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AID FOR TRADE

Keynote Address for OECD Workshop
"Aid for Trade Implementation"

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Keynote addresses normally start with the speaker saying how pleased s/he is to be here. In this case, however, I must start, first by thanking the organizers for inviting me to this important event, and second, by regretting that I cannot attend this conference in person. I look forward to seeing the conference papers and proceedings.

One of the striking empirical regularities across economies is that no country, large or small, has been able to sustain rapid economic growth over a long period of time without adopting relatively open trading regimes. In almost all cases, countries that have opened their economies and successfully achieved rapid growth have embarked upon that path by removing trade barriers and increasing incentives to export, without necessarily moving all the way to free trade. But, as they have succeeded (with a sufficient initial opening), they have undertaken further trade opening and liberalization.

An open trade regime is important for rapid economic growth for a variety of reasons, and opening to trade requires much more than lip service or simply removing a few trade barriers. In this talk, I want first to discuss what is meant by openness and why it is important, quite aside from the simple measurement of growth accounting of "the contribution of exports and imports" to growth.

There are, however, a number of necessary conditions for an outer-oriented trade strategy to be successful, and they go far beyond the removal of some, most, or all trade barriers. They reach deep into the domestic economy. But those same conditions are necessary for successful economic development and poverty reduction in any event. Elaborating on these propositions will occupy the second part of this talk.

Opening the economy for trade and moving toward the appropriate domestic economic environment are both tasks that are of necessity the responsibility of national governments. Indeed, the authorities must be reasonably strongly committed to open trade policies, and make clear that they are committed, in order for the strategy to succeed.

The question then arises as to what aid for trade can do to support the process of opening up and facilitating trade. I turn then, in the third theme, to what aid for trade can do to support domestic policy makers, and what it cannot do.

IMPORTANCE OF TRADE

One of the puzzles of development economics for many years was why the acceleration of economic growth accompanying trade opening was apparently so very large. After all, even in the most successful of rapidly growing outer-oriented economies – South Korea – export growth did not account for even half of all growth in the growth accounting sense. Even now, exports account for less than 40 percent of GDP and yet there is no question but that South Korea was transformed from a very poor country, with per capita income below that of many African countries in l960, to an industrial country by the 1990s.

There are several factors that explain why growth is so much more rapid than anticipated, although the importance of each factor probably differs from country to country. These include: the ability to use the country's abundant resources to best advantage; the utilization of economies of scale for individual firms and industries far beyond that possible in more inner-oriented economies; the competition and incentive structure that spurs more efficient use of resources by individual firms and industries; the exposure to the international market and the technology and know-how that comes with it; and the discipline that an open trading system imposes on politicians and bureaucrats that spurs them to undertake activities conducive to better economic performance while constraining them from adopting costly and inefficient policies that distort resource allocation and diminish growth prospects.

That most poor countries have abundant unskilled labor relative to their human and physical capital endowment is well known. And, as trade theory shows, there are significant gains for all countries when each produces and exports the goods that use intensively the relatively abundant factors and imports the goods using intensively the scarce factors.

It is evident that in an import-substitution oriented economy, or any economy with inappropriate incentives for exports, the scope for expansion of unskilled labor-intensive goods is constrained by the size of the domestic market. Once candles, matches, and similar goods are produced in sufficient quantity to meet domestic demand, further economic growth requires either the expansion of these activities for export or the establishment of new, more capital and skill-using goods. In the latter case, the rate at which unskilled labor can be employed in more productive ways is reduced, and with it, the growth rate and increase in real wages. When firms have sufficient incentives to expand beyond the domestic market, unskilled labor can shift into more remunerative activity at a much faster rate. In the South Korean case, where land is hilly and relatively scarce, the economy shifted from 70 percent rural and agricultural to over 90 percent industrial within a period of three and a half decades. During that time, real wages rose 8 percent annually. Of course, other things had to happen at the same time, to which attention turns later. But the rapid expansion of industrial activity in South Korea was based in large part on the rapid growth of exports, which were, during the first years of rapid development, almost entirely unskilled labor-intensive goods. Had the capital-labor had to rise more rapidly, it is clear that the rate at which South Korea could have grown would have been slower.

