, the benefits and/or costs for producers in terms of participating in one type of value chain compared to another are contingent on how the integration process of producers with this type of trade is managed. Failure to engage in structural transformation and deepening of production capacities could mean that countries get

<sup>10</sup> More broadly it is a non-equity mode of production. See UNCTAD (2013).

caught in (i) supplying raw materials and (ii) being sites for low-value-added manufacturing tasks. Figure 8 presents a stylised view of how value added increases and decreases as producers move from product design to assembly and manufacturing to sales and marketing. Given that lead firms tend to retain high-value functions such as design and marketing within core countries (often where their headquarters are located), some suggest that the 'smile curve' developed by Baldwin (2012) has deepened in recent years (Kwa, 2013).

**Figure 8: Deepening smile curve**



Note: adapted from Baldwin (2012).  
Source: Kwa (2013).

If late industrialisers are predominantly located in the low-value manufacturing parts of GVCs such as basic assembly or commodity production, the question then becomes how to move up the value chain: from product conception towards sales and marketing, the higher-value nodes of production and sale, as shown in Figure 8. This may be challenging because, as discussed by Kwa (2013), most developing countries, apart from a few Asian NICs, are not the source of lead firms. At best, developing countries are second-, or more commonly third- or even fourth-tier suppliers. GVC lead firms, mostly from Organisation for Economic Cooperation and Development (OECD) countries, tend to retain high-value added areas in their home countries and outsource low-value-added activities. Unless developing countries are able to establish their own lead firms this pattern will continue.

Successfully participating in GVCs means that developing countries must develop strategies to maximise the potential gains that may result. If performance has been less than satisfactory, the question then becomes how to influence firms' effective participation. It is therefore important to examine what contributes to domestic value added through existing GVC participation (Keane, 2008). As noted by Banga (2013), countries may be linked to GVCs but not 'gainfully' linked to GVCs. This relates to the extent to which GVC participation results in domestic value added, up-skilling of the labour force, learning and technology spill-over effects, and hence producer upgrading.

### Upgrading within GVCs

Governments set the framework within which the private sector can operate and hence can influence upgrading trajectories. The GVC methodology lends itself to identifying where interventions might be beneficial in terms of capturing more value added or enhancing spill-over effects. This requires knowledge of what levers are in place, and when it might be appropriate to pull them, so as to facilitate the upgrading process of domestic firms trading within GVCs in a sustained way.

- Upgrading processes within GVCs, such as the ability to benefit from technology spill-overs, do not occur automatically (because technology may be proprietary). Lead firms can be encouraged or required to engage actively with their suppliers, including through providing tax incentives or subsidising certain activities (including through the provision of AFT), which could facilitate technology, knowledge and skill transfer into the domestic market.

More importantly, skill formation needs to become institutionalised so that lead firms can subsequently adopt a more hands-off role as producers' capabilities develop.

- Merely facilitating trade is not the same as integrating trade into a country's development strategy. For instance, securing a contract with lead firms may be underpinned by the creation of joint ventures and deeper trading relations, both of which can improve access to technology (hard and soft), facilitate knowledge transfer, among other things, and formulate part of an upgrading strategy for the entire economy. The benefits and costs of GVC participation require closer scrutiny, including the opportunities for firm-level upgrading regionally or globally. For example, Africa is the primary market for SSA's processed goods, rather than the EU or the US (Kwa, 2013; Stevens et al., 2013).
- There are circumstances when smaller and poorer producers and farmers may be excluded rather than included in high-value hierarchical GVCs. But better organisation of producers can help to reduce the diseconomies of scale which may result if goods are sourced from many small individual producers which have to adhere to specific product standards (or NTMs). Hence, these types of intervention may help to overcome coordination failures and ensure smaller firms are included within supply chains.

Table 2 presents the traditional view of methods of upgrading in GVCs. The trajectory, which is considered to be a vertical one, is heavily influenced by the experience of the East Asian NICs, which moved from original equipment assembling to own brand manufacturing. However, what was possible at that time,<sup>11</sup> in that region, within particular value chains, accessing particular markets, may not necessarily be a completely replicable approach.<sup>12</sup> This means that although there may be some lessons that can be learnt from the successful harnessing of GVCs for development by the Asian NICs, and by other emerging economies, strategies may not be totally replicable.

**Table 2: Methods of upgrading**

|                          |  |
|--------------------------|--|
| Process upgrading        | Transforming inputs into outputs more efficiently by re-organising the production system or introducing superior technology. For example, through irrigating land, using pesticides or mechanical picking.   |
| Product upgrading        | Moving into more sophisticated product lines (which can be defined as increasing unit values). This may include through introducing better quality seed supply, or minimising crop contamination or disease.   |
| Functional upgrading     | Acquiring new functions in the chain (or abandoning existing functions) to increase the overall skill content of activities. Such as the transition from original equipment manufacture to own design manufacture to own brand-manufacture. Or becoming a full package supplier, taking responsibility for sourcing inputs as well as directly supplying buyers of lead firms. |
| Inter-sectoral upgrading | Using the knowledge acquired in particular chain functions to move into different sectors.   |

Source: Adapted from Humphrey and Schmitz (2004).

The proliferation of GVCs that has occurred since the rise of the NICs (and other emerging powers) may mean new opportunities for LDCs to engage with more dynamic forms of trade, emanating from non-traditional sectors, and indeed regions. Because producers need to forge links with retailers and develop contractual relations so as to reach end markets and meet product specifications, governments could provide support to their local business associations and export promotion agencies so as to enable dialogue and knowledge sharing.

<sup>11</sup> See Kaplinsky and Morris (2001).

<sup>12</sup> However, some of the theoretical advancements of new growth theory, which developed on the basis of the historical upgrading experience of the East Asian NICs, are generally recognised as being particularly relevant for late industrialisers, such as learning and developing human capital.

There are increasing efforts to unpack what exactly upgrading within a value chain entails. For example, work undertaken at Manchester University as part of the 'Capturing the Gains' project distinguishes between economic and social upgrading. In the framework developed, workforce development is an important part of social upgrading. In other cases, different upgrading trajectories have been noted for different sectors. Fernandez-Stark et al. (2011) identify control over different parts of the horticulture GVC as upgrading strategies. Control over packaging and cold storage is one upgrading strategy. The functions involved in this task are also closely related to the logistics services which are required for effective participation in GVCs and ability to meet the 'just-in-time' requirements specified by buyers and retailers.

Therefore interventions related to these types of service can assist LDCs in terms of upgrading their position within a given value chain. They may also provide more of a foothold to enable LDC participation in new types of GVC, emanating from non-traditional sectors and regions.<sup>13</sup> It is important to note that logistics and transportation services are not separate value chains as conventionally understood. Developing logistics and transportation systems may enable LDCs to obtain more functions within a given value chain (e.g. tourism, horticulture or textiles and clothing), and to move towards becoming a full package supplier (Keane and Page, 2013). This is why trade facilitation interventions in services such as logistics matter, and a 'whole of supply chain' approach are being advocated (Hoekman, 2013).

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<sup>13</sup> See also Keane and Page (2013).

## 4 Developments in trade policy and negotiations

### Key messages

- Because tariffs have been reduced rapidly in recent years, attention has shifted towards NTMs, behind-the-border measures, and new issues such as services, investment and logistics, and how best to address them.
- The agreement on trade facilitation reached under the Bali package is a major step forwards in the latest round of multilateral negotiations under the WTO, although financial commitments for implementation were not specified.
- The new wave of mega-RTAs seeks to address behind-the-border measures and is likely to include WTO-Plus issues. The challenge is to ensure that these serve as building blocks rather than stumbling blocks towards multilateralism, particularly given that LDCs and other small, vulnerable economies are excluded from the negotiating table.

In trade policy 'the devil is in the detail': an understanding of broad concepts and trends is very helpful in recognising the potential effects of any new policy, but the extent to which any treaty or item of legislation actually realises this potential will depend on its detailed provisions (which may run to hundreds of pages). Recent developments and the outcomes of multilateral negotiations at the WTO suggest that trade policy action will be complemented by regional and bilateral negotiations. Much attention is being paid to behind-the-border measures, moving beyond tariffs to consider the role of NTMs.

In this section we first summarise the outcomes from the most recent round of multilateral trade negotiations. We then discuss the next wave of plurilaterals<sup>14</sup> and mega-RTAs as well as other FTAs, including those negotiated between the EU and the African, Caribbean and Pacific (ACP) countries. These agreements all include provisions intended to go beyond those agreed at the multilateral level on a most-favoured-nation (MFN) basis. We elaborate on some of the risks and benefits of preferential trade arrangements (PTAs) and FTAs, with a view to ensuring that this next wave of trade agreements serves more as building than stumbling blocks.

### 4.1 Overview of multilateral trade negotiations

The starting point of the global trade regime can be traced back to the 1947 General Agreement on Tariffs and Trade (GATT) which was created and formed as a mechanism through which its founding members could agree to reduce customs tariffs and facilitate trade between them, further to increases since the Great Depression and World War II. Between 1948 and 1994 the GATT provided the rules to govern world trade. As the globalisation process accelerated in the 1990s, however, it became clear that a broader framework was needed to better govern trade and investment processes. The Marrakesh Declaration established the WTO in 1994. The WTO has a broader scope and remit than the GATT, namely to regulate trade in goods and services, and organise trade negotiations between its members and settle any disputes that arise. Its members agree to uphold principles such as:

- MFN, meaning non-discrimination between nations;

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<sup>14</sup> Plurilateral trade agreements are multi-national legal or trade agreements between more than two countries (those between two countries being bilateral agreements). These agreements are issue based, e.g. there are ongoing negotiations in plurilaterals on services, information technology and green goods. RTAs and FTAs are *country-based* plurilateral agreements that are, in principle, required to liberalise 'substantially all trade' and have 'substantial sectoral coverage' under WTO rules.

- national treatment – non-discriminatory treatment of imported goods compared with domestic goods;
- transparency – all trade legislation must be notified to the WTO; and
- special and differential treatment for developing countries.<sup>15</sup>

The major difference between the GATT and the WTO is the introduction of reciprocity between developed and developing countries. This is because, as discussed by Collier (2005), by the time the GATT was transformed into the WTO, intra-OECD trade in manufactures was virtually tariff free. Hence, the future trade agenda shifted towards OECD liberalisation *vis-à-vis* developing countries, developing country liberalisation *vis-à-vis* the OECD, and intra-developing country liberalisation.<sup>16</sup> The agenda also shifted so as to focus on liberalisation and disciplines in sectors other than manufactures, such as agriculture and services, and addressing other behind-the-border-measures including investment, competition, and public procurement. However, as discussed by Evenett (2008), during the Doha Round WTO members strived to combine a series of disparate accounts into one package – the ‘Single Undertaking’ – that all members would sign up to. In some respects this has been unfortunate: it has ignored the other – and often more flexible – WTO agreements that can also advance common goals, over time. This is because the principle of a single undertaking means that nothing is agreed until all is.

