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Selected Developmental Aspects of Trade and Trade Policies

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SELECTED DEVELOPMENTAL ASPECTS OF INTERNATIONAL TRADE AND TRADE POLICIES

A literature review

Yannick Bineau and Pierluigi Montalbano

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LIST OF ACRONYMS

ACP:	African, Caribbean and Pacific group of countries
APEC:	Asia-Pacific Economic Cooperation
AVE:	Ad valorem equivalents
BIS:	Bank for International Settlements
BRICS:	Brazil, Russia, India, China and South Africa.
CARIBCAN:	Caribbean-Canada Trade Agreement
CARICOM:	Caribbean Community
CDP–ECOSOC:	Committee for Development Policy of the United Nations Economic and Social Council
CEEC:	Central Eastern European Countries
CGE:	Computable general equilibrium
COMESA:	Common Market for Eastern and Southern Africa
CPIA:	Country policy and institutional assessment
CVI:	Commonwealth Vulnerability Index
DC:	Developing countries
DDA:	Doha Development Agenda.
DFID:	Department for International Development
EBA:	Everything but Arms
EC:	European Commission
ECOWAS:	Economic Community of West African States
EERM:	Exchange rate effectively faced by importers
EERX:	Exchange rate effectively faced by exporters
EFTA:	European Free Trade Association
EPA:	Economic Partnership Agreements
EPZ:	Export processing zones
EU:	European Union
EVI:	Economic Vulnerability Index
FDI:	Foreign direct investment
FTA:	Free Trade Agreements
GATS:	General Agreement on Trade in Services
GATT:	General Agreement on Tariffs and Trade
GDP:	Gross Domestic Product
GSP:	Generalized System of Preferences
GTAP:	Global Trade Analysis Project
LDC:	Least-developed countries
MA - OTRI:	Market Access - Overall Trade Restrictiveness Index
MENA:	Middle East and North Africa
MERCOSUR:	Mercado Común del Sur - Mercado Comum do Sul (Common Southern Market)
MFN:	Most-favoured-nation
MTRI:	Mercantilist Trade Restrictiveness Index.
NAFTA:	North American Free Trade Agreement
NSE:	New Structural Economics
NTB:	Non-tariff barriers
NTM:	Non-Tariff Measures
OECD:	Organisation for Economic Co-operation and Development
PTA:	Preferential trade agreements
QR:	Quantitative restrictions
RTA:	Regional trade agreements
RUNS:	Rural-Urban North-South model developed
S&D:	Special and differential
SADC:	Southern African Development Community
SIDS:	Small Islands Developing States
TRI:	Trade Restrictiveness Index
TRIPS:	Trade-Related Aspects of Intellectual Property Rights
TTRI:	Tariff Trade Restrictiveness Index
UN:	United Nations
UNCTAD:	United Nations Conference on Trade and Development
VER:	Voluntary export restraint
WTO:	World Trade Organization

EXECUTIVE SUMMARY

SELECTED DEVELOPMENTAL ASPECTS OF INTERNATIONAL TRADE AND TRADE POLICIES

This report presents the results of a review of the economic literature on selected developmental aspects of international trade trends and trade policies in less developed countries between 2000 and 2011. The views expressed are those which were considered by the authors of this report as reflecting most significantly the stand of the literature on the subject without excluding that dissents exist in the community of economists.

Since the early 2000s, developments in international trade have been important for both developed and developing countries. This report begins by showing that developing countries are becoming ever more open, but certain barriers, which must be quantified still remain. One important conclusion is that a single indicator cannot provide a measure of the trade distortions a country imposes on itself whilst simultaneously capturing the trade distortions imposed on its trading partners.

This report shows that measuring trade restrictions and the relative economic impact of the trade measures a country adopts depends on what are the most suitable indicators and empirical methods of analysis. This is, in turn, linked to the long standing debate on openness in practice versus openness in policy. Indeed, each of these indicators captures a particular effect. Then any analysis should use several indicators. This report outlines three major trade indicators in the literature, as follows:

- The Trade Restrictiveness Index is a suitable indicator if one is interested in the welfare distortions that a country imposes on itself. However, while the Trade Restrictiveness Index is an excellent indicator of the degree of domestic inefficiency caused by the domestic trade regime, it provides little information regarding the trade restrictiveness faced by exporters.
- The Mercantilist Trade Restrictiveness Index is a more appropriate indicator if one is interested in the extent to which trade distortions limit imports.
- The Market Access Overall Trade Restrictiveness Index appears to be a better indicator if one is interested in the barriers faced by each country's exporters when selling in other countries.

The report also points out that during the last decades, the world economy has undergone significant changes in terms of international facts and international policy issues. One important consequence of this evolution is that developing countries are implementing important tariff reductions and trade liberalization policies which favour trade integration even if barriers on some sectors, as the agriculture sector, remain significant. There is still room for further liberalization and the report shows that the effects of globalization depend on how countries are integrated into the global economy:

- Many countries have sought more easily attainable outcomes through bilateral and regional free trade agreements. If the liberalization is undertaken multilaterally, the benefits of trade liberalization are greatest. But it cannot be denied that the benefits are distributed unequally, both across countries and within countries.
- Great attention has to be paid to non-tariff measures. As the level of tariffs has decreased, the relative importance of non-tariff measures has increased. In addition, significant progress has been made in terms of quantifying the effects of non-tariff measures, leading to a better understanding of the costs these barriers impose on doing

business. There is some evidence of non-tariff measures being used as a substitute for the now lower tariffs.

- The WTO estimates that more than 400 free trade agreements will be in force globally in 2011. All WTO members (except Mongolia) belong to at least one preferential trade agreement. Since average tariffs have fallen markedly in recent years, the study considers that tariff preferences are becoming a more minor motivation for entering into preferential trade agreements. In fact, preferential trade agreements are increasingly being used to promote cooperation in the areas of investment, trade facilitation, competition policy and government procurement, as well as wider social issues related to the regulation of the environment and the protection of labour and human rights.
- The proliferation of preferential trade agreements has created a "spaghetti bowl" of crisscrossing arrangements, with little attention to coherence between agreements or to the implications of so many regimes for trade costs, efficiency, and the conditions of competition on global markets. The question of whether preferential trade agreements – and specifically regional trade agreements – represent a WTO-plus by accelerating and extending the liberalisation process on a non-discriminatory basis, or whether they are likely to weaken the WTO by bypassing it, is still open. Although liberalisation through regional trade agreements is generally a second-best option, it may be the only option if there is resistance to liberalisation at the multilateral level.

Poverty eradication is the central focus for development as well as the main target of the World Bank and other development institutions. The "Millennium Development Goals" commit the international community not only to halve poverty by 2015, but also to promote a more open, rule-based trading system, with the latter viewed as reinforcing the former. Then, the report shows that trade integration should promote an "inclusive growth" and reduce poverty:

- The inclusive growth approach takes effect in the longer-term and focuses on the increase of productive employment opportunities as a means of increasing income for excluded groups. As a result, many developing countries have embarked on programmes of external economic liberalization in recent decades, because it helps to raise inclusive and sustainable growth.
- However, there is no simple general conclusion about the relationship between trade liberalisation and poverty. While there are, in principle, many reasons for optimism in the relationship between trade liberalisation and poverty reduction, the ultimate outcome depends on many factors, such as the precise trade reform measures undertaken, the household-level characteristics and those of local institutions (developing countries are not an homogeneous group), which determine the price effects of liberalisation, notably the transmission of border price changes to local levels.

This report also indicates that the above conditions are not always conducive to inclusive growth. Whenever this is the case, further steps need to be taken:

- It is of primary importance to introduce policies which increase the gains from trade liberalization. These policies should include development policies that encourage investment and competition, include openness to foreign direct investment and include macroeconomic policies that encourage stable prices and a competitive real exchange rate and reduce the degree of vulnerability to foreign shocks.
- A desirable trade regime should not only be oriented towards the enhancement of market access to developed economies, but also provide sufficient policy space to domestically crafted growth strategies of developing countries, even, as mentioned in

some cases including “unorthodox” policies such as export subsidies, trade protection and investment performance requirements.

This report shows that other means to reach inclusive growth involve introducing complementary policies which favour the services sector, investment liberalization and the reformation of competition policy. Time constraints of those complementary reforms are important issues because the timing of policy introduction is important and it is generally not advisable to pursue simultaneous reforms if there is limited implementation capacity, strong political opposition or particularly high adjustment costs. Determining the appropriate pace of reform could have both political and financial implications on the service sector, FDI attractiveness and competition policy.
The liberalization of a highly regulated service sector can help to promote economic growth.

- A large body of research has documented the positive association between open service markets, foreign direct investment in services and the performance of downstream domestic firms, including an effect on exports.
- A new strand of regulations and laws are necessary, to ensure that both the policy objectives of liberalization of trade on services which have been decided on are correctly defined, and that the expected benefits of a policy are reached.
- The nature, pace and sequencing of regulatory reform and liberalisation undertakings must be carefully assessed. The liberalization of the service sector must be progressive and must be accompanied by regulatory capacity building.

It is believed that financial globalization is of most benefit to an economy when investment liberalisation policies have been implemented. Some theoretical approaches consider that foreign direct investment is a more favourable source of foreign capital for developing countries than other capital flows because it is usually targeted toward industries consistent with a country’s comparative advantage. It is less prone to sudden reversals during economic crises. In addition, foreign direct investment generally brings technology, management, access to markets, and social networking, which are often lacking in developing countries and are crucial for industrial upgrading. Thus, liberalising foreign direct investment is considered an attractive component of a broader development strategy.

- A liberal policy framework promotes foreign direct investment because it enables foreign companies to invest in a host country. Foreign direct investment flows into host countries are determined by a variety of factors. Determinants include the physical and technological infrastructure of the host country, and the cost and quality of resources, together with inputs and business facilitation measures, such as foreign direct investment promotion, including incentives to foreign investors.
- Foreign direct investment liberalisation is a necessary but not a sufficient host country determinant of investment, and other determinants have to come into play. The debate on whether developing countries can benefit from removing their remaining barriers to the free flow of capital is still open.

Finally, the report explains that competition policy combines all government policies that influence the level of competition as a positive tool regulating the market economy, including measures against restrictive and unfair business practices.

- The main static effects of competition are to reduce the ability of firms to raise price above marginal cost and to ensure that firms produce at the lowest costs.
- The main dynamic consequences of competition can include incentives to innovate, to imitate, and to invest in the development of new technologies and know-how.

INTRODUCTION

The progress of international applied trade literature has been accelerating for many decades. Previously, most trade models considered that international trade of goods was nothing more than a substitute to the exchange of factors of production such as Labour and Capital. This is no longer considered to be the case. However, the fundamental assumptions inherited from those models are that there is no international mobility of those factors of production. Despite the rapid progress of academic research, the diversity in international trade issues has lead to heterogeneous theoretical models. This heterogeneity is reflected in the diversity of aspects that are analysed by applied research and in the relative variety of empirical results.

The multiple theoretical models lead inexorably to different answers to the same questions. The treatment of each answer depends largely on the theoretical and methodological models adopted at the outset. This considered, the only way to make a good assessment of trade policy choices, the degree of openness or more widely of a country's integration into the international trade architecture is to look at different indicators; either indicators of a statistical nature or those resulting from econometric simulations and empirical modelling.

It is necessary to find effective measure of trade restrictions, which can easily be connected with the issue of preferential margins. The question which needs to be asked is, what are the numerous instruments to measure trade liberalisation, trade restrictions and barriers to trade indicators available in the most current literature? Is it possible that a single indicator can provide a clear and concrete measure of the trade distortions a country imposes on itself whilst simultaneously looking at the trade or welfare distortions imposed on its trading partners? If so, what are the different tools, most suitable indicators and empirical methods of analysis that need to be adopted when assessments of trade related policies are requested?

It is all the more important now to have clear definitions of indicators because since the turn of the last century developed countries and developing countries in particular have been faced with an important reshaping of the world's economic environment (relative GDP dynamics, modification in trade hierarchy - and especially the rise of BRICS - the recent financial crisis, the erosion of commercial preferences, firm's strategies). At the same time, there have been many international policy challenges such as; the reform of the global economic architecture, international trade negotiations such as the Doha round or the rise in number of international agreements. Not to mention the approach to environmental challenges. These policies were undertaken on a multilateral basis in different bilateral and multilateral agenda, where the major objective is to increase economic growth. Among developing countries, the recent literature shows that such countries adopt trade liberalization policies, increase number of preferential trade agreements and set up free trade areas. However, if these agreements

increase economic, trade and industrial interdependencies and reduce tensions between countries, does it enhance inclusive growth?

The recent literature focused on the link between trade liberalization, integration into the world economy and growth. However, one needs to ask what signifies this link and what are its causes? A positive correlation between trade liberalization and growth seems to be confirmed by different authors. One also needs to ask how strong is this link and is it similar between countries? Because, in the end, the multiplicative impact of trade on intensive employment based economic growth eventually depends on the impact of productivity. Therefore, it seems difficult to put forward a significant link between trade liberalization and poverty reduction, because the initial conditions for economic growth and the ability of a country to adapt can lead to different growth trajectories. Moreover, the role of local institutions, which determine the price effects of liberalization and the transmission of price changes at a local level, needs to be looked at. How clear is this link since a number of other factors need to be taken into consideration? Indeed, many papers show that while a country's openness favours its development and poverty reduction, empirical research does not lead to a convergent conclusion. How may institutions create positive impulse to growth, taking into account the fact that many factors, such as macro-economic variables, a country's demographic structure, gender balance, quality and skills of labour and capital can interact with each other? What then is the impact of the quality of the factors of production on development and inclusive growth?

Lastly, complementary policies must be implemented to promote development and inclusive growth. Developing countries do not represent a homogeneous group, and emphasis should be firstly set on some more homogeneous sub-groups. Moreover, the comparison of situations between different homogeneous groups of developing countries could provide guidance on the variety of complementary policies that should be implemented. Theoretical studies confirm that the initial conditions in each country and their productive structures exert a powerful influence on the impact of trade liberalization policy and can affect the effectiveness of complementary policies. Hence, what conditions are necessary for complementary policies to be successful and what are the different economic policy tools that are available? The main complementary policies can be macroeconomic policies which affect institutions, exchange rates, competitive situations, FDI, intellectual property protection and business confidence. However, there is no time equivalence between these instruments so that the choice of the timing of any trade policy (tariff reduction, in complement, or not with other policies, services liberalization ...) should be the subject of significant attention. The literature is not able to reach any consensus on the timing characteristics of this issue. Trade policy cannot be limited to trade of goods since services represent a growing share of a country's GDP; this is the case in both developed and developing countries.

This report includes four chapters. This first one will deal with the major concepts, definitions and instruments that can be used to produce comprehensive assessments of trade integration and trade liberalization of developing countries. The second chapter will present the main trends of the changing world economic situation. This part will further investigate the specific situation of factors of success and failure of trade integration within developing countries. The third chapter will focus on inclusive growth and more specifically on factors that can explain success or even failures of developing countries' growth. But, even if conditions which favour inclusive growth are met, complementary policies and reforms to promote development and inclusive growth can be necessary within developing countries. This will be presented in chapter Four.

PART I

DEVELOPING COUNTRIES' TRADE LIBERALIZATION AND INTEGRATION INTO THE WORLD ECONOMY: CONCEPTS, INDICATORS AND INSTRUMENTS

Applied literature on international trade evolves over time[1]. Two aspects are key emerging issues for developing countries: the actual measurement of their trade restrictiveness (with the related issue of their true "preferential margins") and the relative economic impact of the various trade instruments adopted. Both issues are obviously linked with the related issue of what the most suitable indicators and empirical methods of analysis are. This issue is in turn, linked to the long-standing debate on openness in practice versus openness in policy. All of these "aspects of trade" are to be considered essential before drawing any conclusion on the relative impact of trade policy on growth and development that will be dealt in chapter 3 and which is at the core of the present report.

1.1 The "openness in practice" vs "openness in policy" debate

As McCulloch et al. (2001) clearly state, even in the simpler case of openness to goods and services, we should distinguish between being "open in practice" (the so-called "outcome openness") and/or being "open in policy" (i.e., as a result of deliberate policies). These are two distinct sets of issues: the first one is related to non-policy factors such as resource endowments, country size, tastes, technology and other determinants of comparative advantage, while the latter is related to the levels of trade restrictions. For example, size may make a small country open in practice, even though it may apply numerous policy distortions to trading activities. Conversely, a country may have few restrictions on trade but may operate an exchange rate policy that creates large price distortions in practice. Numerous attempts have been made to separate these two sets of factors. The most applied approach is to use deviations of actual from potential trade ratios predicted by gravity estimates. There are an overwhelming amount of references on the gravity model. Since its introduction by Tinbergen (1962) the gravity model has been widely used to explain flows of international trade. Focusing only on the most recent updates on gravity equation see, among others, Anderson and van Wincoop, 2003; Egger, 2004; Baltagi et al., 2003; Egger and Pfaffermayr, 2003; Baldwin and Taglioni, 2007; Baier and Bengstrand, 2007.[2] An alternative approach,

[1] See Appendix A for a brief report on the main elements of the debate around the definitions of trade liberalization and trade integration as well as its links with international trade theory.

[2] The main advancements in applied gravity equations concern the use of panel estimation methods to avoid the problem of unobserved heterogeneity (the standard assumption is that heterogeneity is constant over time

already discussed (see above) but actually hard to perform statistically, is to measure the aggregate level of trade restrictions, i.e., to construct some aggregate measure, which is an average of the levels of trade restrictions on different traded commodities (Francois et al., 2006; Cardamone, 2007; Cipollina and Salvatici, 2008; Kee et al., 2009; Hoekman and Nicita, 2011). A third approach is to rely[3] on *measures of equivalence*, i.e., measures – normally computed as "indexes of restrictiveness" - that provide results that are equivalent to the original data in terms of the information required. They provide an assessment of how far actual observations are from other hypothetical equilibria. Since they are not only based on observed data, equivalence measures are not only dependent on the structural features of the economy (as for outcome measures), but 'model dependent' too, in that the value of the index will vary as the underlying modelling choices and parameters change (Anderson and Neary, 1994, 1996, 2003, 2005, 2007; Anderson, 1995, 1998a, 1998b; Lloyd and MacLaren, 2002; Cipollina and Salvatici, 2008).

What are the implications of not distinguishing openness? From the key issue of the distinction between openness in practice and openness in policy, one can derive two main implications: i) the need to assess the actual links between deliberate trade policies and trade openness (and possibly integration); ii) the need to distinguish the effects of deliberate policies from similar consequences of changes in trade volumes that arise from other determinants (e.g., transport costs, increases in world demand, etc.). Regarding the first point, Nenci (2011), by reconstructing historical tariffs and trade series for 23 countries (over 60% of world trade) in the period 1870-2000, demonstrates that the empirical world level long-term relationship between tariff reductions and trade growth has gradually been diminishing in importance and significance since 1950. Hence, the puzzling evidence is that the expected inverse relationship between tariffs and trade does not seem to hold in present times. Concerning the second point, Rodriquez and Rodrik (2001) warn about the concrete risk that the empirical outcome of trade literature could be biased because of obvious misspecification or use of measures of openness which are proxies for other policy or institutional variables that have an independent detrimental effect on main economic variables, such as growth. This will be discussed in chapter 3.

1.2 How to quantify the degree of developing countries' trade restrictiveness?

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and correlated with independent variables) - see, among others, Egger, 2000; Glick and Rose 2001; Egger and Pfaffermayr, 2003 – and of endogeneity (i.e., a loop of causality between the independent and dependent variables, normally induced by unobserved trade costs, labelled as "multilateral resistance issue") – see, among others, Anderson and van Wincoop, 2003; Feenstra, 2002; Egger, 2004; Baltagi et al., 2003; Egger and Pfaffermayr, 2003; Baldwin and Taglioni, 2007; Baier and Bengstrand, 2007.

[3] This third approach is described in CGE models. Those models will be discussed in chapter 3.

Developing countries largely benefit from a Generalized System of Preferences (GSP)[4]. A country enjoying trade preferences should in principle enjoy a competitive advantage relative to other exporting countries facing higher duties. However, a number of difficulties arise in quantifying such effects: how should one compute the extent of each preferential margin? And, once one gets an actual figure for every single bilateral margin, how does one aggregate thousands of margins in order to provide an overall quantitative assessment of preferential policies? This implies to aggregate both different forms of trade policies (which are not equivalent, see below), and goods of different economic importance (Kee et al., 2009). Commonly used aggregation procedures include simple averages, import weighted averages and frequency or coverage ratios; none of which has a sound theoretical basis (Kee et al., 2009). For example, imports subject to high protection rates are likely to be small and therefore will be attributed small weights in an import-weighted aggregation, which would underestimate the restrictiveness of those tariffs. Similarly, when computing simple average tariffs, very low tariffs on economically meaningless goods would bias this measure of trade restrictiveness downward. Anderson and Neary (1994, 1996, 2003, 2005, 2007) have tackled these problems seriously by proposing theoretically sound aggregation procedures. One important conclusion emerging from their work is that a single indicator cannot provide a measure of the trade distortions a country imposes on itself whilst simultaneously capturing the trade distortions imposed on its trading partners. If one is interested in the welfare distortions that the country imposes on itself (i.e., we want to answer the following question: *What is the uniform tariff that if applied to imports instead of the current structure of protection would leave home welfare at its current level?*) the Anderson and Neary's (1994; 1996) Trade Restrictiveness Index (TRI) is the right indicator. However, while the TRI is an excellent indicator of the degree of domestic inefficiency caused by the domestic trade regime, it provides little information regarding the trade restrictiveness faced by exporters. Thus, if one is interested in the extent to which trade distortions limit imports (i.e., to answer the following question: *What is the uniform tariff that if imposed on home imports instead of the existing structure of protection would leave aggregate imports at their current level*?) a second indicator by Anderson and Neary (2003), MTRI (Mercantilist Trade Restrictiveness Index), is more appropriate.

The issue of measurement of the "preferential margins": Finally, if one is interested in the barriers faced by each country's exporters when selling to other countries (here the relevant question is: *What is the uniform tariff that if imposed by all trading partners on exports of country A instead of their current structure of protection would leave exports of this country at their current level?*) we should rely on a mirror image (from the exporter's perspective) of the MTRI which is labelled by Kee et al. (2009) as Market Access OTRI (MA-OTRI). The

[4] There are currently 13 national GSP schemes notified to the UNCTAD secretariat. The following countries grant GSP preferences: Australia, Belarus, Bulgaria, Canada, Estonia, the European Union, Japan, New Zealand, Norway, the Russian Federation, Switzerland, Turkey and the United States of America.

issue of properly measuring the so called “preferential margins” and hence assessing the relative market access conditions across countries is one of the hottest in current applied literature on trade liberalization and integration. It is important to stress in this respect that what matters for a given country is the relative preference and not just the absolute level of prevailing barriers at the border. Commonly used measures of preference margins compare the preferential tariff to the most-favoured-nation (MFN) rate. However, as underlined by Hoekman and Nicita (2011), this will overestimate the relative preference enjoyed by countries, as in most instances other countries will also have preferential access. In practice it is possible that preferential rates granted to a particular country, although lower than MFN, still penalize it relative to other countries that benefit from even lower or zero tariffs. Hence, to calculate the relative preferential margin the focus needs to be on the average advantage – in tariff percentage points – that a given basket of goods enjoys when exported from country A as compared to when it originates in other countries (Hoekman and Nicita, 2011). A further complication lies again in the aggregation procedure across tariff lines. A proper aggregation would take into account the fact that imports of some goods are more responsive to changes in prices than others. In theory, imports that are less sensitive to prices (inelastic) should be given less weight as tariffs change – as they would have little effect on overall volumes of trade (see again Kee et al., 2009). Of course, when the tariffs have a complex structure, one needs to compute some ad valorem equivalents (AVE) and this implies some well-known methodological problems (see above). The MTRI, first introduced by Anderson and Neary (2003), is included in the family of “equivalence measures” too.

1.3 What instruments of trade liberalization to focus on?

No policy’s equivalence: Protection can take different forms: tariffs, quotas, antidumping duties and/or technical regulations. Any trade policy has impacts on different areas (producer or consumer welfare, volume of trade, efficiency loss, etc.), and, as it is well known since Bhagwati’s (1965) seminal work, there is no “full equivalence’ (in terms of all relevant economic effects) among the different tools applied. A typical way to overcome this problem is to transform trade policies into *ad valorem equivalents* (AVEs). It solves, in principle, the aggregation problem since it summarizes efficiently the trade restrictiveness of different trade policy instruments applied to the imports of a particular good. However, since trade policy is set at the tariff line level and there are literally thousands of tariff lines in a typical tariff schedule the list of measures that have price rising, trade-reducing, welfare-reducing or other economic effects on specific sectors/products is likely to be endless (Cipollina and Salvatici,

2008). Hence, there is no a standard solution on the aggregation issue, other than the so-called "equivalence measures" (see above).

