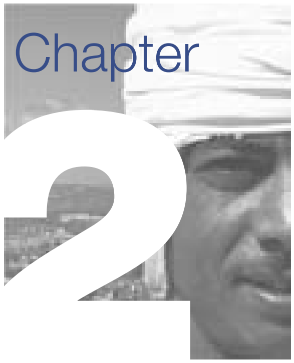


Trade Liberalization—Panacea or Mirage?

In the search for broad-based human development in Africa, is trade liberalization likely to bring real long-term benefits? Considering how meagre the benefits from Africa's trade reforms have been up to now, what is the correct trade policy for African countries? These are the questions at the heart of this chapter, which looks at three areas of central concern to African policy makers: (a) the reasons for Africa's continuing marginalization in world trade, by contrast with the success of some Asian economies; (b) the potential impact of multilateral trade liberalization on Africa's agricultural sector; and (c) the effects of trade reform on the reduction of poverty and income inequalities in Africa. The chapter concludes that liberalization in itself is not a miracle cure and that trade must be liberalized cautiously. Trade has rescued millions from deprivation and poverty, but successful development requires more than the pursuit of free trade alone.

Africa has not yet achieved much from trade liberalization – very little in terms of economic growth and certainly no better integration into the global economy. The continent has simply not been growing fast enough for long enough to break out of poverty and, to make matters worse, it has become increasingly marginalized in international trade. Africa's share of global exports saw a sharp fall from 4.1% to 1.6% between 1980 and 2000, and its share of imports fell from 3.2% to 1.3% over the same period. Even in raw materials, its share in world trade dropped from 8% in 1980 to 4.4% in 2000 (Submaramanian and Tamirisia, 2003).

The chapter compares the performance of African economies since the 1950s to that of the most successful economies of East and South East Asia. Whereas trade policies in Africa have tended to be static and applied with little reference to overall development objectives, those used in key East Asian countries have been both proactive and strategically focused, at different times employing new combinations of selective openness and restriction. A lesson that Africa can draw from the Asian experience is that trade strategy can seek to apply a well-sequenced and optimal combination of openness and control within the context of overall development strategies, while avoiding the kinds of protectionist policies of the 1960s and 1970s that seriously constrained competitiveness.

A major challenge to Africa's agricultural sector is posed by the continuation of developed country protectionism. Despite the commitments entered into during multilateral trade negotiations, rich countries continue to subsidize their agricultural sectors while African countries, under successive structural adjustment programmes (SAPs), have made large cuts in all forms of support to their farmers. Agreement has not yet been reached on the modalities of trade liberalization in agriculture, but there are growing indications of

"A major challenge to Africa's agricultural sector is posed by the continuation of developed country protectionism"

the need for much more substantial cutting of tariffs by developed countries and of the potential benefits that would accrue to developing countries, especially if their own trade liberalization measures were complemented by investment-enhancing policies.

African countries' trade policies need to be harmonized with their national development policies

An overriding issue is the need for African countries' trade policies to be harmonized with their national development policies. Although the evidence concerning the effects of trade liberalization on poverty and inequality tends to be ambiguous, we attempt to identify some broad policy issues that policy makers should consider when drawing up trade liberalization packages. It is noted that trade reform may need to be accompanied by asset redistribution, new skills formation and other kinds of deliberate intervention designed to mitigate income inequalities. In addition, macroeconomic stability helps ensure the effectiveness of trade liberalization itself and maintains the impact of various poverty-reducing initiatives.

Trade liberalization packages and Asia's success

When growth in Africa faltered in the 1980s and the continent became increasingly marginalized in the world economy, countries of East Asia and South East Asia were achieving record growth rates and becoming more integrated into global markets, many of them as dynamic exporters of technology-intensive products. Africa has not been as successful as East and South East Asia in growth performance, agricultural and industrial development and in the assimilation of new technology, four areas of comparison that we examine in more detail below. In spite of the Asian economic crises of the late 1990s, there are still important best practices applicable to Africa from the Asian development experience, especially on the complementary role of trade and industrial policies in the construction of competitive national economies.

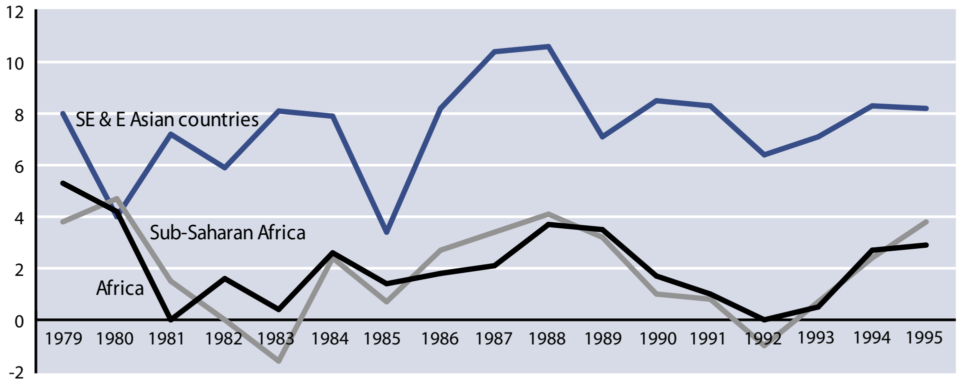
Growth performance

Many East and South East Asian economies sustained high growth and investment rates over long periods, linked to large productivity gains. By contrast, African economies have failed to maintain high growth and investment rates. Between 1965 and 1990, Hong Kong, Indonesia, Japan, Malaysia, Singapore, South Korea, Taiwan and Thailand had the world's highest growth rates (World Bank, 1993). Even when the world economy was in deep recession in the 1980s the Asian countries continued their rapid expansion: between 1979 and 1992 annual growth was 8.1% in South Korea, 7.6% in Taiwan, 7.5% in Thailand, 7.3% in Singapore, 6.7% in Hong Kong and 6.6% in Malaysia. In Africa, although growth was strong in the 1970s, fell sharply in the early 1980s and fluctuated before improving towards the late 1980s, only to plung again in the early 1990s (see figure 2.1).

Strong growth was underpinned by high investment rates in most of the Asian countries: the annual average was more than 20% of GDP between 1960 and 1990 (Page, 1994; see figure 2.2). This went hand in hand with a large push in education and research. Even when African investment rates were high in the 1970s, they never equalled those of the Asian countries. In the 1980s, overall growth and investment in Africa fell sharply as public investment declined.