Since the breakdown of negotiations in the Doha Round in 2008 there have been efforts to salvage talks. The Doha Round subsequently became known as the Bali Agenda. What remained on the table for the 9th WTO Ministerial, held in Bali in December 2013, and was agreed by members was considered to be a major compromise and to some extent a face-saving exercise. Nevertheless, this was the first multilateral trade agreement since 1995 and the creation of the WTO. Table 3 presents some of the main features of the Bali Agenda and where agreement was reached.

**Table 3: What happened at the 9th Ministerial Conference in Bali**

|              | Progress  |
|--------------|---|
| <b>Trade</b> | <ul style="list-style-type: none"> <li>• What was agreed includes ten texts which comprise the Bali Package; these relate to:</li> <li>• Trade facilitation; general services; public stockholding for food security purposes; understanding on tariff rate quota administration; export competition; cotton; preferential RoO for LDCs; operationalisation of the waiver concerning preferential treatment to services and services suppliers of LDCs; duty-free and quota-free market access for LDCs; and a monitoring mechanism on special and differential treatment.</li> <li>• Outstanding issues include food security and the issue of public stockholding, although there is a formal commitment to address these.</li> <li>• Still no binding commitments on export subsidies in agriculture although this is a priority area for the post-Bali work programme.</li> </ul> |

Source: adapted from te Velde et al. (2013).

Given the difficulties associated with the single undertaking, it is likely that more flexible approaches towards liberalisation amongst WTO members, and coalitions of the willing, will be the *modus operandi* in the future. Only some aspects of the Doha Round were retained in the Bali Agenda; to some extent, the main agreement reached by all parties was a commitment to continue negotiations in the future, and make progress where possible.<sup>17</sup> Although the agreement on trade facilitation reached under the Bali Package is considered a major victory, commitments on financial resources were not specified.

<sup>15</sup> The creation of the WTO on 1 January 1995 marked the biggest reform of international trade since World War II and sought to rectify the failed attempt in 1948 to create the International Trade Organisation, as part of the Bretton Woods system. See Keane and te Velde (2011) for further discussion.

<sup>16</sup> Developing countries, particularly the emerging ones, were expected to make concessions in their manufacturing sectors in the Doha Round officially launched in 2001. This was because of perceptions that they had benefited from the ‘public good’ of open world markets, and hence also had to contribute to new liberalisation. Developed countries, in turn, were supposed to undertake liberalisation in their agricultural sector.

<sup>17</sup> See the Ministerial Statement on the Bali Package (<https://mc9.wto.org/draft-bali-ministerial-declaration>).

This makes it difficult to speculate on potential effects, which also depend on the effectiveness of implementation on the ground (see Section 6).

## 4.2 The next wave of trade liberalisation

Because tariffs have come down so rapidly in recent years, as countries have liberalised and become integrated within the global system, attention has shifted towards NTMs and other behind-the-border measures, as well as new issues such as services and investment. This category includes standards and regulations, but it also relates to trade facilitation measures more broadly. This is because slow customs procedures at borders can hinder and disrupt trade. Costs for business increase if there are different rules to adhere to in different markets; they also increase with delays at borders and ports.

The whole of the supply chain approach advocated by Hoekman (2013) focuses on logistics – bringing together a variety of services sectors and sub-sectors that are relevant from a logistics perspective (cargo handling, storage, warehousing, agency services and related ancillary services, as well as all freight services – air, road, rail, maritime, express/courier). Trade facilitation may be defined as the simplification and harmonisation of procedures which add costs to trading, or in some cases prevent it. It includes the activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade. Measures to reduce trade transactions costs could include:

- simplifying customs procedures, including with regard to proving the origin of goods;
- improving efficiency at ports and borders to reduce goods clearance times;
- reducing or eliminating road blocks;
- improving road, rail, air, and sea transport;
- enabling faster cross-border payments and transfers.

Regional integration can help to address these types of barrier to trade. As the previous section has alluded to, the future of trade negotiations is likely to involve bilateral, plurilateral and regional levels. Countries within RTAs and other regional economic communities (RECs), often seek to address NTBs collectively and have programmes to facilitate trade and remove impediments (Keane et al., 2010). This is so as to reap benefits of scale, and because of other public good elements related to interventions. For example, the corridor management committees already established by RECs in SSA are working to ensure common trade processes and designing the appropriate changes at the national level.

Engagement with the private sector and national and regional business associations could help to identify and prioritise the actions required. For all constraints, however, the first step is to review where trade is particularly constrained and identify the types of intervention which will have significant effects at acceptable cost. In the following sections we briefly summarise progress made to date in some of the major agreements being negotiated. We also discuss the extent to which these types of agreement may be considered stumbling or building blocks towards multilateralism.

### New plurilateral agreements and mega-RTAs

Plurilateral trade agreements are agreements between more than two countries. They can be single or multi issue based. RTAs and FTAs are country-based plurilateral agreements that are, in principle, required to liberalise ‘substantially all trade’ and have ‘substantial sectoral coverage’ under WTO rules. Countries decide when to notify such agreements to the WTO, and also the definition of ‘substantially all trade’ they choose. Box 9 summarises some of the new wave of mega-RTAs under negotiation – these are



called 'mega' because of the size of the countries included in terms of their share of global trade.

### Box 9: Mega-RTAs under negotiation

**EU–US Transatlantic Trade and Investment Partnership (TTIP):** This deal is intended to deepen relations between the US and EU and to move further in areas such as services and investment.

**Trans-Pacific Partnership:** Negotiations are between the US and members of the Asia Pacific Economic Community (APEC), that are willing to deepen trade relations and update the existing FTA that exists between some members of APEC. The agreement is considered by the US to serve as a counterweight to increased Chinese influence in the Asia-Pacific region.

**East Asia Free Trade Area:** A wave of FTAs has been signed by the Association of South East Asian Nations (ASEAN) with developed East Asian trade partners such as Japan, Korea and China. These agreements are known as the ASEAN+3 agreements. These agreements may be consolidated in the future through the creation of an East Asian Free Trade Area or Comprehensive Economic Partnership Agreement in East Asia.

In relation to other plurilateral negotiations, the US and EU are leading talks between more than 20 advanced and emerging like-minded economies under the auspices of the WTO regarding a services agreement. Because of these developments, some authors have suggested the overall message is that the West has given up on the grand multilateralism that defined the post-war era (Stevens, 2012). However, this pessimistic scenario is somewhat misleading as such agreements may eventually become stepping stones towards multilateralism. For example, China has expressed interest in joining the plurilateral negotiations at the WTO for services, and work is under way to bring them into negotiations. If plurilaterals are applied within WTO rules, and are structured in such a way as to include the MFN clause, they could be good for developing countries who could benefit from increased market access but are not required to liberalise themselves.

Nevertheless, there remain valid concerns about these types of agreement and their combined effect on the international trade regime more broadly. The devil, of course, depends on the detail. Although the negative effects on low-income countries (LICs) as a result of the EU–US TTIP are expected to be minimal (Rollo et al., 2013), there may be beneficial effects:

- within the TTIP the conversation is around regulatory coherence and standards and how this might save trading costs for developing country exporters who trade with both the EU and the US;
- the small print of such agreements, particularly in relation to RoO and cumulation with third-party countries, could provide a vehicle for further integration with third-party countries.

It is likely that these new agreements will include rules which go well beyond those agreed at the WTO, including on WTO-Plus issues such as finance, social and environmental standards, and public procurement. Table 4 presents the evolution of the number of RTAs signed by the EU and US, Brazil, Russia, India, China and South Africa from 2000 to date. The EU has the largest number in force, but the emerging economies are catching up.

As discussed by Baldwin (2011), this new wave of mega regional and bilateral agreements may be in place within a few years, by which time global trade governance might be marked by fragmentation and exclusion. The challenge for policy makers is to ensure that this pessimistic scenario does not occur. This will not only result in calls for

the remit of the WTO to increase, but also strengthens the need for effective trade surveillance and resources for the WTO's dispute settlement mechanism.

**Table 4: Summary of RTAs**

| Country      | 2000 | 2005 | 2010 | Present number of RTAs |
|--------------|------|------|------|------------------------|
| EU           | 16   | 23   | 31   | 35                     |
| US           | 2    | 6    | 11   | 14                     |
| Brazil       | 4    | 4    | 5    | 5                      |
| Russia       | 13   | 14   | 15   | 16                     |
| India        | 3    | 7    | 14   | 16                     |
| China        | 1    | 5    | 10   | 11                     |
| South Africa | 2    | 3    | 4    | 4                      |

Note: Totals are cumulative; date of entry into force used.

Source: WTO database.

### Preferential trade arrangements

In addition to FTAs, many countries have PTAs – characterised by non-reciprocity. This section covers the EU's preferential trade arrangements. Because a major overhaul of non-reciprocal trading relations has been on-going with the ACP countries since 2000, we focus on these changes. We then proceed to discuss some of the implications of these negotiations for future regional integration strategies.

The evolution of Economic Partnership Agreements (EPAs) – reciprocal FTAs between the EU and ACP which date from the mid-1990s – is interesting from several perspectives. It originates in adverse judgements by the GATT/WTO over Europe's trade preferences and the adoption by Europe of 'the Washington consensus', which favoured open trade regimes to promote development (Stevens et al., 2011). The inability to secure agreement on the new regimes under an FTA has, however, meant that deadlines have shifted from what was originally envisaged. The new deadline – fixed for October 2014 – means that unless agreement on an EPA is reached, ACP members will revert to exporting under the EU's Generalised System of Preferences (GSP), which is briefly described (along with other developed and developing country GSP schemes) in Box 10.

The end of the non-reciprocal trade regime known as the Cotonou Partnership Agreement (CPA) on 31 December 2007<sup>18</sup> has meant the fragmentation of the ACP group into groups of countries divided into regions that have either initialled reciprocal FTAs – EPAs – or which are granted non-reciprocal market access under the GSP. Although deadlines for the negotiations have been extended until October 2014, the implementation of some of the agreements already initialled may prove to be disruptive to existing, as well as potential, trade and investment patterns on an intra-regional basis (Stevens, 2012: 41).

This may be problematic for ACP members that are not classified as LDCs<sup>19</sup> which, if downgraded to the EU's GSP, may face an increase in tariffs on selected products and specific value chains that export to the EU. Whatever outcome is finally achieved by October 2014 is likely to have implications for the future of development and regionalism across ACP members that have so far not signed and ratified an EPA (the Caribbean Forum (CARIFORUM) being the only ACP region to have done so). Box 11 explains how and why this is the case, and what can be done about it. Figure 9 shows those African countries that have initialled or signed an EPA, and the RECs to which they belong.

<sup>18</sup> Political aspects will continue until 2020.