Non-Tariff Measures (NTMs)[5]: As Deardorff and Stern (1998) first highlighted, in a world of falling tariffs (as a result of both multilateral and preferential trade agreements), the economic importance of non-tariff measures (NTMs) is becoming increasingly important (World Bank and IMF, 2008). Current estimates show that the potential for economic benefits from further liberalization of NTMs is likely to be substantial. Andriamananjara, et al. (2004), for instance, considering only a limited range of NTMs, estimated that global gains from their removal would be roughly to the order of USD 90 billion. However, the identification of NTMs' effects is again a matter of quantification (see Appendix A for a list of standard measures of NTMs). According to Ferrantino (2006), before talking about "effective" or "binding" NTMs, one needs to agree on an operational definition of NTMs, i.e., a definition which provides taxonomy of NTMs without imposing "ex ante" whether the items on the list have price-raising, trade-reducing, welfare-reducing or other economic effects. He also argues that for many purposes, the examination of the price impacts of NTMs is ideal and that "handicraft" methods for comparing the prices of goods affected and unaffected by NTMs have an established record of successful application. However, since their information requirements make them impractical to use for broad comparisons across products, industries and countries, econometric analyses of prices, which have been introduced recently, offer new prospects for policymaking (Ferrantino, 2006). Hence, Ferrantino (2006) describes that the most promising areas for further policy relevant empirical investigation into the effects of NTMs are: i) improving data availability, especially price data and data on supply chain performance; ii) bridging the gap between "handicraft" and "mass-production" econometric methods; iii) using the supply chain – which tracks the progressive price increases (and physical transformation) of goods - as a unifying analytical framework of the relative magnitudes of each of the cost-increasing phases of the supply chain; iv) working on "handicraft" considerations for particular products or sectors of interest such as government procurement, technical standards, rules of origin, etc.

Direct vs. Indirect policies: The literature on trade liberalization and trade integration[6] focuses primarily on trade policies implemented at the border, which includes measures to control the volume of imports, the price of imported goods, technical barriers, tariff and para-tariff measures. However, as stated convincingly by many authors (see, amongst others, McCulloch et al., 2001), in many sectors and especially in developing countries, the main price distortions result from "indirect policies", such as inappropriate exchange rate valuation

[5] The term "non-tariff measures" (NTMs) is used here in preference to non-tariff barriers (NTBs), which is used more frequently in the WTO context. The choice is motivated by the focus on the economic effect of the measures in question, rather than a focus on the legal status or non-trade motivations that such measures may or may not have (Ferrantino, 2006).

[6] Larger presentation of this literature is presented in Annex A.

or administrative or institutional constraints on prices, rather than through commodity taxes, such as tariffs and export taxes. Insofar as trade reform does not incorporate the liberalization of such indirect measures it may indeed reduce the covariance between domestic prices and prices at the border (i.e., the actual degree of trade openness). There are many examples. In the 1980s and 1990s, faced with strong pressure to make structural adjustments to their economies, many developing countries adopted sweeping reforms, especially to their agricultural marketing systems. More specifically, according to McCulloch et al. (2001), the extent to which trade liberalization can reduce domestic prices depends on two factors: *the degree of efficiency of local production* (if the 'benefits' of protection have been absorbed primarily by increasing local costs, then liberalization can have little immediate effect on the price of domestically produced goods); *the extent of competition of the domestic markets* (if competition in domestic markets is limited, trade liberalization will give rise to significant reductions in the prices of domestic goods).

Table 1: Summary of leading proposals for additional multilateral disciplines in investment, competition, transparency in government procurement, and trade facilitation

Topic	Leading proponent of additional disciplines	Additional disciplines sought
Trade and investment	European Communities	1. GATS approach (positive list) proposed for inclusion of sectors for which the following proposed disciplines 2. Measures to improve transparency of national investment regimes comparable to those in the GATS agreement 3. Extend applicable non-discrimination principles in the GATS agreement to other forms of direct investment 4. Extend applicable pre-establishment disciplines in the GATS agreement to other forms of direct investment 5. Inclusion of a balance-of-payments safeguard for developing countries 6. Inclusion of 'development provisions' to provide cross-cutting 'flexibilities' across all horizontal disciplines outlined above 7. Definition of included investment includes all direct investments where the investor owns 10 per cent or more of the voting stock 8. All disciplines in this area subject to WTO dispute settlement
	United States	1. Inclusion of portfolio investment flows (taken to include a broad range of financial instruments) as well as direct investments in any multilateral disciplines 2. WTO members should be as open to portfolio investments as they are to direct investments
Trade and competition	European Communities	1. A commitment to adhere to a set of core principles (transparency, non-discrimination, procedural fairness) in the application of competition law 2. A commitment to enact and enforce a law against hard-core cartels 3. The developments of modalities for voluntary cooperation on competition law and policy matters between WTO members 4. A commitment to support the introduction and strengthening of competition laws and related institutions in developing countries
Transparency in government procurement	European Communities	1. Measures on the following matters should be part of a multilateral agreement: choice of procurement method; providing information on national legislation and procedures; publication of procurement opportunities and procedural requirements; information supplied; time-limits for procurement processes; decisions made on supplier qualification and contract award; domestic review procedures; language used in official documentation; and use of information technology 2. Measures to promote transparency including ensuring information on procurement practices, rules and opportunities are made widely available in an easily usable form to all interested parties. Favoured a 'principles-oriented' approach rather than prescriptive rules 3. Inclusion of a provision on technical assistance that mirrors the language of Article 67 of the TRIPS agreement

(*continued overleaf*)

Table 1: (*Continued*)

Topic	Leading proponent of additional disciplines	Additional disciplines sought
	Japan	1. Recognizing the difficulties that developing countries have with the existing transparency provisions of the plurilateral Agreement on Government Procurement, Japan argued for a flexible approach based on core principles. The approach would be legally binding and enforceable 2. The following measures would be covered by the agreement: non-discrimination in transparency; definition and scope; core transparency principles; domestic review procedures; consultations and dispute settlement; technical assistance; and special and differential treatment for developing countries
	Korea	1. Measures on the following matters should be part of a multilateral agreement: scope and definition (of covered government procurement; measures to improve transparency of procurement-related measures, award decisions, and domestic review processes; exceptions; dispute settlement; special and differential treatment; and technical assistance 2. All measures would be legally binding and subject to WTO dispute settlement
	United States	1. Measures to establish 'core transparency elements'. It was argued that these need not be specified 'at this juncture' 2. Explicit conditions would be specified for when single tendering by procuring bodies would be allowed and for transparency associated with such single tendering 3. Commitments on independent review mechanisms that ensure impartiality, that allow for rapid decisions including the possibility of suspending the procurement process, and that grant adequate remedies 4. Noted that disciplines on preference programmes were explicitly precluded
Trade facilitation	European Communities	1. With respect to GATT Article V (Freedom of Transit), in addition to measures to simplify, limit, and standardize customs procedures and documentation requirements, the EC proposed a broadening of National Treatment provisions on modes of transport and provisions on technical assistance and special and differential treatment for LDCs 2. With respect to GATT Article VIII (Fees and Formalities), the EC suggested requiring the reduction in the incidence and complexity of import and export formalities. Non-discrimination across modes of transportation was sought, too. Provision for special and differential treatment would be made 3. With respect to Article X (Publication and Administration of Trade Regulations), the EC emphasized a commitment to transparency through the publication of all relevant information, the establishment of enquiry points for traders, and procedures to make fast and advance rulings for traders. Again, provisions on technical assistance and special and differential treatment were sought

Source: Evenett (2007)

"Trade related" (and Singapore) issues: According to McCulloch et al. (2001), improving competition and efficiency in local production has strong positive economic effects, including pro-poor effects[7]. There is, however, a huge debate around the opportunity to include domestic "trade related" issues in the WTO negotiations. This debate has been largely focused on the "Singapore issues" (investment, competition, procurement and trade facilitation) so called as they were originally proposed by the EC at the Singapore Ministerial Conference (1996). The first three "Singapore issues" (see Table 1) were dropped after the Cancun meeting in 2003 because of opposition from developing countries (see Evenett, 2007a for a presentation of five "wrongs" responsible for the Singapore issues' fate in the Doha Round).

Why have the Singapore issues been so heavily contested by developing countries? The main argument was that the "Singapore issues" were not sufficiently related to the market-access core of the world trading system. Another standard argument is that negotiating and implementing any WTO agreement on the Singapore issues is complex, "highly technical" and places additional demands on the negotiating capacities of WTO developing countries. Others debated conversely, the novelty and the need of introducing "new" issues where GATT's national treatment disciplines already applied to competition law and its enforcement. Moreover, there are some provisions in the General Agreement on Trade in Services (GATS) and in the Agreement on Trade-related Intellectual Property Rights (TRIPS) that refer to anti-competitive practices. Evenett (2003, 2007b) presents an excellent overview of the different positions on the issue, proposing at the same time useful insights for promoting the re-introduction of the "Singapore issues" into the WTO negotiations. Evenett (2007b) highlights that the debate over the Singapore issues is actually a debate about the boundaries of the WTO, which is, in turn, linked to the old debate over "shallow" and "deep" integration that dates back to the early 1990s. However, the deep question of which areas of policy have characteristics that make them subject to binding international commitments at the WTO still does not have an answer. Scholars are increasingly looking at the key role of trade incentives on investment and "trade facilitation" to get a deeper understanding of the links between trade and development. According to Abbott et al., (2009) this means, actually: i) uncovering the factors that determine the evolution of the capital stock by sector; ii) establishing how productivity by sector evolves in response to trade incentives and institutional reforms.

Trade and investment: Trade and investment represent two sides of market access and share many determining factors such as macroeconomic conditions, factor endowments, political economy factors and the like. A growing literature has recognized the existence of two-way feedbacks between financial flows and trade for developing countries (Albuquerque et al.,

[7] Further discussions are available in chapter 3.

2005; Do et Levchenko, 2004; Lane et Milesi-Ferretti, 2004, 2005; Rose et Spiegel, 2004; Swenson, 2004). Most prominent in this literature is the argument that larger inflows of FDI will lead to higher volume of trade as well as other benefits such as increased rates of total factor productivity growth or higher output growth rates. However, a number of research questions still need to be addressed, such as whether the impact of trade on FDI should be different on, for example, countries in different stages of development or whether inflows and outflows of FDI react differently with different types of trade flows or what the effects of substantive investment provisions on trade and investment flows are. Moreover, since WTO members removed investment from the Doha Development Agenda (DDA), countries are increasingly incorporating investment in many recent regional agreements. Hence, it is increasingly becoming important for policymakers to understand the consequences of including investment provisions at the regional level too. Concerning the first set of questions, Aizenman and Noy (2006) identify strong two-way positive feedbacks between trade and FDI. They point out that a developing country experiencing rapid improvement in its productivity will attract growing inflows of vertical FDI, thereby increasing its international trade. In circumstances where the multinational employs skilled workers in the developing country, the greater volume of trade that comes with the vertical FDI ought to increase the demand for skilled workers, thereby increasing the return on human capital in the developing country. This in turn will lead to an increase in the supply of skilled workers, potentially increasing future FDI. Hence, the final prescription is that in an era of rapidly growing trade integration, countries cannot choose their capital account policies independently of their degree of openness to trade. Regarding investment liberalization provisions in regional agreements, Lesher and Miroudot (2006) highlight that investment provisions are positively associated with trade and, to an even greater extent, investment flows. Further, they propose two case studies of "new regionalism" (i.e., regional agreements that include rules on policies beyond trade): NAFTA and New Zealand-Singapore. These case studies reinforce the cross-country empirical evidence that all types of investment provision matter for trade and investment.

Trade facilitation: Trade facilitation is the only surviving item of the four "Singapore issues". Hence, it is still included in the WTO's DDA. This is basically the effort to reduce red-tape barriers to trade such as delays at customs, excessive paper-work, etc., i.e., conceptually "transaction costs" which are primarily a deadweight loss, involving increased costs for commerce without actual collection of revenues.[8] The debate on the impact of "trade facilitation" (and other trade related) measures is lively too, informed by the emergence of new datasets as well as firm-level surveys of the investment climate and the business environment that prevails in countries. Stiglitz and Charlton (2005), for instance, argue that

[8] The Doha Declaration, calls for 'negotiations on trade facilitation . . . [for] further expediting the movement, release and clearance of goods, including goods in transit' (Doha Declaration, para. 27).

intellectual property, protection, investment, and other "trade related" issues should not have a place in trade negotiations agenda and often impose considerable costs and burdens on developing countries. Others (see, amongst others, Francois et al., 2005; Engman, 2005) suggest the so-called trade facilitation aspects of the talks (together with liberalization in services, but appropriate regulation is needed, see Cali et al., 2008) are likely to yield substantial gains for developing nations, since trade and customs' procedures affect the price of traded goods, the ability of governments to collect border-related trade taxes and the geographical location of supply chains, (Engman, 2005). One must note that, although the general discussion on trade facilitation policies has usually been kept separate from that on NTMs, practically all the methods applicable to the analysis of NTMs can be applied to the analysis of trade facilitation, and *vice versa*. According to Hoekman et al. (2010) the pursuit of trade facilitation is particularly important for lower-income countries, especially LDCs, that otherwise may not benefit significantly from the Doha market access negotiations – because they have duty-free, quota-free access to major markets and will not be asked to reform their own trade policies. Available estimates of the trading costs of lack of trade facilitation highlight substantial global gains (about a 9.7% increase in total trade), but these are only preliminary analyses (see, among others, Wilson et al., 2005; Walkenhorst and Yasui, 2003; Ferrantino, 2006). It is now increasingly recognized, generally speaking, that trade competitiveness is a function of the domestic business environment in the exporting countries.

1.4 What instrument has the greatest policy impact?

Comparing measures at the border with domestic trade related policies: Hoekman and Nicita (2011) have compared the trade impact of different types of trade restrictions applied at the border (import tariffs, adjusted for bilateral preferences, and non-tariff measures) with the effects of domestic policies that affect trade costs. Using a standard gravity framework, they suggest that traditional trade policies still have a substantial trade-restricting effect for low-income countries (a reduction in tariffs at the level observed in middle income countries would increase their imports by about 6.5%). Hence, measures at the border (both tariffs and non-tariff measures) continue to be a significant source of trade restrictiveness for low-income countries despite preferential access programs. However, besides trade policy, the impact of trade costs on trade flows is also estimated to be sizeable. More specifically, the estimates show that a 10% reduction in the cost associated with importing (exporting) would increase imports (exports) by about 5% (4.8%). These results suggest that improving market access through reductions in tariffs in export markets also remains an important policy objective. If low-income countries were to improve their market access to a level similar to middle income countries this would increase their exports by more than 10%. Nevertheless, domestic costs, measured by the "Doing business" and the "Logistic Performance Index"

(Hoekman and Nicita, 2011) are quantitatively important too and are supposed to represent an important bottleneck for low-income countries, both in regard to imports and to exports.

Table 2 – Market Access (calculated on OTRI=Overall Trade Restrictiveness Index and on TTRI=Tariff Trade Restrictiveness Index) by trading partner and geographic region

Importing countries	Exporting countries									
	High income	Upper middle income	Lower middle income	Low income	East Asia	E. Europe Cent. Asia	Latin America	Mid. East N. Africa	South Asia	Sub-Saharan Africa
High income	**6.3** *2.4*	**5.7** *1.2*	**7.9** *2.5*	**9.1** *2.4*	**8.3** *2.6*	**5.1** *1.1*	**7.0** *1.5*	**4.3** *0.8*	**10.4** *3.1*	**4.4** *0.7*
QUAD	**6.3** *2.1*	**5.2** *0.9*	**8.6** *2.5*	**10.6** *2.5*	**8.9** *2.7*	**5.2** *0.8*	**6.9** *1.2*	**4.4** *0.5*	**13.6** *3.3*	**4.5** *0.5*
Upper middle	**15.6** *5.6*	**11.8** *3.8*	**15.8** *5.6*	**14.7** *5.7*	**19.2** *7.2*	**10.2** *4.4*	**13.6** *2.6*	**6.0** *2.5*	**14.3** *6.6*	**5.9** *3.5*
Lower middle	**12.4** *7.1*	**11.1** *4.8*	**12.9** *6.7*	**9.4** *5.1*	**13.6** *6.6*	**11.2** *6.2*	**12.6** *5.1*	**6.7** *2.8*	**9.9** *6.2*	**4.0** *2.7*
Low income	**18.2** *10.9*	**14.3** *8.1*	**19.5** *12.2*	**25.4** *12.9*	**22.2** *13.8*	**17.7** *6.2*	**15.9** *9.0*	**16.3** *10.0*	**16.2** *10.4*	**16.3** *12.2*

Note: MA-OTRI in **bold**; MA-TTRI in *italics*. QUAD countries are Canada, European Union, Japan, and USA.

Source: Hoekman and Nicita (2011)

Market access and relative preferential margins by countries and geographic region: Hoekman and Nicita (2011) further underline that upper middle-income countries generally enjoy better market access in both developing and developed countries, because of the composition of exports from these countries, which are skewed toward manufacturing. Conversely, low-income countries face more restrictive market access conditions because their exports are more biased toward agriculture. Across developing country regions, South Asia faces the most restrictive market access, due to export composition (agriculture, textiles and apparel) and because it has relatively limited preferential access. Sub-Saharan countries have the best market access, especially to high income countries, reflecting again export composition (minerals, primary products, plantation agriculture), as well as low or zero (preferential) tariffs in many high income countries. Table 2 confirms that by far the highest levels of market access barriers apply to South-South trade flows (3 to 4 times higher than those that apply in middle- and high-income markets).

Table 3 – Relative preferential margin

Importers	East Asia	East Europe Central Asia	Latin America	Middle East and North Africa	South Asia	Sub-Saharan Africa	High income countries
East Asia	0.22	−0.06	−0.09	−0.02	−0.03	0.01	−0.03
East Europe Central Asia	−0.01	0.45	−0.37	0.39	−0.20	0.04	−0.15
Latin America	−2.54	−1.88	2.98	−0.51	−2.13	−1.22	1.69
Middle East and North Africa	−0.29	−0.24	−0.25	0.91	−0.22	0.10	−0.03
South Asia	−0.21	−0.08	−0.04	−0.26	2.03	−0.15	−0.05
Sub-Saharan Africa	−0.10	−0.03	−0.06	−0.02	−0.12	0.30	−0.06
High Income Countries	−0.46	0.42	0.71	0.19	−0.46	0.13	0.08
Australia and New Zealand	−0.18	−0.61	−0.28	−0.08	−0.23	0.11	0.10
Canada	−1.00	−0.85	1.75	0.01	1.79	0.02	1.01
European Union	0.05	1.07	0.98	0.64	−0.70	0.51	−0.50
Japan	0.34	0.02	0.07	0.00	0.70	0.08	−0.13
USA	−0.67	−0.03	1.01	−0.08	0.22	0.11	−0.03

Source: Hoekman and Nicita (2011)

Furthermore, Table 3 shows that all regions have positive relative preferential margins with themselves. This indicates the importance of regional trade agreements. The most "effective" regional agreements in terms of preferences are in Latin America, where countries enjoy a relative preferential margin of about 3%. Relative preference margins, whether positive or negative, are much smaller for other regions. Countries in Sub-Saharan Africa, for example, enjoy a relative preferential margin of only about 0.5% in the EU, as they compete both amongst themselves and with other countries to which the EU provides preferences (Eastern Europe, North Africa and Latin America). Relative preferential margins are mostly negative for East Asian states.

Finally, Table 4 highlights that developing countries, taken as a group, have on average weaker trade facilitation performance than higher-income economies.

Table 4 – Measures of trade costs (averages by country group)

Policy/indicator	High income	Middle income	Low income
Trade policy tariff (imposed) (%)	1.98	6.86	10.22
Trade policy NTB (imposed) (%)	4.45	4.45	6.71
Trade policy tariff (faced) (%)	2.77	2.79	6.02
Trade policy NTB (faced) (%)	4.56	4.72	5.07
Trade policy RPM (%)	0.04	0.44	0.23
Doing business costs of exports (USD)	774.40	867.20	949.30
Doing business costs of import (USD)	813.60	1024.20	1212.00
Logistic performance index (higher better)	3.90	3.00	2.80

Source: Hoekman and Nicita (2011)

PART II

FACING A CHANGING WORLD ECONOMIC SCENARIO

1.

2. 2.1 The main drivers of the world economic environment evolution since 2002

During the last decade, the world economy has undergone significant changes. We summarize here the most pressing issues related to trade and development. To help the EU in building up a new development and trade agenda, we have made a distinction between "international facts" (i.e., things outside policy control) and "international policy issues" (i.e., effects of man-made deliberate policies).

International facts:

- **The increasing weight of international trade in the world economy**. A great expansion in global trade flows has taken place during the last decades. According to the UN, global exports of goods and services grew at a real average rate of 6.3 per cent in the period 1980 until 2008, while GDP growth averaged 2.9 per cent during the same period (UN, World Economic and Social Survey, 2010). Although developed economies continue to dominate world markets, developing countries expanded their weight too, especially in both low - and high-technology manufactures, to which both reached about 40 per cent of global exports by 2005-2008 (UN, 2010). Developing countries are now new drivers of global trade. They account for a steadily increasing share of the global total: their volume of exports rose more than four-fold between 1990 and 2009. Between 2000 and 2009 their exports rose by 80 percent, compared to 40 percent for the world as a whole (World Bank, 2011). Low and middle-income countries' share in total world imports has nearly tripled, from 12 percent in 1996 to 31 percent in 2008. In the period between 2000-2008, Africa's exports grew by 18 percent per year, mainly driven by exports to low and middle-income countries.

- **The changing structure of international trade patterns and the increasingly global interconnection of economic processes**. Amongst the most important developments in world trade in the last few years is the improvement of the fragmentation of production of both goods and services and the associated development of foreign outsourcing and offshoring (WTO, 2008). Agricultural and

industrial production is increasingly taking place through largely unregulated global value chains dominated by multinationals. Two thirds of world imports currently concern intermediate inputs (EU, 2010). The geographical fragmentation of production has occurred over the past 40 years, but there has been a significant acceleration in the most recent years (UN, 2010). Recent estimates from the World Trade Organization (2009) suggest a share of intermediate manufactured products in non-fuel world trade of about 40 per cent in 2008, while Miroudot et al. (2009) estimate for the OECD countries the shares of trade in intermediates in trade in goods of about 56.2 per cent and in trade in services of about 73.2 per cent in 2006. Another factor behind the observed expansion of world trade has been the increase in the international outsourcing and offshoring of services. Trade in these services rose from 0.5 billion United States dollars in the 1980s to an average of $2.5 billion in the 2000s. The participation of developing countries in global services trade rose from 19 to 24 per cent during the same period. In summary, trade patterns have moved from a country specialization based on goods (primary commodities for the South and manufactured goods for the North) to intra-firm/network specialization in terms of tasks, with the South gaining considerable advantage in the production of manufactured goods (UN, 2010).

- **The rise of emerging economies**. The rise of the emerging economies – such as Brazil, Russia, India, China, and South Africa (BRICS) - as both economic and political actors, is having significant and far-reaching impact on the world economy. Thanks to their economic growth and size, these countries have emerged as important powers, at a regional as well as at a global level, together they account for over 40 per cent of world population and approximately 11 per cent of the value of world GDP (World Bank, 2010). As a result, in the last few years, there has been a growing and large amount of research on these countries (Antkiewicz and Whalley, 2005; Jenkins and Edwards, 2006; Winters and Yusuf, 2007; OECD, 2009; Arestis and Eatwell, 2008; Kaplinsky and Messner, 2008; Gu et al., 2008; McDonald et al., 2008; Qureshi and Wan, 2008; Santos-Paulino and Wan, 2010; Rodrik, 2010; Montalbano and Nenci, 2011). Most of the analysis aimed at assessing the overall impact of BRICS rise has focused on the linkages through which BRICS might affect the world economy, namely: growth and global production networks; trade and financial flows; environmental externalities; governance. In terms of trade, BRICS performance has been well above the world average in the last decade, in terms of both exports and imports. In the period between 2006-2008, exports from India and South Africa increased by more than 20 percentage points with respect to the period 1996-98 (by over 15 percentage points in the case of Brazil and China), whereas imports into India and Brazil increased by over 25 percentage points (by over 15 percentage points in the case of China and South Africa). The competitiveness and growth of these emerging

countries can have various effects on other economies, changing the framework of world trade patterns. Their specialization can generate, in some cases, complementary effects, in other cases competitive effects, opening likely conflicts of interest among trade partners (Winters and Yusuf, 2007; Nenci, 2008). They can be seen as competitors for those economies that have similar comparative advantages in the same products and/or services. At the same time, BRICS can be seen as driving forces for those economies that have complementary production and trade structures, because producers can benefit from the demand for their output from BRICS and they can be included in regional value chains. Looking at global governance, these countries have gradually affirmed their leadership roles as global players not only in the international financial locus but also in the Multilateral Trading System (except for Russia, not yet a WTO member), thanks to their ability to formulate policy and to articulate the views held by broad groups of developing countries. (Humphrey and Messner, 2005).