Figure 2.1

Africa and South East/East Asian economies: comparative growth performance (real annual GDP growth)

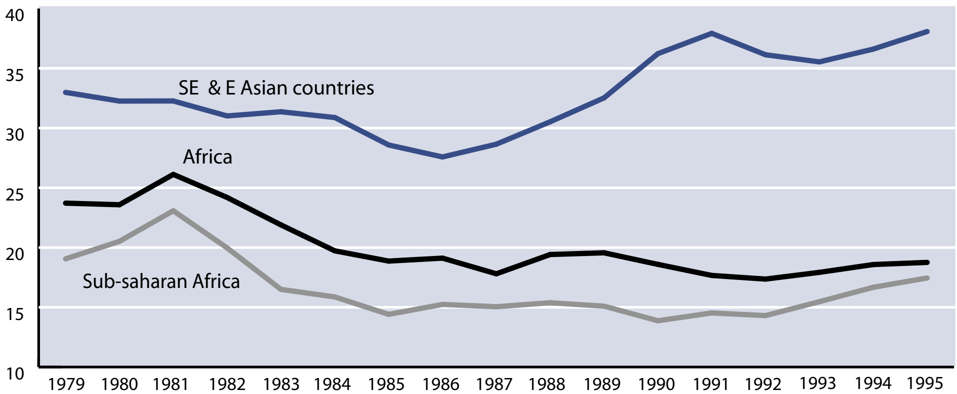


Note: *The countries referred to here as "South East & East Asia" are: Hong Kong, Malaysia, Singapore, South Korea and Thailand*

Source: *ECA, from official sources*

Figure 2.2

Africa and South Eastern/East Asian economies: gross fixed capital formation (% of GDP)



Note: *The countries referred to here as "South East & East Asia" are: Hong Kong, Malaysia, Singapore, South Korea and Thailand*

Source: *ECA, from official sources*

Agricultural modernization

Agricultural modernization played a critical role in the development of several Asian countries. Following the Second World War, Japan, South Korea and Taiwan implemented radical agrarian reforms, which led to strong growth in agricultural production. In South Korea, agricultural value – added grew by 10.3% annually between 1968 and 1979, higher than Brazil, Argentina and the United States (Kim, Hajiwara and Watanabe, 1984). Agricultural yields also increased during this period. This enabled a large part of the rural population to work in industry, and there was a steep fall in agricultural employment as a proportion of overall employment. Growth in rural incomes generated demand for products from the emerging industrial sector.

In Africa, however, a long-running agricultural crisis contributed to the development malaise of many countries. Various modernization strategies, based initially on heavy state intervention and subsequently on free market policies, failed to boost African agriculture. Archaic agrarian structures led to heavy external food dependency in many countries. In turn, low agricultural incomes constrained the success of the import-substitution strategies that most African countries adopted in the 1960s and 1970s. High levels of poverty among the rural population generated waves of migration to urban areas despite already high unemployment in cities.

> *"Industrial development and local mastery of new technologies played a major part in the growth of the most successful Asian economies"*

Industrial expansion

Industrial development played a major part in the growth of the most successful Asian economies. Between 1950 and 1990, manufacturing sector employment increased from 7% to 26.9% in South Korea, from 12% to 32% in Taiwan, from 15.4% to 24.1% in Japan and from 19% to 29.5% in Singapore (World Bank, 1993). Growth in industrial output brought about a rapid transformation in the composition of exports, with a shift towards manufactured products. Between 1967 and 1993, the proportion of industrial exports in total exports rose from 3.7% to 50.5% in Indonesia, from 12.6% to 65.5% in Thailand, from 21% to 78% in Singapore, from 24.9% to 68.4% in Malaysia, from 67.3% to 93.7% in South Korea and from 93.4% to 96.8% in Japan (UNCTAD, 1996). In Africa, industrial development faced considerable problems. Although industrial growth was strong in the 1970s, the economic crisis of the 1980s stymied this progress; industrial development strategies failed to bring about the emergence of competitive industries.

New technology

African and Asian countries also differed in their approach to technology. African countries initially chose strategies based on turnkey technology transfers in order to reduce risks, but this led to greater external dependency particularly through technical-maintenance contracts. The Asian countries developed strategies based on local mastery of new technologies. In both Africa and Asia, access to new technology came through imports rather than local invention and innovation (Bhagwati, 1978). But in Asia this was accompanied by a considerable local effort towards learning, adaptation and imitation of the imported technologies (Amsden, 1990).

The role of the State

Early explanations of the Asian "miracle" focused on the apparent openness of the most successful Asian economies to external markets, by contrast with the import-substitution approach pursued in Africa. The root of Asia's success was thought to lie in state neutrality towards economic sectors, allowing existing comparative advantage to determine the composition of production and exports. State neutrality could take the form of equal exchange rates for exports and imports and equality between domestic and world market prices (Krueger, 1983).

Later it began to be recognized that many Asian States were not at all neutral in their promotion of individual sectors and did much to foster export competitiveness, using mechanisms such as the maintenance of export-friendly effective exchange rates and the granting of large subsidies to exporters (Johnson, 1984). Trade policies were therefore part and parcel of broader national development strategies.

> *Today's most advanced economies used a range of industrial and trade policy tools during early stages of their development to support emerging industries*

In addition, it is recognized that today's most advanced economies used a range of industrial and trade policy tools during early stages of their development to support emerging industries. British industrial capacity was built up by early protection; external openness only came once the country had emerged in the mid-19th century as the world's most developed nation. It was only after the Second World War that the United States opened its economy after a century of restrictive trade policies. France, Germany and Japan also pursued industrial development in a highly controlled context, and were able to take advantage of high levels of protection to achieve strong growth rates (Clemens and Williamson, 2001; O'Rourke, 2000). Recent research has cast further doubt on studies claiming a clear link between openness and growth (see boxes 2.1 and 2.2).

World Bank research has shown how the Asian countries began import-substitution strategies, later shifting to export promotion, has shown in the late 1950s for Japan, in the late 1960s for the first generation and in the early 1980s for the second-generation industrializers (World Bank, 1993). Large investments in human resources and new technologies brought about significant gains in productivity. States also intervened to build economic competitiveness by maintaining low interest rates, protecting selected infant industries, providing export subsidies and credit and establishing export-support institutions.

This new thinking stressed the complementary roles being played by the State and by the market. Pervasive market failures made state intervention necessary and governments built a complex network of institutions to help market actors overcome problems of informational imperfection. This interlocking set of institutions included an organized and qualified civil service, organized forums for negotiation and dialogue between government and business circles, as well as sector institutions which supported the development of new industrial activities (Stiglitz, 1996). In South East Asia, the State organized competition and built institutions to support export activities. Governments strictly regulated financial institutions, channelling loans and subsidies into favoured sectors (Stiglitz and Uy, 1996). State control of markets has thus been critical to the success of these late-developing economies, particularly in bringing about the assimilation of new technology and techniques through imitation and adaptation by producers (Amsden, 1989). In addition, governments promoted education, infrastructure development, and satisfied basic needs such as health (Stiglitz, 1997).

Box 2.1

Measuring economic openness

Assessing the openness of economies is difficult. Measures can be based on the extent of use of certain policy levers such as tariffs or be constructed from outcome variables such as the composition of trade flows. Some popular indicators are listed below:

"Policy" variables

- ***Non-tariff barrier frequency:*** Fraction of imports subject to non-tariff barriers
- ***Average tariffs:*** Average tariff rates (with import categories weighted by their share in total trade)

"Outcome" variables:

- ***Structure adjusted trade intensity***: Deviation of trade share of GDP from its expected value based on structural characteristics
- ***Leamer's openness index:*** Ranking of deviation of trade volumes from values predicted by neoclassical trade theory
- ***Price distortion:*** Deviation of price levels from value expected by purchasing power parity, adjusted for income level
- ***Leamer's trade distortion index:*** Deviation of trade pattern from values predicted by theory
- ***Dollar's real exchange rate distortion and variability indices:*** The extent to which the real exchange rate deviates from its free trade level and the actual variability in the real exchange rate
- ***Black market premium:*** Currency black market premia

Each of these variables captures different features of a country's trade stance, although it has been argued that some of these may be driven by factors unconnected to the trade regime. In addition, statistical analysis has shown that these different indicators are uncorrelated, highlighting the difficulty of unambiguously capturing the nature of countries' trade regimes in indices.

