MAY 2008 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Making Trade Work for Developing Countries

Introduction

Adapting to change is vital for success in the modern global economy, for individuals, companies, industries and regions. New technologies breed new industries, and freer trade leads to new markets as well as global competition. "Structural adjustment" or adaptation to structural change is necessary for economies to reap the benefits of new technologies and emerging market opportunities. But such structural change can create losers as well as winners.

Governments need to find ways to ensure smooth structural adjustment – reaping the gains of a changing global market, while minimising the costs such as job losses. Opening up to trade offers big opportunities, but also brings particular challenges.

Liberal trade and investment policies are increasingly considered a necessary part of the formula for economic growth, given the experience of the past quarter century. But countries opening up their markets may also face initial resistance from their own industries and workers which stand to lose out from new competition. Discussion of economic gains and costs from increased trade liberalisation often focuses on developed countries, but developing countries have also undertaken significant trade liberalisation in the past 20 years as they saw that it could boost economic growth.

Some counties have benefited more than others from trade reforms, however, and there are lessons to be learnt from these experiences. This is important, as to improve economic growth, most developing countries will need to continue with trade reform either as a part of multilateral negotiations, a regional/bilateral process or unilateral initiatives.

This *Policy Brief* looks at how some developing countries have successfully used trade policy reform to support structural adjustment. ■

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Why is structural adjustment necessary?

Changes in global conditions such as new sources of competition, technological change and shifting societal values pose challenges for economies as they have to adapt to the new conditions. Past experience shows that in doing so, economies need to rely as much as possible on market forces to encourage mobility of labour and capital to their most productive uses. Trade reform is an important part of the policies to enable markets to work more efficiently, making it easier for economies to reap the benefits of new technologies and markets. Countries which have embraced trade have generally experienced better results in terms of growth. ■

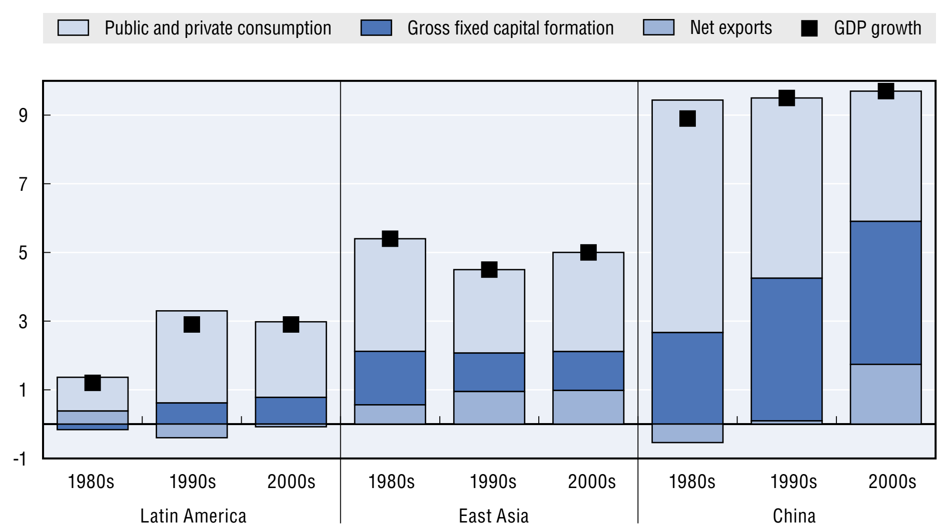
Is adapting to change harder for developing countries?

Cutting high tariffs on imports gives countries an opportunity to make industry more efficient and competitive, and thus to boost growth and living standards. But this process inevitably creates some losers as well as winners. This is true for both developed and developing countries. However, the experiences of developing countries indicate that because of their different policy environment, adjusting to change poses greater challenges for them than for developed countries.

One reason is that developing countries generally have higher existing levels of protection – barriers such as high import tariffs that make imported goods more expensive than domestically produced ones. This means that while the potential benefits of cutting tariffs are greater in the long-term, the short-term adjustment costs may also be greater if the full scope for reducing protection is exploited. A heavy reliance on tariffs for government revenue, high levels of debt in foreign currency, an illiquid foreign exchange market, and/or over-reliance on specific commodities and aid for foreign exchange complicates

Figure 1.

CONTRIBUTION OF NET EXPORTS TO GDP GROWTH



Note: Latin America refers to 8 countries, and East Asia to 6 countries. Regional figures are a weighted average of individual country rates, using each country's GDP in 1990 PPP as weights.

Source: OECD (2008) based on UN-DESA, *National Accounts Main Aggregates database.*

the task of maintaining macroeconomic stability (see Box 1). Lower levels of technological sophistication, inadequate infrastructure, weak property rights (including over intellectual property), restricted access to capital, and a lack of readily available market information often also present challenges for developing country companies in adjusting to the new challenges and opportunities presented by trade liberalisation. Political instability, poor governance and widespread corruption, as well as the absence of a formal social safety net, often also complicate the adjustment process. ■

How can trade help?