- **The financial crisis**. The most dramatic event in this decade is the deep recession which hit the world economy during the 2008-2009 period. The global economic crisis exposed systemic failures in the workings of financial markets and major deficiencies at the core of economic policy making. The crisis started in the USA due to the financial fallout and spread rapidly throughout nearly the entire world, affecting jobs and livelihoods (UN, 2010). The financial and economic crisis hit trade hard. The shock to the global economy was severe and accompanied by a sharp fall in world trade. The fall was sudden and sharp: global trade fell by 23%. The human cost of the crisis fell mainly on the poorest countries that are also likely to bear the brunt of ongoing protectionism and the limited availability of trade finance (BIS, 2011).

- **The preference erosion of developing countries**. The erosion of preferences due to multilateral tariff reductions is a long-standing concern for many developing countries and has become one of the key issues in the Doha Round negotiations. Developing countries benefitting from trade preferences are concerned that reductions of MFN tariffs by preference-granting countries may decrease their advantages with respect to non-preferred competitors and result in significant export losses (Scoppola et al. 2011). Some recent papers focus on the assessment of the magnitude of preference and of losses from preference erosion (e.g. Francois et al., 2005; Amiti and Romalis, 2007; Hoekman et al., 2009; Low et al., 2009). Although using different methodologies and approaches a large part of these studies shares the view that losses due to preference erosion for developing countries are, on the whole, relatively small. Firstly, because preference margins are rather small and secondly because preferences are often underused by the preferred developing countries. However, the literature also emphasizes that there are groups of countries and/or products for which this may not be the case. Low et al. (2009) find that the risk of preference erosion is high for

certain agricultural products and for LDCs. Regarding the European Union, Candau and Jean (2009) find that the value of preferences varies significantly from one developing country to another, with some countries showing rather high values of preferences. Raimondi et al. (2011), by addressing the impact of preference erosion on developing countries' rice exports to the EU, show that the impact of preferences is still very strong for some of the countries concerned and the way preference margins are calculated matters significantly when assessing the existence and extent of their erosion and the values of trade elasticity.

- **The heterogeneity issue**: On the theory side, the most influential development in trade during the last decade has been the framework put forth by Melitz (2003), which explicitly allows for firms to be heterogeneous in terms of their productivity and makes the fixed costs of exporting central to international commerce. The Melitz model accounts for why exporters are better than non-exporters along most performance dimensions and explains why average industry productivity rises as trade barriers fall. The Melitz model placed firms at the centre of analysis on how an economy adjusts to changes in trade barriers (Hanson, 2010). Since the current state of the global economy is more complicated compared to the past, the task of empirically identifying the mechanisms through which trade affects wages, employment, and industry structure is commensurately more challenging. (Hanson, 2010).

International policy issues

- **The stalemate of the multilateral Doha negotiations**. The impasse over the Doha Round, launched in 2001 and aiming for more development oriented multilateral trading rules, reflects the difficulty of getting a proper balance between a common set of rules of the game and the principle of accommodating different capacities amongst countries to competitively involve in trade (UN, 2010). Even though there has been progress in providing developing countries, especially the least developed countries, with greater duty- and quota-free access to developed-country markets through the application of the MFN treatment, important barriers to market access still persist for them. Also, agricultural subsidies in developed countries remain high and continue to limit production and income opportunities for farmers in developing countries. Although the Doha Round has been labelled a "development round", its limitations with respect to providing enough policy space for development have been evident, which helps to explain its stalled status. More generally, the experience of the Doha Round has raised questions about the ability and willingness of governments to advance the multilateral agenda.

- **The reform of the global economic architecture**. The international system relies on specialized institutions and processes to address specific global issues. But the proliferation of the agendas of existing organizations has been a source of incoherence in the system. The global architecture now faces the complex process of defining more precisely the roles of existing institutions and refocusing their activities on core competencies and a strengthening of multilateral coordination mechanisms, to ensure that the activities of individual agencies and commissions are not in conflict and do not overlap (UN, 2010). In the same vein, in response to changes in the global economic order, the G20 has established itself as the *de facto locus* of global economic governance, although some critical views on its effectiveness are starting to proliferate.

- **The growing number of bilateral and regional agreements.** Slow progress in the Doha negotiations combined with their bilateral negotiating advantage has spurred developed countries, in particular, to pursue bilateral and regional trade agreements. Indeed, the surge in regional trade agreements (RTAs), bilateral free trade agreements (FTAs) and, more recently, economic partnership agreements (EPAs), has continued unabated since the early 1990s. Compared to previous decades, the proliferation of preferential trade agreements (PTAs) – both at regional and bilateral level - during the last ten years has taken place at an unprecedented rate. One of the key issues is whether there is a net benefit accruing to developing countries from bilateral or regional North-South agreements. In many cases, industrialized countries have succeeded through these agreements in extracting the compliance of developing countries in areas where they failed to secure consent in the WTO. In effect, many regional trade agreements impose binding obligations on the contracting parties with regard to investment liberalization and protection, as well as competition policy and government procurement (the so-called Singapore issues or "WTO plus"), thus expanding the rights and access of foreign firms and their products in developing-country markets and further curbing or prohibiting government policies that encourage or favour local firms and the domestic economy (Shadlen, 2005). Additionally, as the UN underlines, many North-South bilateral free trade agreements and investment treaties have provisions requiring all transfers relating to investment from the other party to be allowed without delay into and out of a country's territory. This severely limits the capacity to regulate capital flows and impose capital controls (UN, 2010). If we analyze the recent trend of regional agreements we can observe a substantial increase involving a growing number of developing countries. These developments have considerable repercussions on multilateral governance. This trend, combined with the current motley assortment of unilateral, bilateral and multilateral trade agreements – the so called 'spaghetti bowl' of trade deals (Baldwin 2006) – could pose a threat to the proper functioning of the current WTO system. Some trade

experts take a pessimistic view of the latest explosion of PTAs, arguing that there is a link between the surge of bilateral and regional deals and the slow pace of the Doha Round (Bhagwati, 2008). Moreover, because of the relative lack of progress multilaterally in the Doha Round, the evolving set of regional agreements could potentially displace the WTO as the leading edge of global reciprocity-based negotiated trade liberalization for the next few decades (Nenci, 2008). Others scholars are more optimistic, suggesting the proliferation of bilateral and regional deals will eventually, as in the past, have a domino effect, and force the pace of the Doha negotiations.

- **Global warming and climate change related policies:** Climate change poses major challenges of mitigation and adaptation for developing countries. Developing countries are pressed to find alternatives to the energy model of the past in pursuing catch-up growth and industrialization. The adjustments that are being asked of developing countries are unprecedented and will carry heavy investment costs, particularly in the initial stages of the transition. Those costs present a major obstacle to the development of low-emission, high-growth pathways (UN, 2009). There are likely to be important consequences for patterns of production and trade, for food security and for agricultural products. Climate-related policies may have implications for trade. Trade also offers opportunities to adapt to a changing climate, through the acquisition and use of new technology (World Bank, 2011).

3. 2.2 Developing countries' tariffs liberalization and trade integration into the world economy: state of play

The current level of developing countries' trade liberalization: In the last few decades, developing countries have experienced extensive and rapid trade liberalization, spurred by both multilateral trade negotiations and the conditionality related to structural adjustment programs agreed with International Organizations. They have significantly reduced their tariffs, opened their services sectors and embraced foreign investment either unilaterally, or in bilateral trade agreements. The World Bank estimates that developing nations unilaterally lowered their average tariffs by 14 percentage points between 1983 and 2003 independently of GATT/WTO rounds and RTAs (Martin and Ng 2004). Liberalization policies have generally been characterized by a rapid elimination of quantitative restrictions and significant reductions in tariffs to low and uniform levels. The current level of tariffs in many advanced countries is already relatively low, at least on industrial goods. On the other hand, high levels of protection still exist on agricultural goods and significantly affect many developing countries. Likewise, trade in services is subject to many barriers that have their origin in behind–the-border measures related to domestic regulations (OECD, 2011). Tariff reduction has centred more on manufacturing than agricultural products. Middle-income economies have seen the largest decline in tariff reduction, including in agricultural tariffs. By region, countries in East Asia and Latin America (Sub-Saharan Africa) have reduced tariffs the most (least) (Hoekman and Nicita, 2011). While there has been significant progress in lowering barriers to international trade linked to tariffs, the policy relevance of non-tariff measures (NTMs) has increased. Much attention is now placed on NTMs. This is because, as the level of tariffs has decreased, the relative importance of NTMs has increased. In addition, significant progress has been made in terms of quantifying the effects of NTMs, leading to a better understanding of the costs these barriers impose on the cost of doing business. Furthermore, there is some evidence of NTMs being used as substitution for the tariffs that have been reduced (OECD, 2011).

Why is protectionism still in place? There are numerous reasons why a country imposes trade barriers in the first place. These include; infant industry protection, unemployment prevention, balance of payments maintenance and fiscal revenue objectives. The theory of the "second-best" (Lipsey and Lancaster, 1956) provides the theoretical underpinning to explain many of the reasons why trade policy can be shown to be welfare enhancing for an economy[9]. Whenever there are market imperfections or distortions present it is always

[9] The primary focus of the theory is on what happens when the optimum conditions are not satisfied in an economic model. In presence of market imperfections or distortions there is economic rationale for government intervention in the private market. In these circumstances the economy is characterized by a second-best rather than a first-best equilibrium. Trade policies can, correct the distortion or imperfection and thus raise national welfare by more than the loss in welfare arising from the application of the policy. The main criticism is that rarely is trade policy the first best policy choice to correct a market imperfection or distortion. The first best policy, generally, would be a purely domestic policy targeted directly at the

theoretically possible to design a trade policy that would improve national welfare. As such the theory of the second-best provides a rationale for many different types of protection in an economy. It is argued, for instance, that infant industry protection contributed to the development of the EU, US and East Asia. Some are concerned that tariff reductions in the WTO may unduly limit the scope for developing countries to adopt similar policies. However, infant industry protection increases prices for consumers and tends to encourage the production of import-substitutes rather than exports (DFID, 2003). The persistence of trade policies can be explained by looking at the political economy. Even though the aggregate income and wealth of a nation may be expected to grow when trade distortions are reduced, not everyone will gain (Hoekman, Michalopoulos and Winters, 2003).

Is there room for additional benefits to developing countries through tariff cuts? As underlined above, as a result of unilateral reforms and bilateral and regional agreements, global trade has been substantially liberalized in recent years. However, there is still room for further liberalization. The latest round of negotiations on industrial products is important for developing countries, as manufacturing plays an important role in generating economic growth and development, and manufacturing has become increasingly important for many developing countries. The Doha Declaration round has offered in principle an opportunity to address:

- the problems of tariff peaks and tariff escalation;
- the significant differences between bound and applied rates;
- the low proportion of bound tariffs in certain countries;
- the continued use of 'nuisance tariffs' (less than 3%).

The Doha mandate specifies that the needs of developing countries and LDCs should be taken into account, this would include asymmetric reciprocity in reduction commitments. In addition, the mandate refers to the need for impact assessment of tariff reductions. Concerning industrial tariffs in particular, there are two main implications for developing countries in regards to further reductions in industrial tariffs: firstly, improved market access opportunities, and secondly possible financial costs depending upon the choice of trade reform policies implemented. However, in practice these opportunities may not be realized due to a number of market access impediments. Furthermore, while there are benefits for developing countries in reducing their own industrial tariffs in terms of lower priced imports for consumers and producers, developing countries need to ensure that any potential costs from tariff reductions are minimized. The size of these costs would be influenced by a government's choice of trade reform policies and factors such as initial timing of reform,

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market imperfection or distortion (Bhagwati, 1969). One exception occurs when a country is "large" in international markets and thus can affect international prices with its domestic policies. In this case, as was shown with optimal tariffs, quotas, VERs and export taxes, trade policy is the first-best policy.

speed of reform, and the likely impact of adjustment costs on poverty reduction (see Chapter 4). Although the precise impact of further trade liberalization will vary by country, some general trends can be observed. The impact of tariff reductions on employment depends on the competitiveness of domestic producers and the flexibility of domestic markets. Where domestic production is not competitive, imports will reduce domestic production and employment. This could disproportionately affect the poor, depending on which sectors are involved (DFID, 2003). Flexibility in the labour and capital markets need to be promoted in order to respond to new opportunities and to provide adequate safety nets to protect the poor during the process of change. But, since tariffs are often an important source of government revenue in developing countries, any significant reduction may affect a government's ability to finance pro-poor expenditure such as health and education. The revenue effect of a tariff cut depends on the size of the cut and the amount by which the quantity of imports increases as a result. If revenues cannot be sustained, alternative revenue sources must be found to replace tariff revenues.

4. 2.3 Tariff liberalization: factors of success and failure

Since the beginning of the 1980s, several developing countries have opened their economies toward international markets. Whether this process of globalization has been associated with net gains, especially for developing countries is a matter of controversy in the economics literature. If it is true that many countries have benefited greatly from global integration, it cannot be denied that the benefits are distributed unequally, both across countries and within them. Much of the trade dynamism of developing countries as a group is driven by Asian economies, which have collectively more than doubled their share of global exports since 1990. Other regions have seen much smaller increases in market share. Many low-income countries have been less successful in using trade as a means of creating jobs, increasing per capita incomes, and diversifying their economies. And poor households and communities in less advanced regions continue to confront major challenges in dealing with external shocks, rising food costs and harnessing the opportunities offered by a more open world trading system (World Bank, 2011).

As it is known, the international trade theory asserts positive effects of trade[10]. In principle, globalization can create opportunities for countries to leverage global demand for goods and services. It allows countries to benefit from the knowledge and technologies that have been developed anywhere in the world. But as a consequence of the very diverse outcomes we observe among developing countries, criticism of trade and trade liberalization policies has developed in the last decades, especially as far as LDCs are concerned. Among these concerns were fears of trade deterioration for primary exporters, the harmful effect of

[10] Main results are described in Appendix A.

dependence on unstable exports, unbalanced political and economic power that tilt the enforcement and practice of liberalized trade rules in favour of rich countries, and the fact that the benefits of international trade in LDCs might accrue largely to large multinational companies (Nugent, 2002).

In several cases – i.e. China, India, and some other Asian countries – globalization's promise has been fulfilled. High-productivity employment opportunities have expanded and structural change has contributed to overall growth. But in many other cases globalization appears not to have fostered the desirable outcome. Many countries - in Latin America and Sub-Saharan Africa - had experienced slow growth, or even worse, stagnation and decline, inconsistent with the standard models in economics, which predicted convergence. The successful countries had followed policies that were markedly different from those of the Washington Consensus[11], though they shared some elements in common. Those policies had not brought high growth, stability, or poverty reduction (Stiglitz, 2011). The results of these policies in terms of growth and employment generation were at best controversial (Easterly et al., 1997; Easterly 2001). Further alternative points of view are offered by other empirical studies. A large body of empirical work on the productivity-enhancing effects of trade liberalization show that intensified import competition has forced manufacturing industries in Latin America and elsewhere to become more efficient by rationalizing their operations (Cavalcanti et al., 2003; Esclava et al., 2007; Fernandez, 2007; Paus et al., 2003). Typically, the least productive firms have exited the industry, while remaining firms have shed "excess labour". However, the question left unanswered by these studies is, what happens to the workers who are displaced through this process? (McMillan and Rodrik, 2011).

The very diverse outcomes we observe among developing countries suggest that the consequences of globalization depend on the manner in which countries integrate into the global economy. According to McMillan and Rodrik (2011), there are large differences in patterns of structural change across countries and regions and this accounts for the bulk of the differential performance between successful and unsuccessful countries. In particular, while Asian countries have tended to experience productivity-enhancing structural change, both Latin America and Africa have experienced negative results.

Paths of liberalization. The trade literature has been asking for a long period about the correct trade liberalization path to get significant gains from international trade. Two quite distinct paths to or strategies for achieving trade liberalization have been followed (Nugent, 2002). The first one is the traditional "complete" or "first-best" (or "getting prices right") approach. This approach encompasses the following actions (1) removing exchange rate distortions via devaluation or floating the exchange rate and exchange rate unification, (2) removing non-tariff barriers to imports and replacing them with tariffs, (3) homogenizing tariff rates into several categories with smaller spreads between them, (4) freeing imports

[11] As it is well known, the Washington Consensus promoted economic liberalization, privatization, and the implementation of rigorous stabilization programs.

from licensing requirements to increase competition in product markets, (5) privatizing foreign trade, (6) eliminating export taxes, and (7) joining the WTO. The other strategy is a more partial one (we define it as the "second-best" approach), presumably used when the more complete one is deemed politically unfeasible or otherwise unacceptable. This approach has taken two forms: (1) retaining relatively high rates of protective tariffs but offsetting their negative effect on exports with an import duty drawback system and/or export subsidies, and (2) Export Processing Zones (EPZs). In some cases, the two strategies have been used sequentially or even simultaneously. Different countries have paced their reforms very differently. For example, Chile's trade liberalization measures were especially strong and rapid. This is because its leaders had a remarkable agreement on economic fundamentals and believed that radical and rapid reform was the way to implement it (Nugent, 2002). The tariff reduction was strategically counterbalanced by real exchange rate depreciation. Chile also used duty drawbacks somewhat in the first phase and direct subsidies for fishing and tree planting. Unlike the East Asian countries that exported labour intensive goods, Chile was and remains an exporter of natural resource-intensive goods, originally mostly minerals, but later supplemented by fish, forest products and agricultural products (mostly fruit and wine). Mexico's trade liberalization program was also one of the classic kind, involving tariff reductions and real exchange rate depreciation. Yet, it also relied very heavily on the maquila industry, a variant on the EPZ model, in which heavy reliance is placed on imported inputs and built- in exports to the United States but also low linkages to the rest of the economy. The Mexican trade liberalization was accompanied by significant growth in FDI, only some of which was related to the trade liberalization. One aspect of the experiences of Chile and Mexico that is disturbing as far as the income distribution effects of trade liberalization are concerned was due to the fact that the trade reforms were carried out simultaneously with strong measures to trim the public sector, including social protection programs. Hence, social protection against adverse employment was reduced sharply, explaining in part why the upward spikes in income inequality that occurred during these countries' trade liberalizations were the sharpest of any countries reviewed (Nugent, 2002). In several of the later Latin American countries to liberalize trade, such as Argentina and Brazil, much of the trade liberalization occurred as a result of joining MERCOSUR. Turkey's pace of trade liberalization was conversely rather slow and gradual. Very gradual devaluation followed by *tariffication* of NTBs and subsequently tariff rates were features of Turkish trade liberalization. Exporters were also allowed to import their raw materials and intermediate goods at world prices and were assisted by credit and insurance from an Export-Import Bank. The remarkable success of East Asian countries, especially Korea and Taiwan with their trade liberalization programs is well known. These countries combined virtually all means of trade liberalization. In their early phases they relied on duty drawbacks, then EPZs, then tariffication of NTBs and finally tariff reductions (Nugent, 2002). Throughout the liberalization episodes, exchange rates were adjusted so as to maintain stable real exchange rates and assure the profitability of exports. Both countries were relatively interventionist

until fairly recently, but they did liberalize trade. In both cases, the countries started at a very low level and with little except agricultural products to export. Both became major exporters of increasingly sophisticated manufactured goods.

The importance of institutions. Empirical analysis has shown that the trade liberalization process can produce different outcomes. As a consequence of this, in the last decade more attention has been paid to the need for governments to ensure that citizens are able to benefit from the opportunities coming from market openness: workers must be able to acquire the needed skills; firms need to be able to access credit to finance profitable investment opportunities; and farmers need to be connected to markets (Porto and Hoekman, 2010). Hence, the focus of reforms in the developing world has moved from "getting prices right" to "getting institutions right". "Governance reforms" have become the buzzword for bilateral donors and multilateral institutions (Rodrik, 2008). But what kind of institutions should reformers strive to build? Broadly speaking, desirable institutions should; provide security of property rights, enforce contracts, stimulate entrepreneurship, foster integration in the world economy, maintain macroeconomic stability, manage risk-taking by financial intermediaries, supply social insurance and safety nets and enhance voice and accountability. But each one of these ends can be achieved in many different ways (Rodrik, 2007). Furthermore, developing nations are different from advanced countries in that they face both greater challenges and more constraints. This means that the "appropriate" institutions required in developing countries may differ from those that prevail in rich countries. According to Rodrik (2008) the type of institutional reform promoted by multilateral organizations (World Bank, IMF, or WTO) is heavily biased towards a best-practice model. It presumes it is possible to determine a unique set of appropriate institutional arrangements ex ante and views convergence towards those arrangements as inherently desirable. One of its virtues is that it enables cross-national comparisons and benchmarking. This approach is grounded in a first-best mindset which presumes the primary role of institutional arrangements is to minimize transaction costs in the immediately relevant domain without paying attention to potential interactions with institutional features elsewhere in the system. In Rodrik's opinion, dealing with the institutional landscape in developing economies requires a second-best mindset. In such settings, a focus on best-practice institutions not only creates blind spots, leading us to overlook reforms that might achieve the desired ends at lower cost, it can also backfire.

5. 2.4 Theoretical and documented impacts of bilateral and regional trade agreements on free trade multilateral process

The increasing importance of PTAs: Globally, bilateral and regional trade arrangements have emerged as part of the policy landscape. The number of PTAs in force in 2010 was close to 300 and the World Trade Organization estimates that more than 400 free trade agreements (FTAs) will be in force globally by 2011 (WTO, 2011). PTAs are being

embraced by many WTO Members as trade policy instruments and, in the best of cases, as complementary to MFN agreements (Crawford and Fiorentino, 2005): thirteen is the average number of PTAs that a WTO member is party to. It is widely acknowledged that the benefits of trade liberalization are greatest if the liberalization is undertaken multilaterally. Nevertheless, conclusion of the current round of multilateral trade negotiations has proven elusive and many countries have sought more easily attainable outcomes through bilateral and regional free trade agreements. Free trade agreements have also been seen by many as promoting broader economic integration and serving foreign policy and strategic interests (Australian Report, 2010).

In earlier times PTAs were most likely to be motivated by the desire to avoid relatively high most-favoured nation tariffs. The theory on free trade areas and customs unions mirrored this reality by placing the notions of "trade creation" and trade diversion at centre stage. At the same time, considerable attention has been paid to the discriminatory effects of rules of origin on the trade of third parties. More recently, since average tariffs have fallen markedly in recent years, tariff preferences are becoming a more minor motivation for entering into PTAs (WTO, 2011).

PTAs are increasingly being used – and even promoted by International Institutions -to address a host of behind-the-border issues, also known as "deep integration" issues, in order to promote cooperation in the areas of investment, trade facilitation, competition policy and government procurement, as well as wider social issues related to the regulation of the environment and the protection of labour and human rights (Crawford and Fiorentino, 2005). Furthermore, PTAs are becoming increasingly complex, in many cases establishing regulatory trade regimes that go beyond multilaterally agreed trade regulations. Reciprocal preferential agreements between developed and developing countries are on the increase pointing to a decreasing reliance by some developing countries on non-reciprocal systems of preferences; also significant is the emergence of preferential agreements among key developing countries which may be evidence of a strengthening of so called South-South trading patterns (Crawford and Fiorentino, 2005).

The current trend of PTAs: Trade between PTA members is growing as the number of agreements increase. About one half of world trade now takes place among PTA members (WTO, 2011). According to the WTO, the volume of PTA trade in world trade has increased from 18 per cent in 1990 to 35 per cent in 2008. Manufactured goods represented 65 per cent of merchandise trade among PTA members in 2008 and around 64 per cent of intra-trade between parties to plurilateral trade agreements. However, examining total trade flows between PTA partners overstates the amount of trade that takes place on a preferential basis. A deeper analysis shows that only 16 per cent of world trade is eligible for preferential tariffs, the global trade-weighted preference margin amounts to no more than 1 per cent (2 per cent including trade within the EU), and 84 per cent of world merchandise trade still takes place on an MFN basis (70 per cent if intra-EU trade is included). Hence, while the number of

PTAs has been increasing, the importance of preferential trade has not kept pace. This development reflects a substantial reduction in MFN tariffs during the past two decades, either through multilateral trade negotiations or unilateral reductions (WTO, 2011). Developing countries have contributed in no small part to the recent hike in PTA activity. Their participation in PTAs evolved from continuous growth in the number of preferential arrangements with developed countries to an increasing trend of agreements between developing countries: South-South agreements now representing two-thirds of all PTAs in force and North-South about one-quarter. The emergence of South-South integration may also reflect its usefulness as a policy tool for industrialization by facilitating the inclusion of LDCs into regional production networks and the export process. South-South integration also provides a means of strengthening developing countries' bargaining power in multilateral trade negotiations and of addressing region-specific issues, such as transit, migration and water (WTO, 2011). All WTO members (with the exception of Mongolia) belong to at least one PTA. The EU participates in the largest number of agreements (30), followed by Chile (26), Mexico (21), EFTA members (between 20 and 22), Singapore (19), Egypt (18) and Turkey (17). Other emerging economies, such as Brazil (13), India (12) and China (10) are not too far behind (WTO, 2011). One half of all PTAs currently in force are not strictly "regional", in that they include countries from other geographical areas. Growth has taken place both on the "intensive" and "extensive" margin, i.e. it involves both traditionally active PTA participants, such as the EU, Chile and Mexico, and "newcomers", such as Japan, other countries from Asia and the Middle East. Many of these agreements go beyond traditional market access commitments and cover a range of "behind-the-border" areas, such as intellectual property rights, product standards, competition and investment policies (see below).