Sources: *Pritchett, 1996; Rodriguez and Rodrik, 1999*

Trade policy needs to be aligned with development strategy

The East and South East Asian experience shows that trade policies cannot be pursued in isolation from broader development strategies (see box 2.3). Trade policies were integrated into the construction by the State of a dense and multi-layered network of institutions that spearheaded structural transformation and growth (Rodrik, 2002). State support of industry – including tariff and non-tariff barriers, export subsidies and credits and favourable exchange-rate policies – was not directed passively at all economic sectors but was highly selective (World Bank, 1993; Amsden, 1989). State support gradually shifted from final consumer goods sectors towards labour-intensive sectors and later into technology-intensive manufactures. In East Asia not all interventions were positive, while some were aimed at emulating a free trade regime. But in Africa most State interventions were applied haphazardly to economic sectors without any attempt at targeting or sequencing. This tended to generate speculative and rent-seeking behaviour rather than sustained structural transformation and growth.

> *National policies on human capital formation may be of critical importance in fostering international competitiveness*

Box 2.2

Openness and growth: new controversies

New growth theories have stressed the importance of human capital, learning processes, technical change and spill-overs rather than the factors concerned with increasing production alone. These theories have begun to influence thinking on international trade, and they raise questions about the ability of free trade alone to guarantee optimum resource allocation and promote high growth.

Increasing returns may lead to cumulative effects on growth and competitiveness, favouring those countries that can most quickly mobilize human capital, knowledge and the results of research and development. National policies on human capital formation and their support for certain export activities may be of critical importance in fostering international competitiveness. In addition, recent research by Rodrik and Rodriguez (1999) has cast doubt on influential earlier studies purporting to show a relationship between trade openness and growth. The studies critiqued are outlined below:

Dollar (1992): Dollar assesses the degree of openness of economies using indices of real exchange-rate distortion and exchange-rate variability. The first captures the extent of openness to intermediate goods resulting in real exchange rates favourable to exporters and the second captures uncertainties in investment decisions. Using cross-country regressions, Dollar finds that high levels of distortion and exchange-rate variability are correlated with low per capita income growth, a result that leads to the conclusion that openness has a positive effect on growth and development.

Rodrik and Rodriguez argue that Dollar's distortion index does not accurately capture the extent of trade restrictions: in many cases such distortions are the result of monetary or exchange rate policies. Finally, Dollar's regression results are not satisfactory under alternative specifications.

Sachs and Warner (1995): This study measures openness using an index constructed from average tariff levels, non-tariff barriers, the nature of the economic system, the existence of a state monopoly over key exports and the presence of a black market in foreign currency. This openness index is found to be positively correlated with the per capita income growth rate.

Rodrik and Rodriguez find that just two components of the index drive the econometric results: these are the existence of a state monopoly over exports and the presence of a black market in foreign currency. Neither of these accurately captures trade restrictions. Black markets in foreign currencies are caused by various political and economic factors, not just by lack of external openness. Export monopolies were found only in the 29 African countries that had embarked upon SAPs between the late 1980s and early 1990s, and cannot therefore be generalized to conclude a relationship between openness and growth.

Other studies: Rodrik and Rodriquez also cast doubt on the findings of other studies. Edwards (1998) found a positive relationship between productivity growth and nine different

Box 2.2 *(continued)*

Openness and growth: new controversies

indicators of openness. Rodrik and Rodriguez argue that the indicators that drive the results raise methodological problems in terms of capturing the degree of trade restriction and therefore in showing a link between openness and growth. Similar criticisms relating to the use of openness indicators apply to the study by Ben-David (1993).

The relationship between trade openness and growth is therefore hard to prove. It is difficult to condense the various aspects of trade policy into single indicators. But in addition the strong linkage between trade policy and broader economic policies makes it difficult to isolate the impact of trade policy on growth. For policy purposes it is therefore more useful to focus on more concrete features of the complex linkages between trade policies and growth. For this, the comparative perspective used in this chapter is useful.

Source: *ECA, from official sources*

"In Africa, the debt crisis of the early 1980s marked the failure of import-substitution strategies"

Box 2.3

Assessing economic openness: example from Mozambique

Mozambique liberalized its cashew sector and banned restrictions on exports of raw cashews in the early 1990s. In 1980, Mozambique had 14 processing factories and was the first African country to process cashews on a large scale. The ban on exporting raw cashews was lifted in 1991/92 and replaced with an export quota and export tax. The quota was subsequently removed, and the export tax on raw nuts came down from 60% in 1991/92 to 14% in 1998/99. Following these measures, farm-gate prices rose, raw cashew exports increased, and resources were pulled out of cashew processing. However, even under the most favourable assumptions, the magnitude of the benefits generated by these effects were quite small—both in economic terms and in relation to the amount of time and energy that Mozambique's Government spent on this issue over the years. The standard gains from the liberalization have to be set against the efficiency losses that have resulted from the idling of processing plants.

In theory, the workers employed in these plants should have found alternative sources of employment after a reasonable time, perhaps suffering some wage losses in the process. In reality, a large number seem to have remained unemployed. One account claims that 90% of the sector's 11,000 workers were unemployed in 2001. Even if one takes a fraction of this number, the loss in real output is roughly equivalent to the direct efficiency gains generated by the liberalization. Disappointing outcomes were also partly due to complications arising from imperfect market structures in the cashew sector. This means that increases in export prices are not passed on one-for-one to farmers. In other words, traders rather than the poor captured much of the benefits from the liberalization. Externally, the world market for raw cashews is significantly less competitive than that for processed cashews. In effect, India is the dominant buyer of raw cashews from Mozambique. Mozambique's transformation from an exporter of processed cashews to an exporter of raw cashews can be expected therefore to produce a terms-of-trade loss for the country, which limits any gains from liberalization.

Source: *McMillan et al., 2002*

In Africa, the debt crisis of the early 1980s marked the failure of import-substitution strategies (see box 2.4). A new consensus then emerged, emphasizing the role of trade liberalization in growth and development. Openness and export promotion would ensure greater efficiency of resource allocation and bring easier access to new technologies and capital goods. Under SAPs, African countries liberalized trade through the reduction of tariff and non-tariff barriers (although the latter remain a major constraint on intra-African trade). Currencies were devalued to help exporters. The aim was to boost exports and growth, fostering the integration of Africa into the global economy.

"The disappointing outcome of import-substitution strategies in Africa was seen most starkly in the poor productivity performance of new enterprises"

Box 2.4

Import substitution in Africa: poor outcomes

The import-substitution strategies adopted by developing countries from the 1950s onwards were meant to produce locally the consumer goods which had previously been imported from developed nations, so as to help bring about the diversification of economies. These strategies, which aimed to begin with the production of final goods and move gradually towards intermediate goods and capital goods, were accompanied by restrictive external trade policies and considerable protection for emerging industries. Complex systems of tariff and non-tariff protection, exchange control and import licensing were set up to defend local production. Protection was designed to help emerging industrialists move up the learning curve during a transitional period when the domestic price of production exceeded international prices.

Import substitution was at the heart of African development strategies during the 1960s and 1970s. African countries established industries to produce consumer goods, mostly intended for the new urban middle classes. Import-substitution strategies enabled African countries to begin modernizing production structures inherited from the colonial period and the results were seen in an average annual industrial growth rate during the 1970s of 5.5% (followed by a 2.5% contraction between 1980 and 1984 and 0.4% growth from 1984 to 1987). Manufacturing as a proportion of GDP increased rapidly and there was a rise in industrial employment and in its share of overall employment.

