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Part Two: Chapter 1

TRADE AND POVERTY FROM A DEVELOPMENT PERSPECTIVE



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Trade and Poverty from a Development Perspective

Chapter

1

A. Introduction

International trade is vital for poverty reduction in all developing countries. But the links between trade and poverty are in practice neither simple nor automatic. The purpose of this Report is to clarify those links and to contribute to a better understanding of the national and international policies which can make international trade an effective mechanism for poverty reduction in the least developed countries.

The basic argument of the Report is that international trade can play a powerful role in reducing poverty in the least developed countries as well as in other developing countries. But the national and international policies which can facilitate this must be rooted in a development-driven approach to trade rather than a trade-driven approach to development. An exclusive focus on trade, which assumes that poverty is reduced through trade rather than through development, is likely to prove counter-productive. Rather, it is necessary to look at the relationship between trade and poverty from a development perspective.

The Report does three things:

- It defines an approach to analysing trade and poverty from a development perspective.
- It applies the analytical approach to examine the nature of the trade–poverty relationship in the LDCs.
- It sets out the policy implications of the approach for linking international trade more effectively with poverty reduction in the LDCs.

The present chapter sets out the analytical framework. Chapters 2, 3 and 4 apply the approach to examine the links between trade expansion and poverty reduction in the least developed countries. Chapter 5 discusses the relationship between trade liberalization, the major trade policy adopted by most LDCs since the latter half of the 1980s, and poverty reduction. Chapters 6 and 7 examine the policy implications of the analysis and identify some national and international policies which can strengthen the relationship between international trade and poverty reduction in the LDCs.

This chapter begins by describing briefly the current state of the debate on trade and poverty (section B), and identifying the limitations of the current approach (section C). Section D sets out the main elements of the development approach to the trade–poverty relationship, and summarizes the analytical framework which will be used in the present Report. Section E sets out the policy implications of the development approach at both national and international levels. The concluding section summarizes the major points.

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But the national and international policies which can facilitate this must be rooted in a development-driven approach to trade rather than a trade-driven approach to development.

B. Trade, trade liberalization and poverty: Where do we stand?

The relationship between trade and development has been an important policy issue since the early 1950s. An extensive literature has evolved to help policy makers understand how to ensure that international trade can more effectively support development through national policies and the international trade regime. But it is only recently that the subject of trade and poverty has become a subject of intense interest.

There was important conceptual work on the topic of stabilization, structural adjustment and poverty in the late 1980s (Helleiner, 1987; Kanbur, 1987; Demery and Addison, 1987). The World Bank's *World Development Report 1990* placed the problem of poverty reduction in a global context for the first time (World Bank, 1990). UNCTAD (1996) provided a first estimate of the impact of the international trade regime on poverty in developing countries. But most policy-oriented poverty analysis in the 1990s continued to focus on the role of national factors as causes of poverty, and particularly household characteristics (such as the level of education of household members, their access to land and credit, type of employment, and rural or urban location), and it generally ignored the influence of international economic relations on poverty.

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In the last five years all this has changed. There has been a proliferation of studies on the subject of trade and poverty. This has occurred partly because poverty reduction has increasingly become a focal concern of national and international development policies, and partly because the social consequences of globalization have become a major political issue in both developed and developing countries (see DFID, 2000; World Bank, 2002; OXFAM, 2002; UNDP et al., 2003).

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This situation is evident in the fact that most current policy analyses relating to trade and poverty focuses on understanding the effects of trade liberalization on poverty. This can be verified through an examination of some recent authoritative reviews or conceptualizations of the field, including Winters (2000), Bannister and Thugge (2001), Bhagwati and Srinivisan (2000), and Berg and Krueger (2003). These are entitled "Trade and poverty: Is there a link?", "International trade and poverty alleviation", "Trade and poverty in the poor countries", and "Trade, growth and poverty: A selective survey", respectively. But despite their titles, they all actually focus on trade liberalization and poverty. This is also the topic of most of the papers in the bibliography on trade and poverty on the World Bank website and of the chapter in the PRSP Sourcebook which is intended to show policy makers how they can integrate trade into their poverty reduction strategies (Hoekmann et al., 2002).

Much useful progress is now being made on the issue of trade liberalization and poverty (see Reimer, 2002, for a review). An analytical framework has been constructed to identify at the national level the various channels through which price changes associated with the removal of border trade barriers are "passed through" the economic system to influence the welfare of richer and poorer households (Winters 2000; McCulloch et al., 2002). Within this analytical framework, trade policy reform is seen as a price shock which has (i)

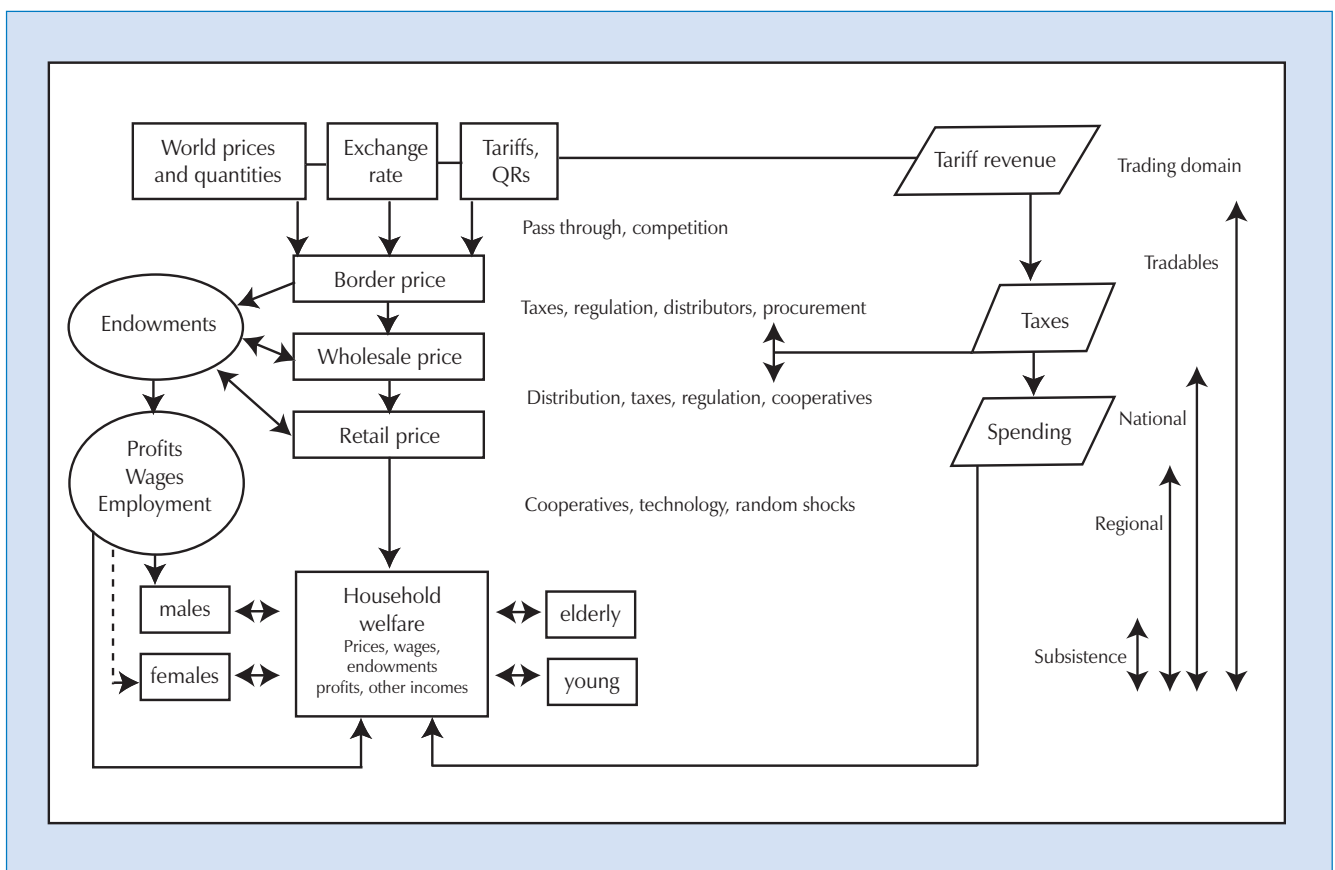
expenditure effects, which arise because of changes in the prices of the goods that are consumed; (ii) income and employment effects, which arise because of changes in the remuneration of factors of production; and (iii) effects on changes in tariff revenues and taxes, which affect transfers and the provision of public goods (see chart 5), as well as affecting the risk and uncertainty that poor households face and giving rise to short-term and medium-term adjustment costs.

Using this general framework, new methodologies have also been proposed to examine the links between trade and poverty (McCulloch, 2003; Nicita et al., 2003). These methodologies are being applied in more advanced developing countries (see Bussolo, Van der Meubugghe and Lay, 2003, on Brazil and Mexico), but more particularly within some of the least developed countries, where they are being included within the Diagnostic Trade Integration Studies (DTIS) undertaken within the framework of the Integrated Framework for Trade-Related Technical Assistance for the LDCs (IF).

Work at the national level is also now complemented by work at the international level to estimate the global and national welfare effects of multilateral trade liberalization. This research builds on earlier modelling efforts to estimate the effects of multilateral trade liberalization on economic growth using the Global Trade Analysis Project (GTAP) model, extending it to transform growth effects into global and national poverty impacts (see, for example, World Bank, 2004; Cline, 2004). New methodological syntheses are now emerging. One approach attempts to link applications of computable general equilibrium (CGE) models which have sought to assess impacts of trade liberalization on poverty and income distribution at the national and regional levels using social

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CHART 5. ALAN WINTER'S ANALYTICAL FRAMEWORK FOR LINKING TRADE LIBERALIZATION AND POVERTY



Source: Winters (2000).

accounting matrices (for example, Decaluwe et al., 1998; Decaluwe et al., 1999; Cockburn, 2001; Lofgren et al., 2001; Harris, 2001) with the results from GTAP simulations (see, for example, Evans, 2001; Hertel et al., 2003a). Another approach seeks to use data derived from household surveys on the composition of sources of income of households at different levels within the overall income distribution to obtain a much more socially disaggregated view of the impact of multilateral trade liberalization (Hertel et al., 2003b, 2003c).