Characteristics of Preferential Trade Agreements: Fiorentino et al., (2009) analyze the current landscape of preferential, specifically regional, agreements. They show how pervasive regionalism has become and emphasize some of the trends in recent years: a strong preference for free trade areas over customs unions; agreements among countries that are not contiguous; a strong preference for bilateral agreements; significant geographical overlap with countries belonging to several different agreements; and considerable diversity in the scope and coverage of different agreements. As underlined above, nowadays preferential agreements between developed and developing countries represent a very large portion of the total. The EU and the EFTA States account for over half of RTAs through the Euro-Mediterranean agreements with partner countries in North Africa and the Middle East and several other bilateral agreements with countries such as Chile and Mexico. The United States is catching up having rapidly concluded several RTAs with developing country partners and with several more on its negotiating agenda. Other countries, such as Japan, Australia, New Zealand and Canada are following. They all are engaged in RTA negotiations, particularly with South East Asian and Latin American countries. The peculiarity of the

preferential agreements falling under this category is that they are underpinned by criteria such as reciprocity and comprehensive trade liberalization as opposed to the non-reciprocal systems of preferences enjoyed by these same countries under schemes like the Generalized System of Preferences (GSP) and other unilateral initiatives such as Cotonou, Everything but Arms (EBA) and CARIBCAN which are under the legal cover of waivers granted by WTO Members. Under the existing WTO provisions on RTAs, the proliferation of preferential agreements between developed and developing countries poses the latter with the challenge of transition from non-reciprocal trade preferences to trade liberalization on a mutual basis under reciprocal RTAs with developed country partners (Crawford and Fiorentino, 2005). A case in point are the negotiations for Economic Partnership Agreements (EPAs) between the EU and the African, Caribbean and Pacific group of countries (ACP) which are supposed to replace the existing non-reciprocal preferences of the Cotonou Agreement.

Preferential Trade Agreements and Economic Partnership Agreements: Among the PTAs, the EPAs have a key place. EPAs are a scheme to create a free trade area between the EU and the African, Caribbean and Pacific Group of States. As part of the Cotonou Agreement, the EPAs aim to promote economic growth and development as well as the smooth and gradual integration of ACP states into the world economy. They represent one of the most important examples of PTAs, specifically North-South. In total, thirty-six of the seventy-seven ACP countries have concluded an interim agreement or EPA with the EU: ten LDCs and twenty-six non-LDCs. Among the other ACP countries, thirty-one LDCs benefit from duty- and quota-free access to the EU under the generalized system of preferences (GSPs) 'Everything But Arms' (EBA) arrangement. The remaining ten non-LDCs are eligible for the standard GSP. Furthermore, negotiations have been aimed at full regional EPA, including a large range of trade in goods, services and trade-related areas, to replace the interim agreements (Fontagné et al., 2011).

The impact of the EPAs is a controversial issue. The debate around them usually focuses on the potential negative effects of a change from the status quo to one compatible with WTO rules, while concentrating on the elements of the agreements related to trade and market access. Critics see the EPAs as an attempt by the EU to force open developing country markets with mercantilist interests in mind. They fear that this market opening will lead to the closure of ACP industries, the undermining of regional trade and major losses in government revenues (Curran et al., 2007).

Over the last decades, there have been numerous attempts to assess the likely impact of the EPAs on ACP economies. The best way to model such interactive processes is to use a computable general equilibrium (CGE) framework. Unfortunately, for most ACP countries the detailed data required are not yet available and CGE modelling is not an option. Up to now, however, efforts to quantify the impacts of EPAs have tended to fall back on more static models which look at the existing situation, in terms of trade and tariffs and model the static

impact of change. Although this 'partial equilibrium' approach is useful for identifying products vulnerable to import surges or losses in tariff revenue, it is not one which gives an indication of overall impact. Almost by definition, it leads to negative impacts, as it emphasizes increased ACP imports, with no counter-weighing increase in exports or production due to the activity fuelled in other parts of the economy. This is the approach taken in many EPA studies (e.g. Ben Hammouda et al, 2006, Milner et al, 2005).

PTAs and the multilateral trading system: The impact of preferential agreements on the multilateral trading system is a debatable issue. Pascal Lamy, in launching the World Trade Report 2011 on July 2011, warned that PTAs "may lock in their members to a particular regulatory regime reducing the potential for trade to prosper with countries outside the arrangement". "The new challenge posed by deep PTAs to the multilateral trading system is one of market segmentation because regulatory systems, which can become divergent, have now more importance on trade flows than tariffs," he added. This proliferation of PTAs has created a spaghetti bowl of criss-crossing arrangements, with little attention to coherence among agreements or to the implications of so many regimes for trade costs, efficiency, and the conditions of competition in global markets (Baldwin and Low, 2009). The question of whether PTAs – and specifically RTAs - represent WTO-plus by accelerating and extending the liberalization process on a non-discriminatory basis, or whether they are likely to weaken the WTO by bypassing it, is still open (see Bhagwati, 1994; Panagariya, 1999; and recently Baldwin, 2006; Baldwin and Low, 2009). Advocates of RTAs cite the gains to be had from economies of scale, competition and the attraction of foreign direct investment. Although liberalization through RTAs is generally held to be a second-best option, it may be the only option if there is resistance to liberalization at the multilateral level. RTAs can be laboratories for change and innovation and may provide guidance for the adoption of new trade disciplines at the multilateral level. Some would argue that the negotiation of multiple agreements provides countries with valuable negotiating skills. Recently, Kawai and Wignaraja (2009) argued that the proliferation of RTAs in Asia is a defensive response to regionalism elsewhere, as well as a reflection of slow progress in global trade talks. The authors argued that RTA formation in Asia can be complementary to the WTO process and benefits the region in a number of ways. The benefits will tend to be higher if there are elements of WTO-plus in the RTAs. Hufbauer and Schott (2009) look at Asia-Pacific regionalism and argue that, notwithstanding fears in certain quarters that rapid growth in regionalism is eroding the WTO system, there are ways in which current and future Asia-Pacific FTAs could complement the WTO. Among the ways that this could happen are the various Asia-Pacific Economic Cooperation (APEC) initiatives aimed at developing best practices in regional agreements and through a proposal to harmonize MFN tariffs to the lowest rates of FTA partners. For its part, the best thing that the WTO could do would be to continue to lower MFN tariffs.

Contrarily, there is evidence to suggest that the negotiation of multiple agreements strains the institutional capacity of even the largest countries and may dampen enthusiasm for liberalization at the multilateral level. RTAs create vested interests determined to avoid the dilution of preferential margins, while labyrinthine rules of origin make international trade more costly and complex. Moreover, RTAs may pose a threat to a balanced development of world trade through increased trade and investment diversion. Finally, the weakest countries may find themselves marginalized (Crawford and Fiorentino, 2005). Recently, Baldwin and Low (2009) explored the emerging relationship between regionalism and multilateral trade arrangements, and in particular the idea that governments could do more to multilateralize regional agreements for the broad benefit of the international trading community. They inquired about the current process of "multilateralizing regionalism", i.e. promoted through the non-discriminatory extension of preferential trading arrangements to additional trading partners. They analyse how regionalism itself might evolve into something different, and also what role the WTO might play in promoting a more inclusive and coherent trading system, free of economic distortions. Hoekman and Winters (2009) look at "deep" regional integration questions from a developing country perspective. The authors are not very optimistic about overall prospects for the multilateralization of developing country RTAs – which they suggest has not really happened and in some cases might not in any event be a good idea. Nor do they see regional agreements offering an effective path to deep integration in developing countries. However, they admit that bilateral progress dominates multilateral action.

Motives for PTAs: Economic and political science theories provide various explanations for why countries establish preferential trade agreements. A trade agreement could neutralize the "beggar-thy-neighbor" effects provoked by unilateral trade policy choices (high restrictions and inefficiently low levels of trade) and achieve higher welfare. Standard economic theory suggests, however, that a multilateral agreement rather than a PTA is the best way to address the problem. Gains in credibility suggest a second reason for signing a PTA. A government may choose to "tie its hands" through an international agreement in order to prevent future policy reversals that would be convenient in the short-run, but inefficient in the long term. A PTA may provide a stronger commitment than a multilateral agreement when a country is small in world markets. There are also "non-traditional" reasons why countries form PTAs. They include: accessing a larger market; ensuring against preference erosion; increasing predictability of future trade policy; signalling stability to investors; and achieving deeper policy commitments (WTO, 2011). But political circumstances are important to justify a PTA as well. Political science explanations of PTA formation focus on the role of political integration, the role of domestic political considerations, the form of governments and institutions, diplomacy and the role of power relations.

The economic impact of PTAs: The literature on the effects of PTAs on trade flows and the choice of countries to form a preferential trade agreement focuses on welfare-enhancing and political arguments to explain association agreements. The standard theory suggests that preferential trade agreements increase trade between member countries and reduce trade with third-countries, leading to negative welfare effects for non-members of PTAs. Since Viner (1950) most studies have analyzed the welfare gains or losses from free trade agreement for member countries. In the traditional *Vinerian* analysis, preferential trade opening allows some domestic production to be replaced by imports from more efficient firms located in preference-receiving countries, leading to welfare gains (trade creation). At the same time PTAs may reduce imports from more efficient non-member countries, implying a welfare loss (trade diversion). The net welfare effect of PTAs depends on the relative magnitude of these opposing effects. PTAs have a positive impact on welfare if trade creation exceeds trade diversion. In brief, two countries are more likely to sign an agreement if they are closer geographically, similar in size and differ in terms of factor endowment ratios. The net welfare gain is higher the closer the two countries are, because of trade creation. The larger and more similar in economic size the two countries are, the higher the welfare gains from trade creation, which is achieved by exploiting economies of scale in the presence of differentiated products. The greater the difference in endowment ratios between two countries, the higher the potential welfare gains from trade creation reflecting traditional comparative advantages. Several studies have tested the traditional theories on trade creation and trade diversion. A number of empirical works show evidence that trade creation, not trade diversion is the norm (Lee et Shin, 2004; Clausing, 2001; Cernat, 2003). While this literature is not conclusive, it suggests that trade diversion may play a role in some agreements and in some sectors, but it does not emerge as a key effect of preferential agreements. Recent studies have found other characteristics - with respect to the traditional ones - that are likely to give rise to potential trade-creating agreements, broadening the concept of “natural trading partners”. Apart from the geographical factors, Baier and Bergstrand (2004) find that trade creation between two trading partners is greater the larger and more similar in economic size they are – because they can exploit economies of scale – and the wider the differences in their relative factor endowments – due to Heckscher-Ohlin comparative advantage. A recent study by Egger and Larch (2008) has further tested and supported these findings in a larger sample. The economic impact of a PTA depends on its particular architecture, the trading impact of the parties involved, and the degree of liberalization undertaken, particularly with regard to sensitive sectors (Crawford and Fiorentino, 2005). Bilateral agreements are intrinsically more difficult to evaluate than either multilateral or unilateral liberalizations because of their second-best nature, that is, the net benefits tend to be uncertain and difficult to assess (Rollo, 2007). Measurement of economic impact, even for relatively simple trade barriers such as tariffs, is not always straightforward and requires a relatively specialized set of economic analytical skills. This problem of measurement is further complicated by the fact that the current wave of RTAs extend their compass beyond the simple dismantling of border barriers

to trade in goods. As mentioned before, such agreements now include within their purview services and other elements of deep integration, for which data are poorer, analytical tools are less developed and the domestic legal implications of any consensus are complex and potentially substantial (UN, 2010).

Empirical effects of a PTA: Research has focused on the impact of trade agreements on countries' trade flows, including the welfare implications on both member and non-member countries. Since the 1970s, a significant strand of trade literature has been focused on the trade effects of PTAs. Within this context, the gravity equation has been the traditional model to investigate the effects of trade agreements on bilateral trade flows (Behar and Cirera i Crivillé, 2010). The first empirical studies included a PTA dummy variable in a gravity model. Most of them treated PTAs as exogenous. These studies highlighted the potential endogeneity bias affecting the preferential agreement variable[12], and subsequently a few studies tried to address the endogeneity issue by considering the role of economic factors, democratic freedom, and transport costs in the decision to conclude a regional agreement (Caporale et al., 2009). Recently, Baier and Bergstrand (2004) found that pairs of countries that sign an agreement tend to share common economic characteristics, which results in net trade creation and welfare growth. Magee (2003) measured the effects of preferential agreements on trade volumes treating FTAs as endogenous. He found that it is likely that two countries will sign an agreement if they are closer geographically, are similar in size and are both democracies. Ghosh and Yamarik (2004) tried to test the robustness of the regional agreement effect by using cross-section data. They concluded that its effect may be over- or underestimated owing to the potential endogeneity of this variable. These findings were confirmed by Baier and Bergstrand (2007), who pointed out that the regional agreement variable is not exogenous and the estimation of a gravity model using cross-section data for investigating the quantitative effect of this variable on trade flows can be biased because of unobservable heterogeneity or/and omitted variables. Caporale et al. (2009) focus on FTAs between the EU and the Central and Eastern European countries and model their effects on trade flows by treating the agreement variable as endogenous. Their estimation results indicate a positive and significant impact of FTAs on trade flows.

Criticism for developing countries: From the developing countries point of view, the promotion of preferential free trade may help developing economies to implement domestic reforms and open up to competitive market pressures at a sustainable pace, thus facilitating their integration in the world economy. This may also benefit the multilateral process by exerting leverage for openness and competitive liberalization in international trade relations. Yet, the development of complex networks of non-MFN trade relations and of regulatory regimes which increasingly touch upon policy areas uncharted by multilateral trade

[12] The potential sources of endogeneity bias in gravity model estimations concern the following econometric issues: omitted variables, simultaneity, and measurement error. For an explanation of these topics see Wooldridge (2002).

agreements may place developing countries, in particular, in a weaker position than under the multilateral framework (Crawford and Fiorentino, 2005).

In conclusion, given the wide variety of motives that induce countries to pursue the bilateral and regional paths, PTAs are likely to remain popular no matter how well the multilateral system functions. The most important challenge is to seek ways to maximize PTAs' welfare effects and their compatibility with the WTO, whilst minimizing any negative effects (Crawford and Fiorentino, 2005; World Bank, 2005).

6. 2.5 Relevant differences in the impact of North-South and South-South trade agreements

Trade agreement impacts and developing countries: As underlined above, several recent studies find evidence that trade agreements do increase countries' bilateral trade flows significantly (Baier et Bergstrand, 2007). Even so, it is not evident that this effect can be applied systematically to developing countries and whether or not this holds for agreements with developed and other developing countries alike. On the one hand, developing countries can be unnatural trading partners due to similarities in endowments, smaller economic size and higher trade costs (Krugman, 1991; Magee, 2003), which implies limited trade increases from South-South agreements. On the other hand, developing countries may share demand for similar goods and may succeed in securing more attractive trade concessions from other developing countries than from rich countries (UNCTAD, 2007). Further, trade agreements can extend beyond tariffs to a broader range of 'behind-the-border' trade policy reforms (Preeg, 1998), which may be disproportionately needed in less mature markets (Behar A. and Cirera i Crivillé, 2010). A number of isolated studies of regional agreements (among Southern countries) found evidence of an increase in trade within the region (Cernat, 2003; Lee and Shin, 2006). However, there is no systematic global analysis of trade agreements involving developing countries which draw distinctions between trading partners. Because low-income countries are endowed with similar relative factor supplies, are economically smaller and have higher transport costs, they have less scope for realizing the gains from trade based on comparative advantage and exploiting scale economies within South-South blocks. By contrast, because North-South agreements integrate economies with different factor endowments and offer developing countries larger market access, they are more likely to produce efficiency gains. This implies that Southern countries are likely to be better served by North-South agreements than agreements among themselves (Ethier, 1998; Krueger 1999). However, if we consider the fact that they have more homogeneous preferences, are more similar in terms of economic size and are geographically closer to each other, developing countries appear to be more "natural trading partners" (Behar A. and Cirera i

Crivillé, 2010). There is also evidence that agreements lead to reforms of other trade-related policies.

The characteristics of North-South and South-South trade agreements: Although the main rationale for developing countries in signing a North-South trade agreement is to secure market access, it often happens that Southern countries gain little access in practice. While in South-South agreements country members typically set up a single value-added rule applicable to all products, North-South agreements impose restrictive rules of origin for particular sectors (e.g. agriculture) that deprive developing countries of the most important source of increased market access (Cieslik and Hagemejer, 2009). Among the studies focusing on specific South-South regional agreements, Mayda and Steinberg (2006) analyze the static effects of COMESA on Uganda's trade and find a small but positive impact on trade creation. Other papers present stronger results: Cernat (2003) analyzes seven South–South trade agreements (AFTA, Andean Community, CARICOM, COMESA, ECOWAS, MERCOSUR, SADC) and finds significant effects on trade creation amongst all them. Lee and Shin (2006) also show robust empirical evidence for intra-bloc trade creation for different East Asian agreements. Among the studies on North-South agreements, Cieslik and Hagemejer (2009) analyze EU-MENA trade deals and find they raise exports from the EU to MENA but not in the opposite direction. By analyzing NAFTA, the most relevant North-South trade agreement, Trefler (2004) finds out that the agreement had a positive and significant impact on Mexico's trade. However, different studies (Anson et al, 2005; Carrere and de Melo, 2004) show that Mexico's access to the US market was very limited in practice because of restrictive rules of origins. More generally, Estevadeordal and Suominen (2004) introduce a synthetic measure of the restrictiveness of rules of origins into the standard gravity model and corroborate this result by finding that they can significantly undermine trade between partners.

North-South agreements are more ambitious in content and coverage than South-South arrangements and involve "deeper" integration. They go beyond tariff restrictions to include harmonization across a broad range of policies, regulations, laws and institutions (i.e. competition policy, investor rights, product standards, public procurement and intellectual property rights). As a consequence of this, North-South agreements are believed to offer more gains to South members associated with improved governance and policy credibility by supporting institutional reform, increased FDI flows and accelerated transfer of technology (Schiff et Winters, 2003).

However, "deeper" integration might not be a welfare-enhancing proposition when trade agreements are between countries with uneven bargaining power (Panagariya, 1999). The main reason is that the agenda is likely to be set by rich countries and developing countries have to adjust their standards, regardless of whether these are appropriate to their conditions. Moreover, they fear that North-South agreements can become an instrument for extracting

concessions of all kinds not just in trade but in other "non-trade" matters. Thus, the benefits in North-South agreements are circumscribed by developing countries' weaker bargaining power and the rules will tend to reflect the status quo of high-income countries (Whalley, 2003). By contrast, South-South agreements are more likely to ensure the same level playing field for its members. They provide a competition framework between countries at similar stages of development that enable them to develop the capacity of competing successfully, starting with the local market and then internationally. Thus, they need to be less concerned about being swamped by high-quality or cheap imports with which it is difficult to compete (Behar A. and Cirera i Crivillé, 2010).

Conclusion: a great part of the trade agreement's success derives from countries' willingness to liberalize, accompanied by intense mutual dialogue and understanding. This is easy to achieve in South-South agreements, where country members have similar reasons to engage into trade agreements (UNCTAD, 2007). For example, Martin et al (2008) find that trade agreements reduce the probability of war by offering a political forum and by increasing the opportunity cost of conflicts that disrupt trade. In consequence, South-South agreements can further help developing countries strengthen their own development strategies building on the advantages of proximity, economic similarity and convergence of interests (Behar A. and Cirera i Crivillé, 2010).

PART III

DEVELOPING COUNTRIES' TRADE LIBERALIZATION, INTEGRATION INTO THE WORLD ECONOMY AND INCLUSIVE GROWTH

3.1 Trade and "inclusive growth"

Trade and growth: According to theory, international trade helps raise and sustain growth by giving firms and households access to world markets for goods, services and knowledge. International trade also helps with lowering prices and increasing the quality and variety of consumption goods, and fostering the specialization of economic activity into areas where countries have a comparative advantage. Trade opportunities are important too for generating the investment and positive externalities that are associated with learning through the diffusion and absorption of technology (Bhagwati, 1988; Irwin, 2001; Hoekman et al., 2004). All that considered, many developing countries have embarked on programs of external economic liberalization in recent decades. By 2000, some 73 percent of countries, representing 46 percent of the world's population, were open to international trade (Wacziarg and Welch, 2008). The effect of greater trade openness on income growth is the topic of a large body of applied research. Over the 1990s the conviction that trade liberalization or openness was good for growth, as stated by the theory, was fostered by some visible and well-promoted cross-country studies, e.g. Dollar (1992); Dollar and Kraay (2002, 2004); Sachs and Warner (1995), Edwards (1998) and Frankel and Romer (1999). This first wave of empirical work however, received pretty severe criticism (see, inter alia, Rodriguez and Rodrik, 2001), mainly concerning the flaws of the applied measures of openness and the weakness of their econometrics as underlined in chapter 1. Generally speaking, they were not able to demonstrate the direction of causality between the phenomena under investigation, with the result that inclusive growth and development can be the consequences of trade liberalization and integration into the world economy, rather than a prerequisite for it (Chang, 2007). A third possibility is that both phenomena are caused by a third factor - such as the quality of institutions that impacts positively on both the prospects for enhanced growth as well as the effectiveness of trade policy (CUTS, 2007; Rodrik, 2000). Furthermore, while at an aggregate level there appears to be a strong relationship between trade openness and growth, trade liberalization creates 'winners' and 'losers': this can limit the poverty reduction impact of trade and may further entrench existing inequalities (Higgins and Prowse, 2010). A second wave of empirical work applied more informative techniques, namely CGE models, which have been largely used to highlight the gains from liberalization accruing to developing countries in connection with the reforms envisaged by the Doha round (Hertel

and Keeney, 2005; Francois et al., 2003; Stiglitz and Charlton, 2005; Anderson et al. 2005; Polaski, 2006; Bouet, A., 2006; Decreux Y., and L., Fontagné, 2009). More recently, a particular CGE model, coming from the Global Trade Analysis Project (GTAP)[13], as price generator emerged (the standard model is Hertel, 1997) as the dominant methodology for the *ex ante* analysis of the economic consequences of comprehensive trade agreements (both multilateral and bilateral). It offers a systematic framework for analyzing price and quantity interactions in all markets, ensuring that both direct and indirect effects are counted[14]. This second wave of empirical work, especially the more recent work, has been much more cautious in quantifying the actual impacts of multilateral trade policies on growth (and poverty, see below). Even under full liberalization scenarios, the estimated increase of world GDP is never higher than 1%, while the absolute magnitude of poverty reduction induced by trade is always relatively small. A number of possible explanations have been proposed for these estimates. The most convincing ones are the following: i) the fact that much international trade is nearly tariff-free and total tariff revenue as a share of world trade (including services) is only about 3.2%, therefore amounting to just 0.7% of world GDP. Moreover, the poorest countries in the world already have tariff free access to industrial countries under non-reciprocal preferences, so further tariff cuts in these markets are not anticipated to have a direct impact on the poor (Hertel and Winters, 2005); ii) a second explanation is linked more closely to the empirical methods actually adopted. Current studies generally adopt a rather conservative stance, looking at the issues that are more easily quantified, overlooking a number of trade related issues that are presumed, in principle, to have significant impacts on both inclusive growth and poverty (see chapter 1). It has to be mentioned as well that the vast majority of the current CGE applications are based on very restrictive assumptions (e.g., the perfect competition hypothesis) and are mainly static in nature. They rely on debatable theoretical simplifications, impose enormous information requirements, and the outcomes are too sensitive to the model (Ackerman, 2005; Ackerman and Gallagher, 2008).[15] As underlined by Stiglitz and Charlton (2005), these methodological limits are particularly strong in the case of developing countries. CGE models often do not account for the presence of persistent unemployment in developing countries; do not address the fact that implementation and adjustment costs are likely to be larger in developing

[13] Other applied models stem from the GTAP database (see, inter alia, MEGABARE; FARM; RUNS; Michigan).

[14] The models built on GTAP database can differ in the choice of parameters and model closure; GTAP models can be static and dynamic; they can consider a single representative household or specific stratification of households; they can have particular emphasis on specific economic sectors such as agriculture or food.

[15] Ackerman (2005) underlines three main distortions linked to CGE models: i) first, the implausible assumptions that every exporter produces a differentiated product and that, even if prices change, there are no shifts from importing to exporting a commodity, or vice versa (Tokarick 2005); ii) secondly, CGE models usually provide a comparison of two different equilibrium scenarios, i.e., an equilibrium assumed before the policy "treatment" and an equilibrium reached after the policy change. As a result, the length and cost of the transition, an issue of great significance from the economic policy point of view, remains completely outside of the analysis and, with them, some crucial dynamic questions; iii) finally, the lack of answers to some of the key questions about the impacts of trade reforms on employment, because of they assume fixed employment, before and after the implementation of the policy.

countries and overlook the dynamic effects induced by trade liberalization. As a result, CGE approach is currently under critique as well (Abbott et al., (2009), Ackerman, 2005; Polanski, 2006; Taylor and von Arnim, 2007; Tokarick, 2008).