Lack of trade tends to reinforce structural rigidities and exacerbate the need for structural change. Many developing countries reformed their trade regimes when they realised that restricting imports to protect their own industries was ineffective for sustained development. For example, in Latin America and East Asia, tariffs have been cut from an average 15%-60% in 1985 to 5%-20% in 2005. In both regions, trade growth has increasingly been considered a vital component of development.

But trade alone cannot guarantee economic development. Trade policy needs to be complemented with a closely co-ordinated policy package to maximise the benefits from increased trade (see Box 2 on Trade and Structural Adjustment: Recommendations for Good Practice). Past experience shows that this is as true for developing countries as it is for developed ones. However, significant differences in the policy environment among developing countries mean that policies need to be customised to meet each country's situation. An approach which has worked for one country may not work in others.

Box 1.

CHALLENGES FOR RESOURCE RICH DEVELOPING COUNTRIES

Chile and Ecuador show two very different ways of dealing with trade shocks. As both countries rely on commodities for exports and government revenues, they have found it difficult to manage booms and busts in world prices, and to avoid a stop-go cycle of structural reforms and backtracking. Rises in commodity prices may lead to appreciation of the currency as demand for domestic currency increases with an increase in commodity exports. But a stronger currency makes it harder to develop other exports. Windfalls in government revenue also led to overspending in boom periods and high fiscal deficits in bust periods.

Chile, learning from its banking crisis and debt crisis in the late 1970s and early 1980s has increased its ability to manage the copper cycle by establishing fiscal rules that insulate government spending from windfalls and downturns and by putting in place a cautious exchange rate policy which aims to avoid misalignment of the real exchange rate. This has led to an increasingly diversified export structure.

Ecuador's oil-based economy has been less successful. Learning from its experience with a stop-go process with spells of tight fiscal policy interspersed with uncontrolled increases in public spending, resulting in major deficits and spiraling debt burdens, Ecuador did adopt a fiscal responsibility law (FRL) in 2002 which capped government expenditure growth and created an off-budget oil fund (FEIREP). However, the oil fund was incorporated back into the budget in 2000 and the money was used for purposes such as social spending. Export diversification remains a considerable challenge.

Trade reforms, to be effective, need to be closely linked with reforms in other areas, such as foreign direct investment (FDI), so that more trade is accompanied by more FDI. Labour market reforms may also be needed to facilitate the movement of labour from shrinking to growing sectors while allowing workers to adapt to change through education. Governments may also need to reform the tax system, as tariff cuts may lead to a drop in government revenue. But tariff cuts can lead to increased tariff revenue if imports increase rapidly, and so cutting red tape and eliminating non-tariff barriers is important. Developing country governments may not have sufficient resources to put formal social safety nets in place, but economic growth (often in export sectors and services) and flexible labour markets, supplemented by some focused social safety net programmes, can act as substitutes. ■

How to go about trade reform?

There are three key issues for developing countries when it comes to reforming ***trade and investment policy***.

First, sequencing and timing of reforms are important, as well as their content. While a gradual approach is often warranted to allow institutions, government bodies and industries time to adjust, a more radical approach may be advisable in some cases. In terms of content, the early elimination of quantitative restrictions (QRs) is especially important to reduce serious distortions of pricing and supply at the outset.

Second, services sector liberalisation can facilitate structural adjustment although care is needed to ensure that an appropriate regulatory framework is in place. Advances in technology are allowing developing countries to increasingly benefit from trade opportunities in services – call-centre services can be provided online from the Philippines as easily as from Manchester. At the same time, improved productivity in services which

Box 2.

GOOD PRACTICE FOR TRADE AND STRUCTURAL ADJUSTMENT

The OECD has drawn up recommendations for good practice for governments to help them deal with structural adjustment. These urge governments to adopt:

- macroeconomic policies which promote stability and growth;
- labour market policies which help develop human skills and facilitate a smooth transfer of resources from declining to expanding activities, while providing adequate assistance to those who experience adjustment costs;
- a sound regulatory and competition environment which minimises the regulatory burden on business entry, exit and transformation, and fosters competition;
- a strong institutional and governance framework that will favour structural reform, while also enhancing public understanding and acceptance of reform measures; and
- liberal trade and investment policies which support structural adjustment by contributing to growth, innovation and competitiveness and which are implemented over a period long enough to enable affected parties to adapt and short enough to avoid policy reversal.

Source: OECD(2005).

provide important inputs to agricultural and manufacturing production can promote exports in user-industries. For example, improvements in air transport services were key for the development of the cut-flowers industry in Ecuador. Export industries become a driving force for reform in services industries such as telecommunication and transport, as these industries face stiffer competition in export markets. Experiences in developing countries indicate that services liberalisation can complement and reinforce trade and economic reform.