But using abundant resources effectively is only one advantage of an open trade strategy. A second advantage is that individual firms can operate at economically efficient sizes. Especially in countries where the population size is relatively small, economic activity oriented largely toward the domestic market constrained the size of firms (and, sometimes, worse, means that either one or two firms will produce as monopolists or quasi-monopolists in the market or size of individual firms will be very uneconomic). But even in countries with very large populations, such as India when it followed import substitution policies, many industries had only one or two firms producing each individual good, as new entrants had an incentive to produce substitutes for other imports and gain their own monopoly position, rather than compete.

The third advantage of an outer-oriented trade strategy, is that domestic firms are both confronted with competition that spurs them to become more productive, and simultaneously exposed to foreign technology and know-how is yet a further advantage of an outer-oriented trade strategy. Over time, economists have come to appreciate the importance of these benefits of an open trading regime to a greater and greater extent. At early stages of development, exposure to competition is probably the more important of the two, while as economies become emerging markets, the know-how and technical expertise to which domestic firms are exposed becomes increasingly important. This can come both through open trade policies, and regimes conducive to foreign direct investment. But the domestic economic environment that supports a successful outer oriented trade strategy is also the one that is attractive to foreign investment.

The final advantage of an outer oriented trade strategy may be the most important of all: it requires a level playing field, and is not compatible with direct intervention in support of individual firms and industries by politicians. To be sure, politicians and bureaucrats can decide on industry- or firm-specific subsidies or inducements for exporters. But once that starts happening, exporters spend more time and pay more attention to happenings in a nation's capital than they do on finding ways to become more competitive in export markets. While exports may rise quantitatively, the benefits in terms of increased productivity and growth are far smaller than they are with a genuine, level-playing field, strategy. Such a strategy focuses on improving the quality of support for all activities, the next topic for discussion.

NECESSARY CONDITIONS FOR TRADE TO YIELD STRONG BENEFITS

Interestingly, and somewhat counter-intuitively, probably the most crucial condition for a successful outer oriented trade strategy is the removal of barriers to imports. For a very low-income country removing high walls of protection, a minimum necessary initial change in the import regime is that exporters must be allowed free and timely access to the international market for any needed inputs (of machinery, equipment, intermediate goods, and raw materials). The reasons for this are obvious: without such access, potential domestic exporters will be at a disadvantage contrasted with their competitors in other countries. Unavailability of appropriate quality and competitively priced inputs can be a fatal disadvantage. For some years until the trade strategy changed, for example, Indian garment-makers were able to export very few garments using zippers. The reason was that zippers could not be imported and the domestically produced ones frequently jammed or failed to hold together. Importers did not renew orders once returns came from customers because of faulty zippers!

But protecting imports more generally is also a disincentive for exports. When producers believe they can sell in a sheltered domestic market, they have little incentive to test the market internationally. While a country may start an outer-oriented trade strategy with import barriers still in place except for exporters, it is important that remaining import barriers be relaxed, and that producers know this will happen.

There are a number of other prerequisites for a successful open trade strategy. It goes without saying that relatively stable macroeconomic policy, and especially a predictable and realistic exchange rate regime (under which the real exchange rate does not fluctuate excessively), is important. Exporters typically receive orders, require at least a few weeks for production, and time for shipment of the goods before they receive payment. If there is considerable uncertainty as to how much the promised foreign exchange payment will be, and whether it will cover domestic costs, incentives to export may be greatly reduced.

Thus far, discussion has focused on border measures that must be compatible with an open trade regime. A number of domestic economic policies must also be appropriately aligned. Central is a realistic commercial code, with appropriate provisions for legal protection and for timely judicial decisions where necessary. In the World Bank's Doing Business annual, in which countries are evaluated on such criteria as the length of time it takes to reach a court settlement and protection of property rights, there is a strong relationship between the strength of legal protections and the degree to which countries are successful exporters.