The revival of case studies: The lack of consensus on empirical evidence on the link between openness and poverty dynamics has induced, more recently, a call for more convincing applied work at the household level and within countries rather than cross-country. Hence, following up the tradition of Krueger (1978) and Bhagwati (1978) there has been a revival of the "case studies" tradition. Abbott et al., (2009), for instance, comparing 16 GGE studies on Vietnam, highlight the inability of CGE models to endogenously represent the mechanisms by which trade may foster development and reduce poverty because of the inherent difficulty to assess quantitatively the impacts of institutional reforms induced by trade liberalization. According to Abbott et al., (2009) progress on how institutional reforms may be captured in research methodologies, in Vietnam and elsewhere, is critical to improving predictions and in establishing the mechanisms by which trade reforms may impact on development and poverty. Similar positive welfare impacts of trade liberalization through employment creation and labour market participation have been derived from Senegal in the agri-food sector, under stringent "worst case" conditions (Maertens et al., 2011). Hertel and Winters (2005) also presented fifteen country cross-section analyses and twelve country studies.[16] They derive, in the end, mixed impacts, with poverty rising in some cases and falling in others. It is interesting to mention that, according to Hertel and Winters' (2005) calculations, while overall the number of countries where poverty slowly declines under the Doha scenario is about the same as the number of countries where it falls, poverty tendency is to decline overall. This is linked to the relative incidence in the sample of several of the most populous countries (Brazil, China and Indonesia, among the first ones). More specifically, the largest poverty reductions, both in absolute and relative terms, are expected to emerge in countries with agricultural export potential to the markets that liberalize most (e.g., Brazil, China, etc.), while poverty is expected to increase in countries which are net importers of agricultural products (e.g., Bangladesh), and which may presently benefit from preferential market access (e.g., Mozambique).

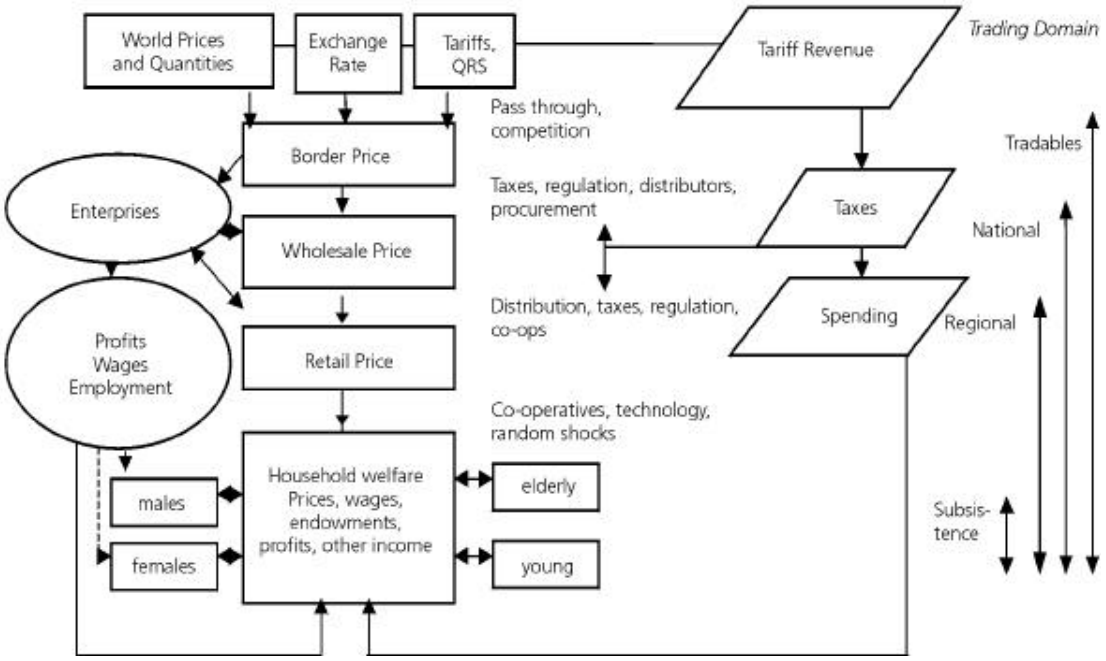
Growth for all? Recently, international institutions have made a supplementary effort to better qualify their long-term targets. From an initial goodwill in the notion of "*trickle-down growth*", to the acknowledgment of the presence of "*immiserizing growth*" (Bhagwati, 1988) they finally get to more qualified "growths" such as 'pro-poor growth'; 'shared growth', and finally "inclusive growth". In spite of the fact that these terms are often used interchangeably, the inclusive growth approach has a broader meaning than just growth with a "poverty bias", which is implicitly the target of all the "pro-poor" efforts. Inclusive growth takes a longer

[16] Bangladesh, Brazil (2 studies), Cameroon, China (2 studies), Indonesia, Mexico, Mozambique, Philippines, Russia, and Zambia.

term perspective and focuses on the increase of productive employment opportunities as a means of increasing incomes for excluded groups (Ianchovichina and Lundstrom, 2009), while in the case of pro-poor growth the main focus is rather on income redistribution (Kakwani and Pernia, 2000; Ravallion and Chen, 2003). Inclusive growth's task is not trivial. It goes beyond redistribution schemes, but equal opportunities are no guarantee of equal outcomes. Moreover, in the early stages of growth, there is a natural tendency for income gaps to widen (World Bank, 2008).

Trade and poverty: the inner channels Poverty eradication is the central focus for development as well as the main target of the World Bank and other development institutions. The "Millennium Development Goals" commit the international community not only to halve poverty by 2015, but also to promote a more open, rule-based trading system, with the latter viewed as reinforcing the former. Many commentators have highlighted the role of international trade on poverty reduction. However, empirical evidence does not show straight correlation between the two. Winters et al. (2004), have tried to deal seriously with this issue by examining the existing evidence about whether developing countries' trade liberalizations have had a pervasive (positive and/or negative) impact on poverty. The issue presents an additional degree of complication since poverty measurement is also a matter of debate among experts (see, inter alia, Reimer, 2002). Analysts therefore are obliged to decompose the link into steps and compile the evidence on each of them individually. The reference conceptual framework followed by the majority of applied researchers has been provided by Winters (2000, 2002) – see Fig. 2- "Trade policy and poverty – causal connection". It considers the following channels: i) the distribution channel, which relates to changes in the prices of goods and services; ii) the enterprise channel, which relates to changes in profits, wages and employment; iii) and the government channel, which relates to changes in taxes and transfers.

Figure 2: Trade policy and poverty- causal connection



Source: Winters, 2000

According to this framework, the empirical literature (McCullogh et al., 2001; Winters, 2000, 2002; Winters et al., 2004; Higgins and Prowse, 2010) agreed that a range of household-related factors, including location and access to local, national and international markets; demographic structures of households; intra-household decision making; and assets will influence the ability of poor households, as well as individuals within those households, to respond to opportunities that emerge as a result of changes in trade and cope with adverse impacts that result from changes in trade. Higgins and Prowse (2010) outline an additional range of contextual factors that affect the extent to which trade changes contribute to inclusive growth and poverty reduction, specifically: the type/s of goods and services traded; the political economy context; the investment climate; macroeconomic stability; and levels of poverty and inequality. Recent cross-country assessments of the relationship between trade, development and poverty reduction found that the same set of policies results in distinct outcomes in different country contexts (CUTS, 2008). Another study on the gender effects of economic partnership agreements (EPAs) in Tanzania, Mozambique and Jamaica demonstrates that to understand the opportunities for and constraints on trade expansion, analysis of transmission mechanisms and context, needs to be carried out at the country or regional level (Fontana, 2009). This is the only way to truly understand how the linkages between trade, inclusive growth and poverty reduction may play out.

As is apparent from the above framework, a starting point for the assessment of the effects of trade reforms on poverty is price changes at the border and their actual affect on the prices of goods that are important for the poor. An overwhelming amount of estimates on the price impact of multilateral trade liberalization has been carried out through various empirical

models. Most of these estimations are based on GTAP models, but other models have been applied as well (such as the RUNS - Rural-Urban North-South model developed by the OECD and the World Bank; or the spatial equilibrium model). They generally assume market clearing conditions, competitive environment and trade homogeneous commodities. Some of the studies (Hertel et al., 2002) offer different quantification, considering both disaggregated commodities price changes and aggregate price changes. The latter are then reported both for producer prices and consumer prices. All the reported price changes are relative to a numeraire specified in each of the studies. Estimates of price changes are also at the centre of the micro-macro synthesis analysis which combine the generated prices with micro-simulation models (see among others Robillard et al., 2003; Ianchovichina, Nicita and Soloaga, 2001; Nicita, 2005; Arndt, 2005). The main finding of this strand of studies is that the effects of trade reforms on world prices are quite small (see, inter alia, Hertel, Preckel, Cranfield, and Ivanic, 2002; Dimaranan, Hertel, and Keeney, 2003; Ivanic, 2005; Hertel and Ivanic, 2005, Hertel and Reimer, 2005; Bouët, et al., 2008; Labord, Fontagnè e van der Mensbrugghe 2009). This conclusion is consistent with the general finding that the direct benefits from trade liberalization associated with changes in prices are typically quite small (McCullouch et al., 2001). Moreover, it is well known that price changes at the border do not necessarily covariate with domestic prices (see chapter 1 of this report and McCulloch et al., 2001). Furthermore, the effect of a single small price change on household welfare depends on whether the household is a net supplier or net demander of the good or service in question (Winters, 2000; Ivanic and Martin, 2008). As a result, some empirical studies highlight modest and mixed evidence on the contribution of trade liberalization on poverty alleviation and the results depend greatly depending on different model specifications (Ackerman, 2005; Cline, 2004; Hertel and Winters, 2005). Winters et al., (2004), who provide one of the most extensive analysis on the issue, demonstrate that there is no simple general conclusion concerning the relationship between trade liberalization and poverty. The authors agree, in principle, that there are many causes for optimism in the relationship between trade liberalization and poverty reduction - both theory and empirical evidence broadly support this position (see, for instance, the general positive links between openness and resource allocation, productivity and growth). However, they highlight that ultimately, the outcome depends on many factors, such as the precise trade reform measures undertaken, the characteristics of the poor, and especially local institutions, which determine the price effects of liberalization, notably the transmission of border price changes to local levels, and through households. Conversely, they find less evidence concerning the adverse effects of trade liberalization on the employment/wages channel (see below) and/or government spending due to falling fiscal revenues. Furthermore, they find relatively little empirical evidence on the effects of trade liberalization on poverty dynamics at the household level, and more importantly, on how households respond to adverse shocks (see Montalbano 2011). Additional research on the issue has been carried out by Hertel, Ivanic, Preckel and Cranfield (2004). These authors, by combining results from an international cross-section of consumption analysis with earnings data from household surveys in Indonesia (according to

the authors these results can be readily extended to any of the other 13 countries in the sample), claim that the aggregate reduction in Indonesia's national poverty headcount following global trade liberalization masks a much more complex set of impacts across groups. In the short run the poverty headcount rises slightly for self-employed agricultural households, as agricultural profits fail to keep up with increases in consumer prices. In the long run the poverty headcount falls for all earnings strata, as increased demand for unskilled workers lifts incomes for the formerly self-employed, some of whom move into the wage labor market. This demonstrates that, apart from price effects, international trade actually has important effects on earnings in developing countries too, more specifically on employment and wages.

The earning side of trade reforms: Actually, multilateral trade policy is popularly seen as responsible for adverse trends in employment and downwards pressure on wages as well as for lowering global labour standards. An influential strand of the applied literature, mainly based on Latin-American countries studies (Perry and Olarreaga, 2006), highlighted that trade liberalization was accompanied in some developing countries (see Attanasio et al., 2004 for Colombia, Feliciano 2001 for Mexico, Pavnick et al., 2004 for Brazil, etc.) by the so called "skill premium" effect, i.e., the fact that, contrary to common wisdom (and theoretical predictions, see Stolper-Samuelson theorem), there has been a significant increase in the relative reward for skilled labour. This effect has been accompanied by an increase in the skilled to unskilled employment ratio within industries (not just in those that use skilled labour more intensively) and hence by rising inequality between skilled and unskilled workers, and even poverty.[17] The need to explain this apparent paradox is one of the main goals of the literature focused on the distributional effects of globalization. It is worth noting that Latin America's increasing skills gap actually contrasts with the earlier findings for East Asia, where liberalization was accompanied by a narrowing of the above gap.[18] Common questions are the following: is the theory underlying the conventional wisdom too stylized to capture the reality of the developing world? Or were there other forces at work that may have overridden the effects of globalization? Did the experience vary across countries and, if so, why? Goldberg and Pavcnik (2007) argue that our understanding of the consequences of globalization for inequality has been greatly improved as the theoretical framework underlying the empirical work expanded to include trade in intermediate products, international flows of capital, trade-induced skills-biased technological change, short-run factor immobility, and firm heterogeneity. Among the possible alternative channels through which trade liberalization may have impacted wages the issue of the so-called "*industry wage*

[17] This conclusion has its own theoretical grounds. If we are willing to accept the assumptions that trade liberalization increases the probability of working in the informal sector, and that informal sector is associated with lower wages and worse job quality (Goldberg and Pavcnik, 2004). However, this causality is not easy to detect empirically, due to the fact that individuals may self-select into the informal sector because of *unobservable* characteristics independent from wages.

premium" (i.e, the part of worker wages that cannot be explained by observable worker characteristics, such as gender, age, education, experience, etc but that are determined only by workers' industry affiliation) is emerging. Many studies have found that industry wage premiums account for a significant portion of individual wage variation. However, evidence on how responsive industry wage premiums are to trade reforms is still uncertain and differs from country to country: some studies find no association between tariffs and industry wage premiums, while others find a positive association between tariff declines and industry wage premiums. Inter-industry increases in the share of skilled workers have been reported for Argentina, Brazil, Mexico, Chile, and Colombia (Robbins 1996; Sanchez-Paramo and Schady 2003; Attanasio, Goldberg, and Pavcnik 2004); Hong Kong (Hsieh and Woo 2005); and India (Kijima 2006). In sum, the evidence supports the hypothesis that trade-opening induced an increase in the likelihood of working in the informal sector. This represents an important transmission mechanism in regards to the impact of trade liberalization and the general increase in wage inequality between skilled and unskilled labour. However, this evidence is not very robust across countries and time and there are additional potential explanations for the differences in findings across markets which may lie in labour market institutions. A number of studies attribute the skill wage premium to a lack of labour reallocation in response to trade reforms. There could be several possible reasons for this: rigid labour markets (which cause the adjustment to trade liberalization to occur through relative wage adjustments (Colombia, Mexico, India), or to the existence of imperfect product markets (so that firms respond by lowering of profit margins (Mexico, Morocco) and not through labour reallocation across sectors. Lack of labour reallocation following trade reform has been documented by Feliciano (2001) for Mexico; by Attanasio, Goldberg, and Pavcnik (2004) for Colombia; by Janet Currie and Harrison (1997) for Morocco; by Topalova (2004) for India; and by Wacziarg and Wallack (2004) in a cross-country study of trade liberalization. Another important controversial element is the role played by skills-biased technological change, measured as the increase in the share of skilled workers by sector. Some literature supports the idea of technological evolution as a determinant of changes in the wage distribution, encouraging the idea that wage inequality would have increased also in absence of trade reform, since the phenomenon is independent of trade opening. Recent theoretical papers have explored channels through which trade openness may have induced or at least contributed to skills-biased technological change (Thoenig and Verdier, 2003; Acemoglu, 2003; Aghion et al., 2003), but while empirical work on the effects on wage inequality of trade alone, or skills-biased technological change alone has been abundant, empirical studies of the *interactions* between the two mechanisms are scarce (see, for example, Pavcnik (2003) and the empirical part of Aghion et al., 2003).

Trade and employment: Although the concern about employment/unemployment impact of trade reforms dominates the public debate on the pros and cons of trade liberalization, it is almost absent in the mainstream models of international trade, which typically assume full

employment. However, when labour markets are characterized by rigidities (as is often the case with developing countries), trade policy changes can lead to transitional unemployment. A useful analytical framework from different theoretical strands of literature is provided by Hoekman and Winters (2005) who underline the important connection between various stylized facts and research findings. They start their analysis by drawing a distinction between the neoclassical the structuralism approach. According to neoclassical models, long-run levels of employment and unemployment are determined by macroeconomic variables and labour market-related institutions rather than trade and trade policy. Thus, according to this view, multilateral trade policy reforms *per se* should not have a long-term impact on employment levels although, of course, they may be accompanied by labour and other market reforms. The "structuralist" models, on the other hand, postulate that trade policy shocks can affect employment permanently by creating or destroying jobs with little or no adjustment in the sectors of the economy not directly affected by the shock. In more detail, empirical literature focusing on the short term (Wacziarg and Wallack, 2004; Goldberg and Pavcnik, 2005; Milanovic e Squire, 2005) demonstrates that trade liberalization can reduce employment temporarily, as could, conceivably a Keynesian shock emanating from increased import competition (public sector job loss is an example, dealing with transitional unemployment resulting from a shock to the formal sector). Unfortunately, on the empirical side, little is known on how changes in trade policy affect the probability and duration of transitional unemployment. Some empirical works (see, inter alia, Kletzer 2004) infer that much of the short-run impact of trade reforms involve reallocation of labour within sectors, reflecting a pattern of the expansion of more productive firms—especially export-oriented or suppliers to exporters—and contraction/adjustment of less productive enterprises in sectors that become subject to greater import competition. In any case, evidence is muted and there is no clear evidence that displaced workers find employment again in export-oriented sectors. Establishing a clear link between transitional unemployment and trade liberalization is even harder in developing countries, where worker displacement surveys usually do not exist. While some countries have experienced an increase in unemployment following trade reforms, this increase is often attributed to macroeconomic recessions rather than trade policy. Generally speaking, there is very little evidence on the link between trade policy and probability (or duration) of unemployment. Much of the long-term, empirical literature (IADB, 2004; Kee and Hoon, 2005; Nicita, 2004) is in agreement that employment returns to its initial level with the equilibrium wage being determined by the intersection of demand and supply. Some important elements in relation to this aspect, are however underlined by Hoekman and Winters (2005): i) if booming sectors do not have access to supply of inputs from abroad their growth will be stopped very quickly with negative impacts on employment; ii) long-term employment creation needs to pursue general complementary policies such as the provision of education, the development of efficient infrastructure and measures to reduce entry barriers for local firms into new activities as well as restrictive labour market regulations; iii) empirical literature finds little evidence of the association between trade

reforms and increases in informal employment and/or deterioration of working conditions. To the extent that such evidence has been found, it seems to be relevant only in settings characterized by severe labour market rigidities (Hoekman and Winters, 2005).

Analysis at the firm level and the so-called "new new trade theory": It is only very recently that economists have discovered a simple truth: firms trade, not nations. Indeed, a lack of statistical information at the firm level has so far prevented the systematic inclusion of firm-level analysis in the policymaker's standard toolbox (Mayer and Ottaviano, 2008). Since some firm-level datasets are now available, their analysis is starting to reveal some new facts that are simply unobservable at the aggregate level. First of all, the fact that the evolution of trade and FDI is driven not only by changes in the "intensive margin (i.e., the average trade and FDI per firm) but even more importantly by changes in the "extensive margin" (i.e., the number of firms actually involved in international activities). More specifically, recent works are increasingly focusing on micro-level analysis, concentrating on the links which exist between exporting and productivity at the firm level. The underlying idea of these works is directly linked with the so called "learning by exporting" argument, which states that exporting may foster learning and improve the technical efficiency of domestic exporting firms.[19] This strong evidence for the beneficial impact of trade liberalization on productivity seems to override the ambiguity which still exists about the links between trade and growth (Winters et al., 2004). However, a debate has arisen on the direction of causality between firm productivity and export status. Starting from the seminal work of Melitz (2003), who modelled heterogeneous firms, recent works have increasingly shed light on a vast array of stylized facts on trade at the firm level. For example: the link between diversification and business environment (Amurgo-Pacheco and Pierola, 2008; Sennis and Shepherd, 2007); the relationship between growth and diversification (Al -Marhubi, 2000; Herzer and Nowak-Lehnmann, 2006; Hesse, 2009); the impact of diversification and vulnerability (Haddad et al., 2009); the fact that firms are multi-product and export multiple products to multiple destinations (Bernard, Redding and Schott 2010); the link between the characteristics of firms and trade performance (Bernard et al., 2007; Helpman, Melitz and Yeaple, 2004; and Mayer and Ottaviano, 2008); the impact of product/process innovation on export propensity (Aw et

[19] The above literature mainly follows a "production function" approach. It models learning-by-exporting as a change in the stochastic process governing a firm's productivity induced by export behavior. However, the measures used for productivity vary significantly among studies. One of the more frequently used is "Total Factor Productivity", estimated both by parametric and semi parametric techniques. One other important tool is the Translog Production Function approach. Once a measure of productivity growth is estimated, the empirical strategy is generally based on regression of this measure on measures of export behavior (learning equation), controlling for other individual observable characteristics. According to the direction of causality highlighted, the group of studies related to research on the link existing between a firm's exporting and a firm's productivity is based on the following hypothesis: i) *emphasis on firms' efficiency:* because of the intrinsic difficulties of dealing with a foreign market and the existence of "sunk costs" associated with selling abroad, only the most efficient and above average performing firms are likely to be able to cope with sunk costs; ii) *emphasis on exporting*: technological and managerial inputs from abroad as well as exploitation of economies of scale by operating in several markets are key determinants for improving exporting firms' productivity.

al., 2009; Cassiman and Martinez-Ros, 2007; Becker and Egger, 2007; Beveren and Vandenbussche, 2009).

3.2 Factors of success and failure: controlling for relevant variables and countries' characteristics

Why do countries show divergence in performance? The issue of diverging economic performances amongst countries is one of the more intriguing issues to understand. Economists traditionally recommended trade liberalization and export promotion as a general solution to generate foreign exchange through export earnings. As the World Bank (2008, pag. 2) put it: "growth of 7 percent a year, sustained over 25 years, was unheard of before the latter half of the 20th century". This has been put in relation with a more open and integrated world economy which allows fast-growing economies to import ideas, technologies, and know-how from the rest of the world. However, the results of trade reforms have been mixed. A number of developing countries in Asia - such as China and Vietnam –experienced "success stories" in facilitating development and poverty reduction through expanding trade opportunities. Conversely, other economies actually failed to increase their volumes of trade, both domestically and internationally, or experienced frustrating efforts at poverty reduction (CUTS, 2007). Moreover, while all the sustained, high growth cases prospered by serving global markets (growth strategies that rely exclusively on domestic demand seem unable to produce long term benefits because of the intrinsic limits of domestic markets), the role of export promotion policy remains ambiguous (World Bank, 2008). We simply do not know the counterfactual: i.e., whether the high-growth cases would have succeeded even without targeted incentives. New streams of research are gradually acknowledging that numerous distortions exist at any time in a given country, and that some are more important than others. In a comparative analysis on the linkages between trade, development and poverty reduction in 15 African and Asian countries[20], CUTS (2007) derives the following key factors: i) first, economic growth remains the most significant pre-requisite to poverty reduction. The project countries that achieved the most significant poverty reduction in response to their reforms were those who achieved the highest levels of economic growth, namely China, Vietnam, and India. In contrast, most of the countries that failed to reduce poverty are those that also failed to stimulate sustained economic growth following their reforms (Kenya, Tanzania and Zambia); ii) economic growth "per se" is not always sufficient to stimulate poverty reduction and the character and distribution of growth plays a major role in determining the extent of poverty reduction, as confirmed by the experiences of Bangladesh, Pakistan, Sri Lanka and Uganda. All of these countries achieved reasonable levels of economic growth, but failed to reduce poverty to the same degree; iii) agriculture and non-agriculture related activities

[20] The fifteen countries under investigation are: Bangladesh, China, Cambodia, India, Kenya, Nepal, Netherlands, Pakistan, Sri Lanka, South Africa, Tanzania, Uganda, UK, Vietnam, Zambia.

remain key, given that the majority of the poor make their living from these sectors; iv) poor business climate (e.g., poor infrastructure, excessive red tape, corruption, inefficient financial sector, weak institutions, etc.) actually hamper growth and poverty reduction (see, on the contrary, the positive experiences in export processing zones in Bangladesh, Nepal and Sri Lanka); v) countries that have benefited the most are those that have carried out selective and gradual liberalization and have continued to provide state support to a number of key economic sectors (see the experiences of both China and Vietnam but also Bangladesh, India and Sri Lanka, that avoided carrying out liberalization in their agricultural sectors in order to safeguard the livelihoods of farmers). In contrast, the most extensive liberalizers over the last couple of decades, the Sub-Saharan African countries, have had more disappointing economic performances. Key economic sectors contracted in the face of global competition and agricultural producers have been left increasingly vulnerable to open markets. The report acknowledges that additional research is needed on this front, especially on the evolving dynamics of service sectors (including informal services) and their contribution to poverty reduction; vi) the key role of institutions in creating and sustaining economic growth and ensuring that the benefits are spread as widely as possible; vii) finally, the fact that global competition, especially with developed countries, has also led to the decline of many sectors, including handicrafts (in Bangladesh, India and Sri Lanka), Technology and Communication (in Sub-Saharan African countries), chemicals, machinery and some agricultural sectors. Hertel and Winters (2005) highlight additional sources of countries' heterogeneity, i.e., the degree of transmission of world prices to rural households, the barriers to the mobility of workers between sectors of the economy, the incidence of national tax instruments used to replace lost tariff revenue, and last but not least, countries' degree of exposure to the shocks generated by the DDA.