<sup>19</sup> This includes: Botswana, Namibia and Swaziland in SADC; Kenya in EAC; Ghana in ECOWAS; Mauritius in COMESA; and Fiji and Papua New Guinea in the Pacific.

### Box 10: Generalised System of Preferences

The adoption of the 'Enabling Clause' by the members of the GATT established the legal framework for the GSP (Page and Kleen, 2005). The GSP was originally launched in 1968, at the UN Conference on Trade and Development where it was agreed that industrial countries would grant non-reciprocal trade preferences not just to their former colonies (where applicable) but to all developing countries. The 1970s marked a turning point in international trade policy, as some of the old special-access arrangements for the emerging independent ex-colonies were reduced or eliminated, and industrial economies were persuaded to enter into the GSP (Page, 1994). They also marked the beginning of trade preferences for development.

The recent reform process of the EU's GSP has reduced by half the number of countries eligible. This reform process is intended to focus preferences on those countries most in need, through graduation of upper-middle-income countries (UMICs) and changes to graduation thresholds across product lines. Other important changes have been made to RoO, particularly for textiles and clothing products, including with regard to cumulation. Although some have argued that analysis suggests a rather limited potential for trade shifts towards LDCs and LICs (Stevens et al., 2011), nevertheless the EU's new GSP – which came into effect on 1 January 2014 – fundamentally alters the character of its trade policy towards developing countries.

- The 'Everything but Arms' (EBA) regime for LDCs grants duty-free quota-free access to all products, except for arms and ammunition.
- The standard GSP offers generous tariff reductions to developing countries. Practically, this means partial or entire removal of tariffs on two thirds of all product categories.
- The 'Special incentive arrangement for sustainable development and good governance' (GSP+) removes fully tariffs on some of the same product categories to which reduced tariffs apply under the standard GSP. It is granted to countries which ratify and implement international conventions relating to human and labour rights, the environment and good governance and demonstrate compliance to the EU.

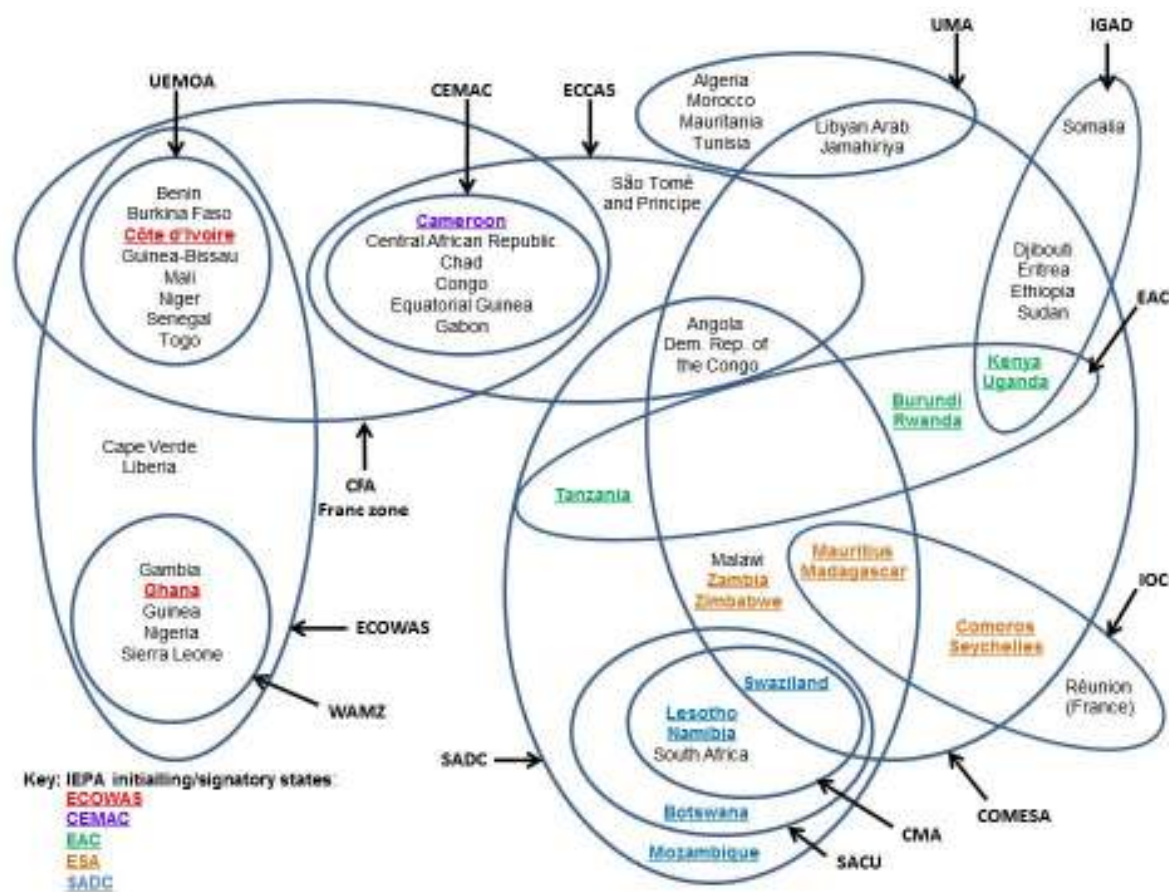
Other developed countries also offer preferential market access to developing countries. And so do, increasingly, the emerging economies such as China, India and Brazil (see Keane and te Velde, 2011). Canada has matched the EU's EBA regime which offers duty free and quota free market access for LDCs. The US currently offers some African countries preferences under its African Growth and Opportunity Act. However, these regimes are generally less secure than other FTAs which are legally binding. In comparison, GSP schemes can change, and sometimes quite dramatically – as the recent reform process of the EU's GSP has shown.

### Box 11: EPAs and regional integration

EPAs have been negotiated at the regional level. But countries also have the option to sign up to an interim agreement individually. In cases where one or some members of a REC sign an EPA with the EU but the other members do not, regional integration processes could be undermined. For SSA there are a number of instances where this may occur, particularly for countries that operate within functioning CUs. These instances include within the East African Community (EAC) and the Southern African Development Community (SADC). In the case of West Africa, and within the Economic Community of West African States (ECOWAS), members are due to adopt a CET by 2015.

Liberalisation towards the EU by one or two members but not by the others would break the CET and, at best, require internal adjustments that would severely dilute the anticipated economic and political gains from integration (Stevens, 2012: 41). There are strong motivations for the non-LDC members of these RECs to agree to an EPA with the EU. Other concerns have arisen because the structure of RoO differs between EPAs. Under the previous regime governed by the CPA, full cumulation across regions was provided for. This is limited under the new regime which will affect cumulation across RECs as well as within them (should not all countries sign an EPA).

Figure 9: African EPAs and RECs



Source: Stevens et al. (2010).

### 4.3 Overview of regional trade integration

Most countries belong to at least one bilateral agreement or RTA. The surge in RTAs has continued since the early 1990s. According to WTO figures, the vast majority (over 90%) of the agreements signed up to are FTAs, with the remainder being CUs. The observation that some countries have signed up to mutually incompatible commitments in different accords is partly because 'trade negotiations' are, in reality, not always mainly about trade – they can be an extension to a country's broader foreign policy. RTAs can be incompatible if they require members to do different things.<sup>20</sup> For this reason no country *does* belong to more than one CU (by definition) but some countries have signed up to a timetable for the creation of a CU, implementation of which has not yet reached the critical point at which they must decide. This section provides a brief overview of regional integration processes across SSA, South Asia, the Pacific and Caribbean.

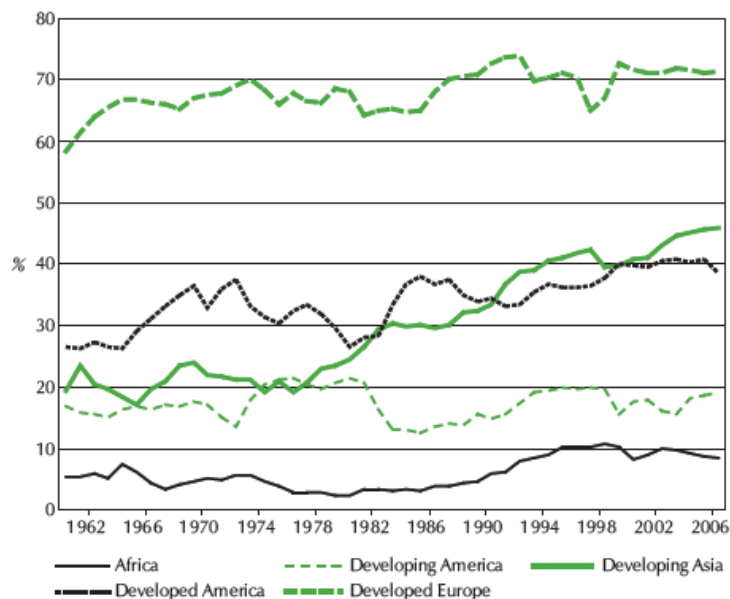
#### Regional trade integration in SSA

Intra-regional trade is particularly low in Africa. Figure 10 shows the share of regional exports in total exports for several world regions: the share in Africa is the lowest (at 10% or lower), and stands in stark contrast to that of developing Asia, which has grown very fast. RTAs on the African continent (as shown in Figure 9) are like a spaghetti bowl of overlapping agreements: complementing each other in some cases, but with

<sup>20</sup> One country cannot, for example, belong to more than one CU. Members of a CU adopt a single set of tariffs which they all apply (often with some exceptions, but only a limited number); so one country cannot agree to a tariff on widgets of 10% in one CU and of 20% in another.

conflicting objectives in others. The problems arise if the different groups to which a country belongs have incompatible requirements.

**Figure 10: Intra-regional exports as a proportion of total exports**



Source: UNCTAD (2009).

Almost all of the RTAs state as their goal closer economic integration, but implementation is at very different stages. There is also a strong drive to reconcile any existing incompatibilities. Negotiations to foster closer economic integration between and within RECs continue on the continent and the level of ambition is high. For example, the Tripartite Agreement aims to foster closer integration between the Common Market for Eastern and Southern Africa (COMESA), SADC and EAC, and to create an FTA and eventually a unified CU.

### Regional trade integration in South Asia

Bangladesh, Bhutan, India, Pakistan, Maldives, Nepal and Sri Lanka established the South Asian Association for Regional Cooperation (SAARC) in 1983, and Afghanistan joined in 2007. In 1993, the original members of SAARC established the South Asian Preferential Trading Arrangement (SAPTA) which, in 2006, was superseded by the South Asian Free Trade Agreement (SAFTA), which Afghanistan may join (SAARC, 2006). SAFTA is an RTA under which members will substantially remove barriers to the flow of goods originating within the region by the lowering of tariffs to 0–5% by 2016<sup>21</sup> (de Mel, 2007).