One way in which the rule of law is subverted is with corruption. When bribes are necessary to achieve the necessary approvals, they not only add to costs and uncertainty, but increase delays and the time it takes to get something done. When businessmen must spend their time courting government approvals through bribery or other means, essential time of managers is diverted from the requirements for successful exporting.

The rule of law is essential not only for trade, but also for healthy growth of domestic economic activity: it is one of the many ways in which doing the "right thing", which is necessary for an outer oriented trade strategy, is equally desirable for the economic growth of the entire domestic economy.

A reasonable degree of flexibility in markets is also needed. This is especially true for low-income countries with relatively abundant unskilled labor, with regard to laws and regulations governing workers. Comparative advantage in unskilled-labor intensive products can be wiped out if there is a minimum wage significantly above what would be the market-determined wage. At one point early in its development efforts, the Government of Papua New Guinea managed to attract a chopstick-making factory to build its factory there. But the factory closed within a year, despite the abundance of cheap wood: Papua Guinea's minimum wage was well above that of the Philippines, and the factory's owners relocated.

Since a major objective of development is poverty reduction, and more productive employment for unskilled workers is a major means of achieving higher living standards, insuring that regulations governing the labor market do not provide disincentives for hiring unskilled labor is important.

Even if an activity is not lost due to high minimum wages or rigidities imposed in hiring and firing, other consequences of overly rigid labor market regulation can follow. In several countries, including India and

Turkey, there are documented instances of firms expanding in unskilled-labor intensive activities by using more machinery and even reducing their work force. In those and many other instances, scarce capital has been wasted, and the benefits of bringing more unskilled workers into more productive employment were lost.

More broadly, an open trade strategy will not achieve its potential without adequate attention to appropriate infrastructure and appropriate pricing of it. Provision of infrastructure is a key responsibility of governments, and assuring that the supply of shipping, phone and other communication services, roads, and power is crucial. Achieving a balance between the rate of growth of capacity for these facilities, which serve all economic activity, and the rate of growth of production in goods produced by the private sector is central to the macroeconomic responsibilities of governments.

Without reliable infrastructure services, the potential for many exports is lost. In the early l960s, the World Bank economist David Morawetz did an important study of clothing exports of Hong Kong and Colombia. His starting point was the observation that Colombia was closer to the U.S. market than Hong Kong, and wages were lower. Why then, he asked, was Colombia exporting so few garments to the U.S. while Hong Kong exported so much? He found that Hong Kong producers could communicate overnight by phone with their foreign (mostly New York) buyers, adjusting order quantities as needed. They could deliver goods by air freight within 24-48 hours of receipt of an order. Colombian production processes encountered more unpredictable delays, and shipping delays were frequent. Morawetz reported that importers had stopped placing orders in Colombia after they received shipments of winter clothing the following spring, or could not meet demand for additional supplies on a reasonable timetable. The fault, he judged, lay primarily with the lack of reliable infrastructure services.

For the Aid for Trade initiative, infrastructure provision is an area with much potential, especially when lower-cost facilities can be provided across borders. The high cost of transport within Africa, and between Africa and other regions, is well known. As with rule of law, improving the cost and availability of these services would benefit the domestic economy as well as exporting activities.

Last, but certainly not least, any successful development strategy will raise the demand for capital and skilled labor. Governments hold major responsibilities for assuring, first of all, that all their citizens have access to primary education, and then increasing the supply of skilled workers. It is important that training at the secondary level of technicians such as draftsmen, nurses, and mechanics, expand supply so that, as the supply of doctors, engineers and scientists increases, their time and abilities are not wasted on being their own technicians. As with the other prerequisites of an outer oriented trade strategy, appropriate attention to education and training is vital not only for success with an outer oriented trade strategy, but also for domestic economic activity.