These strategies soon ran into problems (Bruton, 1998). The development of final goods production led to a rapid increase in imports of intermediate and capital goods, leading to worsening trade imbalances and balance-of-payments deficits. Small domestic markets did not generate sufficient demand for the products of emerging industries, preventing industries from taking advantage of economies of scale. Import substitution was biased towards elite urban consumers to maintain political support, focusing on consumer goods for the middle class.

The disappointing outcome of import-substitution strategies in Africa was seen most starkly in the poor productivity performance of the new enterprises. The purpose of protection was to help emerging firms close the gap in productivity with their developing country counterparts; enterprises were supposed to use the protection period to invest and learn so as to increase their productivity. But protection in Africa failed to make enterprises more competitive. Instead it generated rent-seeking behaviour by firms, as they took advantage of insulation from international competition. Import substitution delivered very poor results in terms of productivity improvement, structural transformation of the economy and export diversification.

Source: *ECA, from official sources*

The results were disappointing. African growth recovered in the 1990s, with average annual rates of 4% in 1996, 2.9% in 1997 and 3.3% in 1998. There were increases in per capita income, but growth remained unstable and too low to significantly reduce poverty. The share of industry in GDP fell from 39% to 32% between 1980 and 1997. Productivity growth decreased from 3.8% in 1997 to 3.2% in 1998. Africa's share in world merchandise exports fell from 6.3% in 1980 to 2.5% in 2000 in value terms. Exports recorded a mere 1.1% average annual growth over the 1980-2000 period, compared to 5.9% in Latin America and 7.1% in Asia (UNCTAD, 2003).

“The critical difference between the African and Asian experiences lies in their capacity to formulate and implement effective long-term development strategies”

About 70% of developing countries' exports are manufactures but Africa has hardly participated in the recent boom in manufactured exports. Seventeen of Africa's 20 most important non-fuel export items are primary commodities and resource-based semi-manufactures. The region's share of manufactured exports in total merchandise exports increased only by 10 percentage points in two decades—from 20% in 1980 to 30% in 2000. This figure includes South Africa: for Sub-Saharan Africa (SSA) excluding South Africa the share would be significantly lower. The value of manufactures grew at an average annual rate of 6.3% per annum in the 1980-2000 period. This is only about half the growth rates recorded by Latin America (11.5%) and Asia (13.6%) over the same period.

The share of Africa's manufactures in world manufactured exports remained unchanged at 0.8% over the two decades. Latin America's share of global manufactures exports rose from 1.9% in 1980 to 4.6% in 2000. Asia's performance was even more significant, with its share in global manufactures trade reaching 21.5% in 2000, up from only 7.1% in 1980 (UNCTAD, 2003).

Africa's opening up to external markets did not bring about a strong recovery in growth or integration into the international economy. In an environment marked by weak infrastructure in a number of African countries, trade liberalization efforts in themselves could not easily yield results. High transport costs, the inefficiency of logistical services to international trade and weaknesses in support services certainly affected the export performances of the African economies.

Planning for the longer term

The critical difference between the African and Asian experiences lies not so much in the extent to which these regions opened up, but in the extent to which policies and services supported and implemented a long-term strategic plan, correctly sequenced over time. Industrial development in East and South East Asia was driven by a combination of import substitution and export promotion. Most African countries have so far proved unable to develop their industrial export capacities. In many countries, the bulk of production and investment remains tied to import-substitution strategies that relate to the production of final consumer goods. In Asia, ever since the late 1960s export promotion has been designed to meet the dual purpose of importing capital goods (and new technologies) and of exporting goods to boost growth and maintain long-term equilibrium in the balance of payments, while in Africa, the majority of countries have remained focused solely on supplying their domestic markets. When these countries were forced to open up in the 1980s, the expected gains could not then be realized because of the weakness of their production capacity.

Effective trade policy is therefore not a simple, static choice between openness and control but a matter of correctly sequencing these over time. In Korea, the import substitution pursued in the 1960s took the form of a restrictive trade policy to defend domestic producers against imports. From the late 1960s, certain sectors were opened up (Amsden, 1989; Wade, 1990). The development of infant industries was helped along by restrictive trade policies that enabled them to build their competitive edge. At the same time, the country was wide open to the import of capital, intermediate and high-technology goods needed for the development of new industrial activities. Later on, trade liberalization was pursued for those products that had reached maturity. Openness then both generated export revenue and provided firms with the incentive to expand, so reducing speculative behaviour.

By restricting the use of trade policy instruments, WTO rules leave today's developing countries less room for manoeuvre than many of the East Asian countries had in the past

The ordering and sequencing of openness and control across different sectors over time will certainly pose great challenges for African governments, for reasons of both capacity and political economy. Given the negative outcomes of import substitution and the ambiguous results of liberalization, African countries now need to identify the correct mix of state and market actions and avoid the kinds of policies that may generate rent-seeking behaviour by firms.

The challenge of multilateral liberalization

Trade policies can support growth and development. However, an important question is whether this potentially diverse set of tools can still be used within the context of the increasing liberalization of the world economy and, moreover, can be compatible with World Trade Organization (WTO) regulations. By restricting the use of trade policy instruments, WTO rules leave today's developing countries less room for manoeuvre than many of the East Asian countries had in the past. Together with lower customs duties, less progressive tariffs and the reduction of tariff peaks, the Uruguay Round negotiations brought about the transformation of non-tariff barriers into tariffs. The Uruguay Round also required countries to reduce export subsidies apart from those on agricultural products. The WTO, which arose out of the Uruguay Round, aimed to further reduce trade barriers.

Has the birth of the WTO heralded the end of national trade policies? Certainly not: despite the WTO rules' overarching aim of deepening trade liberalization, the rules are in fact flexible enough to allow individual countries to pursue national trade policies. The rules do allow differential treatment, especially for the least developed countries, exempting them from certain provisions and giving them longer transitional periods. For example, developing countries can raise duties when imports pose problems for their balance of payments position or threaten their local industries. These provisions were used by Mexico in 1995 when it raised customs duties on textiles and clothing from 20% to 35% in order to cope with a rapid increase in imports.

The rules also allow some support for export industries. Although certain kinds of subsidies are prohibited, they can be used to promote research activities and to support vulnerable regions or pre-competition product development (Amsden, 2003).

Effects of liberalizing agricultural trade

A critical area of concern for African countries is agricultural trade liberalization. This sector is the most vital component of African economies. It makes up the bulk of national income and provides livelihoods for 80-90% of the population. At the same time, about 20% of Africa's merchandise exports come from agriculture. Some countries receive well over half of their export revenues from the sector.

"Agriculture makes up the bulk of national income and provides livelihoods for 80-90% of the population"

In terms of world trade, however, the agricultural sector has become the most distorted market of all. Agriculture and food would account for 64.8% of the total global welfare gains if all trade barriers were removed by 2005. But the distribution of these gains differ from country to country and also from region to region with the largest share going to developed countries (Anderson, 2003).

Agreements under the Uruguay Round of trade negotiations were intended to reduce the effect of distortion in the agricultural trade market. It is clear that the commitments made during the Uruguay Round were not enough. Envisaging the negative effects of distortions on agriculture, at the conclusion of the Uruguay Round Agreement, agriculture and the service sectors were the only mandated sectors for further trade liberalization negotiations. On this basis, since the year 2000, negotiations on the modalities of liberalization of trade in agriculture continued. Countries submitted their proposals as the Doha Declaration set a deadline of 31 March 2003 for producing formulae and numerical targets for countries' commitments.