Even so, SAFTA has been widely criticised for lacking breadth and depth in fostering regional economic integration (Das, 2008; Raihan and Razzaque, 2007). It is mostly limited to lowering of barriers on trade in goods and leaves out other important trade-related areas of cooperation and integration for the region such as services and investment. It has also been argued that SAFTA is likely to lead to trade diversion rather than trade creation, particularly in the case of goods exported from India to Bangladesh (Razzaque, 2007). The distribution of gains between large and small countries is likely to be disproportionate and resultant specialisation in trade across countries could also be potentially harmful (Winters, 2009). Although a normal practice in trade agreements, the SAFTA sensitive list provisions weaken the regional integration process because they are

<sup>21</sup> The full liberalisation time-line is as follows: India and Pakistan by 2013; Sri Lanka by 2014; and Bangladesh, Bhutan, Maldives and Nepal (the four LDC members of SAFTA) by 2016.

so extensive. It is estimated that the sensitive list covers 53% of goods originating and traded in the region (Weerakoon and Thennakoon, 2006).

### Regional trade integration in the Pacific

RTAs in the Pacific Island economies include the Melanesian Spearhead Group (Fiji, the Solomon Islands, Papua New Guinea and Vanuatu) and the Pacific Island Countries Trade Agreement which includes all 14 island countries, and entails gradual liberalisation of tariffs. The highest profile recent negotiations have been on the Interim Economic Partnership Agreement (IEPA) with the EU and those in prospect are on the Pacific Agreement on Closer Economic Relations Plus (PACER+) with Australia and New Zealand. The Pacific region, as part of the ACP group, has been involved in negotiating an FTA with the EU. Thus far, Fiji and Papua New Guinea have signed an IEPA. Both agreements are complex deals. The main text is identical for both countries but, critically, their liberalisation schedules are completely different. The region has found it difficult to accept the IEPA as the model because its requirement to liberalise 'substantially all' imports has worrying revenue implications (PIPP, 2008; Soni et al., 2007). Trade taxes are a crucial source of revenue, and are also used (or are claimed to be used) as important policy tools to regulate exports and make them sustainable – the latter being important in a situation where exports are predominantly primary commodities (South Centre, 2007).

### Regional trade integration in the Caribbean

Fifteen of the Caribbean states belong to CARICOM, and a further five are associate members; nine also belong to the Organisation of Eastern Caribbean States (OECS) – see Box 12. Most CARICOM members<sup>22</sup> have agreed a common market and a CU, while the OECS is a monetary union with a single currency. Although only one Caribbean state (Haiti) is recognised internationally as an LDC, the members of CARICOM are divided into More Developed Countries and Less Developed ones, with the former offering special and differential treatment in terms of commitments under the CU to the latter. CARICOM was established in 1973 by the Treaty of Chaguaramas, which superseded the Caribbean Free Trade Association.<sup>23</sup> In 2001, the Treaty of Chaguaramas was revised, clearing the way for the transformation of the CU into the CARICOM Single Market and Economy (CSME). The OECS was created in 1981 by the Treaty of Basseterre.<sup>24</sup> In 1989 CARICOM signed an FTA for goods with the Dominican Republic. Together they form the CARIFORUM sub-group among the ACP signatories of the CPA. The CARIFORUM–European Community EPA has been signed by all CARIFORUM states except Haiti, which is an LDC (although the Bahamas has postponed completing and submitting its services and investment offers).

#### Box 12: Membership of CARICOM and the OECS

**CARICOM members:** *Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Suriname, Trinidad and Tobago.*

**CARICOM associate members:** *Anguilla, Bermuda, British Virgin Islands, Cayman Islands, Turks and Caicos Islands.*

*Note:* Countries in *italics* = OECS states; countries in **bold** = More Developed Countries.

<sup>22</sup> Excluding the Bahamas and Haiti.

<sup>23</sup> The first signatories were Barbados, Jamaica, Guyana and Trinidad and Tobago.

<sup>24</sup> As the successor to the West Indies Associated States. The OECS was in part established to serve as an umbrella body for already existing institutions such as the Eastern Caribbean Currency Authority (1965), later renamed the Eastern Caribbean Central Bank (1983), as well as the Eastern Caribbean Supreme Court (1967).

In addition to liberalisation on goods, the EPA includes liberalisation of services and investment as well as a number of other behind-the-border measures and clauses such as MFN and regional preference; the latter clause means whatever is granted to the EU in both goods and services must also be granted to other CARIFORUM members. This has caused some alarm since it means that countries will need to liberalise towards the Dominican Republic (which is a competitive supplier of goods also produced in the smaller Caribbean states) at the same pace as towards the EU (which tends to export goods that are different from those produced in the Caribbean). Some argue that the EPA has served to further institutionalise the fragmentation of the CSME as a CU (Gasiorek, 2008). Others argue that the EPA may serve to anchor the regional commitments that states have given to the CSME at a political level but have failed fully to implement (Lodge, 2008).

# 5 Trade and development - evidence of impact

## Key messages

- People are affected by trade policy reform, as producers, labourers and consumers. The net effect on households is therefore the sum of many different, partly offsetting, effects. Governments can influence these effects and reinforce positive and mitigate negative trade shocks
- Both static and dynamic effects arise from trade policy reform. It is the latter effect which can help to sustain growth in the long run.
- The relative productivity of exports (and imports) and the technology they embody, as well as the resultant spill-over effects they generate, serves to highlight the importance of why not only *what* you export matters, but also *how*.

Today there is no specific theory suggesting there should be a different impact of trade between developed and developing economies. Theory suggests that trade can contribute to growth. However, it is acknowledged that trade openness is a necessary, but not sufficient, condition for sustained GDP growth. Much depends on complementary policies. In a sense the question is how to maximise the benefits and minimise the costs associated with the trade-growth linkage. The literature identifies two main reasons that support the idea that developing economies might not always gain from free trade.

- First, there might be some dynamic transition path and adjustment costs resulting from the reduction of trade barriers.
- Second, there may be market failures, externalities as well as institutional failures, that prevent gains from being materialised.

In this section we first introduce a framework which provides insights about the link between trade and poverty reduction. We then provide an overview of most recent literature which focuses on trade and development: the trade-growth-productivity nexus, trade and employment issues. Finally, we draw attention to literature that explores movement into the production of more productive and sophisticated exports, and which suggests that what matters now is not only *what* you export, but also *how* in terms of ensuring that trade contributes to development.

## 5.1 Trade and poverty: how governments can influence the effects of trade<sup>25</sup>




Figure 11 provides a framework in which to view the myriad factors that mediate the impact of trade on an individual's livelihood. It shows how trade affects different people and groups according to their ability to respond to the new circumstances, and whether they are affected primarily as producers or as consumers. It is designed to draw the eye up from the bottom of the chart (and the welfare of individuals) to the levels of national institutions and markets that shape their environment (the lower sphere) and the international changes that impact a country (the upper sphere). Although it is a highly simplified view, the figure is complicated and challenging for the reader. The following sub-sections deal in turn with the areas on which the figure shines a spotlight. Most examples relate to trade in goods because it is the most familiar. But trade in services is very important and increasingly features in trade negotiations. The range of instruments available to government to control trade in services is rather different from the toolbox for goods; in some respects, a government has more control and in others it has much less.

<sup>25</sup> This sub-section is adapted from Stevens et al. (2010).



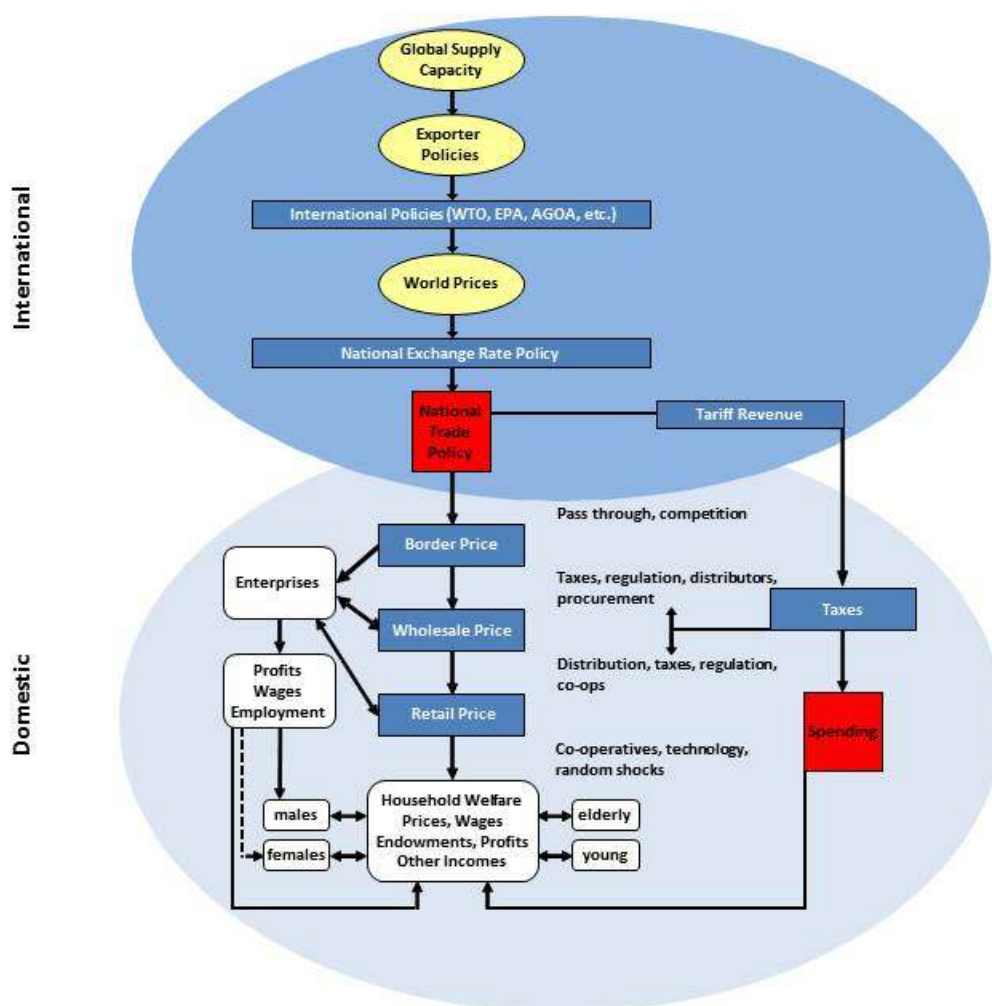
## Spheres of influence

How much authority do policy makers in developing countries have to control the impact of trade on their country and guide it onto a more dynamic strategic path? The answer is that this varies according to the forum and the type of trade effect. This diversity is captured in Figure 11 by the use of differently shaped and coloured boxes. There are four types of box. Three of them show how far factors can be influenced by a country's government:

-  oval factors over which a national government has no significant influence;
-  rectangle those where governments have some, but not full, control; and,
-  square instruments which are largely in government hands.

