

# AFD'S ECONOMIC NEWSLETTER

## The Trade-Growth Relationship

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## EDITORIAL

**A**s this issue of the *Economists' Letter* shows, the link between trade, growth and poverty reduction is approached today in a more realistic, pragmatic way. Until recently, trade liberalisation was regarded as the key to any growth strategy – a view that neglected the complexity and the often idiosyncratic nature of the causal chain between trade and growth.

*It is self-evident that trade and development are linked, since trade is necessary to any productive activity. Development and aid policies should thus continue to emphasise trade promotion, but there are two pitfalls to avoid. The first, in the context of multilateral trade negotiations, consists in giving excessive weight to the international dimension of trade; local and regional trade must be considered as well, and indeed given precedence, unless development is to be regarded merely as the promotion of a few mineral and commodity exports having a primarily international market. The second pitfall is to focus excessively on trade liberalisation, when the main barriers to trade often lie elsewhere: inadequacy of all kinds of infrastructure; weak logistical capacity; poor countries' difficulties in complying with the quality and safety standards that govern access to international markets; the acquisition cost of the information needed for trade development; under-developed financial systems and, more generally, an economic and institutional environment that is often less than favourable to the development of productive activities.*

*Ultimately, aid for trade is nothing other than aid for development. The term "aid for trade" is used, however, to designate more targeted actions to promote the exports of poor countries by helping the latter to overcome some of the above-mentioned barriers. The idea is to support these countries in the Doha Round of multilateral trade negotiations, which is primarily concerned with this link between trade and development (it is known as the "development round"). The Agence Française de Développement devotes substantial resources to aid for trade as thus defined, through financing for road and port infrastructure, support for financial sectors, efforts to bring output up to international standard, corporate upgrading and other activities. The goal is not international trade per se, but economic growth and poverty reduction.*

**Pierre Jacquet**  
AFD Chief Economist

# “ The trade-growth relationship ”

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Trade policy was a central element of the development policies recommended by the “Washington consensus” (Williamson, 1990). Questioning of that consensus led to a broader debate over trade’s role in development, which led in turn to the adoption of strategies focused on poverty reduction and to the Millennium Development Goals (MDGs). In this context, many empirical studies of the trade-growth relationship have been undertaken, with the twin advantages of new analytical tools and international databases <sup>(1)</sup>.

At both the global and country levels, there is no real doubt that a correlation exists between economic growth and trade development. The emerging countries of Asia all based their economic take-off on a strategy of integration into the world economy, and they are now among the world’s biggest exporters. Conversely, the poor growth performance of the least advanced countries (LACs) has been correlated to their gradual marginalisation in world trade: the 49 LACs’ share of world exports is less than 0.5%, and trending down.

The fact that trade and growth are correlated does not necessarily imply, however, that trade liberalisation is a pre-condition, or indeed a sufficient condition, for development. In addition, as noted by Nye, Reddy and Watkins (2002), it is necessary to specify the combination of liberalisation policies considered. Economies such as China, Korea, Taiwan and Vietnam all succeeded in becoming integrated into the world economy because they adopted export-led growth strategies combined with unorthodox trade policies: restrictions on foreign investment, export subsidies, relatively high tariff and non-tariff barriers, etc.

In any case, if a general correlation exists between trade, trade liberalisation and growth (and not solely between trade and growth), then it should be easy to distinguish between countries pursuing an open trade policy, trading

a great deal with other countries and recording high growth rates, from the other countries, i.e. countries having a low level of openness, not well integrated into world trade and recording low economic growth.

There was a wave of enthusiasm for econometric analysis of the link between openness and growth in the 1990s. Sachs and Warner’s (1995) paper on this subject drew a great deal of attention. These authors estimated growth equations over the 1970-1989 period for 122 countries, divided into two groups (closed and open countries). A country was defined as “closed” if it displayed at least one of the following characteristics:

- 1:** non-tariff barriers covering 40% or more of total trade,
- 2:** average rate of customs duty of 40% or more,
- 3:** black market exchange rate premium of 20% or more with respect to the official exchange rate over the period,
- 4:** socialist economic system,
- 5:** state monopoly on main export products.