The ongoing methodological work on trade liberalization and poverty is generating ever more technically complex, model-based analyses, which are in their turn spawning their own empirical and methodological controversies.

A key insight from all of this work at both national and international levels is that the direct impact of trade liberalization on poverty varies widely from country to country depending on internal structures, and that domestic factor markets are critically important to the nature of the relationship. A useful checklist of questions which a Government undertaking trade liberalization should ask when determining the poverty impact of trade liberalization has also been proposed (Winters, 2000). There is also deeper understanding of the relationship between trade liberalization and food security (FAO, 2003). However, the links between trade liberalization and economic growth are not treated as well. There is a very large literature on this subject¹. But the debate on whether or not “openness” is good for growth and poverty reduction does not die down. There are strong methodological objections to some of the key empirical findings which indicate a positive relationship between openness and growth (see, in particular, Pritchett, 1994; Rodriguez and Rodrik, 2000). But recent objections have prompted further responses (Srinivasan and Bhagwati, 1999; Berg and Kreuger, 2003; WTO, 2003) as well as amendments to the case for openness (Dollar and Kraay, 2002).

The controversy about the effects of openness has now seesawed between “it is good” and “it is bad” to reach the more nuanced position that “it is good if the right complementary policies are adopted”. This common-sense proposition is, unfortunately, tautological and empirically irrefutable. The ongoing methodological work on trade liberalization and poverty is generating ever more technically complex, model-based analyses, which are in their turn spawning their own empirical and methodological controversies. But as this occurs, it is important to stand back and ask:

- Is it right to limit the analysis of trade and poverty to the analysis of the effects of trade liberalization on poverty?
- Will it be possible to identify the most effective policies to link international trade with poverty reduction if the analysis is limited in this way?

Is it right to limit the analysis of trade and poverty to the analysis of the effects of trade liberalization on poverty?

This Report is founded on the view that the answer to these questions is no. A broader approach to policy analysis of the links between trade and poverty is necessary.

C. The limits of the current approach to analysing the trade–poverty relationship

The problem with the current approach is not a question of the value of the work being conducted. Good work is being done on different sides of the openness debate, and that work is yielding policy insights. The problem arises because the current approach is very limited.

There are four major limits to the current approach:

- It puts the cart before the horse in policy analysis.

- It prioritizes trade liberalization over poverty reduction as a policy objective.
- It excessively narrows the field of trade and poverty.
- It cannot address issues of long-term dynamics which are central to sustained poverty reduction.

1. THE CART AND THE HORSE

Analysing the relationship between trade policy and poverty is different from analysing the relationship between trade and poverty. Conclusions about the former should ideally be based on an analysis of the relationship between trade and poverty. To start by focusing on trade policy and poverty before examining the relationship between trade and poverty is to put the cart before the horse. It puts the cart first in a way that is likely to exaggerate the role of trade policy in trade development. This is because trade development depends on macroeconomic policies and non-trade policies as well as trade policies. Particularly important in this regard are policies which promote the development of productive capabilities through capital investment, skills acquisition, organization change and technological modernization. It also puts the cart first in a way which is likely to exaggerate the role of trade liberalization within trade policy. Trade policy, which may be understood as “the overall structure of incentives to produce and consume, and hence import and or export, tradable goods and services” (Helleiner, 1998: 588), cannot be reduced to trade liberalization.

A great danger of the current approach is that “unrealistic expectations will be created regarding what can be accomplished by trade policy alone” (Rodrik, 1992: 103), and in particular unrealistic expectations will be created regarding trade liberalization. As Rodrik (ibid.: 103) puts it: “A reasonable hypothesis is that trade policy plays a rather asymmetric role in development; an abysmal trade regime can perhaps drive a country to economic ruin; but good trade policy cannot make a poor country rich. At its best, trade policy provides an enabling environment for development. It does not guarantee entrepreneurs will take advantage of this environment, nor that private investment will be stimulated...Claims on behalf of liberalization should be modest lest policy-makers become disillusioned again”.

The current approach is likely to exaggerate the role of trade policy in trade development and to exaggerate the role of trade liberalization within trade policy.

2. THE PRIORITIZATION OF TRADE LIBERALIZATION

The importance of macroeconomic and non-trade policies for trade development is widely recognized. But within the current approach to trade liberalization the question being asked is the following: “What are the complementary policies necessary for ensuring the expected positive effects of trade liberalization, in terms of economic growth and poverty reduction?” This is a very different approach to non-trade policies from one that asks: “What trade and non-trade policies are required in order to achieve growth and poverty reduction objectives?” In the former case, the best complementary policies are chosen subject to the constraint that trade liberalization is being, or has been, undertaken. In the latter case, the task is to find the best trade and non-trade policies that are likely to achieve growth and poverty reduction objectives.

What the current approach does is to take trade liberalization as a given and then see how to make poverty reduction goals compatible with it, rather than to make poverty reduction the priority and then ask how trade liberalization might

fit into this. The latter approach may well lead to the conclusion that the best policy option is to undertake trade liberalization and then adopt complementary policies. But this cannot be determined empirically if one just focuses on the relationship between trade liberalization and poverty and then gives policy makers advice on how “to develop suitable responses to ensure the poor gain from trade liberalization” (McCulloch et al., 2002: xxvi). It requires one to stand back and examine the relationship between trade and poverty, how trade and non-trade policies affect the relationship between trade and poverty, and the role of trade liberalization in those trade policies.

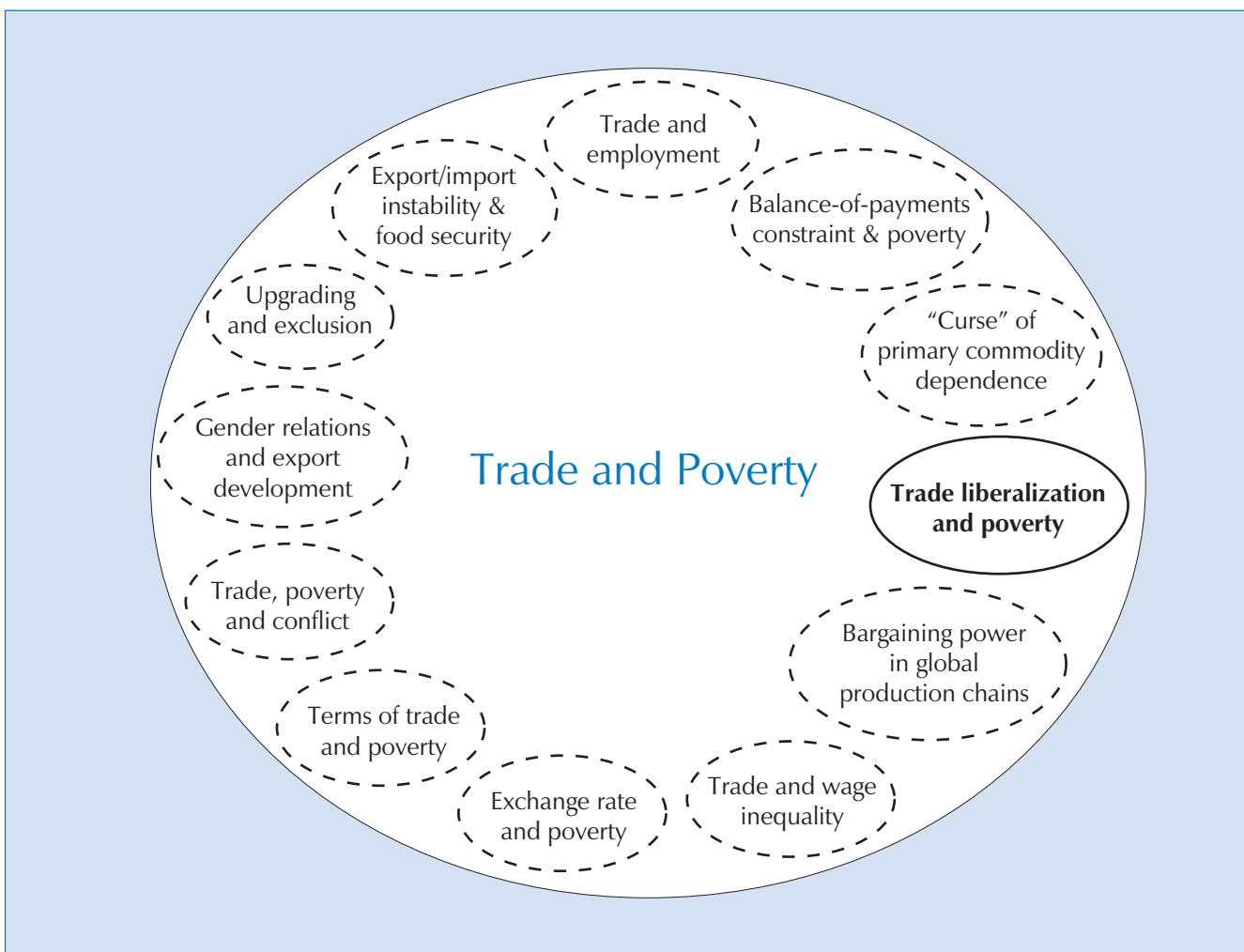
The field of trade and poverty should be drawn so that it encompasses all issues which are relevant to a proper understanding of the relationship between trade and poverty.

3. THE NARROW FOCUS

The current focus on trade liberalization and poverty also excessively narrows the subject of trade and poverty. It does this, firstly, by concentrating on a limited part of the overall problematique of trade and poverty, and secondly by limiting the aspect of international trade which is the focus of attention.