New tendencies: According to Rodrick (2007), we are now confronting an historic opportunity, with the softening of convictions on both state planning and free-market reforms, and the concrete possibility to agree on an agenda for more "intelligent" intermediate economic policies. He argues, for instance about the need to think about industrial policy in a somewhat different light than what is currently the standard in the literature, i.e., more as a process than as a list of targeted outputs (which are unknowable ex-ante), based on a strategic collaboration between the private sector and the government aimed at the removal of the most significant obstacles. Acknowledging Imbs and Wacziarg's (2003) main findings that the process of specialization in different countries diversifies over most of their development paths, as well as Klinger and Lederman's (2006) complementary analysis, that show that the number of new exports also follow an inverted U-curve income. Rodrik (2007) claims that a desirable trade regime should be not oriented towards the enhancement of market access, but rather to provide much greater policy space to domestically crafted growth strategies of developing countries, even including "unorthodox" policies such as export subsidies, trade protection and investment performance requirements. In this respect,

the role of the WTO should be to regulate the interaction between different national regulatory regimes rather than to narrow the differences among them. Rodrik's works are part of a general trend of reconsidering some of the previous wisdoms on trade impacts. Lin (2011), among others, recently proposed a new approach, called "new structural economics": i.e., recognizing that many developing countries start climbing the industrial ladder with the legacy of distortions. He suggests a gradualist approach to trade liberalization, including temporary protection during transition for less competitive industries. In the same wake, the World Bank (2008) suggests that successful cases share an increasingly capable, credible, and committed government as well as strong political leadership.

Which categories in the developing group should be focused on?: Developing countries are not a homogenous group. Numerous efforts have been made to categorize developing economies in sub-groups characterized by more homogenous characteristics. For instance, regarding the capacity to generate and sustain high growth, the World Bank (2008) identifies the following four groups of countries: land locked African Countries, small states, countries rich in natural resources and middle income economies. Within the above categories, international competitiveness is a key issue, e.g. land locked and small states are, generally speaking, assumed to be highly vulnerable to external shocks; countries rich in natural resources are assumed to be affected by the "Dutch disease" (i.e., natural resources reduce incentives for diversifying exports), and middle income economies tend to lose their comparative advantage as long as they narrow the gap with high income economies. A number of classifications have been proposed by international institutions and non-governmental actors to address the vulnerability of developing countries to trade openness. To avoid confusion and overlapping of policy instruments it is worth presenting in detail the meaning of the categorization used. Categories normally used are; fragile states, vulnerable states, SIDS (Small Islands Developing States), etc. *SIDS* are States characterized by a "natural and/or endogenous inability to face external shocks"[21] (UNU-WIDER, 2008; Briguglio 1995; Atkins et Mazzi, 1999; Easterly et Kraay, 1999; Briguglio et Galea, 2003; Winters et Martins, 2004; Witter, Briguglio, et Bhuglah, 2002; Briguglio et al., 2009); *Fragile States* are states where the government does not deliver core functions to the majority of its people, including the poor. Key determinants of States' fragility are a low policy score and/or an intrinsic institutional weakness. A standard assessment of evaluation of "fragile" states is when the World Bank's country policy and institutional assessment (CPIA) falls below a particular threshold. A number of post-conflict states fall into this category (UNU-WIDER 2008). Of course, many countries may meet both the criteria for structural vulnerability and State fragility, owing to the influence of the former on the latter. However, the two concepts are based on opposite grounds - structural versus policy factors - and cannot

[21] Two major alternative efforts have been developed so far: A "Commonwealth Vulnerability Index (CVI)", carried out by the Commonwealth Secretariat and an "Economic Vulnerability Index (EVI)" by the Committee for Development Policy (CDP) of the United Nations Economic and Social Council (ECOSOC).

be used in the same way to design policies (Guillaumont, 2009). Indeed, the link between vulnerability and trade openness remains ambiguous (Montalbano, 2011). If we take into account the redistributive nature of trade, it is certainly not possible to denounce any shock that may cause even a single individual to suffer a reduction in income. Furthermore, the simplest analysis of risk suggests that at low levels of trade (as typical in developing economies), further trade liberalisation would tend to reduce the risk of exposure because (larger) world markets with many players are likely to be more stable than (smaller) domestic ones (Winters, 2002). However, if world markets are more variable than domestic ones we can get the opposite effect. At the same time, if external shocks are different in nature, foreign exposure brings a "new set" of shocks that may raise uncertainty, lower expected utility (Calvo and Dercon 2003 and 2007; Ligon and Schechter 2003 and 2004) and harm people's ability to cope (Dercon, 2001). Finally, people may be unwilling or unable to undertake new potentially profitable activities induced by trade liberalisation due to increasing uncertainty. In this case, they will suffer the adverse effects of trade reforms without the compensating benefits of higher average earnings (Winters, 2000; Winters et al., 2004). Vulnerability to trade is usually equivalent to vulnerability to poverty because of trade openness. All of the limits of standard poverty analyses apply (see Chaudhuri et al., 2002). However, Montalbano et al. (2006, 2008, 2010); Guillaumont (2009); Naudé et al. (2009), deal with a broader definition of vulnerability to trade, as overall, there exists the likelihood that an economic system would undergo a negative outcome (below a certain norm or benchmark) due to "perturbation". The above definition of vulnerability is well suited to be applied to a broad range of welfare measures, benchmarks and shocks. This helps to enlarge our views on vulnerability from the simple notion of "expected poverty" as it has been traditionally looked at (Montalbano, 2011). It is worth noting that vulnerability analyses can be highly informative for policymaking on different perspectives: to assess the pervasive and differentiated impact of covariate shocks that are of main interest for international economic policy; to help national policymakers set priorities and calibrate domestic coping mechanisms and safety nets; to shed light on the pervasive role of geographic, regional, industry and competition polices (Montalbano, 2011). Please note, however, that at this stage SIDS, vulnerable countries and all the other above categories, remain largely informal groups. Notwithstanding the numerous efforts carried out by UN agencies and other international organizations to help and sustain special commitment for SIDS, people are still sceptical about the legitimacy of countries in this group to be considered as a category requiring special attention. SIDS too remain a largely an informal group, formed in 85% of cases by medium-high income countries. Current membership is by self-selection and depends heavily on the various definitions and assessment methods adopted (see table1).[22] Currently the only officially recognized sub-classification of developing countries is the category of LDCs

[22] For a selection of SIDS "desirable" characteristics see Winters et Martins, (2004)

(established by the UN in 1971) which is explicitly targeted in the preference schemas under the WTO.

3.3 Impacts of bilateral and regional trade agreements and relevant differences between North-South and South-South trade agreements

7.

What has the actual impact of multilateral trade agreements on developing countries been thus far? According to the (WTO, 2007)'s special issue on sixty years of multilateralism in trade, the main credit of the GATT/WTO system has been its contribution in global tariff reduction and in reducing NTBs. Both of these achievements have only marginally involved developing countries, considering their general limited involvement in the multilateral rounds till the Uruguay round and the lower levels of reciprocity expected from them. The new DDA calls for additional involvement of developing world and, at the same time, for a more responsive role for the WTO towards development needs. As the WTO (2007) clearly states, this requires an explicit recognition of developing countries' heterogeneity. Some countries, namely the LDCs, need incremental approaches to S&D as well as effective assistance and technical support as indispensable complements to better rules. Other countries require an issue-by-issue analysis of needs in relation to the rationale for S&D, the form it takes, the conditions attached to it and its compatibility with the rules-based character of the organization.

Is the preference erosion of LDCs really an issue? As Hoekman et al (2009) highlight, preferential margins (see chapter 1) are overall rather small for most countries[23] and there are surprisingly small gaps between the preference margins granted to LDCs and to developing countries as a whole under EU, Japanese and US preference schemes.[24] Indeed, Carrere and de Melo (2011) - using HS-6 tariff level data for the US and the EU - estimate that once the erosion from preferential access into the EU to non-LDCs are taken into account, LDCs have - under various "Swiss formulas" for tariff cuts – roughly a 3% preferential margin in the EU market, and nearly discriminated tariffs in the US. Carrere and de Melo (2011) claim as well that LDCs' effective market access is further reduced by the complicated rules of origin applied by the EU and the US, since generally, the most restrictive rules of origin fall on products in which LDCs have the greatest preferential market access. This leads to the conclusion that the magnitude of LDCs preference erosion will be very small relative to the total potential gains from global multilateral liberalization. Even if there is no general consensus about the degree of preference erosion worldwide, scholars generally agree that the

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[23] They tend to be higher, on average, in Europe relative to the other markets.

[24] Hoekman et al., (2009) show also the presence of a substantial variation in the preference margins across countries (more than 10% of the value of EU exports in Dominica and Seychelles and more than 5% in Senegal and St. Lucia).

Doha Round is likely to lead to relatively limited preference erosion unless the negotiations become a lot more ambitious (Martin and Matoo, 2008). It is worth recalling that even in the EU, which stands out as the largest provider of preferences, the track record of the adopted unilateral preferential system as a mechanism to promote the economic integration of developing countries into the world economy has been mixed at best. This is in part linked to the rules of origin and other forms of conditionality, but it also reflects the presence of supply capacity constraints in many beneficiary countries (Hoekman et al., 2009).

What is the challenge of the proliferation of RTAs? A long standing debate concerns the challenge made to the multilateral trading system by the proliferation of regional trade agreements (RTAs)[25]. The new transparency measures announced in July 2006 should, in principle, increase the level of transparency of RTAs by mandating the WTO Secretariat to prepare reports on notified RTAs. However, it is important to stress that, no matter the specific characteristics, all RTAs necessarily imply negative impacts on third parties because they inherently imply some degree of trade diversion. That is why the issue of the actual measurement of the true preferential margins of developing countries –within the matrix of regional/multilateral trade agreements - is gaining relevance (see chapter 1). The intensity of trade diversion for each RTAs is linked to the difference between tariffs applied to regional partners and those applied worldwide. Preference erosion granted by multilateral agreements versus regional agreements is a key issue for developing countries (see, for instance, ACP countries that benefit from a duty free market access to EU for nearly 90% of their products). However, the overall effects of RTAs on trade structures of partner countries are not clear yet (Egger et al., 2008). Common questions are the following: i) do RTAs mainly stimulate gains from specialization as would be reflected in a growth of the share of inter-industry trade? Or do they mainly foster gains associated with scale economies and product differentiation which would show up in a growing share of intra-industry trade? And, finally, what are the associated consequences for trade structure? Baier and Bergstrand (2001), looking at the EU RTAs with third countries, provide partial answers to the above questions. They confirm the findings of Egger et al., (2008) that, even after taking proper account for the self-selection bias, the impact of RTAs is quantitatively important both in terms of trade volumes and intra-industry trade shares.

What are the main differences between North-South and South-South RTAs? According to the theory of comparative advantages, production patterns in Southern developing countries are, in principle, more compatible with those of the Northern economies. Furthermore, South–South trade across developing economies is, by definition, carried out by countries at a similar stage of development and, hence, similar competitiveness. As a result, South-South trade agreements are unlikely to generate great benefits but only trade diversion

[25] With the only exception of Mongolia, all WTO Members are a party to at least one preferential trade agreement (WTO, 2007).

(Venables, 2003). However, if we are able to take into account of the cumulative causation mechanisms and, hence, to "endogenize" the comparative advantage variable, the qualification of the impact of RTAs goes beyond the trade creation vs trade diversion pattern. Fugazza and Robert-Nicoud (2006), for instance, show that South–South trade can have the effect of lowering the price of intermediate inputs and eventually allows exporters in those countries to serve international markets. Anderson and Martin (2005), report that developing countries are the major beneficiaries of reforms within their own regions. They calculate that 50 per cent of the welfare gains to developing countries following full global liberalization derives from changes to developing countries' own policies. Furthermore, notwithstanding the North-South preferences, the average import weighted applied tariffs on exports from these regions to developed countries is still higher than those facing developed countries themselves. This reflects the composition of imports with different tariffs rather than higher tariffs on the same item. Fugazza and Vanzetti (2008), by applying a GTAP general equilibrium model that includes linkages between economies and between sectors within economies,[26] find contrasting results comparing the effects of North–South and South–South liberalization. While for individual developing countries, obtaining further access to developed countries' markets is particularly beneficial if preferential access is obtained, the largest overall welfare gains would be obtained from South–South trade liberalization. The striking feature of this analysis is that South-South gains are superior to the gains from the alternatives, including free trade and the pending Doha outcome. These results derive from the observation that the gains from reducing one's own tariffs tend to outweigh the benefits of other countries opening up their markets.

Do emerging countries represent a threat for the developing world? A common worry in the developing world is actually its degree of competitiveness with the fast growing big emerging economies, especially China and India. The majority of studies - mainly focused on China's competitiveness- highlight a relatively low impact on developing countries' exports to third markets, especially with Sub-Saharan Africa (Lall et al., 2005; Blazquez-Lidoy, Rodriguez and Santiso, 2006, Lederman, Olarreaga and Rubiano, 2006; Jenkins and Edwards, 2006; Goldstein et al. (2006); Kaplinsky and Morris, 2008), with the exception of a few Asian countries - the more advanced East Asian ones, (Schott, 2006)- and the Southern Asian countries which specialize mainly in labour-intensive manufacturing (Shafaeddin, 2004). In all of the cases, the authors agree that India poses much less of a competitive threat in third markets than China. Qureshi and Wan (2008) argue that emerging economies generate complementary as well as competitive effects in some cases. More specifically, they show the usual moderate competition of China and India with Latin American countries (with

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[26] Industries are assumed to be perfectly competitive and characterized by constant returns to scale. Imports are distinct from domestically produced goods, as are imports from alternative sources. Primary factors are substitutable but as a composite are used in fixed proportions to intermediate inputs. Fugazza and Vanzetti (2008) use the standard GTAP closure modified to maintain fixed trade balances for all regions but the United States.

the notable exception of Mexico) and with African countries; moderate to high complementarity between the imports of China and the exports of the East Asian countries, especially Japan, South Korea, Malaysia, Singapore and Thailand, the US, the UK and Germany; strong competitive effects between China, and to a lesser extent India, and the EU, the US and East Asia in medium- to high-technology industries. However, by presenting a world map of trade specialization clusters, Montalbano and Nenci (2011) assess empirically the presence of a competitiveness threat for the developing world coming from China, India, Brazil and South Africa, which show a trade specialization performance more similar to that of the other developing countries.

Table 1. **Three lists of SIDS and the membership of AOSIS**

SIDS implicitly recognized by the UN (48) **The economic list**	SIDS within the membership of AOSIS (39) **The political list**	Members and observers of AOSIS (43)	SIDS according to the UN Secretariat (46) **The institutional list**
American Samoa	*American Samoa*	*American Samoa*	*American Samoa*
Anguilla	Antigua and Barbuda	Antigua and Barbuda	Antigua and Barbuda
Antigua and Barbuda	Bahamas	Bahamas	*Aruba*
Aruba	Barbados	Barbados	Bahamas
Bahamas	Cape Verde	Belize	Bahrain
Bahrain	Comoros	Cape Verde	Barbados
Barbados	*Cook Islands*	Comoros	Belize
British Virgin Islands	Cuba	*Cook Islands*	Cape Verde
Cape Verde	Dominica	Cuba	Comoros
Comoros	Fiji	Dominica	*Cook Islands*
Cook Islands	*Guam*	Fiji	Cuba
Cuba	Grenada	*Guam*	Dominica
Dominica	Haiti	Grenada	Dominican Republic
Dominican Republic	Jamaica	Guinea-Bissau	Fiji
Fiji	Kiribati	Guyana	*Guam*
French Polynesia	Maldives	Haiti	Grenada
Guam	Marshall Islands	Jamaica	Guinea-Bissau
Grenada	Mauritius	Kiribati	Guyana
Haiti	Micronesia (F. States of)	Maldives	Haiti
Jamaica	Nauru	Marshall Islands	Jamaica
Kiribati	*Netherlands Antilles*	Mauritius	Kiribati
Maldives	*Niue*	Micronesia (F. States of)	Maldives
Marshall Islands	Palau	Nauru	Marshall Islands
Mauritius	Papua New Guinea	*Netherlands Antilles*	Mauritius
Micronesia (F. States of)	*Puerto Rico*	*Niue*	Micronesia (F. States of)
Montserrat	Samoa	Palau	Nauru
Nauru	Sao Tome and Principe	Papua New Guinea	*Netherlands Antilles*
Netherlands Antilles	St. Kitts and Nevis	*Puerto Rico*	*Niue*
New Caledonia	St. Lucia	Samoa	Palau
Northern Mariana Is.	St. Vincent and the Gr.	Sao Tome and Principe	Papua New Guinea
Niue	Seychelles	St. Kitts and Nevis	Samoa
Palau	Singapore	St. Lucia	Sao Tome and Principe
Papua New Guinea	Solomon Islands	St. Vincent and the Gr.	St. Kitts and Nevis
Puerto Rico	Timor-Leste	Seychelles	St. Lucia
Samoa	Tonga	Singapore	St. Vincent and the Gr.
Sao Tome and Principe	Trinidad and Tobago	Solomon Islands	Seychelles
St. Kitts and Nevis	Tuvalu	Suriname	Singapore
St. Lucia	*United States Virgin Is.*	Timor-Leste	Solomon Islands
St. Vincent and the Gr.	Vanuatu	Tonga	Suriname
Seychelles		Trinidad and Tobago	Timor-Leste
Singapore		Tuvalu	*Tokelau*
Solomon Islands		*United States Virgin Is.*	Tonga
Timor-Leste		Vanuatu	Trinidad and Tobago
Tonga			Tuvalu
Trinidad and Tobago			*United States Virgin Is.*
Tuvalu			Vanuatu
United States Virgin Is.			
Vanuatu			

Non-independent territories are in *italics*

Sources: Permanent Mission of Mauritius to the United Nations in New York, 3 February 2004
www.sidsnet.org/aosis/members.html (AOSIS)
www.un.org/special-rep/ohrlls/sid/list.htm (Office of the High Representative)

PART IV

THE ROLE OF COMPLEMENTARY POLICIES AND REFORMS IN PROMOTING DEVELOPMENT AND INCLUSIVE GROWTH

4.1 Theoretical framework

Trade, economic structure and complementary policies

When trade reform has been implemented in an unstable macroeconomic framework or without any effort being made to strengthen trade-related domestic institutions or without appropriate complementary policies, it has often either been reversed or has failed to stimulate growth. Determining the appropriate trade policy stance and the associated complementary policies for a country should consequently figure in the design of growth policy and development and poverty-reduction strategies (Hoekman, Michalopoulos and Winters, 2003). The gains from trade liberalization depend on various factors, such as a sound investment climate, a sufficiently large "absorptive capacity" (e.g., human capital) to capture the spillover benefits from trade, and an absence of major domestic distortions (Freund and Bolaky, 2008; Keller,1996; Borensztein, De Gregorio and Lee, 1998; Chesnokova, 2007; Manova, 2010; Bhagwati, 1971; Krishna, 2010; Porto and Hoekman, 2010).

According to Acemoglu and Zilibotti (2001), trade liberalization does not lead to productivity improvements in developing countries if they fail to improve their human capital and to enforce intellectual property rights. Likewise, in Banerjee and Newman's work (2004), the lack of financial development and sluggish factor mobility make poor countries lose out from trade openness, as unproductive sectors are wiped out by foreign competition, but the capital and labour attached to them fail to be diverted towards more efficient uses. In the analysis of growth effects of trade openness, Bolaky and Freund (2004) find that trade opening promotes economic growth only in countries that are not excessively regulated. They argue that in highly regulated countries, there is no growth because resources are prevented from flowing to the most productive sectors and firms, and trade is likely to occur in goods where comparative advantage is actually missing. Calderón, Loayza, and Schmidt Hebbel (2004) find that growth is null for low levels of per capita GDP, increases at a decreasing rate as income rises, and reaches a maximum at high levels of income. Chang et al. (2005) present empirical evidence on how the growth effect of openness depends on a variety of structural characteristics that are subject to improvement through economic and institutional reforms. They find that the growth effect of openness is positive and economically significant if certain complementary reforms are undertaken.

Recently, Topalova and Khandelwal (2010) found that the efficiency gains from trade reforms were largest in industries that also experienced the most deregulation and the biggest progress in investment liberalization. Stone and Shepherd (2011) showed that access to skilled labour and finance are particularly important to allow firms to generate productivity gains from intermediate goods imports while access to finance and macroeconomic stability are important for the impact of imported capital goods. Similarly, Chang et al. (2009) found that the positive impact of trade on growth is larger if it is accompanied by increased education, better infrastructure and a deeper financial market, as well as institutional and regulatory reforms.

8. 4.2 The appropriate complementary policies, reforms and implementation tools

Complementary reforms to increase the gains from trade liberalization are of primary importance. “Complementary policies are those which it would be useful to have in place or to implement simultaneously with a trade liberalisation. They are not directly compensatory, but are rather designed to ease the adjustment strains and help households avoid poverty by allowing them a greater degree of economic viability” (Winters, 2001). Some of these are general, and some are focused on making the trade policy reform more likely to benefit the poor (Hoekman B., C. Michalopoulos, M. Schiff, and D. Tarr, 2001).

Generally speaking, such reforms should include development of a regime that encourages investment and competition, including openness to foreign direct investment and should include macroeconomic policies that encourage stable prices and a competitive real exchange rate.

Main Complementary policies:

Institutions. The success of trade policy reforms depends upon a variety of institutions, both public and private. On the government side, an effective and non-corrupt authority is critical to the success of reforms. Policy should not aim at subsidising market activity but at creating the market as an institution (Winters, 2001). Other institutions include marketing and export finance. For the poor to benefit, it may be useful to establish institutions, such as a cooperative, that can put together large shipments from individual producers to supply foreign markets. Such institutions should also be able to obtain financing linked to their exports. Furthermore, donors and international development banks can provide both financing and assistance in the design of such programs. (Hoekman B., C. Michalopoulos, M. Schiff, and D. Tarr, 2001).

Macroeconomic and exchange rate policies. A stable macroeconomic environment and a real competitive exchange rate is crucial if trade liberalization is to be sustained and to contribute to an efficient allocation of resources. Trade reform works through the

transmission of price signals, which in a regime of high and variable inflation are concealed. Macroeconomic stability is thus a key complementary policy (Hoekman B., C. Michalopoulos, M. Schiff, and D. Tarr, 2001). A competitive real exchange rate is also crucial to create conditions for the support of trade liberalization policies. Where the exchange rate is overvalued, industries that are competing in the global market have a competitive disadvantage and this generates political pressures for protection (Shatz and Tarr 2001). Initially, trade liberalization is likely to lead to a trade deficit because the rise in imports following liberalization tends to occur faster than the export supply response. A depreciation of the real exchange rate can help to restore a balance between exports and imports, since it makes imports more expensive and exports more profitable. Under a flexible exchange rate regime, the real exchange rate will adjust through market forces while under a fixed one, trade reform should be accompanied by a devaluation of the domestic currency.

Competition policies. By lowering external barriers to international competition and by reducing government-imposed barriers to entry by domestic firms, it is possible to increase the competitiveness of markets. In small countries, an open trade regime is crucial, since there are fewer domestic firms contesting the market. In large countries, administrative and legal barriers to domestic entry are most important, since there are more potential entrants blocked by domestic barriers to entry (Hoekman, Kee, and Olarreaga 2001). Distribution networks have an effect on trade reform. According to Hoekman et al. (2001), if there are barriers to entry into distribution, those who control this sector may be the main beneficiaries of trade liberalization, being in a position to pocket much of what used to be collected as tariff revenue and not passing import tariff cuts on to consumers. Competition among private firms is also important: exclusive government licenses to the private sector should be avoided to prevent farmers being obliged to pay artificially high prices for their inputs and selling outputs to a single buyer at depressed prices.

Industrial policies. Among complementary polices, some scholars belonging to the New Structural Economics (NSE) school of thought have recently outlined the renewed relevance of industrial policy for developing countries. In particular, these scholars underline that in addition to an effective market mechanism, the government should play an active role in facilitating industrial upgrading to convert developing countries' outdated structure to a modern one (Lin, 2010). In developing countries, governments can play such a role through the channels of information, co-ordination and compensation for externalities. The role of the facilitating state in industrial upgrading is to encourage the emergence of firms, industries and sectors that once launched, will make effective use of the country's current comparative advantage (Lin and Chang, 2009). This means that economic development in a country should exploit the existing opportunities embedded in the country's areas of comparative advantage, while recognizing the potential for industrial upgrading when those areas of comparative advantage have been exploited. According to Lin and Chang (2009),

governments have adopted a variety of measures to promote industrialization and technological upgrading, with a wide variety of results. Used well, the unique powers available to governments can be wielded to initiate and support long-run sustained improvements in factors and productivity.