Three proposals were put forward for further liberalization of trade in agriculture. These refer to cuts in tariffs, quotas and domestic support (see table 2.1).

Table 2.1

Proposals to reduce agricultural trade barriers

	Out of quota tariff[1] (% cut)	Export subsidy (% cut)	Domestic support (% cut)	Import quota (% cut)	Swiss coefficient[2]
European ("conservative")					
Developed countries	36	45	55	-	-
Developing countries	24	30	37	-	-
Swiss ("ambitious")					
All countries	-	100	100	-	25
Harbinson					
Developed countries	-	80	60	20	2
Developing countries	-	70	20	20	1

Notes:
1. "Out of quota tariff" refers to tariffs applying above the import quota under the Uruguay Round's two-tier tariffication system;
2. The Swiss cuts higher tariffs by a higher percentage, so tending towards harmonization. The "coefficient" refers to the maximum final tariff rate.
***Source:** ECA, from official sources*

Although agreement has not been reached on the different proposals it is useful to identify the effect of each of them on Africa. Using the United Nations Conference on Trade and Development (UNCTAD)'s Agricultural Trade Policy Simulation Model (ATPSM) the impact of changes in the agricultural trade policy regime on welfare can be estimated (see Annex A2.1 for description of the main features of the model). Table 2.2 shows the net effect on welfare of each of the proposals at a global and African level. Figure 2.3 shows the results for Africa. This impact is the sum of changes in consumer surplus, producer surplus and government revenue as a result of changes in trade volumes and prices.

Under the European proposal, all subregions in Africa - apart from North Africa - suffer from welfare losses under liberalization. SSA as a whole loses some $280 million while North Africa gains $50 million. North Africa gains because of benefits to its consumers through cheaper meat, fruit, cotton and tobacco products, although producers and governments would lose. In other regions of SSA, consumers would be hurt by higher prices. Benefits to producers because of easier access to developed country markets would not be large enough to offset this. Developed countries would benefit from this proposal, leading to welfare gains for the world as a whole: gains to consumers as a result of reduced prices, and gains to government because of reduced provision of subsidies, outweighing the losses to producers flowing from less domestic support. For developing regions and SSA, however, the gains to producers, as a result of better market access from this kind of liberalization, would be insufficient to outweigh welfare losses as a result of higher consumer prices and lower government revenues.

Table 2.2

Annual net welfare change from liberalization ($US billions)

	European	Swiss	Harbinson
West Africa	-0.09	0.03	-0.20
Central Africa	-0.01	-0.02	-0.02
East Africa	-0.05	0.59	-0.08
Southern Africa	-0.12	0.07	-0.24
North Africa	0.05	-0.03	-0.16
Sub-Saharan Africa	-0.28	0.66	-0.55
Least Developed Countries	-0.26	0.86	-0.74
Developing Countries	-0.04	5.07	5.02
Developed Countries	11.63	18.77	15.99
World	11.32	24.7	20.28

Source: *ECA, from official sources*

Under the Swiss proposal, there would be overall welfare gains to all regions except North and Central Africa. SSA as a whole would accrue overall welfare gains of $660 million. Central Africa would lose through the negative impact on consumers of higher prices for dairy products, meat and fruits, although consumers would gain on vegetables. In SSA as a whole, consumers would gain through lower prices for vegetables, meat, tobacco, cotton and oilseeds. This outweighs government revenue and producer losses. North and Central Africa lose under this proposal as a result of subsidy cuts because these such regions are net importers of subsidized agricultural products from developed nations. North Africa loses because of falls in government revenue and losses to producers, which outweigh consumer gains. Declines in government revenues are driven by sharply reduced tariffs on tobacco and cotton, which are important sources of revenue in this region. Although SSA as a whole also sees losses in government revenue and producer welfare, the gains to consumers outweigh these.

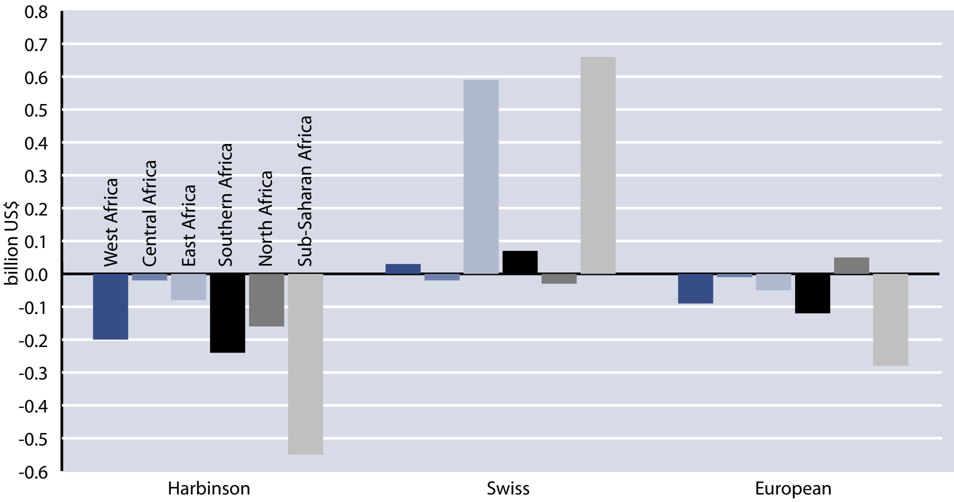
This analysis shows that the Swiss proposal brings the greatest benefits to Africa, particularly sub-Saharan Africa

In the Harbinson proposal, all of Africa's subregions suffer welfare losses. This overall loss is caused by reductions in government revenues, because of lower tariffs, and losses to consumers, because of higher agricultural prices. Globally there are welfare improvements driven by large gains in developed countries.

This analysis shows that the Swiss proposal brings the greatest benefits to Africa, particularly SSA. Developed countries also gain, with the largest share of the gains going to them. So, agricultural liberalization based on deeper cuts to higher tariffs will be more beneficial to Africa than linear tariff reduction formulae.

Figure 2.3

Impact of agricultural trade liberalization on welfare in Africa



Source: *ECA, from official sources*

Africa has to diversify its exports — as an ECA study underlines

A forthcoming study by ECA, using a general equilibrium model, reveals the extent of the gains that might be realized by African countries if full liberalization of Organization for Economic Cooperation and Development (OECD) agriculture is to be achieved. Using the Global Trade Analysis Project (GTAP) model, which is a multisector and multiregion model widely used by trade analysts to examine the impact of trade policies, the study analyses three different trade reform scenarios, capturing different degrees of trade liberalization: “little”, “modest” and “full”[1]. In the static version of the model, the study finds that full liberalization of trade would increase global welfare (income) by 0.3%, but would add 0.7% to income in the African region. But the absolute gains for SSA are quite modest – some $704 million – when compared, for example, with the $15.9 billion gains for the EU15[2]. The study also suggests that the gains from liberalization grow with the depth of reforms. While North Africa benefits from all liberalization scenarios, SSA incurs losses when partial liberalization is carried out. This is largely due to the impact of preference erosion, with many African countries being major beneficiaries of existing preferential trading arrangements. Partial market access (the “little” and “modest” scenarios) reforms would thus increase the degree of competition they face in export markets.