The field of trade and poverty should be drawn so that it encompasses all issues which are relevant to a proper understanding of the relationship between trade and poverty. What it might encompass has not been a matter of debate given the current focus on trade liberalization and poverty. But chart 6 suggests possible topics which might be included in the field. Within this view, trade liberalization and poverty is a subset of a number of policy issues within the general problematique of trade and poverty. These include the following: (i) the

CHART 6. ISSUES IN TRADE AND POVERTY



effects of primary commodity dependence; (ii) the balance-of-payments constraint on poverty reduction; (iii) the relationship between export and import instability and vulnerability; (iv) the relationship between upgrading the composition of exports towards higher-quality and higher-skill products and the social exclusion of poorer producers from livelihoods; (v) bargaining power in global production chains and the distribution of gains from trade; (vi) how the development of non-traditional exports affects gender relations; (vii) the effects of trends in, and variability of, the terms of trade on poverty; (viii) the relationships between trade and employment; and (ix) the relationships between trade and inequality.

The field of trade and poverty should also be drawn to encompass all aspects of trade. The focus in the current approach is the “openness” of the economy. This term is the subject of considerable semantic confusion as it is used to refer to both the level of trade integration of the economy (measured by the ratio of imports and exports to GDP) and the level of trade restrictions (tariff and non-tariff barriers). But the point here is that there are many aspects of trade beyond “openness” which are important to poverty reduction. Imports are as important as exports, and a key constraint on economic growth may be import instability. The types of exports and imports, and their growth rate, are also as important as the level of trade integration. The growth effects of international trade are also related to the organization of trade through global production chains and buyer–seller links. Moreover, lifting the balance-of-payments constraint may be the key to faster economic growth and poverty reduction. Table 24 indicates schematically some sources of economic growth and some of the aspects of trade that are associated with them. The relative importance of, and also interrelationships between, these links between trade and growth vary between countries.

The field of trade and poverty should also be drawn to encompass all aspects of trade.

TABLE 24. SELECTED MECHANISMS THROUGH WHICH INTERNATIONAL TRADE CAN HAVE GROWTH EFFECTS

Source of growth	Associated aspect of trade
1. Static and dynamic efficiency gains arising from specialization according to current comparative advantage	<ul style="list-style-type: none"> • Openness • Exposure to international trade competition
2. Exploitation of a “vent for surplus”	<ul style="list-style-type: none"> • Export growth, particularly natural-resource-based or tourism-based
3. Increased capacity utilization	<ul style="list-style-type: none"> • Increased import capacity
4. Increased investment	<ul style="list-style-type: none"> • Economies of scale through selling to domestic and external markets • Reduced costs of capital goods through imports • Reduced costs of wage goods through imports
5. Increased technology acquisition and learning	<ul style="list-style-type: none"> • Buyer–seller links • Machinery and equipment imports embodying foreign technology • Exports that have great potential for learning through technology transfer
6. Structural change	<ul style="list-style-type: none"> • Composition of exports and imports • Product and market diversification
7. Releasing the balance-of-payments constraint on economic growth	<ul style="list-style-type: none"> • Export growth • Import substitution • Reduced income elasticity of imports • Increased elasticity of export growth with respect to growth of world income • Reduction of non-essential imports

4. WEAKNESSES WITH RESPECT TO LONG-TERM DYNAMICS AND INDIRECT IMPACTS

What the current approach to the issue of trade and poverty is very good at is understanding the direct impact on poverty of changes associated with trade liberalization...

A further limitation of the current approach is that it cannot adequately address the issues of long-term dynamics which are so important for sustained poverty reduction. What the current approach to the issue of trade and poverty is very good at is understanding the direct impact on poverty of changes associated with trade liberalization, which is conceptualized, as noted above, as a policy shock, and at understanding the short-term dynamics of that change. What it is less good at understanding is the indirect impact on poverty of change in a country's level and pattern of trade, and the long-term dynamics of that change.

The difficulty of the current approach as regards dealing with long-term dynamics has a simple origin. The theoretical core of the analysis of the link between trade liberalization and poverty is the efficiency and welfare gains, that can be achieved in economies that have previously discouraged export production through a shift in the incentive structure away from import-competing activities and non-tradables towards exportables. Trade is also expected to lead to factor price equalization between countries. What this means is that in countries with relative labour abundance, real wages should rise, and thus the process of resource reallocation will not only increase the level of national income, but also, in situations where the major asset of the poor is labour, it will be pro-poor.

The great merit of the current work on trade liberalization and poverty is that it is testing this theory. But the point here is that the efficiency and welfare improvements are one-off gains which occur as resources are reallocated. If the conditions are right, GDP should grow whilst the reallocation occurs. But the sustained growth which is necessary for poverty reduction will not occur unless it positively affects fundamental sources of economic growth. As Cooper (2001: 9) put it, "once resource re-allocation has occurred the 'growth' will cease unless it is sustained by one or more of five factors:

...What it is less good at understanding is the indirect impact on poverty of change in a country's level and pattern of trade, and the long-term dynamics of that change.

- (1) the redistribution of real income raises the national savings rate, leading directly or indirectly (via the capital market) to a higher rate of investment;
- (2) the relative price of investment goods is reduced, so that a given level of national savings finances greater investment;
- (3) productive foreign investment flows into a country in greater amount on a sustained basis;
- (4) the redistribution of income or new competitive pressure leads people to attain higher levels of economically useful skills;
- (5) the efficiency of labour and/or capital is continually improved as a result of the imports, which convey useful information from abroad as well as enhanced competitive pressure on domestic producers".

Various "grey area dynamic effects" of trade liberalization have been proposed, including improved economic efficiency through exposure to international trade competition, reduction of rent-seeking (or directly unproductive profit-seeking) activities (Krueger, 1974), and improved quality of national institutions (Dollar and Kraay, 2002). Moreover, using theories of endogenous growth, models have been constructed to show how trade can have dynamic effects and thus increase the rate of growth (Young, 1991; Romer and Rivera-Batiz, 1991). But these models often incorporate assumptions on increasing returns which contradict those required for the static welfare gains

which are the bedrock of the analysis. In the end, the identification of dynamic effects of trade liberalization rests on empirical investigation, and as stated earlier, the results in this area remain inconclusive. As Winters (2000: 59) puts it, “Overall, the fairest assessment of the evidence is that, despite the clear plausibility of such a link, open trade alone has not yet been unambiguously and universally linked to subsequent economic growth”.

In short, the current approach is helpful for understanding the problem of poverty alleviation during liberalization reforms. But the most important effects of trade on poverty are likely to occur through indirect impacts and long-term effects of sustained economic growth and development. The current approach does not take us very far in understanding how to achieve the sustained reduction in the incidence of poverty by half which is the goal of the international community. That depends on sustained economic growth and development.

D. A development approach to the trade–poverty relationship

1. ELEMENTS OF A DEVELOPMENT APPROACH

It is possible to elaborate various approaches to the relationship between trade and poverty which go beyond the question of trade liberalization. This Report adopts a development approach. The essence of a development approach to trade and poverty is that it begins with an analysis of how development occurs, rather than an analysis of how trade occurs, examining the role of trade within processes of development and assessing the effects of trade on poverty from this perspective. The advantage of this approach is that it can build on existing policy analysis and research which examine international trade from a development perspective (see box 3). There is a rich literature in this regard on the development implications of export expansion and export composition, including both commodities and manufactures, as well as some work on the growth effects of imports, import composition and import instability. But the analytical challenge is to extend this work to the relationship between international trade, development and poverty.

The trade and poverty relationship is of immense importance as it extends the discussion of international trade from questions of the quantity of trade to questions of the quality of trade. Unlike the “quality of growth” and the “quality of employment”, about which much has been written, the concept of the “quality of trade” has not been elaborated in the recent debate on trade theory and trade policy analysis. Focusing on trade and poverty entails opening up this question of the quality of trade in terms of the social outcomes of expanded international trade.

The seven basic elements of the development approach adopted in this Report can be summarized as follows:

- (1) The issue of trade and poverty cannot be reduced to the issue of trade liberalization and poverty.
- (2) Sustained poverty reduction occurs through the efficient development and utilization of productive capacities in a way in which the population of working age becomes more and more fully and productively employed.

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BOX 3. LINKING DEVELOPMENT, INTERNATIONAL TRADE AND POVERTY

It is possible to base analysis of the links between development, international trade and poverty on two overlapping sources: theories about how trade occurs and the gains from trade; and theories about how development occurs and how trade fits into this process. These different starting points can lead to different conclusions. Potential conflicts between international trade theory and growth theory in terms of their principles of resource allocation were identified early by Chenery (1961). He noted that, within trade theory, the optimum pattern of production and trade for a country is determined from a comparison of the opportunity cost of producing a commodity with the price at which the commodity can be imported or exported. This approach is particularly concerned with conditions of general equilibrium. Growth theory, in contrast, places more emphasis on sequences of expansion of production and factor use by sector. It shows how endowments that are the basis for comparative advantage are created.

Chenery suggested that five main considerations should be taken into account in applying the principle of comparative advantage from a development perspective.

- Firstly, the possibility of a structural disequilibrium in factor markets, which means that the costs of labour and capita do not reflect their opportunity costs, must be recognized.
- Secondly, the fluctuating nature and the low income and price elasticities of demand for primary products must be allowed for. This implies that the market value of the stream of export earnings should be reduced to reflect the economic effects of instability.
- Thirdly, the possibility of rising efficiency as labour and management acquire increasing experience in actual production needs to be recognized. This implies that changes in comparative advantage need to be accounted for, as well as differences in the potential for cost reduction through learning and accumulation of experience in different sectors.
- Fourthly, there are dynamic external economies in which cost reductions or demand increases in one sector lead to cost reductions in other sectors. If a group of investments is only profitable if undertaken together, the comparative advantage approach must assess different combinations of investment and address the simultaneous determination of the levels of consumption, imports and production in related sectors.
- Finally, the limited ability of policy makers to foresee changes in demand and supply puts a premium on flexibility. Optimum development policy should result in a pattern of resource allocation that allows for unforeseen changes in supply and demand even at the cost of some loss of short-term efficiency.