In the same vein, but with some distinctions, is the work of Harrison and Rodríguez-Clare (2009). By presenting a wide survey of the literature on the impact of industrial policy (meant as adoption of protection measures), Harrison and Rodríguez-Clare (2009) conclude that protection in the last decades of the twentieth century generally failed to generate higher growth. Hence, they envision an important role for what they refer to as "soft" industrial policy, the goal of which is to develop a process whereby government, industry and cluster-level private organizations can collaborate on interventions that directly increase productivity. The idea is to shift the attention from interventions that distort prices to interventions that deal directly with the coordination problems that keep productivity low in existing or emerging sectors. They propose - instead of tariffs, export subsidies, and tax-breaks for foreign corporations - programs and grants, which for example, help particular clusters by increasing the supply of skilled workers, encouraging technology adoption and improving regulation and infrastructure. Among possible instruments or policies, there exists: “regulation to enforce higher quality standards in cases of imperfect information or externalities; public investment in specific infrastructure projects; attraction of foreign direct investments to bring in foreign technologies; scholarships for studies abroad in areas deemed important for growth and diversification; grants for innovative projects proposed by single firms or entrepreneurs, prizes to innovative firms, grants for research projects proposed by organized producers and performed by local research centres, and technical assistance to allow long-term collaborative strategies for education and research between business associations and universities” (Harrison and Rodríguez-Clare, 2009).

In comparison with the more traditional approach to industrial policy, the soft version proposed has two the additional advantages: it reduces the scope for corruption and rent-seeking associated with hard industrial policy such as protection or selective production subsidies; it is much more compatible with the multilateral and bilateral trade and investment agreements that many LDCs have implemented over the last decades (Harrison and Rodríguez-Clare, 2009). Of course, as emphasized by Rodrik (2004), some policies associated with hard industrial policy remain feasible, such as fiscal incentives to particular sectors or to new activities. But clearly the policy space for hard industrial policy has shrunk over the last decades, whereas the space for soft policy remains basically unrestricted.

Infrastructure. Improving the quality of infrastructure is of primary importance for developing countries. Potential opportunities to benefit from a more open trading regime by poor producers have been lost because of the absence or deterioration of infrastructure. In the same way, many of the benefits of relaxed retailing regulations and the availability of new and/or cheaper goods have been confined to urban and peri-urban areas (Winters, 2001). Estimation results show that infrastructure plays a key role in LDCs performance. Increasing

road density and its quality has a large impact on both trade and economic growth. The impact of electricity infrastructure problems appears to be more limited and is due to reliability. In contrast with findings for other groups, the telecommunication infrastructure also contributes to the trade performance and economic growth of LDCs. The impact on trade is smaller than for other types of infrastructure and may be related to the role telecommunications play in addressing the problem of remoteness from main markets that affect many LDCs (Hallaert et al. 2011).

Safety Nets. According to Hoekman et al. (2001), one of the most important complementary policies for the poor is an efficient social safety net. All trade policy reforms need to consider the potential hardships faced by the poor in activities that are opened up to foreign competition. Broadly defined, the policy options to be considered are; establishing a general social safety net, safety net measures targeted to those who would be harmed by the trade reform and limiting the scope of reforms in order to minimize adverse impacts of reforms on the poor.

Specific safety nets linked to trade reform have an uneven and complex history. As it is difficult to distinguish between workers who are affected by trade reform from those who are harmed due to normal turnover in an economy, it is difficult to justify providing safety net programs only to poor people harmed due to trade reform. In this sense, it is preferable to employ general, country-wide safety nets to deal with problems linked to trade reform rather than to establish distinct trade-related special safety net programs (Hoekman B., C. Michalopoulos, M. Schiff, and D. Tarr, 2001).

Foreign direct investment and intellectual property protection. Foreign direct investment (FDI) is an important channel of technology transfer across national boundaries. Hence, it is important that FDI involve labour-intensive production and transfer of skills through training. Improvements in communications, transport, and information technology, together with trade liberalization, have led companies to locate the labour-intensive parts of production in developing countries. Such investment can be an important catalyst for the creation of low-skilled employment—as exemplified by Mexico and several Southeast Asian countries (Hoekman B., C. Michalopoulos, M. Schiff, and D. Tarr, 2001). According to some scholars, intellectual property rights protection can help attract FDI in sectors that rely on patent protection, helping to tilt the focus of investment projects toward manufacturing (Smarzynska 2000; Hoekman et al., 2001). Intellectual property protection can also be crucial for the poor in developing countries, especially for products and sectors that rely heavily on traditional knowledge and culture. Ineffective protection of intangible assets and intellectual property can have adverse consequences for poor people who are either the producers or the beneficiaries of assets that have been built up over time. The costs of intellectual property rights include the price increasing effect of protection, which can harm the poor by preventing access to drugs and by keeping prices higher than the cost of production. Intellectual property rights protection must therefore be complemented by trade and

competition policy instruments that can serve to offset the market power granted to the holders of those rights (Maskus 2001).

Establishing Business. According to Winters (2001), if trade liberalization opens up business opportunities in new areas, new businesses are likely to be required. If the regulations for establishing these activities are restrictive, and their ability to get inputs weak, these opportunities will go begging. Similarly, regulations on expansion and on labour recruitment and separation could curtail the willingness of existing firms to expand.

Complementary policies: a comprehensive list

Macroeconomic stability:

- Avoid Exchange rate overvaluations
- Reduce Exchange rate volatility
- Correct sequencing of reforms
- Anti-cyclical macro management

Mature and stable institutions:

- Clear and predictable rules of the game
- Clear legal system, independent judges
- Public safety

Export orientation:

- More than tariffs
- Reduce anti export bias
- SPS, health
- Norms
- Logistics: ports, customs, services

Competition et regulation:

- Promote competition
- Create markets
- Facilitate industrial upgrading
- Increase productivity
- Market-friendly regulation
- Transparency and technical criteria
- Conducive to productivity gains and low prices
- Let the price mechanism allocate resources
- Roads, railways, ports airports
- Telecommunications: connectivity, coverage, costs, quality

Deep and stable financial markets:

- Supervision and prudent regulation
- Independent Central Bank

- Deepening of capital market
- Hedging instruments

Low corruption and transparency:

- Diffusion through:
  - Information
  - Performance evaluation
  - External auditing
- Online public procurement and tenders

Selective export promotion:

- SMEs with export potential
- Information on export opportunities
- Advice on procedures
- Specialized advice
- Information on markets
- Business contacts
- Fairs, foreign missions, video business
- Offices abroad

Links with real sector:

- Link SMEs with export chains (clusters)
- Modernising management
- Quality (certification)
- Education et training
- Technology diffusion
- Business cooperation

Source: Mulder, 2007, www.uneca.org

9. 4.3 The issue of sequencing between trade liberalization and domestic and regional regulatory framework

Background: the "shock therapy" vs "gradualism" debate. The debate about the type and speed of reforms to accompany trade liberalization process dominated economic discussions in the profession in the '90s, on the eve of transition. Between the end of the 1980s and the beginning of the 1990s, the Soviet empire disintegrated and neoliberal economists provided the post communist policy elites with a blueprint for constructing a market economy (Hamm et al., 2010). These economists developed the so-called "shock therapy" policy package, consisting of rapid and extensive privatization of state-owned enterprise, liberalization of prices and trade and the adoption of fiscal austerity policies. The neoliberal approach was influential in the formulation of policies but it was criticized from the beginning by "gradualists" voices from both economists and sociologists. There was a strong debate between shock therapists, who advocated radical reforms and rapid transformation, and gradualists, supporting a more cautious approach to reforms. Shock therapists pointed to the

example of East European countries and Baltic states; fast liberalizers and successful stabilizers, that experienced a recovery after two to three years fall in output, while the Commonwealth of Independent States countries were doing much worse. Shock therapists argued that rapid liberalization allows the avoidance of the painful and costly period of transition between the defunct centrally planed economy and the fledgling market economy (Popov, 2000). Gradualists cited the case of China and objected to the elimination of old regulations and institutions before the new ones are created, warning that the institutional vacuum could have a devastating impact on output. Looking at the Chinese case, gradualists argued that the lack of recession and high growth rates were the result of the "step by step" approach to economic transformation.

Accordingly, much of development economics had been asking how transition economies could successfully achieve market-oriented policy frameworks. The debate was not about the goal, but the path to that goal, with some advocating "shock therapy", while others focused on pacing and sequencing —a more gradualist tack (Stiglitz, 2011). This is the issue of timing and sequencing of reforms. And closely connected with this is the relationship between the sequencing of trade liberalization and domestic reforms.

Timing and sequencing. The success of trade reform policies is dependent on timing. For example, it is generally not advisable to pursue simultaneous reforms if there is limited implementation capacity, strong political opposition or particularly high adjustment costs. However, developing country governments should consider the introduction of simultaneous complementary polices to help support the implementation of trade reform policies. According to DFID (2003), a government may wish to pursue policies relating to the creation of stable macroeconomic conditions and seek to identify options to address potential adverse impacts on government revenue from further trade liberalization.

Determining the appropriate pace of reform could have both political and financial implications. For example, rapid implementation removes distortions quickly, providing clear price signals to facilitate further adjustment but at higher short-term costs than a gradualist approach. Following a gradual approach, the government has more time to explain the reforms to its citizens; this is useful because often, reforms can be perceived as threatening.

As seen from above, trade liberalization policies in developing countries often occur in conjunction with other macroeconomic reforms. The sequencing of reforms refers to the order in which these macroeconomic reforms are introduced, both *across* sectors and *within* sectors. For a long time economists have argued about the appropriate sequencing of economic reform. A substantial amount of literature on the optimal sequencing of economic reforms emerged in the mid-1980s, prompted largely by a desire to understand the disappointing experiences with liberalization programs in Latin America. Before the massive push towards reform, the generally accepted view on sequencing was: 1. Trade liberalization should be gradual and buttressed with substantial foreign aid. 2. An effort should be made to minimize the unemployment consequences of reform. 3. In countries with very high inflation,

fiscal imbalances should be dealt with very early on in the reform process. 4. Financial reform requires the creation of modern supervisory and regulatory agencies. 5. The capital account should be liberalized at the very end of the process and only once the economy has been able to expand successfully its export sector (Edwards, 2008).

In the early 1990s the issue of speed and sequencing became central in analyses on how to design a reform strategy for the Transition Economies.

The issue of reform sequencing in developing countries has been extensively debated in the context of both trade and financial liberalization. The concentration of structural adjustment programmes on trade liberalization fostered considerable discussion on the optimal sequencing of tariff reductions and the removal of quota protection measures in affecting the impact of liberalization on economic performance. Stiglitz (2002) writes in relation to economic development that successful economic programs require extreme care in sequencing. According to him, during the 1990s and early 2000s reform policies were implemented too fast, in the wrong sequence and often using inadequate – or wrong – economic analysis.

Ultimately, most observers continue to believe that there are substantial welfare gains to be gained by giving freer play to market forces. But many have concluded that there are problems inherent in the transition process itself that argue against liberalizing all markets simultaneously (see Conley and Maloney, 2009). The debate is still open.

The role of institutions. During the last decade there has been increasing attention paid to the role of institutions in influencing the impact of trade and complementary policies on growth. Concerning the case of the Transition Countries, Popov (2007) states that although the reduction of output during the transformational recession was mainly determined by the magnitude of the pre-transition distortions, an additional reason for the extreme depth and length of the transformational recession was associated with institutional collapse. However, the speed of liberalization did not have any significant impact on performance. According to Popov, it is precisely this strong institutional framework that should be held responsible for both the success of gradual reforms in China and shock therapy in Vietnam (where strong authoritarian regimes were preserved and previous institutions were not dismantled before new market institutions were created), and for the relative success of radical reforms in Central European countries (where strong democratic regimes and new market institutions emerged quickly). It is the collapse of strong state institutions that started in the USSR in the late 1980s that explains the extreme length and depth of the former Soviet Union countries' transformational recession. On the other hand, strong institutional capacity does not lead automatically to responsible economic policies. Uzbekistan and Belarus, for instance, which seemed to have stronger institutional potential than other former Soviet Union states, did not demonstrate substantially better (macroeconomic) policies. According to Popov, changes in the institutional capabilities of the state have a dramatic impact on performance. It follows that the debate about the speed of the liberalization ("shock therapy" versus "gradualism")

was to a large extent mis-focused, whereas the crucial importance of strong institutions for good performance was over looked. More generally, the focus on institutions has received a strong boost from the rediscovery of institutions as a driver of long-term economic performance in the empirical literature on economic growth (Acemoglu, Johnson, and Robinson, 2001; Easterly and Levine, 2003; Rodrik et al., 2004).

10. 4.4 Focus on services, investment liberalization and competition policy in ensuring inclusive growth

4.4.1 Services

Increasing importance of Services. Modern economies are increasingly dominated by services and the importance of services as a share of overall production and employment increases with growth and development. Over the last three decades, services have grown from roughly 58 percent of GDP to almost 75 percent across the OECD (Francois and Hoekman, 2010). But the sector is also important for developing countries. In Latin America, for example, services accounted for 66 percent of value added in 2007, up from 49 percent in 1977. Similar trends can be seen in other regions. Even in sub-Saharan Africa, there has been a marked shift in value added toward the service sectors.

Trade in Services: While traditional international economics textbooks assume that services are largely non-tradable, increasing evidence suggest that service sector liberalization is a major potential source of growth in economic performance. At the same time, services trade carries worries about off-shoring and the potential pressure this places on wages in high income countries (Francois and Hoekman, 2010). Indeed, in two seminal studies, respectively on UK and US economies, Amiti and Wei (2004 and 2005) conclude there is little evidence for a negative effect of off-shoring on services. However, they highlight that the effect on employment depends on the methodology, allowing or not for both "substitution" and "scale" effects to be captured. The empirical research has not yet produced univocal results about the consequences of off-shoring on labour markets. Most of the existing studies on the labour market effects of off-shoring focus on the impact of the international fragmentation of production on skill composition of employment (Egger and Egger, 2005; Falzoni and Tajoli, 2009) or on skill wage premium (Feenstra and Hanson, 1996; 1999). Indeed, services are very heterogeneous and span a wide range of economic activities. Hence, Francois and Hoekman (2010) claim it makes little sense to speak collectively of “the service sector”. Different services play different roles in the economy; have very different market structures; rely on different modes of supply in contesting foreign markets. From a trade perspective, it is useful to better understand the interactions between various modes of supply for specific services as this will determine in practice which policies are a binding barrier to trade and which are redundant. More generally, such knowledge is needed to identify the appropriate sequencing and design of policy reform and trade agreements.

Services and economic growth. While the expanding economic importance of services has not gone unnoticed, services have not figured prominently in the economic growth and development literature and have only recently been highlighted in the trade literature. The literature strongly suggests that services play a crucial role in productivity growth in general. Though the general rise in the importance of services is driven by both final and intermediate demand factors, changes in the trade and production patterns of producer services are particularly striking (Francois and Hoekman, 2010). Services are inputs into production. Services facilitate transactions through space (thanks to transport and telecommunications) or time (i.e. financial services). Services are frequently direct inputs into economic activities and thus determinants of the productivity of the 'fundamental' factors of production – labour and capital – that generate knowledge, goods and other services. Education, R&D and health services are examples of inputs into the production of human capital (Francois and Hoekman, 2010). Once it is recognized that services are often inputs, an expansion of the service sector can increase growth. Oulton (2001) has shown that an expansion in stagnant service inputs may increase overall growth because greater outsourcing of services by productive firms in non-stagnant sectors entails a reallocation of factors that increase overall output and aggregate productivity. Most of this literature does not consider the role of services in the "production function" for R&D and human capital formation. Pugno (2006) is an exception. An expanding body of research – surveyed in Francois and Hoekman (2010) – has documented the positive association between open service markets, foreign direct investment in services and the performance of downstream domestic firms, including on exports.

Empirical findings for developing countries. A large group of studies also point to positive linkages between service sector openness and growth in developing countries. For example, Mattoo, Rathindran and Subramanian (2006) find that countries with open financial and telecommunications sectors grew on average, about 1 percentage point faster than other countries. A full liberalization of these sectors was associated with an average growth rate 1.5 percentage points above that of other countries. Eschenbach, Francois, and Schuknecht (2000) find strong linkages between a range of measures of financial sector openness and growth. Along similar lines, Eschenbach and Hoekman (2006) investigate the impact of changes in services policy on economic performance over the period 1990-2004 for a sample of 20 transition economies. They find that changes in policies towards financial and infrastructure services, including telecommunications, power and transport, are highly correlated with inward FDI. They conclude that policy reform explains the post-1990 economic performance of the transition economies. Analyses of trade in financial services and growth include Francois (1995), Barth, Caprio and Levine (2006), Murinde and Ryan (2003), Claessens (2003), and the contributions of Claessens and Jansen (2000). This literature tends to find a positive link between financial sector openness and economic growth performance. Given that developing countries tend to have higher restrictions on foreign

competition, there is a significant potential growth bonus for developing countries that move from closed regimes toward open regimes (Francois et Hoekman, 2010).

Services liberalization. Liberalization of the service sector entails the reduction or elimination of prohibitions, quantitative restrictions and regulations that prohibit foreign direct investment, limit the share of ownership of foreign firms, limit the number of expatriates that can be employed, or restricting the amount of imports of a particular service. Such restrictions frequently apply to both domestic and foreign suppliers, creating public sector monopolies in the provision of services, such as in air and maritime transport, telecommunications or financial services (Hoekman, Michalopoulos, Schiff, and Tarr, 2001). Empirical research suggested that many countries had a potential interest in liberalizing trade in services, reflected for example, in many of the poorest developing countries having a "revealed comparative advantage" in services when measured on a balance-of-payments basis. Building on the early literature in this area, there is now a substantial body of research on the topic, as well as a long list of research issues yet to tackle. Among the most recent works we find Sauvé and Stern (2000), Stern (2000), Findlay and Warren (2000), Lejour and Smith (2008), Stern, Mattoo and Zannini (2008), Marchetti and Roy (2008) and Reinsdorf and Slaughter (2009). Successful liberalization in developing countries will often require substantial strengthening of domestic regulatory institutions and related infrastructure. An implication is that additional instruments may be needed in trade agreements to focus on improving regulation and related enforcement capacity. Many observers have expressed concerns that trade agreements may deprive regulators of the ability to achieve social objectives. The challenge is to achieve a balance between greater competition and preserving desirable regulatory freedom (Francois and Hoekman, 2010).

The impact of Services liberalization. The potential implications of trade liberalization in services are tied closely to the mode of liberalization and to underlying market structure. In addition, the implications of liberalization are closely tied to gains from trade in other sectors (Francois and Wooton 2009).

One strand of the literature that quantifies the impact of policy in the service sector focuses on past episodes of liberalization and deregulation. For example, Fink, Mattoo and Rathindran (2003) analyze the impact of policy reform in basic telecommunications on sector performance using a large panel data set for developing countries over the period 1985 to 1999. Government monopolies are usually present in telecommunications services. As a result of changes in telecommunications technologies the "natural monopoly" argument for state ownership has been eroded, and many countries now allow competition, but restrictions are often maintained. Fink et al. (2003) analyze the impact of specific policy changes relating to ownership and competition on sector performance. They conclude that both privatization and more competition lead to significant improvements in performance, but that a comprehensive reform program produced the largest gains. They also conclude that the sequence of reform matters.

A key message from the recent literature on firms is that openness in a range of producer or intermediate service sectors is linked to increased export competitiveness for high-technology manufacturing sectors (Fink, Mattoo and Neagu, 2005). Francois, Manchin, and Pelkmans-Balaoing (2009) offer evidence that variations in communications-related infrastructure translate into significant variations in export performance in a range of developing countries. In a recent study of the Czech Republic, Arnold, Javorcik and Mattoo (2007) found a significant positive relationship between FDI in services following liberalization and the performance of downstream domestic firms in manufacturing. In the work of Arnold, Mattoo and Narciso (2008), which focused on sub-Saharan African economies, a significant positive relationship was found between firm performance and the performance of three service input industries for which data was collected through enterprise surveys (access to communications, electricity and financial services).

The theoretical literature also demonstrates that sequencing of policy reforms may be important because of interactions between market structure and alternative modes of supply within sectors.

Sequencing and regulatory framework in the services sector. Services tend to be highly regulated. Liberalization of service markets can require new or different types of regulatory intervention to ensure both that the expected benefits of liberalization are realized and that important policy objectives continue to be achieved. Consequently, opening services markets involves a broad and complex set of policies, regulatory instruments, institutions and constituencies, domestic and foreign, public and private. Changes in technology, along with unilateral privatization and liberalization by a wide range of countries, has also led to a major growth in trade in services. High speed, real time Internet links have greatly expanded existing trade in some services and, by reducing costs, have increased the number of small and medium-sized enterprises involved in international services trade. These developments have in turn both posed regulatory challenges (e.g., enforceability of national regulations) and increased the pressure for more transparent, streamlined regulatory frameworks (OECD, 2003).

Experience demonstrates that the nature, pace and sequencing of regulatory reform and liberalization undertakings must be assessed with attention. Some specific regulatory tools might be useful in this regard. Prior consultation can contribute to the development of better regulation, providing more information as to all available options. Such information could shed useful light on the appropriate sequencing of liberalization and regulatory reform, as well as on the particular regulatory reforms required to reach the expected benefits of liberalization. Insights gained through prior consultation into the experiences of other countries could also be useful in designing and sequencing domestic reforms. Finally, prior consultation can also provide an early warning system.

Other tools may also be helpful. For example, a register of regulations can help promote the development of a competitive market by facilitating use by foreign suppliers of liberalized market access. Regional agreements could also be used to consider the implications of a proposed regulation for trading partners, in particular the impact upon developing country trading partners.

However, such regulatory tools also imply relevant administrative costs. Trade in services is vast and encompasses many different sectors. The range of public and private actors, and the number of regulations is enormous. Hence, the administrative burden of conducting prior consultation could be significant.

Indeed, the complexity of service sector reform, and the critical need for liberalization efforts to be rooted in, accompanied by and, in some instances preceded by sound regulation (including enforcement capacity) can present formidable challenges to developing countries. This points to the need for liberalization of services to be progressive and to be accompanied by regulatory capacity building (OECD, 2003).

4.4.2 Investment

Investment and growth. Neoclassical theory predicts a positive relationship between capital inflows and growth. This theory argues that international capital mobility serves several purposes: it allows countries with limited savings to attract resources for productive domestic investment projects; it enables investors to diversify their portfolios; it spreads investment risk more broadly; and it promotes inter-temporal trade (Eichengreen et al. 1999). Therefore, the theory generally favours open or liberalized capital markets, with the expectation of more efficient allocation of savings, increased possibilities for diversification of investment risk, faster growth, and the dampening of business cycles. Some neoclassical economists however argue that liberalized financial markets in developing countries can be distorted by incomplete information, large and volatile movements in and out the system, and many other problems leading to sub-optimal consequences that are damaging for general welfare (Lin, 2011).

The new structural economics approach considers foreign direct investment in a positive way as well. According to this approach, FDI is a more favourable source of foreign capital for developing countries than other capital flows because it is usually targeted toward industries consistent with a country’s comparative advantage. It is less prone to sudden reversals during panics, and does not generate the same acute problems of financial crises as do sharp reversals of debt and portfolio flows. In addition, direct investment generally brings technology, management, access to markets and social networking, which are often lacking in developing countries but are crucial for industrial upgrading. Thus, liberalizing inward direct investment is considered an attractive component of a broader development strategy.

Notwithstanding these theoretical statements, there is little evidence of a clear relationship between capital inflows and growth. Since Rodrik (1998), who found no correlation between capital account liberalization and growth, large amounts of time have been spent on efforts to identify or discredit the existence of an effect.

Though the economic literature lacks consensus on the benefits of financial globalization, foreign direct investment is believed to be one of the most important channels through which financial globalization benefits the economy (Prasad et al., 2003; Kose et al., 2006).

FDI determinants. FDI flows into host countries are determined by a variety of factors.

Among these factors, the literature indicates that the key determinants in terms of location are the classical sources of comparative advantages of the host country. Firms choose the investment site that minimizes the costs of production. Among these kinds of determinants there are: the physical and technological infrastructure of the host country; the cost and quality of resources and other inputs and business facilitation measures, such as FDI promotion, including incentives to foreign investors. The riskiness of investment in terms of the economic and political environment also affects investment decisions. In this respect, greater macroeconomic and political stability of the host country could attract more foreign investment (Bevan and Estrin, 2000). In this vein, Bengoa and Sanchez-Robles (2003) found that the overall level of economic freedom, economic stability and the level of human capital are important determinants of FDI for subsets of Latin American countries. Trevino and others (2002) examine the effects of three types of reforms—microeconomic, macroeconomic and institutional—on FDI inflows in seven Latin American countries. They report that the most significant factors explaining FDI inflows are the level of GDP, privatization, and CPI inflation proxying macroeconomic stabilization (Campos and Kinoshita, 2008). Prasad et al. (2003) argue that financial globalization may bring about positive economic benefits in developing countries under certain preconditions. These preconditions include sufficiently developed financial markets and good institutions, and macroeconomic policies. Similar views are reiterated by Kose et al. (2006). Host country institutions also influence investment decisions because they directly affect business operating conditions. The cost of investment consists not only of economic costs but also other costs such as bribery and time lost in dealing with bureaucracy and local authorities (Campos and Kinoshita, 2008).