“These findings drive home the urgency of adopting policies to promote export diversification out of primary commodities and into industrial and service industries with a higher value-added”

However, when the model is modified to allow for dynamic effects, the study finds that there is a substantial increase in the benefits of trade reforms to all regions of the world. For the SSA region, the welfare gains from full liberalization increase from $704 million in the static model to $4.3 billion in the dynamic model. That is, the gain to SSA in the dynamic model is about six times as large as in the static model. The huge welfare gain from the dynamic model is associated with the impact of capital accumulation. The results therefore emphasize the importance of complementing trade liberalization with investment enhancing policies.

There is a potential downside from further agricultural liberalization – the findings of the simulation exercise suggest that the reforms may force countries to specialize more in the production of agricultural commodities. In particular, they result in the contraction of industrial activities in the region and the shift of resources into the production of commodities such as grains, sugar and cotton. Although this change in the pattern of specialization is dictated by comparative advantage, there is cause for concern because excessive dependence on commodities increases the degree of vulnerability faced by the region. These findings drive home the urgency of adopting policies to promote export diversification out of primary commodities and into industrial and service industries with a higher value-added.

How trade liberalization affects human welfare

In considering the impact of trade liberalization on human well-being, it is vital to consider its effects on poverty and inequality. Some of the key questions are: What risks to vulnerable groups arise as a result of trade reforms? What are the transmission channels in the short and long term?

The linkages between trade policies, income distribution and poverty in Africa are growing areas of research. Although little is known about how trade liberalization affects income distribution and poverty, it is possible to draw some general preliminary policy lessons. Trade policies affect household welfare through the following mechanisms (Winters, 2000):

- Prices of consumption goods;
- Factor prices, income and employment;
- Government revenue;
- The incentives for investment and innovation, which affect long-run economic growth; and
- Short-run risk and adjustment costs.

Empirical evidence on the effects of trade policies on income distribution and poverty are mixed because of diverse country experiences and methodologies

The effects of trade policies on prices of consumption goods and factors of production are the most documented linkage: these channels have a direct bearing on the state of income growth, wealth creation and income distribution. Some studies, particularly those based on economy-wide models, address the fiscal impact of trade policies and analyse the effects on household welfare through changes in public expenditure patterns. The effects of trade policies on incentives for investment and on short-run adjustment costs are less well known because of limited data.

Poverty and inequality

Empirical evidence on the effects of trade policies on income distribution and poverty are mixed because of diverse country experiences and methodologies. Most approaches start from standard trade theory which says that trade liberalization will benefit a country's relatively abundant factor of production. In Africa, unskilled labour is a relatively abundant factor and trade liberalization should therefore reduce income inequality, but this is not borne out by the evidence. Many of the underlying assumptions of standard trade theory such as factor mobility and perfect competition are unlikely to hold in developing countries.

Other approaches suggest that countries abundant in natural resources such as land can experience a rise in income inequality following trade liberalization (e.g. Bourguignon and Morrison, 1990; Fischer, 2000). Countries that are abundant in land are relatively poor in capital and labour, and hence the return to their ownership is raised. Since both capital and labour are owned inequitably in Africa, inequality tends to rise (see figure 2.4). (A lower population density represents higher land abundance; for these countries, inequality is higher).

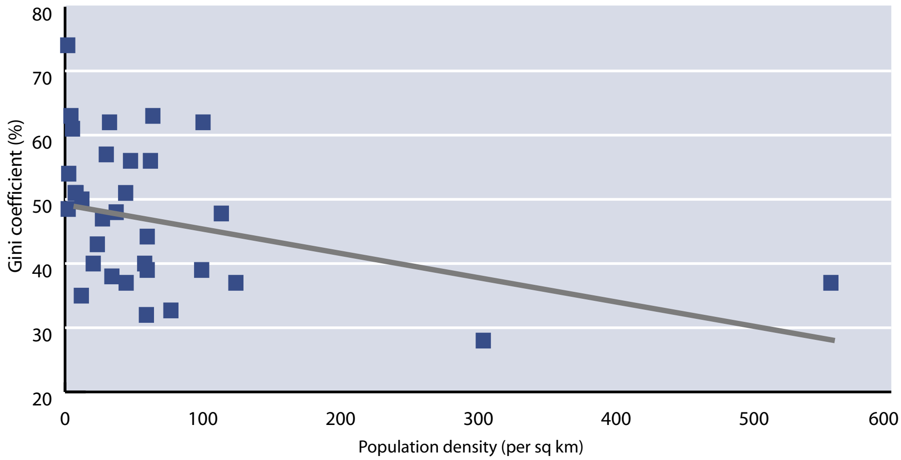
Cross-country evidence has shown that openness is positively correlated with income inequality (Spilimbergo et al. 1999; Fischer, 2000; Easterly, 2002; see figure 2.5) although other studies have found a weak or neutral effect (Dollar and Kraay, 2001). Political economy explanations have focused on the fact that resource-rich countries, which mainly depend on a few export products, tend to have institutions that favour the persistence of income inequality (Easterly, 2002).

Economy-wide models identify the effects of trade liberalization on household welfare, government revenues and inequality, through three main channels (Bourguignon et al., 1991):

- Changes in factor incomes following trade liberalization affect income distribution. This occurs through the labour market, where changes in the prices of tradable goods (exportables and importables) cause changes in labour demand;

Figure 2.4

Endowment of land and income inequality

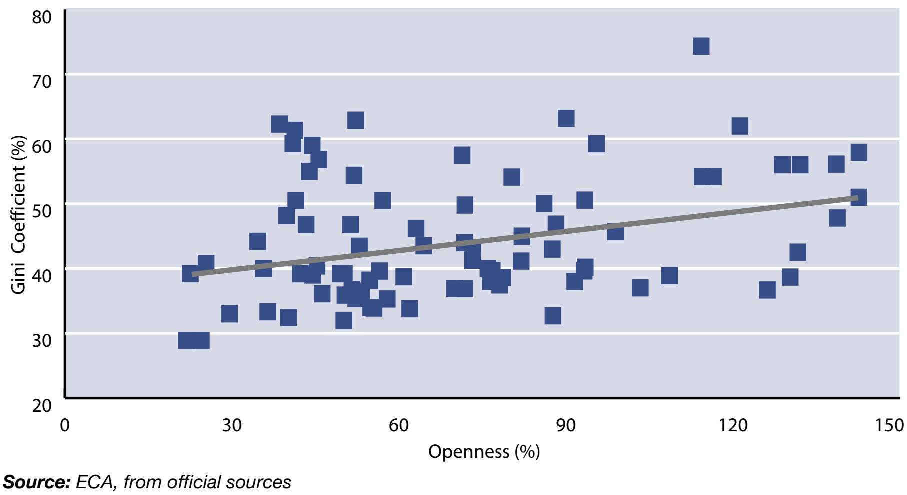


Source: *ECA, from official sources*

Note: *The Gini coefficient is a measure of inequality with values between 0 and 1; values closer to 1 indicate greater inequality*

Figure 2.5

Openness and income inequality in Africa in the 1990s



Source: *ECA, from official sources*

Note: *Openness is measured as the share of exports and imports in GDP*

- Changes in relative prices affect consumption expenditure. Depending on the pattern of consumption of households belonging to different groups, changes in the prices of tradables and non-tradables cause changes in welfare; and
- Changes to the return to capital affect the distribution of household wealth creation.