Both development theory and international trade theory have been transformed since Chenery's insights about the differences between growth theory and trade theory. But the problem of integrating these two bodies of knowledge, focusing on trade on the one hand and development on the other, remains. Since the early 1980s, there has been a strong tendency for ideas from international trade theory to dominate understandings of development processes. This occurred initially through comparisons between the relative success of "outward-oriented" and "inward-oriented" development strategies. When these terms were used precisely they were defined in terms of incentive structures in relation to production for exports or the domestic market (see Bhagwati, 1986). An outward-oriented development strategy was one that had a trade regime in which, on average, incentives are neutral, biased neither for nor against exports.

The domination of the international trade perspective within development thinking was further strengthened in the 1990s through arguments that fast and full integration with the world economy was the key to seizing the opportunities of globalization and minimizing the chance of being left behind. From this perspective, global integration began to substitute for national development as the major policy objective of Governments.

Although the mainstream tendency has been for trade theory perspectives to dominate development thinking in recent years, a number of researchers and policy analysts have continued to start from the development end, rather than the trade end, of the relationship between trade and development. Notable in this regard is the extensive work of Rodrik, including his interpretation of East Asian development success as being due not to changes in the incentive structures and profitability of production for exports or the domestic markets but rather to incentives for investment (Rodrik, 1995), and also the work of Helleiner (see in particular Helleiner, 1994, 2003). The work of UNCTAD on the East Asian development strategies (UNCTAD 1994, 1996), the relationship between globalization, growth and distribution (UNCTAD, 1997), the underlying causes of Africa's weak economic performance and possible policy responses (UNCTAD, 1998), the Latin American experience with economic reform (UNCTAD, 2003) and the international poverty trap facing many least developed countries (UNCTAD, 2002) has also been informed by an approach which starts by examining the sources of growth and development, and then considers how international trade fits into this process. This Report seeks to build on that body of work concerned with international trade from a development perspective, extending it to the issue of trade and poverty.

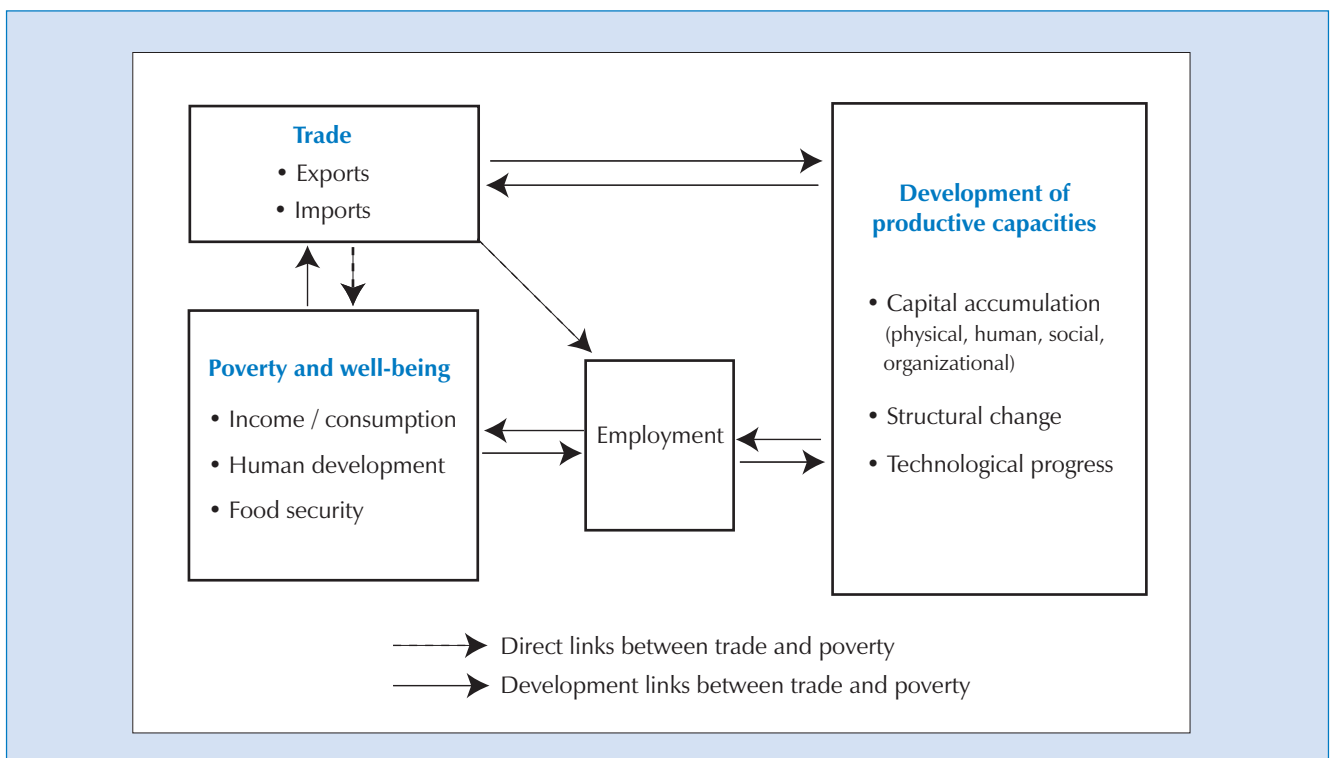
- (3) International trade can facilitate, hinder or modify this process.
- (4) The relationship between trade and poverty varies with the composition of the international trade of a country.
- (5) The relationship between trade and poverty varies with the level of development of a country and the structure of its economy.
- (6) The relationship between trade and poverty is affected by the interdependence between trade and international financial and investment flows, between trade and debt, and between trade and technology transfer.
- (7) Sustained development and poverty reduction expand international trade.

The first element of this approach has been dealt with above. This section continues by elaborating the second and third elements, which constitute the basic analytical framework of the approach, and then goes on to examine the fourth, fifth and sixth elements — which are a major source of variation in the trade–poverty relationship between developing countries — and finally the seventh element.

2. THE BASIC ANALYTICAL FRAMEWORK

The basic analytical framework, which is set out in chart 7, has three components: (i) international trade; (ii) the development and utilization of productive capacities; and (iii) poverty. The latter is defined in a multidimensional way to include low income and consumption, lack of human development, and vulnerabilities such as food insecurity. For income and consumption poverty, an important issue is the choice of an international poverty line. This Report focuses on the \$1/day and \$2/day international poverty lines as these are relevant to the LDCs. But there is a debate as to whether these

CHART 7. THE RELATIONSHIP BETWEEN TRADE, THE DEVELOPMENT OF PRODUCTIVE CAPACITIES, EMPLOYMENT AND POVERTY



BOX 4. PRITCHETT'S PROPOSAL FOR A THIRD INTERNATIONAL POVERTY LINE BASED ON THE STANDARDS FOR DEFINING POVERTY IN INDUSTRIALIZED COUNTRIES

The \$1/day international poverty line is based on the median of the national poverty lines of the 10 poorest countries for which data is available (World Bank, 2000/2001). For more advanced developing countries as well as transition countries, this low standard is largely irrelevant, and thus a \$2/day international poverty line is also increasingly being used in international analyses of poverty. But is there a case for complementing these with a third international poverty line based on the national poverty lines or standards for defining poverty of industrialized countries?

Pritchett (2003) argues that there is a strong case. Most OECD countries, with the exception of USA, do not have an official national poverty line. Using a range of estimates, notably the threshold of less than 50 per cent of median household income (adjusted for household size), which is a common way of defining poverty in OECD countries, and using an estimate based on the minimum wage, he suggests that \$15/day (in 2000 purchasing power parity dollars) represents a reasonable approximation of what constitutes a minimally adequate level of income in industrialized countries. He proposes that this can thus serve as a third international poverty line, complementing the \$1/day and \$2/day standards which he calls "destitution" and "extreme poverty" respectively.

He presents various arguments as to why the adoption of the third international poverty line makes sense. First of all, it is not ethically justifiable to argue that what is considered unacceptable human deprivation in one country is not also unacceptable in another. This, of course, depends on the income poverty line being defined in a way that takes account of differences in what a dollar can purchase in different countries. But the purchasing power parity exchange rates do this. With income defined equivalently in this way, it is difficult people in a rich country to say, "We adopt one standard of living as poverty for our own citizens but for your citizens we think a much lower level of well-being is sufficient". Moreover, it is difficult for developing countries to argue that the poverty reduction to which they are aspiring is the eradication of the level of human deprivation considered unacceptable in the five very poorest countries in the world.

Secondly, even the rich in poor countries are experiencing human deprivation compared to the poor in rich countries. This is important, as a key objection to the adoption of the higher poverty line is its implication that nearly everyone in many poor countries are poor and that people in the upper part of the income distribution in poor countries would be classified as poor by the new common standard, even though they are not "really" poor. Pritchett tests this argument by comparing various physical indicators of well-being between the poor in rich countries and the richest quintile in poor countries. He finds that:

- While the average infant mortality rate among the poor in most OECD countries was 10 per 1000 or less, infant mortality of the richest quintile in all of the [developing] countries examined was much higher than 10 – from substantially higher in Brazil to 4–6 times higher in Côte d'Ivoire, Nepal and Nicaragua, and up to ten times as high in Pakistan. More than 3 in 10 children of the "rich" [richest quintile] in India, Nepal, Nigeria and Pakistan, show signs of chronic malnutrition.
- In industrialized countries completion of basic education is nearly universal, even among the very poor. In contrast, even among the richest quintile in poorer countries, between a quarter and three quarters of children do not complete even 9th grade.

Thirdly, with the adoption of a high poverty line, poverty reduction can be a shared national project. Pritchett argues that poverty reduction is not a politically viable stance for a democratic government if there is a very low poverty line and the poor constitute only a small proportion of the total population.

Fourthly, he argues that if the poverty reduction objective is interpreted strictly, any income gains above the poverty line contribute nothing to the desired results, and thus a whole range of important development activities become more difficult to justify. In this context, with the adoption of the low poverty line, there is the danger that development institutions can become relief and charity institutions.

Pritchett argues that governments and development institutions should focus on poverty reduction. He proposes that a \$15/day international poverty line, based on the standards of poverty in the rich countries, should complement the existing \$1/day and \$2/day standards, which can be considered global standards of "destitution" and "extreme poverty" respectively. Within this new framework more complex anti-poverty goals should be adopted. These should go beyond simply reducing the proportion of the population living below the poverty threshold; instead, they should pay more attention to the distribution of income amongst the poor, attaching different degrees of policy priority to achieve income increases for various more and less impoverished strata amongst the poor.