There are, of course, many more attributes of economic policy for successful economic growth. But the last one I shall take time on here is the critical importance of the credibility of the authorities as to their commitment to an outer oriented trade strategy. There must be credibility not only that the strategy will persist (which is critical), but also that the authorities' commitment is sufficient so that legitimate bottlenecks and obstacles will be addressed. While the authorities should not be sympathetic to cries of protection for individual firms or industries, they should be alert to factors, such as unreasonably high port charges, distortionary taxes paid by exporters, and power outages, that negatively affect all producers.

THE ROLE OF AID FOR TRADE

Almost all of the desiderata for an open economy that have been discussed are within the purview of the domestic authorities. However, this does not mean that Aid for Trade could not play a crucial role. Aid for Trade could provide meaningful inputs to the trade authorities as to the desirability of opening up the economy.

Before discussing aspects of that role, however, it needs to be pointed out that provision of assured sustainable access to markets in developed countries can play a key role in convincing the authorities (and the body politic more generally) that adoption and maintenance of an outer oriented trade strategy is worthwhile.

Too often, opponents of opening up the economy (often themselves the beneficiaries of protection) use the specter of lack of market access as an argument against change. Opponents play on skepticism about the potential for exporting and the likelihood that it will succeed to increase opposition to an outer oriented strategy. And, the more opposition there is, the less likely it is that producers will move quickly to take advantage of opportunities. The more that happens the more slowly benefits of the changed strategy will be realized, giving opponents yet further ammunition.

Moreover, while an outer oriented trade strategy can convey benefits (because of competition, access to new technology, etc.) even in the absence of a high rate of growth of exports, a higher rate of growth delivers even more benefits to the economy. Hence, a first task of aid for trade is to support efforts to remove protection in the industrial countries and emerging markets.

A second major contribution of Aid for Trade could be to provide support for the proponents of an open economy within the national government. By support I mean arguments and knowledge they can use in making the case for opening up. This can take the form of providing information about successes in other countries, in addition to support, discussed below, for technical assistance.

Ignorance of the possible benefits of opening up can itself be a barrier. In Mexico, it is reported, a leading opponent of NAFTA was an owner of a white goods manufacturing company. The apartment-sized refrigerators that were produced usually lasted less than a year before a new (domestically-made) compressor was needed. The businessman believed that, once NAFTA was in effect, his refrigerators would no longer be able to compete. Despite his efforts, NAFTA came into being. With its introduction, the businessman discovered that he could buy foreign-made compressors that were both cheaper and longer-lasting. Not only did he retain his share of the Mexican market, but he became the largest seller of apartment-sized refrigerators in the U.S. market! Obviously, Aid for Trade cannot and should not attempt to meet the concerns of individual producers and other opponents of opening up. But provision of information that could be used by local authorities through publications, conferences, and the media, on the experience of other countries, can increase support for opening up, which in turn can increase confidence that the policy changes, once made, will continue.

Beyond these activities, Aid for Trade can do much by way of technical support, both in terms of provision of information as to sales opportunities abroad, and as to needed quality control, technical aspects of foreign standards, training nationals in the intricacies of paperwork for exporting and importing, and other issues. Much attention is to be paid to these issues in this conference, so I need not dwell on them here.

Aid for Trade can also play a positive role in highlighting the priorities among the alternative activities that the authorities could undertake. This might take the form of estimating the relative importance of various infrastructure deficiencies and other cost-raising issues, sponsoring feasibility studies to compare with foreign costs to show where domestic producers are at greatest disadvantage (and perhaps what needs remedial action first), or otherwise supporting policy makers in deciding where to focus their political resources to achieve meaningful improvements.