Third, FDI can facilitate structural adjustment as a key driver of export growth as has been the case for electronics and automobiles in Thailand. It can also act as a conduit for technology transfer as has been seen with the copper, wine and salmon industries in Chile; or the cut-flower and processed tuna industries in Ecuador. FDI can also help make it easier to achieve structural change through mergers and acquisitions – developments in the cement industry in the Philippines are just one example. ■

How to boost exports?

One of the key lessons from past experience is that *exports* may be crucial in the early stages of trade reform. *Imports* often rise quickly as a result of trade reform, and indeed they are a crucial element of the process. Imports help set a correct market price for goods leading to better allocation of resources; and imports also bring in new technology. But while importers respond relatively smoothly to changes in relative prices, the response of *exporters* tends to be slow. Imports thus typically increase faster than exports after trade reforms. This can lead to various problems; a growing trade imbalance and macroeconomic instability; a short to medium term increase in unemployment; less resilience to external shocks; and difficulties in maintaining continued support for trade reform. So governments need to pay special attention to encouraging a rapid export response to trade reforms.

Macroeconomic stability and appropriate exchange rates early in the trade reform process are important elements in eliciting a strong and wide export response. Governments can also lend a hand through well-designed policies that encourage exports, such as measures that facilitate access to competitively-priced inputs, policies which provide access to financing, and policies to ensure that potential exporters have access to information about foreign markets.

Exporters need access to competitively-priced inputs for their products if they are to succeed in an increasingly competitive global market. Tariff exemptions or reimbursement of duty on materials to be used for exports, export processing zones and other mechanisms have been used with success by countries such as Thailand and the Philippines. Access to competitively priced financing is also important and can be promoted through capital market reforms or other measures to facilitate export financing.

Access to information on export markets and technology is also important. Potential exporters may just give up if it is expensive and complicated to get hold of reliable information about foreign markets. Governments can play a role in gathering and making available such information. Chile provides a good example: the trade promotion office provided focused information on foreign markets and customers, facilitated the sharing of information between exporters, while promoting the reputation of Chilean exports. While export subsidies can be an option, they are generally prohibited under rules under the World Trade Organisation (WTO), are not the most effective policies from an economic point of view and may introduce new distortions in the economy, defeating the purpose of trade liberalisation. ■

Why are coherence and credibility important?

Trade reform has been implemented as a part of overall economic reform and various policies are closely interlinked. The close linkages between trade and FDI policy, exchange rate policy, fiscal policy, or capital market policy, among others, mean that different government agencies must co-ordinate closely to ensure that policies are coherent and that reforms can be sequenced to bring about better results. Credibility of reforms is important since trade reforms will successfully induce reallocation of resources only if the private sector considers reforms will be sustained. Deeper reforms, mutually supporting and consistent policies, a track record of successful reforms and international commitments are some ways countries have used to enhance credibility of reforms. ■

What role for multilateral co-operation?

Multilateral trade liberalisation through the WTO and regional trade agreements (RTAs) can support trade reform and facilitate structural adjustment in various ways. They can signal a government's commitment to trade liberalisation and enhance credibility of reforms; they can also act as a trigger for economic reforms. International commitments can serve to lock in earlier unilateral liberalisation and to provide an upper limit to any backtracking. For example, when Chile decided to reverse preceding trade reforms in the 1980s, it was only able to raise tariffs to 35%, Chile's bound rate in the GATT, compared with 100% before reforms.

Multilateral trade liberalisation as well as bilateral and regional initiatives can also help structural adjustment by helping provide access to foreign markets, which helps encourage exports. The Philippines and Thailand have gained access to world markets through multilateral trade liberalisation, and Chile has used FTAs to widen export markets. The Doha Development Agenda (DDA) negotiations at the WTO, and other free trade initiatives can facilitate adjustment for developing countries.

Development assistance can also help countries to better manage structural adjustment through financial support and capacity building. In particular, the aid for trade initiative should lead to additional and more effective resources aimed at helping developing countries to overcome supply-side constraints, improve their trade capacity, and increase their ability to benefit from the multilateral trading system and multilateral liberalization.

Conclusion

As economies face various changes in underlying economic and societal conditions, policies to facilitate change and “structural adjustment” are becoming more important than ever before. Trade reform supplemented by complementary policies can facilitate structural adjustment and aid economies in taking advantage of emerging opportunities and facing the challenges posed by change. Differences in the policy environment can pose challenges for developing countries in moving ahead with trade reform. Experience shows that industries in developing countries can face initial difficulties in boosting exports following trade reform, requiring specific policy responses. Multilateral trade liberalisation can facilitate trade reform by providing export markets. ■

For further information

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For further reading

OECD (2005), **Trade and Structural Adjustment: Embracing Globalisation**, ISBN 978-92-64-01096-3, € 60, 339 pages.

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