The fourth (a white rectangle) is used in the lower, 'domestic', sphere to indicate areas of decision making that are primarily private, though of course they are influenced to varying degrees by government policy.

**Figure 11: Trade policy and poverty: causal connections**



Source: Adapted from McCulloch et al. (2001).

Of the seven boxes shown in Figure 11 in the upper, 'international', sphere only one is a red square, denoting an instrument largely in government hands. This is summarised as 'national trade policy' which is a simplifying term for the different instruments that governments use. The other boxes are either blue rectangles, indicating that a government has some influence (e.g. by engaging in international trade negotiations) but not complete control, or yellow ovals, showing that the arenas are largely outside the direct influence of a developing country government (e.g. the responses of OECD states to the global financial crisis, or the EU's reform of its Common Agricultural Policy, or the standards set by the private sector buyers of imports in rich countries). An effective 'trade policy' necessarily involves close working between ministries and between government and stakeholders.

### The domestic sphere

This is the sphere in which a government has most instruments at its disposal to influence the impact and trajectory of trade. The price individuals receive for what they sell, and pay for what they buy, will be influenced by international trade to the extent that the price of goods at the border filters down to them through all of the intermediate boxes.

As **consumers**, households and individuals will be affected by the final retail prices of goods that are imported and those that are domestically produced and linked to imports (for example, because they use foreign inputs). As **producers**, they are also affected if they work for an enterprise (including sole traders/producers) for which imports are either an input or a competitive product. Changes to tariffs, from which governments in poor countries derive a significant part of their revenue, may also affect the volume of government spending on services for the poor. Since most people are affected both as producers (in a firm that uses or competes with imports or both) and as consumers, often on different products and sometimes on the same ones, the net impact will be the sum of many different, partly offsetting effects. In very broad terms, producers gain when demand increases as a result of trade and may lose when supply increases. For consumers it is the other way around.

Since many of these filters can be influenced by domestic national government policy there is much that can be done to reinforce positive and mitigate negative effects of trade shocks. If the wholesale and retail markets operate efficiently, any change in the price at the border will feed through into similar changes to the retail price. If the price falls this is good for consumers and input users, but bad for competing producers. If it rises (for example following a depreciation in the exchange rate) the reverse is true. But if markets are not competitive then these changes will happen only in part, or perhaps not at all. For example, intermediaries involved with trade may not pass on any reduction in costs that results from the removal of tariffs to producers (e.g. purchasers of fertiliser may not necessarily experience a reduction in prices if import tariffs on this product fall). Markets are characterised by imperfections. Governments may change spending priorities to cushion the poor and, over time, develop alternative sources – or they may not. So the impact of any given external change will be different in some countries (and for some groups) from others.

### The differing impacts of domestic and international trade

One lesson to be taken from the lower sphere of Figure 11 is that the impact on an individual or household of *international* trade overlaps to a large degree with the impact of domestic trade. But once the goods or services have crossed the border, the pathways along which their influence flows are the same as for those traded domestically.

There are big differences between international and domestic trade. These concern the breadth of effects, and the extent of change to demand and supply. Contrary to much that is written, it is domestic rather than international trade that has the greater short-

term impact on most groups in society. This is simply because in most countries domestic trade is larger than international trade. This statement does not apply to those individuals who are right 'in the firing line' of international trade (for example, because they work in a factory that exports, or one facing severe competition from imports), but most people are not in this position most of the time.

The interplay of these two differences means that for many groups (those not directly affected by the changes to demand/supply on the world market) the influence of international trade will be small relative to that of domestic trade, and by definition indirect – unless a trade shock is so great that the whole economy is affected. But for those groups that are directly affected the effects of the step changes brought about by a new demand on the world market (such as, for example, created in recent years by Chinese imports of some mineral products) or of supply (such as the sharp falls in computing prices over recent decades) can be very powerful indeed.

These results have political implications. Those groups which stand to lose as a result of a trade policy change tend to be more concentrated and face a more substantial impact than those which might gain. Hence reforms that might contribute to growth and poverty reduction might not be undertaken; those that may benefit from such reform may be totally unaware just how disproportionately they are adversely affected by the *status quo*. This might explain why protectionists lobby hard to protect their immediate interests – more so than the potential beneficiaries of longer-term benefits. The effects are very obvious in rich countries, where sectors such as agriculture receive government support that is disproportionate to their economic or social importance. But it applies equally, though perhaps less visibly, in all countries.

## 5.2 Why what you export matters

There are two new measures of export performance which suggest that *what* you export matters. First, the export sophistication measure developed by Hausmann et al. (2006) is based on export data and the *per capita* incomes of exporting countries. Producers 'upgrade' by increasing the technological sophistication of their exports, as indicated by the income which accrues to specific product lines. The measure does not require industry data, but simply information on the *per capita* incomes of exporting countries and disaggregated export data. Box 13 provides further information on the measure.

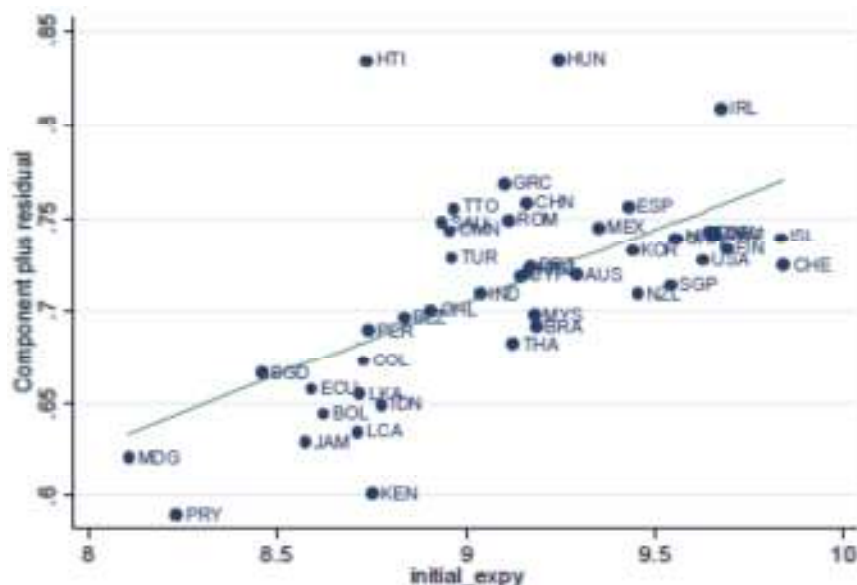
The methodology follows Lall et al. (2005); however rather than constructing competitiveness indices and locating countries and regions within upper or lower quartiles, it presents sophistication results across products and for individual countries' export baskets. It also excludes much of the discussion related to the development of industrial capabilities as emphasised by Lall (1993), since it focuses solely on income and limited human capital indicators, such as population size. All export goods are ranked according to the income level of the country that exports them, which is taken as a measure of 'sophistication'.

The second measure based on export data was developed by Hausmann and Klinger (2006), who explore Southern imitation of Northern goods which are 'new' in the South. They take as their starting point the premise that producing new things is quite different from producing more of the same: each product involves highly specific inputs such as knowledge, physical assets, intermediate inputs, labour training requirements, infrastructure needs, property rights, regulatory requirements or other public goods.

### Box 13: Export sophistication measure

Figure 12 shows growth in exports over the period 1992–2003 as a function of the 1992 level of EXPY (controlling for initial income levels). EXPY is constructed as an income/productivity level that corresponds to a country's export basket. Hence it is a measure of the productivity level associated with a country's specialisation pattern. The data show a strong relationship between the types of good a country exports and subsequent growth. Countries that export goods associated with higher productivity levels grow more rapidly, even after controlling for initial income per head, human capital levels, and time-invariant country characteristics.

**Figure 12: Relationship between productivity of exports and growth**



Source: Hausmann et al. (2006).

For example, farming asparagus requires a certain type of soil, mechanised farming equipment, agribusiness that produces at an efficient scale, port infrastructure to ship the product unspoiled and 'connections with the small group of multinational purchasers of this product'. It is assumed that established industries have, by definition, assured the presence of all related inputs and that these are subsequently made available to new entrants into a given industry. Box 14 provides more detail on the measure. But firms that venture into *new* product lines are posited to find it much harder to secure requisite inputs; hence they can be better supported by governments to do so.

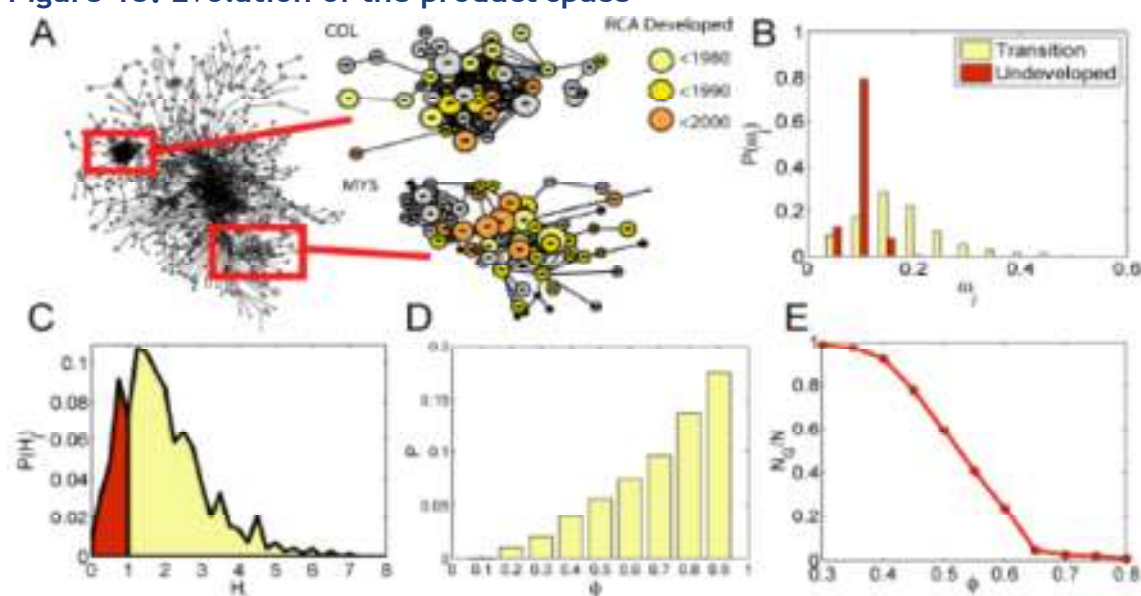
Although both measures have helped to draw attention to why *what* you export matters, as well as *how*, there is an underlying assumption that there is a natural tendency to move from one product to another in a somewhat linear fashion. Although firms with some basic manufacturing experience may be able to move more easily from garment assembly to shoe production, or vegetable exporters to cut flowers, history suggests that, with concerted effort, it is possible for countries to defy their comparative advantage and jump into the production of more sophisticated products that are far from existing productive structures, e.g. the development of the Nokia firm in Finland (Chang, 2009). External economies related to knowledge spill-overs suggest strategic interventions may be necessary to diversify into products where learning effects are

highest. This leads to a consideration of soft infrastructure such as institutions that provide training, technical assistance, and other types of business advisory services.<sup>26</sup>

#### Box 14: Moving across the product space

Figure 13A shows the empirical evolution of the product space across Colombia (COL) and Malaysia (MYS) respectively. The colour code shows when these countries first developed  $RCA > 1$  for products in the garment sector in COL and in the electronics cluster for MYS. Figure 13B presents the distribution of density for transition products and underdeveloped products. Figure 13C shows the distribution for the relative increase in density for products undergoing a transition with respect to the same products when they remain underdeveloped. Figure 13D presents the probability of developing a Revealed Comparative Advantage (RCA) given that the closest connected product is at proximity  $\phi$ . Finally, Figure 13E shows the largest connected component ( $N_{\phi}$ ) with respect to the total number of products in the system  $N$  as a function of proximity  $\phi$ .