Source: Pritchett, 2003.

should be complemented with a higher international poverty line in a global analysis of poverty (see box 4).

The framework indicates that there are direct and indirect links between trade and poverty. Trade affects poverty directly through its impact on the cost of living, jobs and wages, and government revenue for public goods such as health and education and for socio-economic security systems. But there are also development links between trade and poverty which occur indirectly through the development and utilization of productive capacities. Whilst the former types of links are important for short-term poverty alleviation, it is the latter types that are most important for sustained poverty reduction in most developing countries.

The importance of the development of productive capacities for poverty reduction can be understood in intuitive terms through the simple wisdom that if you give a hungry person a fish they can eat that day, but if you give them a fishing rod and teach them how to fish and manage fish stocks with others sustainably, they can eat for the rest of their lives. Unless one envisages a world in which millions of people depend on international welfare transfers, the only way to reduce global poverty sustainably is through the development of productive capacities.

The development of productive capacities involves three basic processes: first, accumulation of physical, human and organizational capital; second, structural transformation; and third, technological progress.

Investment in the acquisition of ever-increasing stocks of various forms of capital is the first and most basic component of increasing productive capacity. The process of capital accumulation entails investment in material capital equipment, but it goes beyond this. It involves investment in education, health and human skills as well. The development of human capabilities is an integral part of the development of productive capacities. The development of institutional arrangements to transform natural resources and intellectual property into economic assets (through, for example, changes in property rights regimes), and the expansion of the social and organizational capital underpinning economic activity (for example, through creating business firms), are also important. It also involves maintaining renewable natural capital which is used in the economic process.

Along with increasing capital per worker, productive capacities increase through structural transformation. As Adam Smith recognized, this process begins with people specializing in different economic tasks, rather than meeting their subsistence for themselves, and the development of an increasing domestic division of labour. However, sustained poverty reduction has usually involved a process of structural change in which the proportion of the labour force employed in primary activities (agriculture, mining, forestry, fishing) declines and the proportion employed in other sectors of the economy which are not subject to diminishing returns rises. Historically, industrialization has been a potent mechanism of productivity growth through changes in the occupational distribution because of sectoral productivity differences between agriculture and manufacturing.²

Finally, productive capacities increase through technological progress. Improvements in agricultural productivity are particularly important in the earliest stages of development. Rapid technological progress can also be achieved in the manufacturing sector in late-industrializing countries owing to the existence of a technological gap between the latter and the more advanced industrial countries and the possibility of acquiring and mastering existing

Unless one envisages a world in which millions of people depend on international welfare transfers, the only way to reduce global poverty sustainably is through the development of productive capacities.

technologies (Grossman and Helpmann, 1990). Opportunities for catch-up growth have been particularly evident in the manufacture of standardized industrial products and of goods at a mature stage in the product cycle.

The development of productive capacities depends critically on the availability of a surplus for investment over basic consumption needs, and on adequate incentives for the private entrepreneurs, whose initiatives animate the development process. Institutions to deal with the multiple coordination failures which can arise in the development process are also important. At any moment in time, the level of development of productive capacities acts as a constraint on what goods and services a country can trade efficiently and also on the scale of trade. But international trade plays an essential role in supporting the efficient development and full utilization of productive capacities.

This occurs through both exports and imports and, as discussed earlier, may involve a variety of channels. Trade can enable more efficient use of a country's resources by enabling imports of goods and services which, if produced domestically, would be more costly. It can enable increased capacity utilization and the realization of a "vent for surplus" if external demand enables the employment of previously idle (or surplus) labour and land resources which were previously not utilized owing to a dearth of effective domestic demand. It can lift a balance-of-payments constraint on sustained economic growth. It can improve the returns on investment by reducing production costs or enabling economies of scale. Exposure to international trade competition can act as a spur to greater efficiency. Exports and imports can also be associated with the acquisition of technology.³

It is through these positive effects on the development of productive capacities that international trade works to reduce poverty. Indeed, sustained poverty reduction occurs through the development of productive capacities. However, as chart 7 shows the relationship is mediated by changes in employment opportunities (jobs and livelihoods) and employment conditions that occur along with productive development. But the link between productive development and poverty is complex, involving trade-offs and also social conflict and negotiation. In a capitalist system, profits are the engine of accumulation and innovation, but the higher the profit share, the lower the wage share. Income disparities also act as an incentive. Without access to foreign savings, there will inevitably be a short-term trade-off between the average level of consumption, which is closely associated with poverty in the poorest developing countries, and the level of investment. Productivity growth associated with technological progress also often creates employment losses in the short term. Moreover, industrialization involves major social transformations. Changes in systems of socio-economic security, which are usually inter-related with forms of employment and which assure support or compensation during periodic events which result in income or employment loss, are particularly important. As Amartya Sen (1981) has pointed out, vulnerabilities may be particularly great during the development process in the period after the "moral economy" which guarantees a basic subsistence to members of a rural community breaks down, but before the safety nets associated with widespread wage employment are put in place. The nature of all these links between productive development and poverty is affected by the level and manner of a country's trade integration with the rest of the world.

For the development of productive capacities to be poverty-reducing it must occur in a manner in which productive capacities are not simply developed but must also be fully utilized and developed in an efficient way. The development

At any moment in time, the level of development of productive capacities acts as a constraint on what goods and services a country can trade efficiently and also on the scale of trade. But international trade plays an essential role in supporting the efficient development and full utilization of productive capacities. This occurs through both exports and imports.

of productive capacities must also ensure that natural capital which provides livelihoods for the majority of the population in the early stages of the development process is not excessively depleted before replacement income-earning opportunities are available. Resources allocated for the public provision of health, education, housing, water and sanitation, as well as economic infrastructure, are all part of the process of productive development.

Finally, and most basically, the development of productive capacities must occur in a manner in which the working age population becomes more and more fully and productively employed. How trade affects this process is central to understanding the trade–poverty relationship. Krueger (1983) did important empirical work on the relationship between trade and employment and established an agenda of questions which need answering. Moreover, a number of empirical studies have recently been completed on the impact of trade with industrialized countries on manufacturing employment and wages in selected more advanced developing countries (Ghose, 2003). But apart from discussion of wage inequality, the current literature remains particularly thin on the relationship between trade and employment (for reviews see Sen, 2003; Rama, 2004). Better understanding of the links between trade and employment must be a key priority for better understanding of the links between trade and poverty.

If poverty reduction occurs, various feedback mechanisms can start to reinforce the process of development of productive capacities. One aspect of this is a falling birth rate, which provides a demographic bonus to the trend in income per capita. As the ratio of the population of working age to the total population increases, a larger fraction of the total population is employed and the gap between output per worker and income per capita declines. But the population also becomes more productive and more skilled, investment in human capital bears more fruit as life expectancy rises and wasted human talent of all kinds, pursuing its own interests, is mobilized to support the development process.

For sustained poverty reduction, the development of productive capacities must occur in a manner in which the working age population becomes more and more fully and productively employed. How trade affects this process is central to understanding the trade–poverty relationship.

3. VARIATIONS AMONGST DEVELOPING COUNTRIES IN THE TRADE–POVERTY RELATIONSHIP

There is much diversity amongst developing countries in the interrelationships between international trade, productive capacities and poverty. International trade can facilitate or hinder the process of productive development and also modify the relationship between productive development and poverty reduction. Three dimensions of this variation are the following: the composition of the trade; the level of development and production structure; and the interdependence between trade and other international economic relations.

(a) The composition of trade

The composition of trade is as important for the nature of the trade–poverty relationship as the level of trade. This applies both to exports and imports. Ignoring the form of a country's integration with the rest of the world through trade can lead to major fallacies (see box 5, and also Sprout and Weaver, 1993).

For exports, there is a particularly sharp distinction between commodities and manufactures. Commodity exports are subject to short-term price and demand fluctuations, as well as having episodes of medium- to long-term terms-of-trade decline. Commodities are also subject to intense price competition, as

BOX 5. GLOBALIZERS, NON-GLOBALIZERS AND COMMODITY DEPENDENCE

One of the most influential recent articles on trade and poverty is by Dollar and Kraay (2001). It seeks to identify developing countries "that have significantly opened up to foreign trade since 1980s" and to compare their experience with that of developing countries "that have remained closed" (p. 7). The two groups, called "globalizers" and "non-globalizers" respectively, are identified on the basis of trade/GDP ratios (in constant prices) and reductions in average tariffs. The globalizers are the top third of 72 developing economies in terms of the increase in their trade/GDP ratio between 1975–1979 and 1995–1997, or the top third of tariff-cutters (on the basis of absolute decline in average tariff rates) between 1985–1989 and 1995–1997. Dollar and Kraay compare trends in growth and income inequality in the two groups of countries and conclude:

"The poor countries that have reduced trade barriers and participated more in international trade over the past twenty years have seen their growth rates accelerate. In the 1990s they grew far more rapidly than the rich countries, and hence reduced the gap between themselves and the developed world. At the same time the developing countries that are not participating in globalization are falling further and further behind. Within the globalizing developing countries there has been no general trend in inequality" (p. 12).

Thus "on average, greater globalization is a force for poverty reduction" (p. 26) and "open trade regimes lead to faster growth and poverty reduction in poor countries" (p. 27).

This work has generated intense discussion, much of which is methodological (for critiques, see Rodrik, 2000b, on an early version, and Nye et al., 2001). But Birdsall and Hamoudi (2002) have also shown that there is a close overlap between "globalizers" and "non-globalizers" on the one hand, and countries classified as "least commodity-dependent" and "most commodity-dependent" economies (on the basis of the share of primary commodities in their total merchandise exports during the period 1980–1984) on the other hand. Only two of the most commodity-dependent countries (Rwanda and Mali) are classified as "globalizers".