It is also argued that FDI and trade openness can be positively related as FDI flows can be considered complementary to trade flows (Caves, 1992; Singh and Jun, 1996). If trade flows are complements to FDI flows, then we should expect more FDI to be directed to the countries with more liberalized trade regimes. On the other hand, if FDI is basically intended for tariff-jumping purposes, more restrictive trade regimes may be able to attract more FDI (Campos and Kinoshita, 2008).

In general, the OECD identified ten broad policy areas where host country policies affect investment decisions: investment policy, investment promotion and facilitation, trade policy, competition policy, tax policy, corporate governance, policies for promoting responsible business conduct, human resource development policy, policies related to infrastructure and financial sector development and to public governance (OECD, 2006).

Investment liberalization policy. One primary condition to attract FDI is the adoption of an investment liberalization policy. Within the context of efforts by governments to create an environment which is attractive to investors, a key challenge consists in identifying and eliminating unwanted barriers to entry. These barriers consist of a wide array of factors that discourage investment. An important role for government is to identify and try to eliminate or reduce unnecessary barriers to entry that discourage investment. However, FDI liberalization is a necessary, but not sufficient host country determinant of investment, and other determinants have to come into play for investment to flow into a country. A liberal policy framework promotes FDI in the sense that it enables foreign companies to invest in a host country. However, there is no guarantee that investment will actually occur (UNCTAD, 2009). If a host country does not have some basic economic determinants in place it is unlikely that promotional efforts or incentives will be successful in attracting significant FDI. Successful implementation of economic reform by the host government provides a positive signal to investors, as progress toward a stable macroeconomic environment implies less investment risk and uncertainty (Campos and Kinoshita, 2008). Alfaro and others (2004) examine the links between FDI, financial development, and economic growth and found that countries with better developed financial markets are able to exploit FDI more efficiently. Similarly, Prasad and others (2007) also argue that the absorptive capacity measured by financial development of the recipient country is a precondition to the benefits of foreign capital inflows to higher growth. Campos and Kinoshita (2008) support and extend those findings by suggesting that financial reform is not only more important than financial development but also that financial reform is more important than other structural reforms.

The current economic and financial crisis has brought into discussion the dynamics of international investment relations and emphasized the emerging trend towards a review of liberal FDI policies. Among other matters, questions related to prudential measures, balance of payments exceptions and safeguards are being discussed. In particular, it is pertinent to underline the need to adequately reflect a proper balance between predictability and stability on the one hand, and flexibility to regulate investment on the other hand (UNCTAD, 2009). Since the mid-1980s, most developing countries have opened their markets to foreign investment in an attempt to benefit from the development input that these investments can generate for host countries. Transition economies have joined in this trend successively. Consequently, these countries replaced previous restrictive and controlling policies and institutions with new ones aimed at attracting FDI. Thus, many developing countries and countries in transition have reduced – to various degrees –restrictions on FDI entry, improved

the standards of treatment and protection of foreign investors and eased or eliminated restrictions on their operations. The process of opening up to FDI and establishing enabling frameworks for FDI vastly accelerated during the 1990s and continues today. However, the debate about whether developing countries—with their different degrees of economic, financial market and institutional development—can benefit from removing their remaining barriers to the free flow of capital is still open.

4.4.3 Competition

Competition policy and growth. Competition policy is the combined effect of all government policies that influence the level of competition as a positive tool regulating the market economy, including measures against restrictive business practices and unfair business practices. Contents of the policy are classified into market structure, market behaviour, and market performance.

The primary objective of competition policy is to enhance consumer welfare by promoting competition. Economic efficiency is generally enhanced by encouraging competition (Brooks, 2005). One of the key links between competition policy and growth has been the role that competition policy plays in increasing economic efficiency, both static and dynamic. Both theoretical and empirical research in recent years has emphasized this role (Cook et al., 2007). Competition gives firms continuing incentives to make their production and distribution more efficient, to adopt better technology and to innovate. These sources of productivity improvement lead to growth (OECD, 2008).

Where competition policy is part of an open and well-regulated economy, it can help encourage both domestic investment and FDI, because it encourages investor confidence by setting a consistent framework within which the business sector operates. The efficient use of resources is especially crucial in the development context where resources are particularly scarce (OECD, 2005).

The main static effects of competition are to reduce the ability of firms to raise price above marginal cost and to ensure that firms produce at the lowest costs. The dynamic consequences of competition can include incentives to innovate, to imitate, and to invest in the development of new technologies and know-how.

Competition policy reinforces economic efficiency by preventing or providing remedies for market structures and business practices that weaken the degree of inter-firm rivalry in markets. Competition policy also promotes good governance in the corporate sector as well as in governments by diminishing the opportunities for rent-seeking behaviour and the corruption that often accompanies it. Competition law and regulatory tools are invoked mainly to regulate firm behaviour and market failures.

Opening markets alone is not sufficient enough a step for countries to reap the full benefits of competition. Firms will still find incentives to engage in anticompetitive practices, so policies to promote and protect competition are now prominent on the policy agenda of a country. These competition policies are important both in public sector management where, for example, public utilities may have characteristics of natural monopolies, and in private sector development. They ensure that the benefits of competition help promote the international competitiveness of a country's firms as they encounter the discipline of connecting to the global economy (Brooks, 2005).

Competition policy plays an increasingly important role within the context of the global development agenda (also due to the pressure by major developed countries). During economic transition or reforms, the benefits of trade reform and developing a market economy are magnified when most restrictions on competition are removed. This important lesson has motivated measures aimed at promoting competition in a number of developing economies, including China (which has firm plans to develop and implement a new competition policy), India (where competition policy has been revised and expanded) and Vietnam (where a new competition policy was adopted in late 2004). In China and Vietnam, stringent competition legislation is considered "a constructive step toward the development of a market economy and a defensive measure to level the playing field between domestic firms and foreign-invested firms" (Brooks, 2005).

11. 4.5 Successful complementary policies and reforms and means of implementation and enforcement

According to the Growth Diagnostics approach suggested by Hausmann, Rodrik, and Velasco (2005), identification of the "binding constraints" in each country is key to promote a serious process of reform. This framework highlighted the inability of governments to reform everything and stressed the need to prioritize reforms. More recently, McMillan and Rodrik (2011) have underlined that the speed with which the structural transformation takes place is the key factor that differentiates successful countries from unsuccessful ones. Another key aspect to achieve successful reform process is to promote consistency and coherence between competition, industrial, trade, and investment policy regimes.

Concerning the competition policy implementation, it has been emphasized that in most developing countries, the interests of consumers are poorly represented and are weaker than those of producers. In this regard, it can be crucial that the competition authority adequately represents consumer interests and has independence from ministries or other agencies representing producers. Organizing and promoting consumers' rights creates a real force for ensuring the promotion of competition. At the same time, the implementation of competition policy serves to reinforce consumer rights and the competition culture that helps to ensure that the benefits of competition will be realized. Effective competition policy depends on

active and fair enforcement. If first-generation reforms (that lay the basis for macroeconomic stability and institutional infrastructure) are top priority for transition countries or at early stages of market development, considering competition policy issues at an early stage can help to ensure that they mesh well with other policies (Brooks, 2005).

But the design and enactment of laws is not enough; what matters is efficient enforcement. For example, while Thailand has had a competition law for years, its enforcement has been weak and generally ineffective due to lack of adequate resources, political will and independence of the competition authority. The challenge in the coming years will be to design practices and institutions that are robust, fair and transparent, especially in societies with a history of close business–government relations (Brooks, 2005).

A positive example of enforcement is in Korea. To reinforce the prestige and credibility of the competition enforcement agencies, the government endowed the Korea Fair Trade Commission with significant powers to tackle anticompetitive practices and to force the economic restructuring of large business groups. The chairman of the Commission answers directly to the prime minister and sits in the cabinet of the national government. These institutional arrangements provide the chairman of the Commission with a mandate as well as the means to help ensure that any new legislation will be consistent with the principles of competition (Brooks, 2005).

Links between policies. The benefits of competition are greater with strengthened property rights, a credible legal and judicial system, trade and investment liberalization, and infrastructure expansion. Korea's experience showed that trade liberalization does not automatically lead to a more competitive domestic market, and that better outcomes are achieved when trade and investment liberalization are accompanied by measures to increase competition. This highlights the importance of competition from an early stage of economic growth and of incorporating competition policy into the broader economic policy framework (Brooks, 2005). For foreign investors the existence of a competition policy indicates some commitment by the government to ensure a level playing field among domestic and foreign investors and adds transparency to the commercial market. Competition policy is therefore complementary to other policies, and liberalization and privatization policies cannot be expected to contribute automatically to economic growth if competition policy and its related institutional infrastructure are lacking. The complementarities of competition and competition policy with trade, foreign direct investment and other policies highlights the need for active competition advocacy to ensure that other legislation and regulations are compatible with the goals of competition policy (Brooks, 2005).

CONCLUSION

Since the beginning of the century, numerous empirical studies have confirmed the assumption that trade integration and trade liberalization within developed countries as well as developing countries has risen sharply, even though this trend started many decades earlier. However, this conclusion, confirmed by stylized facts and empirical estimations depends in practice upon analytical indicators used to measure the openness of an economy, trade integration and trade liberalization. One of the major outcomes of the recent literature is that one cannot proceed with any analysis using a single indicator to obtain a relevant measure of economic openness and trade distortions. It is necessary to use different indicators. In addition, it is clear that the choice of indicators used will influence the assessment of trade liberalization, trade integration and the impact of the many economic policies needed to influence trade situation.

However, despite the diversity of indicators and theoretical models, a major conclusion is that developing countries are increasingly integrated into world trade. Trade barriers, which are not necessarily related to the imposition of tariffs and non-tariff barriers still do remain. They may result from the effects of the economic policies adopted by certain countries. The dynamics of the global economy has led to an important change in the impact of the global context of developing countries. The international trade and financial environment has greatly changed the standing of developing countries even though the impact of economic policy decisions has been limited. Despite the unfavourable international situation, however, developing countries have increased their tariff reduction to balance for the low impact exerted by the decisions of international political and trade organizations. However, the literature shows that the consequences of globalization for each economy depend on how each one is linked to the global economy. Therefore, many nations, including developing countries are increasing their trade agreements between each other. This ultimately affects the effectiveness and impact of trade policies. Moreover, the agreements that these countries make, appear to have a greater effect when they include nations that share common characteristics, as opposed to countries with more pronounced differences, such as large gaps in GDP or differences in comparative advantages.

This report concludes that trade liberalization, which involves amongst other policies, lower trade tariffs, can increase growth in developing countries. However, trade liberalization alone is not sufficient to ensure long lasting growth for a developing country. Despite the fact that the theory describes in detail the conditions which influence economic growth, practice has shown that these conditions are not always met. This report confirms the hypothesis that countries do not necessarily experience inclusive growth with high levels of employment and poverty reduction when they integrate more closely with global markets. The report shows

that there are specific economic conditions which need to be met for inclusive growth to become a reality. These fundamental economic conditions are not the same in every country. The labour market situation, the affect of wages and prices on the labour market, the institutions in the country and the country's comparative advantage all play a significant role. Not only does trade liberalization not necessarily favour inclusive growth, but it also does not ensure poverty reduction. In fact, the literature indicates that even if the eradication of poverty is a clear objective of major international institutions, the risk that a developing country will enter into the poverty trap cannot be ignored. Furthermore, the diversity of the economic and political situation amongst developing countries suggests that further research needs to be conducted if were are to better understand the mechanisms which affect a country's ability to achieve inclusive growth and ensure poverty reduction.

The report clearly shows that many studies emphasize the need to adopt complementary policies to promote development and inclusive growth as well as to increase the gains from trade liberalisation. Some policies are more general and some are more focused on benefiting the poor. The most recent literature shows that those complementary policies should include development of a regime that encourages investment and competition, develop openness to foreign direct investment and should include macroeconomic policies that encourage stable prices and a competitive real exchange rate. However, the report shows that the main difficulty lies in the timing of policy implementation, even if there are well-known welfare gains to be reaped from freer market economy. The report shows that while increasing the markets' flexibility is a major factor leading to increased productivity, shock therapy has a disruptive effect for markets which are better suited to gradualist policies if the domestic authorities are willing to implement complementary policies and reforms. Currently, the latest research appears unable to give a clear assessment of how policies should be sequenced in specific developing countries.

Finally, international trade is not limited only to the exchange of agricultural and manufactured goods. The report shows that trade of services account for an increasing share of the current international trade trends and can promote productivity growth, high levels of employment and inclusive growth. However, it is necessary that developing countries should be aware of the risks involved in dropping their barriers to trade in goods as well as services in the pursuit of domestic growth. The academic literature posits that the sequencing of policy reforms is very important in regards to liberalization of services, because the service sector is often regulated to a greater extent than the manufacturing sector. This being the case, a broader and larger set of policies are necessary, this is however an area which requires more academic research. The report also shows that FDI can be an important source of growth, especially if the investment is directed towards areas where the country already has a comparative advantage. This implies the need to develop broader policies which focus on the

liberalization of investment. There is currently no consensus in the literature on the practical details of such liberalization nor on the time scale involved in seeing its benefits.

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APPENDIX - Trade liberalization and trade integration: What do they mean and how to measure them

Trade liberalization: The debate around trade liberalization and its measurement has been extensively investigated since Krueger (1978) and Bhagwati's (1978) seminal works. These authors provide the first systematic attempt at formally classifying trade regimes.[27] However, they adopted a very broad conceptualization of trade liberalization as "*any policy that reduces the degree of anti-export bias*".[28] It is worth noting that this definition is heavily grounded on the empirical identification of the anti-export "bias". Moreover, this notion of liberalization can coexist with high tariffs (Edwards, 1993). Papageorgiou et al. (1991) provide a more convenient definition of trade liberalization as "any change which leads a country's trade system toward *neutrality* in the sense of bringing its economy closer to the situation which would prevail if there were no governmental interference". This definition is still very broad since it comprises virtually any process (deliberate or not) able to enhance "the degree of neutrality of an economic system". According to McCulloch et al. (2001), the real issue in trade liberalization is the extent to which international trade determines local prices. Hence, they provide a third definition of trade liberalization "*as the extent to which international trade determines local prices*". In fact, if we made the small country assumption (which is plausible when we talk about developing countries, but not when we are looking to the fast growing emerging economies), the degree of co-movement between international and local prices can be considered a good proxy of the size of local distortions to be removed. This is relevant since in many sectors and in many countries, the main price distortions result from indirect policies, such as inappropriate exchange rate valuation or administrative or institutional constraints on prices, rather than through commodity taxes, such as tariffs and export taxes. Insofar as trade reform incorporates the liberalization of such indirect measures, it may induce large price changes, even if the liberalization of tariffs is in itself rather modest[29].

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[27] According to Krueger and Bhagwati, trade liberalization has five different phases: Phase I is characterized by across-the-board imposition of quantitative controls, usually associated with a balance of payments crisis; Phase II by a more complex and discriminatory control system, increasing the anti-export bias of the regime; Phase III is the beginning of the liberalization process and is characterized by the implementation of a (nominal) devaluation and relaxation of some quantitative restrictions (QRs); Phase IV is characterized by further steps towards liberalization, through the replacement of quotas by tariffs are implemented. In Phase V the economy has become fully liberalized: current account transactions are fully convertible and QRs are not used any longer. While the first two phases characterize an illiberal trade system, Phases III through V represents different stages in the movement towards free trade.

[28] According to Krueger and Bhagwati (1978) trade orientation was measured by the degree by which the protective (and incentives) structure in a country was biased against exports. A formal index of the degree of bias was defined as the ratio of the exchange rate effectively paid by importers (EERM) to the exchange rate effectively faced by exporters (EERX). If this ratio is greater than one it is said that the trade regime is biased against exports.

[29] Trade liberalization and trade integration are, generally speaking, separate issues from, "economic liberalization". Interest in the latter issue has been renewed recently by the EC since it poses it as a pre-requisite to membership for the Central

Trade integration: Trade integration - i.e., the increase a country's participation in world markets - is a key component of the wider process of economic integration. It comprises the gradual removal of obstacles to the factors of production's movement as well as the harmonization of the main economic sectors. The process of trade integration can have a discriminatory or a non-discriminatory nature. In the first case, it is driven by multilateral trade policies carried out under the supervision of the World Trade Organization. In the latter case, it is carried out by national deliberate policies and it is driven by preferential agreements among groups of countries (but it can have a bilateral nature too), normally but not necessarily characterized by a regional nature. It is apparent that a true understanding of the above definitions is essential before drawing any critical assessment on the conclusions carried out by applied literature, and the subsequent choices for policymaking. For instance, while Edwards (1998) argued the presence of a positive association between trade and growth to be robust to the measure of openness applied, Rodriquez and Rodrik (2001) claim that simple measures of trade barriers tend not to enter significantly in well-specified growth regressions, regardless of time periods, subsamples, or the conditioning variables employed.

Standard measures of trade openness: McCulloch et al. (2001) provide a comprehensive list of standard measures of trade openness (see table 2.1).

Eastern European Countries (CEECs)' candidates. In this context, the EC linked the degree of "economic liberalization" of economies in transition to the presence of a "functioning market economy" such as an economy where prices of goods and services are determined by the market and there is an enforceable legal system, including property rights, actually in place. Despite the fact that in the real world, market economies do not exist in pure form, it is broadly acknowledged that macroeconomic stability and consensus about economic policy enhance the performance of a market economy, while a well-developed financial sector and the absence of any significant barriers to market entry and exit improve its efficiency.

Table 2.1 Measures of openness

Measure	*Definition*
Trade dependency ratio	The ratio of exports and imports to GDP
Growth rate of exports	The growth rate of exports over the specified period
Tariff averages	A simple or trade-weighted average of tariff levels
Collected tariff ratios	The ratio of tariff revenues to imports
Coverage of quantitative restrictions	The percentage of goods covered by quantitative restrictions
Black market premium	The black market premium for foreign exchange, a proxy for the overall degree of external sector distortions
Heritage Foundation index	An index of trade policy that classifies countries into five categories according to the level of tariffs and other (perceived) distortions
IMF index of trade restrictiveness	A composite index of restrictions on a scale of 0 to 10
Trade bias index	The extent to which policy increases the ratio of importable goods' prices relative to exportable goods' prices compared to the same ratio in world markets.
The World Bank's outward orientation index	An index that classifies countries into four categories depending on their perceived degree of openness
Sachs and Warner index	A composite index that uses several trade-related indicators: tariffs, quota coverage, black market premia, social organization and the existence of export marketing boards
Leamer's openness index	An index that estimates the difference between the actual trade flows and those that would be expected from a theoretical trade model

Source: McCulloch et al. (2001)

Standard Measures of Non-Tariff Measures (NTMs): Ferrantino (2006)

The "handicraft" price gap method

This method estimates the degree to which NTMs raise domestic prices above international prices in the countries imposing them. It estimates a "price gap" between domestic prices and international prices by comparing prices of goods affected by an NTM with goods unaffected by an NTM. In some sense this is an ideal method. It can be used to incorporate detailed specific information about the workings of policies, and gives results in terms of a "tariff equivalent" (ad valorem percentage change) that can be compared with tariffs and used in simulation models. Price data are not always readily available for all products and countries of interest. It is often difficult to make two price measurements for the same good and be confident that one fully reflects the effects of an NTM while the other is unaffected. Adjustments need to be made for such factors as transport costs and wholesale and retail margins. It is costly or difficult to make comparisons for many countries or policies this way.

Price-based econometric methods

These methods attempt to incorporate the intuition behind the price-gap method and extend it to many countries and products simultaneously. They take advantage of systematic reasons prices are higher in some countries than others to identify the extent to which high prices for some countries and products may be attributable to NTMs. Because these methods are capable of handling larger quantities of data than the "handicraft" price-gap method, they offer the promise of being able to compare the effects of NTMs more broadly, in order to identify which categories of goods they are most applicable to, using a common method for all countries and products. Their results can also be expressed as ad valorem tariff equivalents and used in simulation models. Price data is not always readily available for all products and countries of interest. Because a common method is used for all products and countries, a good deal of product- and policy-specific detail must be set aside. Thus, results for

specific cases may diverge widely from those which would have been obtained using a case-by-case analysis. Choices about the econometric specification may influence the results obtained.

Quantity-based econometric methods

These methods look for evidence that the presence of NTMs leads to lower trade flows, or that the presence of trade facilitating policies or practices leads to higher trade flows. Statistical analysis of trade data is employed, including both gravity models (emphasizing country size and economic distance between countries as factors explaining trade), factor-content models (which emphasize differing availability of resources in different countries), and models blending features of gravity models and factor-content models. Trade data on quantities are much more abundant and more internationally standardized than price data, so that in principle all products in all countries can be analyzed. Recent advances in methods offer hope for future progress. The effect on trade flows may be of more direct interest to policymakers than the effect on prices. The general limitations of econometric work (using common methods may ignore product-specific information, choices about econometric specification may affect results) apply to both price based and quantity-based methods and may be more severe for quantity-based methods. Results from quantity-based methods can only be expressed as tariff equivalents or price gaps by use of additional assumptions and information.

Simulation methods

Simulation models contain a representation of economic conditions consistent with basic economic principles. They have been used widely to simulate the effects of changes in tariffs on trade flows, prices, production in specific industries and sectors, GDP, and economic welfare. General equilibrium models represent the linkages between industries and countries. Partial equilibrium models are used to analyze specific narrowly-defined products or sectors in cases for which some of the linkages can be set aside. Simulating the effects of NTMs requires that a tariff equivalent or similar measure be estimated by one of the methods discussed above. By taking advantage of economic theory, simulation methods are able to produce estimates of a much wider variety of impacts of changing NTMs than other methods. The results obtained from such methods usually have a clear explanation in terms of causal factors. Some of the benefits of larger general equilibrium models require a significant up-front investment of time and effort. While the results obtained may be sensitive to certain assumptions, sensitivity analysis can usually be performed to find out how important these assumptions are.

Source: Ferrantino (2006)

Applied vs theoretical literature: The present report is mainly focused on applied literature on international trade. However, trade theory should be acknowledged as a fundamental background. In this respect, it is important to underline that the various strands of trade theory that take turns over time should not be seen as alternative views of trade phenomena, but rather as additional and progressive pieces of the international trade puzzle. The ultimate aim of the trade theory (and of its different strands) is to provide an answer to the following key question: why do countries trade? (i.e., what are the determinants of trade) and the related issue of what are the "gains from trade". Each strand of the literature complements the others, providing additional explanations on this key issue (e.g., Ricardo stressed differences in technology; Heckscher-Ohlin relative factor endowments; New Trade Theories scale economies, size and location; New trade theory organizational choices of firms, trade costs, FDI, etc. – see the box below). They provide neither alternative views of the same phenomena (e.g. New Trade Theories complement traditional theories adding the role of scale economies, New Trade Theories by adding the role of heterogeneous firms and so on and so forth) nor different measures or indicators associated with different strands of the theory.

Box 1 – Overview of Trade Theories

Model	Determinant of trade	Key assumptions	Original idea
Ricardian model	Differences in technology	Labor is the only scarce factor of production, all occupations pay the same wage, labor unit requirements are constant.	Henry Martyn, *Considerations upon the East India Trade* (1701) David Ricardo, *The principles of Political Economy and Taxation (1817)*
Heckscher-Ohlin model	Relative endowments of productive factors	Two factors of production (capital and labor), same technology, factor mobility between sectors.	Eli Heckscher (1919) and Bertil Ohlin, *Interregional and International Trade* (1933)
Specific factors model ("Ricardo-Viner")	Factor specificity and endowments	Extension of the Ricardian model with three factors of production (one mobile and two that are specific to a sector).	Ronald Jones (1971) and Paul Samuelson (1971)
Models of trade with imperfect competition / New trade theory	Scale economies, size, location, initial conditions	Increasing returns, differentiated products, imperfect competition (monopoly, duopoly, oligopoly, monopolistic competition)	Chamberlin (1933), Dixit and Stiglitz (1977), Krugman (1979,1980), Brander and Krugman (1980), Helpman (1981)
Models of heterogeneous firms / New new trade theory	Organizational choices of firms, trade costs, relationship between trade and FDI, unbundling, sourcing patterns	Intra-industry heterogeneity of producers, imperfect competition, incomplete contracts, trade in tasks	Bernard, Eaton, Jensen and Kortum (2003), Melitz (2003), Antràs and Helpman (2004), Grossman and Rossi-Hansberg (2006)

Source: academic lecturers

The ultimate goal of the applied literature is to test the feasibility of the theoretical assumptions and conclusions. This implies additional empirical assumptions, as well as the adoption of the most appropriate indicators and econometric methods. Applied research is thus a very compelling exercise for scholars, but essential for policymaking.