Figure 13: Evolution of the product space



Source: Adapted from Hidalgo et al. (2007).

The process of development usually coincides with a growing role of services in the economy (alongside a reduced role for agriculture). Thus services constitute an increasing percentage of GDP in nearly all developing countries. Imports of services can significantly improve performance by bringing greater competition, international best practice, better skills and technologies and investment capital. The entry of foreign service-providers may therefore yield better services for domestic consumers, and improve the performance and competitiveness of domestic firms. Many services are key inputs to all or most other business, e.g. infrastructure services such as energy, telecommunications and transportation; financial services, which facilitate transactions and provide access to finance for investment; health and education services, which contribute to a healthy, well-trained workforce; and legal and accountancy services, which are part of the institutional framework required to underpin a healthy market economy.

<sup>26</sup> As succinctly put by Pack and Saggi (2006: 26): 'it seems much more efficient in the current state of intensifying world competition and the growing importance of extensive and complex supply networks to allow foreign firms to facilitate the reduction of costs in the host economy. This would suggest a change in focus from even the new industrial policy to one that focused on negotiation with MNCs on issues ranging from environmental regulation and taxes to efforts ensuring local learning.'

### 5.3 The trade-productivity-growth nexus

Opening up to trade increases the returns to skill and opens up new opportunities through learning and increased competition. Export growth promotes learning and the diffusion of technical knowledge (Grossman and Helpman, 1991; Chuang, 2000). Even though the exports of developing countries are usually of low skill content, they can induce technology transfer from developed to developing countries. Because technical change has been skill-biased in the past decades in several countries (Berman and Machin, 2000) technology transfer promotes the accumulation of human capital (Pissarides 1997). This is reinforced by the fact that learning from technology transfer is faster in the presence of trade. Stokey (1996) shows that trade may result in a rise in wage rates and skill premia. Accumulation of human capital enhances the quality of labour, which increases factor productivity.

In a recent extensive example, Dutz et al. (2011) use a sample of more than 26,000 manufacturing establishments across 71 countries (both developed and developing) and find that (i) bigger enterprises are more likely to invest in research and development (R&D), innovate and have higher total factor productivity (TFP); (ii) enterprises that are incorporated are significantly more likely to do R&D, and incorporation is a plus factor for process innovation by old and large firms and for TFP of micro and mature firms; (iii) foreign borrowing is a strong and statistically significant correlate of R&D activity and TFP for small and young establishments; and (iv) firms that export are significantly more likely to engage in R&D and innovation, and have higher TFP.

Compared to the income-level effects from trade policy reform posited by the neoclassical trade theory, the new trade literature incorporates a long-run effect on growth. In this sense it is important to distinguish between the static and dynamic effects of trade policy reform. For example, endogenous growth theory argues that trade openness positively affects *per capita* income and growth through the diffusion of knowledge and technology, innovation or direct foreign investment. When product markets are associated with imperfect competition exporters can exploit economies of scale, and hence reduce their costs for a given level of inputs and increase productivity (Grossman and Helpman, 1991).

#### The issue of causality in the trade-productivity relationship

The link between export diversification and TFP is strongly established at the firm level. New new trade models featuring firm heterogeneity have highlighted complex relationships between trade and productivity. According to those models, the causality between trade and productivity runs one way at the firm level, but there are feedback loops at the aggregate level. For example, according to Melitz (2003) causation may run both ways depending on whether we look at the firm or aggregate level. Firms are heterogeneous in productivity levels, and only the most productive export. However, the literature does suggest that firms may increase their productivity through exporting and learning by doing effects.

For example, Fernandes and Isgut (2005) re-investigate Colombian manufacturing firms (further to the seminal 1998 work by Clerides et al.)<sup>27</sup> and find that even when controlling for the bias caused by self-selection of the most productive plants, results suggests firms do learn by exporting. However, not all learn to the same extent and some forget what they have learnt. Some of their 'novel' results include that learning-by-exporting (LBE) effects are more than proportional to export-output ratios, suggesting the existence of spill-overs of efficiency gains from export-related tasks to

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<sup>27</sup> Kraay et al. (2001) use the same datasets as Clerides et al. (1998); they document how international packages come in bundles: exporting, importing intermediate goods, importing capital goods, and sales of equity to multinationals are not independent activities.

domestic market production. However, the study is unable to detail how and why some firms are more likely to achieve LBE than others.

### Trade and gains from diversification in imports

Because integration with some GVCs requires the import of intermediate goods before exporting final products, the issue of trade diversification in imports is as important as in exports: an increase in imports has important implications for aggregate welfare, productivity, employment and inequality. A rise in diversification of imports may also lead to productivity gains through 'import competition'. Studies focusing on developing countries find a positive effect of increased import competition on domestic productivity in developing countries.<sup>28</sup>

Gains from trade are measured in terms of productivity growth realised through lower input prices, access to higher quality of inputs and access to new technologies embodied in the imported varieties. Trefler (2004), studying the Canada–US FTA, is one of the few analyses to consider the impact on both productivity and employment, pointing out the existence of adjustment costs (which encompass unemployment and displaced workers in the short run) and finding overall that there is evidence of a rise in aggregate welfare. The effect of an increase in imported input diversity on productivity is likely to depend on the level of the absorptive capacities (human capital and spending in R&D, etc.) of the importing country (Eaton and Kortum, 1996).

## 5.4 Trade and employment

The role of factor endowments, more specifically labour, has been discussed with regards to the Heckscher-Ohlin-Samuelson trade theory which postulates that developed countries, which are relatively more capital-abundant, should import unskilled-labour-intensive goods. This should benefit unskilled workers in the exporting developing country relative to skilled workers, supporting a reduction of inequalities in developing countries. However, this is not always borne out by the empirical evidence, which rather supports the existence of an increased wage gap in developing countries.<sup>29</sup> Studies suggest that exporting to developed countries necessitates quality upgrading and adoption of new technologies, supporting an increased demand for skilled labour and resulting in increased wage inequality in developing countries (Yeaple, 2005; Verhoogen, 2008). Employment in extractive industries tends to be rather limited as most processing takes place in more technologically advanced economies.

This divergence rather than convergence may be explained by new trade theories which focus on learning by doing and incorporate spill-over effects. New trade models emphasise the important role of human capital in terms of long-run growth. There are several new factors with the potential to affect the nature through which trade and employment are linked. First, trade increasingly takes place as part of GVCs; hence the types of activity undertaken by GVC participants influence labour market outcomes (Shepherd, 2013). For instance, many GVC firms contribute to technological upgrading that in turn increases the relative demand for skilled labour, implying higher relative wages for skilled workers but also greater wage inequality between skilled and unskilled workers. There is also evidence that engaging in international activity provides greater opportunities for women to enter the formal labour market (Shepherd and Stone, 2013). Such observations support initiatives on education and capacity building in developing countries.

In long-run growth models, aggregate employment is determined by growth in the labour force, macroeconomic variables and labour market institutions. Trade enables

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<sup>28</sup> These include Levinsohn (1993) for Turkey; Krishna and Mitra (1998) for India.

<sup>29</sup> See, for example, Attanasio et al. (2004) for Colombia; Berman and Machin (2000) for 14 low and middle-income countries; Robbins and Gindling (1999) for Costa Rica.

growth which can be translated into employment opportunities measured by the employment elasticity of growth. Hence a further debate is on whether the structure and type of exports, and specialisation, matter for growth and employment; then what governments can do to promote activities that both absorb surplus labour and contribute to its up-skilling overtime.



## 6 What is aid for trade?

### Key messages

- While other financial flows (e.g. foreign direct investment and remittances) are becoming increasingly important, AfT remains a vital and relatively stable source for bridging the saving-investment gap in LDCs and LICs.
- The evidence on the effectiveness of AfT points to the fact that it can face similar challenges to aid programming; conflicting incentives for different actors often lead to bottlenecks.
- There is, however, evidence that AfT is effective in reducing trade costs and increasing exports.
- Ultimately the areas of focus depend on country priorities, but it must be borne in mind that future events will also help to shape the nature of the AfT; this includes the trade facilitation agenda and regional integration.

The AfT initiative was launched in 2005 at the WTO Hong Kong Ministerial Conference. Aid channelled to build up developing countries' trade capacity, however, predates the WTO Hong Kong Ministerial Conference. Moreover, the AfT initiative itself has evolved since then. The WTO Bali Ministerial Conference in December 2013 set a new path for the initiative by linking it to the post-2015 development agenda. This section first summarises the focus of the AfT initiative, and provides evidence on recent flows. We then review the literature on its effectiveness. Finally we offer some insights regarding future directions.

### 6.1 Definition and purpose of aid for trade

The AfT initiative was launched to address concerns over the 'development deficit' in the multilateral trade liberalisation process.<sup>30</sup> There was a realisation that trade policies centred on 'openness' alone are not sufficient to achieve economic growth and development and moreover that the trade-related opportunities and challenges for developing countries are context specific.<sup>31</sup> The WTO set up AfT Task Force<sup>32</sup> to recommend the operationalisation of the AfT the initiative (see Gillson et al., 2004; Page, 2007; Adhikari, 2011). The Task Force recommended the following six areas of focus for the AfT initiative (WTO, 2006): trade policy and regulation; trade development; trade-related infrastructure; building productive capacity; trade-related adjustment; other trade related needs. Hence, the primary focus of AfT is to help improve trade outcomes and impacts in developing countries.

The OECD uses the following definitions to monitor AfT flows, which are presented in Figure 14:<sup>33</sup>

- *Technical assistance for trade policy and regulations* (e.g. helping countries to develop trade strategies, negotiate trade agreements, and implement their outcomes)

<sup>30</sup> See: [http://www.wto.org/english/thewto\\_e/minist\\_e/min05\\_e/final\\_text\\_e.htm](http://www.wto.org/english/thewto_e/minist_e/min05_e/final_text_e.htm).