Birdsall and Hamoudi show that the comparative evolution of trade/GDP ratios of countries classified as "globalizers" and "non-globalizers" is almost the same as that of "most commodity-dependent" and "least commodity-dependent" countries. The non-globalizers start in the 1960s with much more "open" economies than the globalizers, if openness is measured by the trade/GDP ratio. The increase in the ratio among the non-globalizers is at least equal to if not slightly faster than that of the globalizers until the late 1970s or early 1980s, but then it falls sharply in the early 1980s. Exactly the same pattern is observed for the most and least commodity-dependent economies (see box chart 1A and B).

They decompose the trade/GDP ratio into import/GDP ratio and export/GDP ratio, and show that the increase in the trade/GDP ratio in the late 1970s and the collapse in the early 1980s in the most commodity-dependent economies are associated with the emergence of trade deficits and their rapid closing in the 1980s with the debt crisis.⁸ The changes reflect the fact that the most commodity-dependent economies financed large trade deficits in the late 1970s and early 1980s (when prices were high) with expected export revenue. When prices collapsed, their capacity to import fell sharply and they were forced to close their trade deficits in order to balance the current account (see box chart 1C and D). The apparent stagnation in the "openness" of the non-globalizers thus partly reflects the shift in global demand for primary commodities and the structure of world prices beginning around the world at the start of the 1980s.

They go on to consider whether trade liberalization in the 1980s caused both increases in trade/GDP ratios in the "globalizers" and shifts in export content. They test this by dividing the most and least commodity-dependent countries into those that cut tariffs most (the top 33 per cent of tariff-cutters) and those that cut tariffs least. The evidence suggests that the most commodity-dependent countries "were not able to achieve an increase in their trade/GDP ratio, whether they cut tariffs steeply or not. By comparison, the vast majority of the least commodity-dependent countries saw increases in their trade/GDP ratios, regardless of whether they cut tariffs steeply or not" (ibid.: 16).

Finally, they show the comparative growth experience of the most and least commodity-dependent groups of countries in the 1980s and 1990s. The commodity-dependent countries grew more slowly in both decades, and the overwhelming majority of them saw declines in PPP-adjusted per capita incomes during the 1980s.

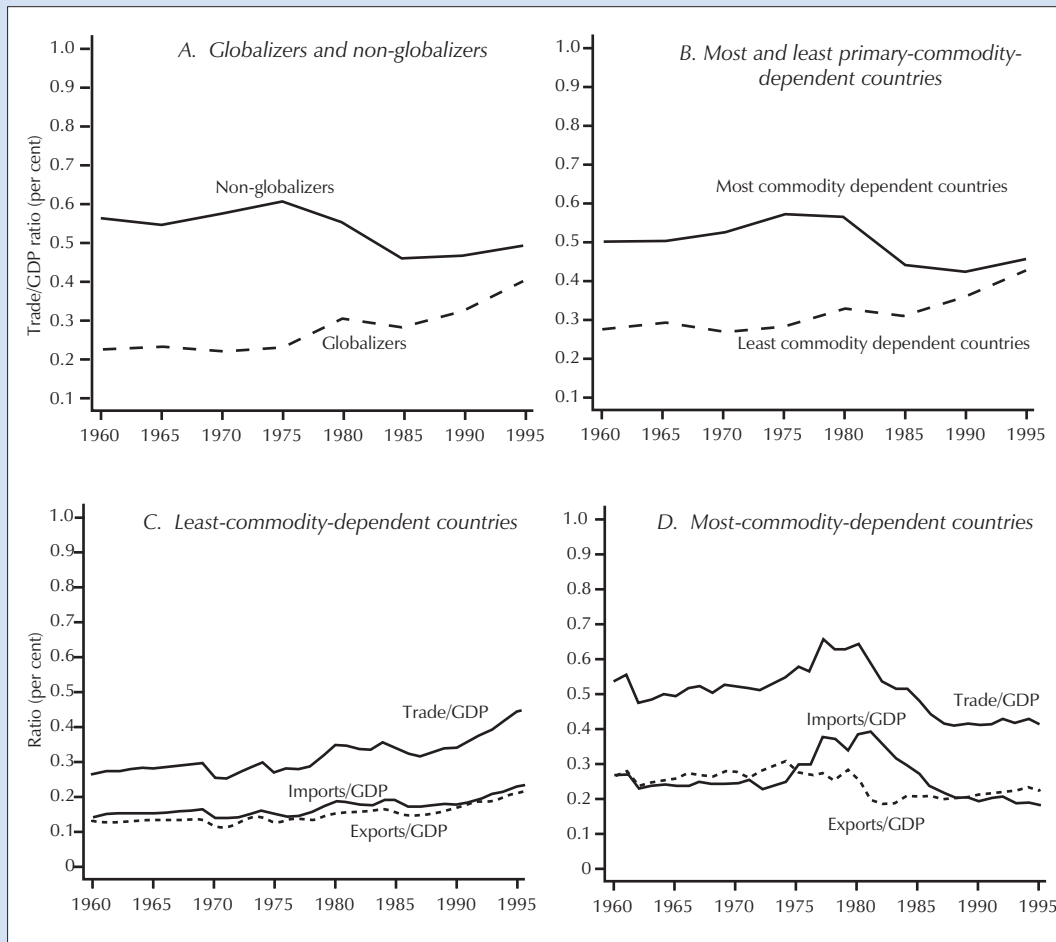
Birdsall and Hamoudi conclude that "Dollar and Kraay have not isolated the benefits of 'participating in the global trading system' but rather the 'curse' of primary commodity dependence" (ibid.: 5). As they put it most starkly,

"Countries with high natural resources and primary commodity content in their exports are not necessarily 'closed' nor have they necessarily chosen to 'participate' more in the global trading system. For them, reducing tariffs and eliminating non-tariff barriers to trade may not lead to growth. In this context, terms like openness, liberalization and globalization are red herrings" (ibid.: 5–6).

Box 5 (contd.)

This may be going too far in the sense that a key issue for the primary-commodity-dependent economies is the relationship between commodity dependence and liberalization and globalization. But their analysis certainly shows the fallacies and also serious policy errors which can arise from analysis of the links between trade and poverty that does not include an examination of the type of exports.

BOX CHART 1. TRENDS IN EXPORT/GDP, IMPORT/GDP AND TRADE/GDP RATIO IN GLOBALIZERS AND NON-GLOBALIZERS VERSUS MOST AND LEAST PRIMARY-COMMODITY-DEPENDENT COUNTRIES, 1960–1995



Source: Birdsall and Hamoudi (2002).

a result of which productivity gains are normally passed to the consumers rather than benefiting the producers. Because of the involvement of fixed factors of production, such as land and reserves in mines, they can be also subject to diminishing returns. In contrast, manufacturing is subject to substantial static and dynamic economies of scale. There is often higher income elasticity of demand for manufactures exports than for commodity exports.

The composition of imports also matters. There is less research in this area. But a careful analysis of the way in which imports can act as a channel for technology transfer has found that import-induced technology transfer is more important in sectors with medium productivity growth in high-income countries and that it is of little importance in "traditional" sectors (Choudri and Hakoura, 2000). Moreover, capital goods imports have been found to have specific important growth effects (Lee, 1995; Maurer, 1998; Egwaikhide, 1999).

The composition of trade is as important for the nature of the trade–poverty relationship as the level of trade. This applies both to exports and imports.

In very low-income economies which depend on a narrow range of low-value-added primary commodities and have deep mass poverty, there is a strong tendency for the domestic vicious circles of economic stagnation and persistent poverty to be reinforced by external trade and financial relationships. In this situation trade can be part of an international poverty trap in which low and unstable commodity prices interact with unsustainable external debts and an aid/debt service system (see UNCTAD, 2002).

In contrast, some more advanced countries which have managed to upgrade their commodity exports and diversify into exporting manufactures have been able to use international trade to achieve very high rates of economic growth. This occurs in particular in countries where there is a strong profits-investment and export-investment nexus (see UNCTAD, 1996). In some countries there has been a virtuous circle in which increased manufactures exports lead to faster growth of manufactures output, which, because of the positive effect of the overall level of manufacturing output on labour productivity, induces greater productivity growth.⁴ This in turn makes manufactures more competitive and enables increased manufactures exports.

The relationship between trade and poverty also varies with a country's level of productive development and structure of production and employment. This overlaps with the composition of trade, but it is not quite the same.

Exports can have a particularly strong poverty-reducing impact in these cases. But not all countries which export manufactures have experienced export-accelerated industrialization. Indeed, the more common recent experience, in which the growth of manufacturing exports is linked to integration into global production chains and assembly of imported inputs, is more likely to be associated with stagnant or even declining manufacturing output (UNCTAD, 2002).

A major research issue within a development approach would be to assess how the trade-poverty relationship varies with the types of exports and types of imports. This would encompass not simply commodity and manufactures exports, but also the development and poverty-reducing potential of service exports and also exports based on the new "knowledge-based" creative industries. It would also entail deeper analysis of how import composition matters.

(b) The level of development and structure of production and employment

The relationship between trade and poverty also varies with a country's level of productive development and structure of production and employment. This overlaps with the composition of trade, but it is not quite the same.

The fact that the relationship between export growth and output growth varies with the level of development was an important element of initial research on the relative merits of inward-oriented and outward-oriented development strategies. This early research focused on what were then described as "semi-industrial countries" (see Balassa, 1970), and the kind of positive relationship between outward orientation and growth that was identified in the semi-industrial countries was difficult to find in the poorer developing countries (Feder, 1986). Later analysis appears to have forgotten this insight and to apply conclusions derived from countries with more advanced levels of productive development to all countries. Research on the trade-poverty relationship from a development perspective would seek to recover this finding and examine how the relationship applies in the least developed countries as well as in more advanced developing countries.

Variations in the trade–poverty relationship amongst the developing countries owing to their structure of production and employment is also an important issue. In many developing countries, a large proportion of the poor work in agriculture and live in rural areas. This has led to the view that agriculture is the key issue for trade and poverty reduction, particularly in international negotiations. But from a dynamic development perspective poverty reduction does not depend simply on agricultural productivity growth and improved employment prospects in agriculture: productivity growth and employment expansion in non-agricultural sectors are also important. Indeed, historically, most successful cases of sustained poverty reduction have involved a shift in the occupational distribution away from agriculture. In these cases productivity growth has occurred in agriculture and other sectors of the economy in a balanced way such that there is a net addition to income-earning opportunities (jobs and livelihoods) on an economy-wide scale (Bhadhuri, 1993).