Box 2.5 illustrates the effects of some measures of trade liberalization on growth, household incomes and poverty for a fairly typical African economy, based on an economy-wide model. The analysis shows that tariff reform could be beneficial to the poor, while removal of export subsidies could increase the incidence of poverty. In both cases, GDP falls due to declines in all factor incomes. The reason that tariff reduction led to a decline in poverty is mainly explained through the possibility of achieving basic needs at a lower cost than before the reform.

"In some cases, trade liberalization could worsen income distribution by reducing the demand for unskilled labour"

Box 2.5

Trade reform in a typical African economy

Using a stylized model of a small open African economy, the welfare effects of trade reforms across sectors can be simulated. Households can be divided into six types: rural, small landowner, large landowner, urban low-income, urban high-income and capitalist. Factors of production are skilled and unskilled labour, land and agricultural capital. The sectors in the economy are agriculture, producing traditional and export crops, services (private and public), industry and mining. The base-level income distribution is approximated on the basis of actual data sets and the poverty line is allowed to vary with relative prices and is determined by the model.

Variables	Percentage change following a reduction of the price of exports by 30%	Percentage change following a reduction of tariffs by 50%
GDP (factor cost)	-5.88	-1.56
Wage of unqualified labour	-6.56	-1.31
Wage of qualified labour	-3.83	-1.69
Small land/owner	-6.93	-1.46
Large land/owner	-6.91	-1.69
Mean household income	-4.1	-1.7
Headcount ratio	7.2	-3.4
Poverty gap	11.4	-13.2
Square poverty gap	13.8	-3.1

Both a 30% reduction in the price of exports (caused say by a removal of export subsidies), and a 50% reduction in tariffs on imports will have an effect of reducing GDP and household income. Rates of return to all factors of production also decline, leading to an increase in the incidence of poverty.

Although the tariff cuts lead to lower GDP, poverty falls. This is because of a fall in the domestic price for imports that compete with traditional agriculture and the industrial sector. With a reduction in import prices, agents substitute their consumption of domestic products for imported goods. This, in turn, favours a decline in the consumption price of locally-produced goods. Although exports increase, this will not be enough to absorb the overall decline in demand for domestically produced goods. As a result, factor prices fall and thus GDP declines. Poverty decreases mainly because of the adjustment of the poverty line to changes in relative prices.

Source: *Declauwe et al., 1999*

Country experiences as to the effect of trade liberalization on poverty vary considerably, depending on consumption patterns and economic structure. If resources cannot move quickly in response to new price conditions, tariff reductions may not stimulate exports enough to bring about reductions in poverty. If domestic firms cannot compete with producers of imported products, and the labour market is rigid, employment may fall and poverty increase in the short term. In some cases, trade liberalization could worsen income distribution by reducing the demand for unskilled labour.

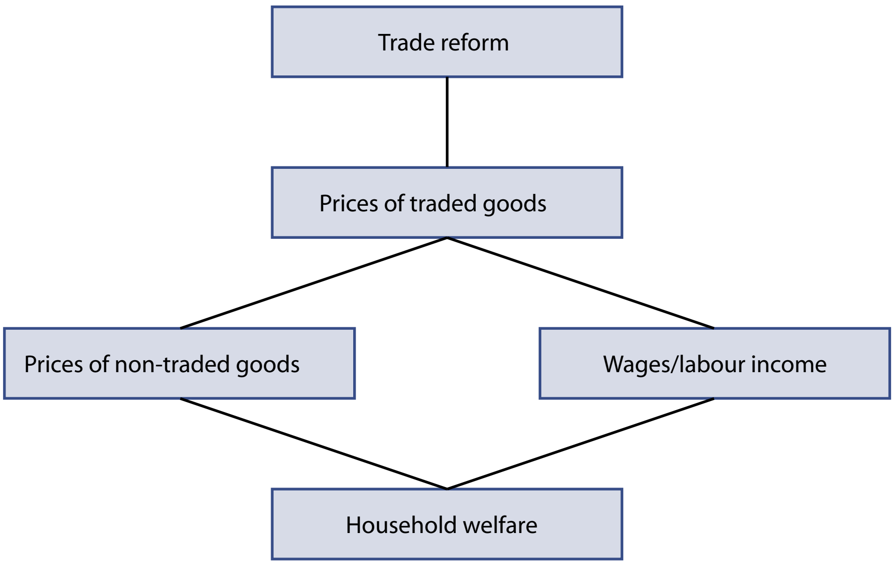
> *A study of South Africa showed that trade liberalization has the potential to benefit poorer people*

A study of South Africa showed that trade liberalization has the potential to benefit poorer people. A complete removal of tariffs would boost the welfare of black South Africans who depend heavily on the export sector, but would cut that of white South Africans (Devarajan and Mensbrugghe, 2000). Similar analysis of Tanzania demonstrated that a 50% reduction in import duties would improve household welfare in a revenue-neutral setting for the government budget. Smallholder farmers would be the primary beneficiaries of export expansion. This may apply to other countries where the export sector is made up of poor and smallholder farm households. In economies where large-scale farmers dominate the export sector, and smallholders dominate the non-tradable sector, trade liberalization may not lead to such a reduction in poverty.

The welfare impacts of trade reform in Africa are complex, depending on the initial income distribution, the structure of the economy, levels of market integration and export diversification, as well as on a country's overall trade orientation. Trade reform has different welfare effects on different social groups. For some, the effect is transitory, while for others it could

Figure 2.6

Illustration of impact of trade reform on household welfare



Source: *ECA, from official sources* be of a long-term nature. Trade reform can have effects on intra-household inequality and gender disparity. There may be changes in job opportunities and in the composition of workforces with the evolution of female-intensive or male-intensive employment groups.

The welfare of households can be evaluated in light of partial equilibrium analysis, which considers labour income, capital income, transfers and other exogenous income now affected by liberalization (see figure 2.6). In a small open economy, the price of traded goods is determined by the international market and by the tariff level. Tariff reductions affect wages in the traded goods sector and prices of non-traded goods, leading to changes in income and expenditure of the household.

The net effect on household welfare depends on the budget shares spent on traded versus non-traded goods by households, the extent to which prices of non-tradable goods respond to changes in the prices of tradables, and by the degree to which earnings are affected by a change in the price of tradable goods.

Detailed household survey data can be used to analyse the net impact of several types of trade reforms on overall income distribution. It is also possible to look at the "pro-poorness" of a trade policy using this approach. Tariff reductions on commodities consumed by the poor (such as food) can have substantial welfare gains and improve income distribution. Case (1998) found that in South Africa the consumption effect alone of trade reform could improve the welfare of both black and white households, with the effect for black households being larger.

In a typical agrarian economy, the removal of tariffs, export subsidies, or export taxes affects household welfare in more than one way since households are both producers and consumers (Winters, 2002). Gains on the consumption side could easily be offset by losses in production if the household is a net producer of non-tradables.

In most African countries, the market structure of agricultural exports is oligopolistic, principally dominated by middlemen with substantial power in the determination of prices. As a result, they are the primary beneficiaries of any increase in the price of exports. The pro-poorness of trade liberalization therefore also depends on market structure, and the role of poor farmers in price determination. In primary products, supply responses can be weak and price gains to producers small, and this suggests a small welfare gain to the poor.