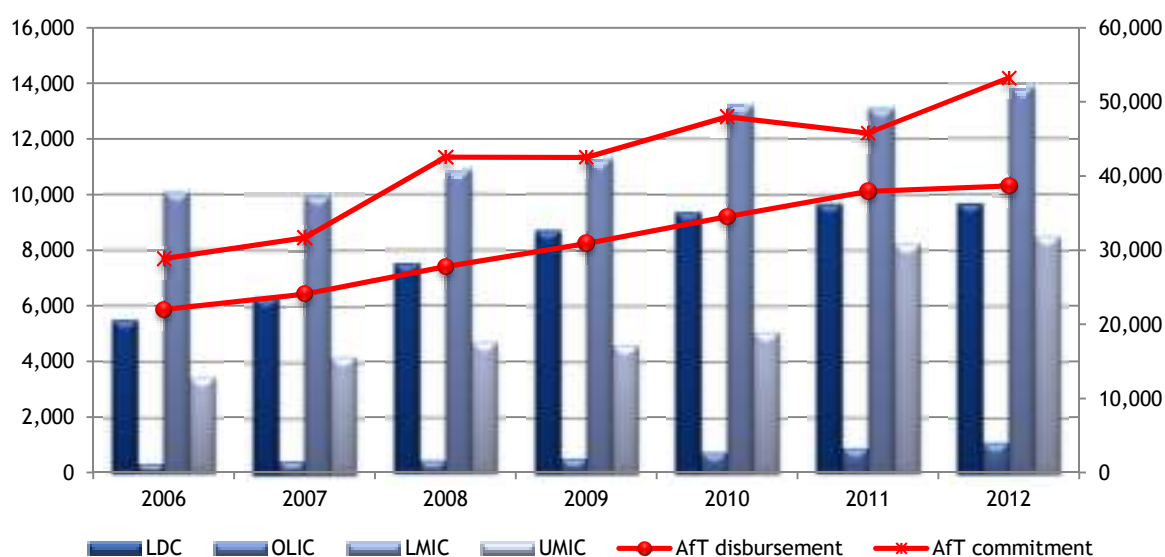
<sup>31</sup> Dani Rodrik summarises this as follows: 'trade and financial openness are unlikely to lead to economic growth on their own, and may occasionally even backfire, in the absence of a wide range of complementary institutional and governance reforms. This is in sharp contrast to the views expressed in the literature on trade and growth of some 10–15 years ago, in which the assertion was that trade liberalisation in particular has an unconditional and strong effect on economic growth on its own--even in the absence of other reforms. Once again, the evidence has rendered the older views untenable' (Rodrik, 2007: 10).

<sup>32</sup> See: [http://www.wto.org/english/tratop\\_e/devel\\_e/a4t\\_e/implementing\\_par57\\_e.htm](http://www.wto.org/english/tratop_e/devel_e/a4t_e/implementing_par57_e.htm).

<sup>33</sup> For further information see: <http://www.oecd.org/dac/aft/aid-for-tradestatisticalqueries.htm>.

- *Trade-related infrastructure* (e.g. building roads, ports, and telecommunications networks to connect domestic markets to the global economy)
- *Productive capacity building*, including *trade development* (e.g. supporting the private sector to exploit their comparative advantages and diversify their exports).
- *Trade-related adjustment* (e.g. helping developing countries with the costs associated with trade liberalisation, such as tariff reductions, preference erosion, or declining terms of trade).
- *Other trade-related needs*, if identified as trade-related development priorities in partner countries' national development strategies.

**Figure 14: AfT flows (constant prices, 2011, US\$ millions)**



Notes: Disbursement by income group (left axis). Total AfT disbursement and commitment (right axis). LDC = Least- developed countries. OLIC = Other low-income countries. LMIC = Lower-middle-income countries. UMIC = Upper-middle-income countries. The above only includes ODA (Official Development Assistance), and not other development flows (Loans, Grants and Other Official Flows (OOF)). Source: Authors' calculation based on OECD Creditor Reporting System (CRS) disbursement data (downloaded November, 2013).

Since its inception commitments under the AfT initiative have increased rapidly, reaching US\$48 billion in 2010. AfT commitments reduced to US\$41.5 billion in 2011, but increased in 2012 (see Figure 14). AfT flows, as monitored by the OECD, are a sub-set of Official Development Assistance, Other Official Flows, Grants and Loans.

## 6.2 Evidence on AfT effectiveness

While other financial flows (e.g. foreign direct investment and remittances) are becoming increasingly important, AfT remains a vital and relatively stable source for bridging the saving-investment gap in LDCs and LICs. A growing body of evidence shows that AfT is effective in reducing the cost of trading and increasing trade capacity, income and growth in recipient countries. However, the impact of AfT tends to be determined by factors such as the type of AfT flow, recipient-country-specific factors (including institutional quality), the sectors receiving AfT flows, and geographic region.

Many qualitative assessments of in-country AfT programmes have further highlighted how AfT has been effective in helping developing countries improve trade capacity, in particular trade policy and regulations. In 2011 the OECD collected 269 case stories from 150 countries on AfT, which provides developing country responses on how AfT is

helping them expand trade (OECD/WTO, 2011).<sup>34</sup> The 2013 OECD/WTO *Aid for Trade at a Glance* further shows that AfT has helped developing countries increase exports. For instance, the report finds that a 10% increase in AfT programmes to building productive capacity has led to an increase of almost 0.4% in exports in LICs. Table 5 below summarises the recent empirical evidence on AfT effectiveness.

**Table 5: Empirical evidence on AfT effectiveness**

|                                  |   |
|----------------------------------|---|
| Type of AfT flow                 | <ul style="list-style-type: none"> <li>• OECD/WTO (2013) find that AfT does have a significant and positive association with greater exports. The results suggest that a 10% increase in the amount of bilateral aid for trade committed to developing countries would increase their exports by about 0.3%. While these amounts may appear small, they indicate that an increase in aid for trade of 10% (or about US\$1 billion) would increase exports of developing countries by about US\$9 billion in recent years (OECD/WTO, 2013: 154).</li> <li>• Busse et al. (2011) examine aid directed to trade policy and regulations and trade facilitation on trade costs in developing countries as well as on the time of trading. They find that AfT is both statistically and economically significant in reducing the costs of trading.</li> <li>• Cali and te Velde (2011) find that AfT investments aimed at improving trade facilitation reduce import and export costs as well as time of trading.</li> <li>• Vijil and Wagner (2010) find that aid to trade-related infrastructure help recipient countries' increase exports. A 10% increase in aid to infrastructure leads to an average increase of the exports to GDP ratio for a developing country of 2.34%.</li> <li>• Gourdon et al. (2011) examined the effectiveness of a single, well-defined export promotion instrument: an export promotion matching grant. Their results suggest that recipients of the matching grant have experienced significantly better export growth (in terms of volumes, products and destinations) than non-recipients.</li> <li>• Helble et al. (2009) find that a 1% increase in assistance directed to trade facilitation could generate an increase in global trade of about \$415 million.</li> <li>• Ivanic et al. (2006) find that aid for infrastructure, AfT development and AfT policy together help reduce worldwide trade costs by 0.2% and to generate a total welfare gain of \$18.5 billion. Moreover, aid directed to trade policy is the most effective in lowering trade costs of the importer and exporter; trade facilitation is also found to have a significant and large impact on the trade costs of the exporter.</li> </ul> |
| Recipient country's income level | <ul style="list-style-type: none"> <li>• Ferro et al. (2011) examined the impact of AfT in five service sectors by LICs, LMICs and UMICs. The impact of aid to transportation and banking services is found to be positive and significant for LICs and LMICs, but it turns negative and significant in the case of UMICs. The effectiveness of AfT to sectors such as energy and business services increases with the income level of the group of recipient countries.</li> <li>• Busse et al. (2011) find that none of the types of AfT considered are effective in reducing the costs of trading in LDCs, but found to be effective in non-LDCs. Authors further explain that this may be due to low absorption capacity in LDCs.</li> <li>• Portugal-Perez and Wilson (2010) find that marginal effect of infrastructure improvement on exports is decreasing in income. But the impact of information and communications technology on exports is increasingly important for richer countries.</li> </ul>   |
| AfT by sector                    | <ul style="list-style-type: none"> <li>• Massa (2013: 9) finds that 'aid for trade facilitation on its own is important for fostering export flows, but it is its combination with good-quality institutions in recipient countries that allows aid for trade facilitation disbursements to unfold their positive effects'.</li> <li>• Ferro et al. (2011) suggest that aid to the transportation and energy sectors is the most effective in boosting exports. A 10% increase in aid to transportation and energy is associated with a 2% and 6.8% increase in manufacturing exports.</li> <li>• Portugal-Perez and Wilson (2010) find evidence that trade facilitation (as measured by the physical infrastructure indicator) has a greater impact in the fuels and the ores and metal sectors compared with the textiles and manufactures sectors.</li> <li>• Brenton and von Uexkull (2009) find that export development programmes tend to have a higher impact in sectors that already have strong export performance.</li> <li>• Ivanic et al. (2006) find that aid to trade policy can significantly lower costs of trading in the processed agriculture and primary agriculture sectors.</li> </ul>  |

<sup>34</sup> For full discussion on the case stories see: <http://www.oecd.org/dac/aft/48395815.pdf>

|                            |  |
|----------------------------|--|
| AFT by geographical region | <ul style="list-style-type: none"> <li>• Cali and te Velde (2011) find that AFT facilitation has a larger cost-reducing impact in SSA than in the entire sample of developing countries.</li> <li>• Ferro et al. (2011) find that aid to the services sector has different impacts across developing regions. Aid to business appears to have a positive effect on exports in Latin America and the Caribbean (LAC) and in the Middle East and North Africa (MENA), but a negative impact in South Asia (SAS). On the other hand, aid to banking displays a negative relation with exports in LAC as well as in MENA, but has a positive impact on exports in SAS. These results suggest that regions with a high percentage of UMICs (e.g. LAC and MENA) benefit more from aid to business than regions with several LICs and LMICs (e.g. SAS). The latter gain the most from aid to banking.</li> <li>• Portugal-Perez and Wilson (2010) find that aid to infrastructure produces much more significant trade gains in SSA compared with other regions</li> <li>• Ivanic et al. (2006) find that Asia sees the highest welfare gain from AFT facilitation, followed by SSA.</li> </ul> |
|----------------------------|--|

Source: Further updated from Basnett et al. (2012).