International trade can have either positive or negative effects on this process of production and employment change. There are a number of agrarian-labour-surplus economies in East Asia where international trade has facilitated the process of productivity growth and labour reallocation from agriculture to industry (see Fei and Ranis, 1997). In these cases, international trade has built upon and strengthened positive development interlinkages between agriculture and a growing capitalist industrial sector within the domestic economy. However, it is possible for international trade to weaken those links, thus leading to an enclave-based pattern of economic growth. This will be discussed later in this Report in the context of the least developed countries.

(c) Interdependence between trade and other international economic relationships

The relationship between trade and poverty is also influenced by the interdependence between trade and various other international economic relationships. To put it simply, how trade is related to poverty is affected by how trade is related to aid, debt, private capital flows and technology acquisition. For example, trade flows which are associated with FDI building global production chains might have different poverty-reducing effects from trade flows associated with domestic entrepreneurs extending a local industrialization process to external markets. Or imports based on tied aid might have different effects from imports financed out of export revenue.

These interdependencies matter for the trade–poverty relationship. From the point of view of developing countries, the knot through which the relationship between international trade and external finance is drawn together is the balance of payments. This critical constraint on development and sustained poverty reduction is conspicuously absent in the current debate on trade and poverty. Trade performance is also strongly linked to the level and stability of the exchange rate. The management of the exchange rate to achieve external trade and financial objectives is a key and complex issue.

4. THE FEEDBACK FROM SUSTAINED POVERTY REDUCTION TO INTERNATIONAL TRADE

A final element of the development approach to poverty reduction outlined here is that it would examine not only the impact of international trade on poverty trends but also the feedback effects from poverty reduction to international trade. What is important in this regard is that development and

How trade is related to poverty is affected by how trade is related to aid, debt, private capital flows and technology acquisition.

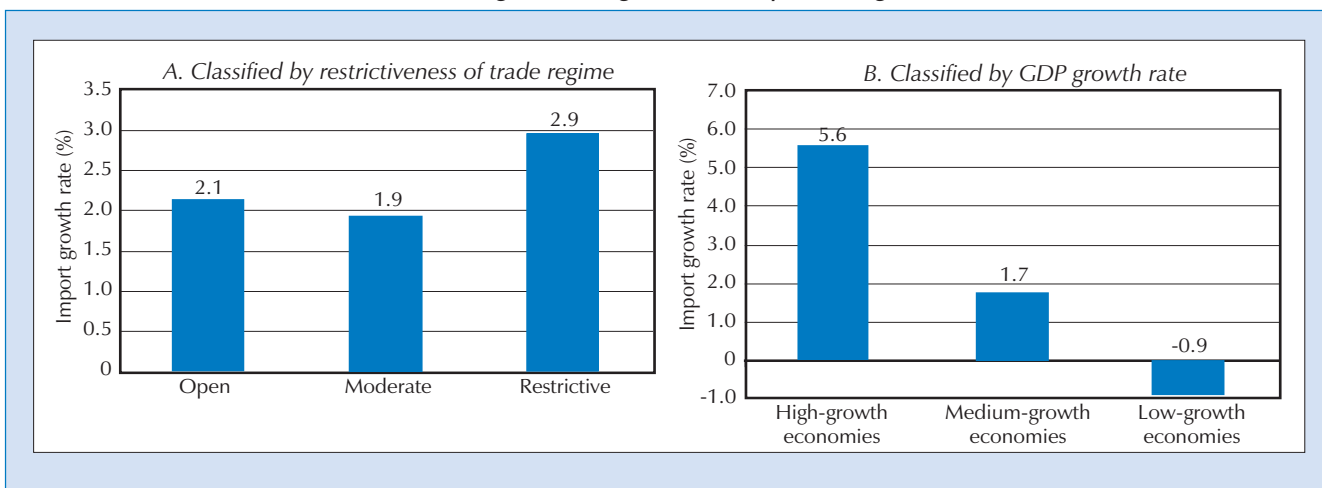
sustained poverty reduction are major motors for expanding international trade. On the one hand, the development of productive capacities enables developing countries to expand their exports. But on the other hand, rising income per capita and reduced poverty lead to increased imports.

Development and sustained poverty reduction are major motors for expanding international trade.

Simple evidence of the relative importance of trade liberalization and economic growth for import growth in developing countries is shown in chart 8. This compares the rate of growth of real imports per capita over the period 1997–2001 in developing countries classified according to the openness of their trade regime in 1997 and according to their real GDP growth rate during 1997–2001. If economic growth was closely correlated with the trade regime this exercise would not make much sense. But out of the 108 countries for which data are available, only 10 out of 35 classified as having been “open” have high GDP growth, and only 7 out of 36 countries classified as restrictive have low GDP growth. There are 37 countries which have either high GDP growth with a “restrictive” trade regime or low GDP growth with an “open” trade regime.

Given the mismatch between the trade regime and the growth performance, which reflects the fact that economic growth depends on so many factors in addition to the trade regime, the question that arises is the following: is trade liberalization more important than economic growth in explaining the growth of imports per capita in developing countries? What chart 8 shows is that openness of the trade regime is not in fact a good indicator of the rate of import growth. Real imports per capita grew at a rate that was slightly higher in “open” economies than in moderately restricted economies (2.1 per cent per annum as against 1.9 per cent per annum over the period 1997–2001). But the restrictive economies actually have slightly higher import growth rates — 2.9 per cent per annum. However, there is a very clear distinction between the developing

CHART 8. GROWTH RATE OF REAL IMPORTS PER CAPITA IN DEVELOPING COUNTRIES CLASSIFIED ACCORDING TO THE RESTRICTIVENESS OF THEIR TRADE REGIME AND TO THEIR GDP GROWTH PERFORMANCE, 1997–2001
(Average annual growth rate, percentage)



Source: World Bank, *World Development Indicators 2003*, CD-ROM; and IMF, Trade Restrictiveness Indicator.

Note: The imports and GDP figures are expressed in constant local currency terms. The countries' trade regimes were divided into open, moderate and restrictive according to the IMF trade restrictiveness indicator in 1997. A country's trade regime rated between 1 and 4 is considered to be open, while ratings between 5 and 6 are considered to be moderate and ratings above 7 restrictive. Countries were divided into high-, medium- and low-growth depending on their growth performance during the period 1997–2001. The high-growth developing countries are the top third (with a real GDP growth rate higher than 4.2 per cent), the medium-growth developing countries are the middle third (with a real GDP growth rate between 4.2 per cent and 2.08 per cent), and the low-growth developing countries are the remaining third (with a real GDP growth rate lower than 2.08 per cent). The GDP growth averages are calculated using the simple arithmetic average formula. India and China are included in the sample, but the overall average is not significantly affected by their presence.

countries when they are classified according to their GDP growth rates. Imports per capita grew by 5.6 per cent per annum in the high-growth economies, and by 1.7 per cent per annum in the medium-growth economies, while they declined by 0.9 per cent per annum in the low-growth economies.

This is a very simple statistical tabulation over a short period. However, it suggests that in terms of the expansion of global markets, economic growth is much more important than trade liberalization. During the structural adjustment era from 1980 to 2000, extensive trade liberalization was undertaken by developing countries. This resulted in a more import-intensive pattern of economic growth (UNCTAD, 1999). If economic growth and poverty reduction could be stimulated and sustained in developing countries now, there would be a major expansion of their imports per capita and also of world trade, which could benefit the developed countries in particular, as well as the developing countries.

In terms of the expansion of global markets, economic growth is much more important than trade liberalization.

E. Policy implications of the development approach

The development approach advocated here is an approach for analysing the trade–poverty relationship. However, it is worthwhile to outline briefly some of the policy implications of this approach.

1. NATIONAL POLICIES

A major danger which has arisen from an exclusive focus on the question of trade liberalization and poverty is that integration into the global economy has come to be seen as a mechanism of poverty reduction in itself. But it is development, the long-term process in which the incomes, productive capacities and freedoms of people increase, which is in practice the key to poverty reduction. Trade liberalization is certainly part of the development process and a very important policy issue. But it is wrong to assume that trade liberalization, or increasing trade integration as measured by the trade/GDP ratio is, in and of itself, the same thing as development.

The approach adopted here implies that the national policies which best support poverty reduction should not be based on an integration strategy alone but rather on a national development strategy with an integration component.⁵ The aim of such a strategy should be:

- To create and sustain a dynamic process of capital accumulation, structural change and technical progress in order to develop productive capacities;
- To manage integration with the global economy, including both external finance and external trade, and technology acquisition;
- To ensure that development is inclusive, incorporating marginal groups, paying attention to gender equity, and ensuring the achievement of certain minimum standards of human well-being, which are expressed in terms of poverty reduction, human development and food security.

Making international trade a more effective mechanism of poverty reduction is a policy problem which is embedded within this triple challenge. It is in this

A major danger which has arisen from an exclusive focus on the question of trade liberalization and poverty is that integration into the global economy has come to be seen as a mechanism of poverty reduction in itself. But it is development, the long-term process in which the incomes, productive capacities and freedoms of people increase, which is in practice the key to poverty reduction.

context that the important policy questions of how trade liberalization fits into a development strategy and how integration with the world economy can best support national development and poverty reduction arise. There are no easy answers or quick fixes. However, linking international trade to poverty reduction is best achieved through national development policies that are pragmatic, inclusive and outward-looking.

The hallmark of pragmatic development policies is that they are continuously learning on the basis of past experience. This entails a rejection of economic fundamentalism, of all varieties, and instead an evaluation of what works and what does not work in different contexts. Pragmatic development policies are private-sector-led. However, they recognize that it is not only government failures that are constraints on development and poverty reduction. There are significant market failures as well. Moreover, there are unequal outcomes associated with poverty which arise because markets work as well as because markets fail. This is partly because markets reward those who already have productive assets — financial assets, human capital, access to land and the equipment to work it (Birdsall, 2002). But the response of entrepreneurs to effective demand can also marginalize the needs of the poor. This is most dramatically evident in famine situations when food is shipped out of regions where people are starving because of the lack of a local purchasing power (Sen, 1981).