Employment and wages

Some trade models predict the short-run and long-run effects of trade liberalization reforms (changes in import tariffs) on employment and wages for a small, open developing economy without wage rigidities. In the short run, employment in the exportable sector increases, while it declines in the importable sectors. The employment effects in the non-tradable sector are ambiguous (see tables 2.3 and 2.4). This situation also remains unchanged in the long run. Thus, the effect of trade liberalization on employment both in the short run and in the long run is the same in all sectors. But, the effect on wages is different. In the short run, wages tend to decline in all sectors and then rise in the long run. In the short run, in the exportable sector, the wage rate falls because of an increase in the supply of labour. Wages fall in the importable sector because of lower demand for its products. In the long run, wages in the exportable sector rise as labour demand increases in the sector. In the importable sector, wages also rise as labour shifts to the exportable sector. Wages in the non-tradable sector increase as labour shifts to other sectors.

Positive welfare effects can be enhanced if liberalization is well timed and carried out under conditions of macroeconomic stability

Table 2.3

Short-run employment and wage adjustments following trade liberalization in traditional trade models

Sectors	Employment	Wages
Exportable	Increasing	Decreasing
Importable	Decreasing	Decreasing
Non-tradable	Ambiguous	Decreasing

Source: *Fosu, 2002, adapted from Edwards, 1988*

Table 2.4

Long-run employment and wage adjustments following trade liberalization in traditional trade models

Sectors	Employment	Wages
Exportable	Increasing	Increasing
Importable	Decreasing	Increasing
Non-tradable	Ambiguous	Increasing

Source: *Fosu, 2002, adapted from Edwards, 1988*

In Africa, under import liberalization, large numbers of enterprises have simply been unable to compete, and this has led to employment contraction. In Ghana, Malawi, Mali, Senegal and Tanzania, firms that adapted by upgrading workers' skills with training were net beneficiaries of import liberalization, while those that were less prepared faced stiff competition and eventually lost out. In Zambia, a reduction in protection led to a significant contraction of output; the laid-off workers are now working in the informal sector, where incomes are much lower.

The case of Tunisia's manufacturing industry shows the effects of import liberalization accompanied by access to external markets (mainly in Europe) on employment and wages. Tunisia's case illustrates the preparedness of industry to benefit from import liberalization as well as the ready market for its exports in Europe. It contrasts sharply with the case of Zambia, where there was no export sector that could absorb the employment that was lost in the importable sector. In the case of Mauritius, unskilled and female labour benefited from trade through increases in wages and employment, particularly in the export sector. In both Tunisia and Madagascar, investors have responded positively to changes in market conditions and incentives, in terms of change of product lines, introducing new machinery and seeking export markets (and availability of finance).

> Trade liberalization may lead to a decrease in wage levels in the long run run, but these can increase with the acquisition of experience and skills

Trade liberalization may lead to a decrease in wage levels in the short run but these can increase in the long run, with the acquisition of experience and skills (i.e. the lowering of costs of production and subsequent increases in efficiency). Trade liberalization accompanied by adequate and appropriate responsiveness, as well as by supportive policies, can increase employment, which in turn can improve the welfare of society. Meanwhile, the effect that trade reforms may have on the informal sector should be of interest to policy makers, as this is a source of livelihood to a significant majority of self-employed people, especially women and the younger members of society.

In summary, some of the lessons from looking at the link between trade liberalization and human welfare are as follows:

- The effect of trade liberalization on household welfare and poverty varies across countries. Outcomes will depend on the consumption patterns of the poor, the state of domestic industries, the degree of labour mobility and the market structure of the tradable and non-tradable sectors.

- The welfare effects of trade liberalization depend on the state of income distribution. With income inequality already quite high in most African countries, the distributional consequences of trade reform are of critical importance. Trade liberalization needs complementary measures, such as asset redistribution, skills formation and other interventions to mitigate possible rises in income inequality.

- Positive welfare effects can be enhanced if liberalization is well timed and carried out under conditions of macroeconomic stability (Winters, 2002; Bhagwati and Srinivasan, 2002). Some components of trade liberalization packages can be inflationary and thus damaging to the interests of the poor, unless they are accompanied by appropriate macroeconomic policies.

- Integrating poverty diagnostics with trade policies can minimize adverse effects on the poor. Poverty mapping, which identifies where the poor live, how they are affected by agro-climatic conditions and their demographic characteristics, and earning attributes (wages, subsistence production, etc.) could assist in devising pro-poor trade policies. Poverty studies along sector lines could also identify winners and losers, and help to minimize adverse poverty effects (Kanbur, 1988).

Conclusions

This chapter has drawn attention to the role of trade policies in any country's development strategy. In order to contribute effectively to national development efforts, trade policies must be dynamic and thus avoid giving constant and linear support to the economy as a whole or to certain sectors above all others. On the contrary, they must be adaptable, and differentiated between sectors and between the various segments of a given sector. Consideration of this issue, therefore, must not be restricted to the sterile debate between openness and control.

The key priority is to focus on: seeking the optimal combination of the different instruments of trade policy; and building the necessary institutions to support the economic development process, by improving the competitiveness of the economy as a whole. At the same time, African countries must avoid the kinds of damaging protectionism that have already hampered the integration of their economies into global markets.

While the recent reforms of the rules of international trade in the WTO framework have left the developing countries with less room for manoeuvre, they also offer them a degree of flexibility to use trade policy in their development efforts. It is this flexibility which the developing countries are seeking to strengthen in the context of international negotiations and the Doha Round. For Africa in particular, cuts in agricultural tariffs, particularly high tariffs, are critical to enhancing overall welfare.

> *In order to contribute effectively to national development efforts, trade policies must be dynamic*

Finally, trade policies must be framed with reference to impacts on vulnerable groups. These effects will depend on an economy's consumption patterns across groups as well as market structures and the functioning of labour markets. Trade liberalization may need to be accompanied by measures to mitigate possible negative distributional impacts. Adverse social effects of trade liberalization may be contained by macroeconomic stability. Finally, trade policies need to be more closely aligned to national approaches to poverty alleviation.

Annex

A2.1: Agricultural Trade Policy Simulation Model (ATPSM)

ATPSM was developed by UNCTAD in 1990 and significantly enhanced in the late 1990s to address issues arising from the outcome of the Uruguay Round. The principle of ATPSM is that trade policy modifications induce price changes that alter supply, demand, exports and imports. The model calculates a market clearing world price where the global sum of net import changes equals zero. It is a deterministic and static model covering 176 countries. It is also a partial equilibrium model, dealing only with the agricultural sector. These characteristics make it different from the Global Trade Analysis Project (GTAP) model, which is a general equilibrium model.

The model consists of a system of equations representing supply, demand and trade flows for different agricultural goods for each country in the model. One of ATPSM's main advantages is that it covers 36 agricultural commodity groups and detailed policy changes can be simulated so as to trace the welfare effects of different kinds of agricultural trade liberalization. The model can capture changes to agricultural tariffs, subsidies (domestic support and export subsidies) and quotas.

Unlike other models such as GTAP, which require information on elasticities to determine domestic demand, ATPSM estimates domestic consumption and production prices using composite tariffs.

Notes

[1] Policy changes envisaged in the "little" scenario are tariff reductions (agricultural goods by 36%, all other goods by 20%); reduction in export subsidies by 20%; reduction in domestic support by 20%; and trade facilitation by 1%. The "modest" scenario envisages tariff reduction of all goods by 50%; reduction of exports subsidies by 50%, and trade facilitation by 1.5%. The "full" scenario encompasses 100% reduction in tariff, export subsidies, and domestic support, and trade facilitation by 3%.

[2] The EU15 countries are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

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