### 6.3 Designing effective Aft programmes

An increasing body of evidence points to a number of donor/recipient-specific factors that influence the effectiveness of Aft. These include (OECD/WTO, 2011 and 2013; Basnett et al., 2012):

- **Determining Aft priorities**, including the identification of binding trade-related constraints to growth, the needs assessment process, the integration of needs into national development plans; and how donors respond to trade-related needs through their country or regional programmes. For LDCs, trade related constraints are identified in their Diagnostic Trade Integration Study supported by the Enhanced Integrated Framework.<sup>35</sup> These include an action matrix on what needs to be done to address the constraints. For non-LDCs, the Poverty Reduction Strategy Papers and national development plans provide information on trade related constraints. Some non-LDCs, for example Namibia, have conducted Diagnostic Trade Integration Study-type trade constraint analysis.<sup>36</sup>
- **Structuring Aft delivery**, examining particularly what we know about the different delivery instruments, the benefits and drawbacks of bilateral and multilateral programmes as well as pooled funds and regional approaches entailing multiple recipients (including Aft to RECs and transport corridors).
- **The design and implementation of projects and programmes**, focusing on delivery of national and regional Aft programmes, issues of intra- and inter-donor coordination, integration of country systems, inter-ministerial coordination on the recipient side and the linkages of programmes to the transnational and regional level.
- **Monitoring and evaluation**, including different methodologies used and how this informs ongoing and future programmes at the global, regional, national and project levels.

Basnett and Engel (2013b) examine Aft through a political economy lens, and analyse how conflicting incentives for different actors often lead to bottlenecks. They further explore the available qualitative and quantitative data to understand the main barriers to greater effectiveness at each stage of the programming cycle, what individual country experiences tell us and, finally, how both donors and recipients can address some of these barriers to ensure greater Aft effectiveness. Table 6 summarises the main findings on the barriers that undermine the effectiveness, and thereby the outcome and impact, of Aft programmes.

<sup>35</sup> See: <http://www.enhancedif.org/>.

<sup>36</sup> See: [http://www.undp.org/content/dam/namibia/docs/povred/undp\\_na\\_povred\\_namaidfortradeframstrat\\_2011.pdf](http://www.undp.org/content/dam/namibia/docs/povred/undp_na_povred_namaidfortradeframstrat_2011.pdf).

**Table 6: Potential barriers to increasing AfT effectiveness at different programme stages**

| Key processes within stage  | Potential barriers to effectiveness  |
|---|--|
| <b>Identification of AfT needs</b>  |  |
| Determining relevance of trade-related constraints in poor development outcomes | <ul style="list-style-type: none"> <li>• Data on the impact of trade-related constraints.</li> <li>• Selection the appropriate tools to analyse constraints.</li> <li>• Resolving competing priorities in other sectors.</li> <li>• Familiarity of country context by experts identifying constraints.</li> </ul>  |
| Prioritising binding constraints to improved trade performance                  | <ul style="list-style-type: none"> <li>• Adequate resources to prioritise among large number of needs.</li> <li>• Capacity or agreement on priorities between actors.</li> <li>• Consultation with other line ministries, the private sector and other non-state actors.</li> </ul>  |
| <b>Selecting the most effective structure for the delivery of AfT</b>           |  |
| Developing AfT objectives and strategies  | <ul style="list-style-type: none"> <li>• Familiarity among donor officials with own AfT strategy and priorities.</li> <li>• Linkages between AfT and other related development strategies (e.g. agriculture, infrastructure, small and medium enterprise development).</li> <li>• Understanding at country level of AfT as a concept and its objectives (and what projects are considered to be AfT).</li> </ul> |
| Selection of appropriate aid instruments and modalities                         | <ul style="list-style-type: none"> <li>• Assessment of the relative benefits and risks of loans and grants (and blended finance).</li> <li>• Assessment of benefits (improved efficiency) and risks (may create too much uniformity in provision) of pooling funds.</li> </ul>   |
| Structuring transnational programmes  | <ul style="list-style-type: none"> <li>• Effective coordination between regional recipients and/or member states of RECs.</li> <li>• Capacity among RECs to design, implement and monitor AfT investments.</li> <li>• Potential linkages/conditionality between AfT and RTAs.</li> <li>• Donor structures to deliver regional and transnational AfT.</li> </ul>  |
| <b>Design and implementation of AfT</b>   |  |
| Developing programmes that reflect AfT priorities                               | <ul style="list-style-type: none"> <li>• Coordination between donor agencies to avoid duplication.</li> <li>• Effective recipient focal point and coordination mechanism.</li> <li>• AfT awareness among donor field offices.</li> <li>• Joint planning between donors and recipients on trade related constraints.</li> </ul>   |
| Implementation of programmes  | <ul style="list-style-type: none"> <li>• Coordination between ministries, and between implementing agencies and ministries.</li> <li>• Stable tenures of officials on both sides to improve coherence and consistency.</li> <li>• Improvements and utilisation of country systems to deliver AfT.</li> </ul>   |
| <b>Monitoring and evaluation</b>  |  |
| Developing a clear results framework  | <ul style="list-style-type: none"> <li>• Set objectives that have direct impacts on trade-related constraints and are both deliverable and measurable.</li> <li>• Use empirically tested results chains.</li> </ul>  |
| Selection of appropriate indicators   | <ul style="list-style-type: none"> <li>• Develop quantifiable indicators that translate to national priorities.</li> <li>• Establish clear indicators, particularly on institutional capacity.</li> </ul>  |
| Impact assessment   | <ul style="list-style-type: none"> <li>• Develop baseline data.</li> <li>• Use of sophisticated evaluation methods.</li> <li>• Effective control for other policy variables.</li> </ul>  |

Source: Basnett and Engel (2013a and b).

## 6.4 What areas should AfT focus on?

Ultimately the areas of focus depend on country priorities, but it must be borne in mind that future events will also help to shape the nature of the AfT initiative. This includes the outcome from the 9th Ministerial Conference in Bali and the statement made by WTO members regarding support for trade facilitation. Other important events will be the

post-2015 global development agenda (Basnett, 2013b).<sup>37</sup> The WTO Bali Ministerial Conference states that AfT would be framed by the post-2015 global development agenda.<sup>38</sup> Table 7 suggests how AfT could contribute in achieving objectives and goals in the emerging global consensus on development.

**Table 7: Future directions for AfT**

| Future directions                              | How can AfT help?  |
|--|--|
| Building productive capacity                   | <ul style="list-style-type: none"> <li>• Identify value-chain bottlenecks that undermine incentives to invest, trade and that block economic transformation.</li> <li>• Address market failure to increase productive capabilities.</li> <li>• Improve learning by doing. In the absence of transferable blueprints a lot depends on learning from trial and error.</li> <li>• Make markets work by removing governance failure.</li> </ul>  |
| Reducing the cost of trading                   | <ul style="list-style-type: none"> <li>• Modernise customs, and facilitate technology transfer to improve border procedures. Improve capacity to meet technical barriers to exports, and leverage investments for trade infrastructure.</li> <li>• Improve the quality of trade-related institutions and trade-logistics services.</li> </ul>  |
| Helping developing countries benefit from GVCs | <ul style="list-style-type: none"> <li>• Support diversification and increased value-added exports.</li> <li>• Support strategic industrial policy to address market failures.</li> <li>• Provide logistical infrastructure to reduce trade costs and improve trade competitiveness; new evidence suggests that the costs of trading matter even more now than in the past.</li> <li>• Alleviate non-tariff barriers to trade, and help build developing countries' capacities to meet technical barriers to exports.</li> <li>• Promote coordination between countries to alleviate inefficiencies at the 'whole of the value-chain' level.</li> </ul>  |
| Help leverage other financial flows            | <ul style="list-style-type: none"> <li>• Alleviate coordination failure.</li> <li>• Improve regulatory frameworks and help reduce investment risks.</li> <li>• Support the design of innovative financial instruments to leverage private financial flows, particularly remittance, for trade infrastructure development.</li> </ul>   |
| Deepening regional integration                 | <ul style="list-style-type: none"> <li>• Encouragement of greater regionalisation of trade-related projects, which will benefit from economies of scale and potential administrative streamlining, scaling up success, and improving knowledge-sharing and best practice.</li> <li>• Creation and operation of better regional AfT instruments, particularly in the areas of infrastructure development, trade facilitation and building productive capacity.</li> <li>• Regional AfT could help to strengthen the implementation of regional trade commitments.</li> <li>• Regional AfT strategies could improve vertical coherence to ensure that national trade policies and regional priorities reflect each other.</li> </ul> |

Source: Basnett (2013a).

<sup>37</sup> The 2013 *European Report on Development* chapter on trade and investment in post 2015 can be found here: [http://www.erd-report.eu/erd/report\\_2012/documents/chapters/Chapter8-Goods\\_Tradeandinvestment.pdf](http://www.erd-report.eu/erd/report_2012/documents/chapters/Chapter8-Goods_Tradeandinvestment.pdf).

<sup>38</sup> See: <http://www.odi.org.uk/opinion/8056-wto-bali-declaration-least-development-countries-trade-facilitation-agriculture-doha-round>.

## 7 Concluding remarks

This Trade Topic Guide has shown how trade theory, trade patterns and trade policy have evolved in recent years. The theory has evolved in recent years so as to incorporate aspects previously left out of standard neoclassical trade theory, such as the role of human capital. To some extent these theoretical developments have been driven by the need to account for the ability of the NICs to sustain a trade-induced growth strategy over time, which has contributed to dramatic reductions in poverty and boosted human capital (which has subsequently helped sustain growth overtime). The role of trade within a poverty reducing growth strategy has been demonstrated in recent years to be very powerful force, if harnessed and managed in the right way.

The role of scale effects which may arise because of spill-over effects (such as skilled labour), or the clustering of activities, is no longer assumed away but is instead incorporated into theoretical models. The complexity of trade models has increased and the focus is increasingly on the firm. This perspective is shared by the GVC literature. The methodological approach of GVC analysis, however, provides a lens through which to analyse not only how firms are coordinated by lead firms, but also how governments can influence these structures so as to bolster the position of domestic firms or enhance other learning and technology spill-over effects so as to assist in upgrading processes.

The 'whole of supply chain' approach is also being increasingly adopted with regard to trade policy negotiations. Services and investment are increasingly of interest, as are those measures that can help to integrate producers within supply chains and facilitate trade – for example NTMs such as standards, and improvements in trade facilitation more broadly. Tackling these barriers to trade is inevitably easier to address at the bilateral and regional levels, which provides some explanation for the proliferation of RTAs in recent years and which looks set to continue.

These developments may provide new trade opportunities for those countries so far left out of more dynamic supply chains, or which are struggling to upgrade within existing GVCs. However it must be understood that some barriers to trade may lie outside direct government control. It is the private sector that trades, and hence governments must think creatively about the appropriate means of intervening and designing rules. Consulting business associations and supporting private sector engagement may help to identify where quick wins may lie, or where longer-term interventions may be necessary.

The key is designing effective interventions which address not only the potential static adjustment costs which arise from any trade policy reform but also the potential dynamic effects. Trade policy reform is inevitably political because there are winners and losers, and the latter may be the more vociferous. Aft has a role to play in terms not only of assisting with trade-related adjustment but also developing productive capability. Because so does aid more broadly, understanding the role of trade within an overall development strategy becomes paramount.

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