Linking international trade to poverty reduction is best achieved through national development policies that are pragmatic, inclusive and outward-looking.

Successful poverty reduction also requires inclusive development policies. This is clear when the majority of the population are poor. But it applies even if the poor are only a small proportion of the national population. In this situation, targeting the poor rather than pursuing broad-based development may actually be counter-productive. Firstly, it is clear that within a private-sector-led approach it is actually the behaviour of the rich that has an important impact on social outcomes. This comes partly through demand effects, which were first underlined by Adam Smith. But equally important are the ways in which the business class uses profits — whether for luxury consumption or reinvestment in ways which create more jobs for the majority (see UNCTAD, 1997). Secondly, the narrow focus on the poor rather than on broad-based development may undermine the sense of national community which has often provided the hidden ingredient of successful poverty reduction through development.

Finally, successful poverty reduction requires outward-looking development policies. The term “outward-looking” is used here to refer to policies which are based on “constant attention to” trade, technological and investment opportunities globally (Keesing, 1967: 304). An outward-looking policy is not necessarily the same as a policy of trade and financial liberalization. The latter can be one form of an outward-looking policy. But laissez-faire is not a necessary condition for an outward-looking policy. On the contrary, it is possible to undertake an outward-looking policy with varying degrees of government intervention.⁶ Moreover, it is now becoming an important lesson of cumulative experience with economic reforms since the early 1980s that Governments may undertake liberalization without in practice being outward-looking in the active sense in which this term is defined here.

2. INTERNATIONAL POLICIES

The development approach also has implications for international policies, and in particular for the design of the international trade regime. That trade regime is founded on two visions of global justice (Helleiner, 2003). The first,

non-developmental, vision sees the purpose of the rules system as to provide stability and predictability for market participants, and to set certain restrictions on how national Governments may pursue their own diverse purposes. Economic freedom is seen as a good in itself, rather than as a means to development and poverty reduction. The second vision sees the rules system (and trade) as a means to an end rather than an end in itself, something which is instrumentally rather than intrinsically valuable. From this point of view, the purpose of the rules system is to facilitate positive development and poverty reduction outcomes. The critical question for negotiators designing the international trade regime would not be “how do we maximize trade and market access?” but rather “how do we enable countries to grow out of poverty?” (Rodrik, 2001: 10).

The design of the international trade regime seeks to incorporate both visions. Thus the concern to establish stability, predictability, market access and a level playing field for all participants is complemented by the concern, expressed in the first substantive paragraph of the agreement establishing the WTO, that the system be also designed in such a way that it contributes to raising living standards, ensuring full employment and promoting sustainable development. Reconciliation of possible tensions between these two visions of global justice has now become central to the design of the international trade regime. This follows expansion of its membership to include most developing countries, the perception of a “development deficit” in the current round of WTO negotiations, and also an increasing concern to make poverty reduction the “litmus test” of the success of the trading system.⁷ It is in this context that a proposal to monitor the working of the international trade regime in terms of development and poverty reduction benchmarks has been made (UNCTAD, 2003).

If poverty reduction is taken as the priority goal, then the development approach to trade and poverty sketched out in this chapter has important implications for the design of the international trade regime. It implies that an international regime which facilitates the expansion of international trade is not sufficient for poverty reduction. Rather, it is necessary to have an international trade regime which does not constrain the national policies of developing countries for developing their productive capacities. To be precise, *the international trade regime should enable rather than constrain the efficient development and utilization of the productive capacities in a way in which the population of working age becomes more and more fully and productively employed*. What this means in practice depends on the relationship between international trade, the development of productive capacities and poverty reduction.

Giving priority to poverty reduction does not mean that it is possible to ignore the value of stability, predictability and economic freedom. But it is important to recognize that freedoms of all kinds, including the freedom of choice which underpins the working of a market economy, are severely curtailed in societies where most people live with barely sufficient income to meet their basic subsistence needs. It is through poverty reduction that personal liberty can be actually rather than formally realized. It is through development and poverty reduction that the two visions of global justice can, in the end, be reconciled.

Finally, the development approach to trade and poverty implies that the international trade regime is not the sole international policy issue which needs to be addressed in order to link international trade more effectively with poverty reduction. Because the way in which trade is related to poverty is affected by

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how trade is related to aid, debt, private capital flows and technology acquisition, a central international policy issue is the question of coherence between action in the different domains.

The interdependence between these domains implies that a slogan such as “trade not aid” is misleading. The issue is not one or the other. It is rather how to make any existing negative synergies between aid and trade into positive synergies, how to use aid to build productive capacities and thus how, in the long term, to reduce the need for aid. Similarly, it is necessary to link trade with external debt problems. For the poorest countries, the close connection between primary commodity dependence and the build-up of unsustainable debt is clear (UNCTAD, 2002). For middle-income countries, the links between growing trade deficits, excessive reliance on unstable forms of private capital inflows and currency crises are also evident (see UNCTAD 1999, 2002). These systemic links must be taken into account in the design of international policies which make international trade a more effective means of poverty reduction in developing countries.

The focus on trade liberalization and poverty is hampering identification of the most effective national and international policies to ensure that international trade supports sustained economic growth, which is the key to substantial poverty reduction on a scale necessary to meet Millennium poverty reduction goals.

F. Conclusions

This chapter has argued that the current approach to policy analysis and research on trade and poverty is too narrowly focused on the issue of trade liberalization and poverty. Progress is being made in this subject. There is a better understanding of the short-term and direct channels through which border price changes associated with trade policy reforms impact at the household level, and also new methodologies to estimate these impacts and the poverty impacts of multilateral trade liberalization. This is helping policy makers to alleviate poverty during trade liberalization. However, the narrow focus is hampering identification of the most effective national and international policies to ensure that international trade supports sustained economic growth, which is the key to substantial poverty reduction on a scale necessary to meet Millennium poverty reduction goals.

The chapter argues that in order to identify such policies it is necessary to stand back from the subject of trade liberalization and poverty, and focus objectively on the links between trade and poverty. It proposes a development approach to analysing the trade–poverty relationship. After this has been done, it is then possible to see how trade liberalization can fit into a broader development strategy.

The analytical core of this development approach is the idea that sustained poverty reduction occurs through the efficient development and utilization of productive capacities in a manner in which the working age population becomes more and more fully and productively employed. International trade can facilitate, hinder and modify this process. This approach thus encompasses the long-term and indirect impact of trade on people’s lives and livelihoods through the development of productive capacities, as well as the short-term and direct impact which is currently considered in the literature on trade liberalization and poverty. It makes trade and employment a central issue for understanding trade and poverty.

An important aspect of the approach is that it seeks to identify variations amongst developing countries in terms of the trade–poverty relationship. Three key dimensions of diversity are: the composition of trade; the level of development and structure of production; and the nature of the

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interdependence between trade and financial and investment flows, as well as between trade and debt and trade and technology transfer. Finally, the approach encompasses analysis of the way in which poverty reduction affects trade.

The rest of the Report applies this development approach to understanding the relationship between trade and poverty in the particular situation of the least developed countries. The Report is a first attempt at understanding this complex issue. It cannot answer all the difficult questions which the approach raises. But the outline of ways to link international trade to poverty reduction in LDCs more effectively can be discerned, and a deeper programme of policy analysis and research should be able to extend and refine the findings.

Notes

1. See, for example, Dollar (1992), Edwards (1992), Levine and Renelt (1992), Sachs and Warner (1995), Krueger (1998), Frankel and Romer (1999), Dollar and Kraay (2001), Greenaway, Morgan and Wright (2002), Yanikkaya (2003) and Santos-Paulino and Thirlwall (2004).
2. Recent research has shown that labour reallocation effects away from a Malthusian traditional sector can increase the effective return on physical capital by around 30 per cent in industrializing countries (Landon-Lane and Robertson, 2003). Also, work on research into the sources of economic growth in sub-Saharan Africa shows that reallocation of labour from the agricultural sector to more productive sectors has “contributed significantly to growth in the current and earlier periods” (Berthelemy and Söderling, 2001: 333). Another estimate, for low-income countries from 1960 to 1980, suggests that the shift of labour from agriculture to industry can explain as much as two thirds of growth per capita in those countries during that period, but a much lower amount in more advanced developing countries (Pack 1992, quoted in Fei and Ranis, 1997: 43).
3. These different channels are rooted in different theories on the gains from trade.
4. The relationship between manufacturing output and productivity, which was particularly emphasized by Kaldor, is known as Verdoorn’s Law. It has been found in various settings – see Thirlwall (2002: chapter 3) and, for the test of this relationship within Africa, see Thirlwall and Wells (2003).
5. This position is similar to that of Rodrik (2000b), who identifies the shift from a concern with development to a concern with integration as a major weakness in current policy debates. As he puts it, “The trouble with the current discourse on globalization is that it confuses ends with means. A truly development-oriented strategy requires a shift in emphasis. Integration into the world economy has to be viewed as an instrument for achieving economic growth and development, not as an ultimate goal” (p. 28).
6. This point is vital for interpreting the successful East Asian development experience. See, for example, Bradford (1994).
7. On the notion of a development deficit in the current round of negotiations, see Ricupero (2004), and on the importance of poverty reduction as a litmus test of the multilateral trade agreements, see Puri (2003).
8. The emergence of trade deficits is important as they show that the trade/GDP ratio is “a highly idiosyncratic statistic”. Changes in the ratio are driven not simply by the value of exports and imports but also by changes in the trade deficit. This is because the ratio is exports plus imports (X+M) divided by GDP, which equals total domestic consumption and investment (both public and private) plus exports and minus imports (+X-M). A country running a trade deficit will be more open by this measure than a country running an identically sized trade surplus even though the sum of their export/GDP ratio and import/GDP ratio is the same.

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