Before concluding the discussion of the role of Aid for Trade, I should spend a few minutes addressing some things that may be less helpful or even counterproductive. In general, preferences are far less effective than assured sustainable market opening in industrial countries. A businessman contemplating whether to expand to supply an export market wants assurances that that market will remain open on stable terms. There are several problems with preferences. If they are GSP, they can be time-bound, which itself is a problem. Moreover, most GSP preferences are subject to ceilings, so that if an exporter (or his fellow producers) is too successful, preferences may no longer apply. Further, both for GSP and for preferential trading arrangements, issues arise as to when the preference-granting country may extend preferences to additional countries, thereby eroding the value of preferences to the potential producer.

Finally, those working on Aid for Trade need to avoid restricting their support to any particular sector or industry within the economy. In part because it is difficult to break the habits associated with provision of favors for particular firms or industries, and an outer oriented trade strategy needs to be uniform and across the board, any support in Aid for Trade that particular sectors need special attention should be eschewed. Moreover, when there is a level playing field, it is not possible to predict which economic activities will benefit. In Chile, for example, it was assumed that opening up would benefit Chilean industrialists, and it did, to an extent. But the largest beneficiaries were the growers and exporters of fruits and vegetables. Once the authorities had embarked with determination on removing tariffs and other forms of protection and adopted a realistic exchange rate, Chilean fruit and vegetable exports grew by leaps and bounds. This not only benefited Chilean farmers, but it also resulted in the employment of much unskilled labor in packaging and shipping. This was essential for exporting, but is also resulted in a large increase in demand for unskilled labor.

Once incentives are fairly uniform, exports can originate in things previously not considered and it is not possible to predict what will succeed. Two of the first major commodities whose exports grew in Korea were ladies' wigs and plywood. Neither of these had been considered; indeed, the wood to be processed into plywood had to be imported! No one could have forecast that Denmark would become a large exporter of Lego sets! Attempts to convince about the preferability of an outer oriented trade strategy by attempting to identify which commodities will be exported is dangerous, not only because it is not possible, but also because the temptation for the authorities then is to support the identified activities or sectors. That, as seen above, is not consistent with a successful outcome.

Aid for Trade can be very supportive in many ways. And, in situations where there are political battles over trade policy, supporting those advocating an opening up of the economy can be highly productive. Identification of needed changes in the legal environment, infrastructure, and other aspects of policy, can be invaluable, especially when based on careful analysis of the data. Direct assistance with building capacity for the technical aspects of paperwork and quality control can also prove invaluable.

CONCLUSIONS

Countries have differed in the extent to which they have opened their economies, and their success has been roughly related to the degree of support for, and belief in, the open trade regime. While luck does play a role in determining the success of the strategy, most countries where policy changes have been thoroughgoing and sustained have experienced significant acceleration in their growth rates. Getting the policy change started is difficult; with success, it gets somewhat easier. However, not everything can be done at once, and success is more likely if the major impediments to an appropriate allocation of resources are identified and addressed first. Once they are addressed and success is evident, momentum seems to build for further reforms, and recognition of the contribution of exports to economic growth increases.

But a little opening may not achieve very much. If there are many domestic regulations affecting behavior, if the exchange rate is unrealistically overvalued, or if the extent of change is relatively limited, producers are more likely to wait and see what happens next than they are to act. And, as they wait and see, the lack of impact of measures taken is evident, and critics of the strategy gain momentum. Identification of bottlenecks and barriers is, for that reason, critical, and understanding of how they affect potential traders is an area where Aid for Trade can make a large contribution.

Successful trade opening requires that much be done to improve productivity in the domestic economy as well. Enhancing the rule of law, increasing the flexibility of the labor market, provision of better infrastructure, and the many other things that can improve trade prospects also increase the productivity of the domestic economy. Hence, Aid for Trade is really one form of support for more rapid economic development and for poverty reduction more generally. By focusing on trade and its role, it can provide support for trade opening, with its direct beneficial effects on the growth rate and resource allocation, but also enable more efficient economic activity more generally.

This conference is one concrete activity toward that end. Even small improvements in growth rates and poverty reduction are greatly worthwhile. Aid for Trade is potentially an important contributor to that objective.