An economy was defined as “open” if none of these five conditions applied to it at any time during the period. The authors show that open developing countries (DCs) were growing at a rate of 4.49% a year, as against 0.69% for closed DCs: “This suggests that within the group of open economies, both developing and developed, we should tend to observe economic convergence.... The data suggest that the absence of overall convergence in the world economy during the past few decades might well result from the closed trading regimes of most of the poorer countries”. In short, trade liberalisation policies explain growth.

<sup>(1)</sup> The most commonly used international databases include Summers and Heston (1991), Deininger and Squire (1996), WIDER (United Nations) and Povcalnet (World Bank).

## ■ Lowering trade barriers is not enough

This article and others in the same vein come up against at least four types of problems (Winters, 2004; Winters, McCulloch and McKay, 2004):

- **the definition of “openness”** refers to a liberal trade regime (low customs duties, few non-tariff barriers, etc.) and the indicators used all relate to trade policy (volatile real exchange rate, black market exchange premium, export monopolies, etc.);
- **measuring openness** raises many problems, starting with the aggregation of customs duties, conversion of non-tariff measures into tariff-equivalents and verifying the credibility of, and adherence to, trade policies. Aggregation of customs duties is particularly problematic because these indicators are generally not well correlated and because the results are sensitive to the methods used (Siroen, 2001);
- **the specification of the growth equations and causal relationships** has been criticised, notably by Brock and Durlauf (2001), who argue that the usual specification for growth equations cannot be used to estimate the effects of openness (correlation between the determinants of growth, etc.). Moreover, the direction of the causal relationship is unclear: does trade liberalisation cause growth, or the other way around?
- Lastly, it is difficult to **identify the effect of trade policies**. For example, Baldwin (2003) observes that these policies are never implemented in isolation, and Winters (2004) argues that if they are to have a lasting effect they must be combined with other policies, such as measures to promote investment and human capital.

This last problem had not escaped Sachs and Warner. Though they acknowledge that trade liberalisation is only one component of reform programmes, they regard it as a *sine qua non* condition for reform <sup>(2)</sup>. This makes it both convenient and meaningful to evaluate a country's reform programme in terms of progress in its trade liberalisation policy. In that case, however, Sachs and Warner's paper must be placed within the same framework as those that measure the growth impact of structural reform policies. The problem is that this literature reaches no firm conclusion, as some authors find that DCs having undergone structural adjustment showed lower average growth than the other DCs (Barro and Lee, 2002; Hutchison, 2002; Przeworski and Vreeland, 2000).

Studying the link between trade and income level aims to resolve, by construction, the problems involved in defining and measuring indicators of openness, since in this case the volume of trade is regarded as a proxy for the impact of trade policy. However, this once again raises the question of the causality between trade and growth.

Rodriguez and Rodrik (2000) note that openness as measured by the trade-GDP ratio is endogenous: large countries will have a low ratio, while smaller countries will tend to be more open. This relationship is verified in a dynamic analysis. Taking a different tack from other studies on this subject, Rodrik (1998) shows that the mediocre performance of African countries is the consequence of their economic difficulties, rather than vice versa.

To adjust for the endogenous nature of this measure of openness, Frankel and Romer (1999) estimate the relationship between the openness ratio and long-term per capita GDP, considering only the proportion of openness defined in this way, which is independent of the level of income. They proceed in two steps.

1. First, they estimate a bilateral trade equation using a gravity model with demographic and geographic explanatory variables. Aggregation of this equation for a given country provides an estimate of the geographical component of its trade.

2. Next, they estimate an equation in which the geographical component of trade is an instrumental variable, with the explanatory variables being the country's population and surface area. They conclude that an openness ratio one percentage point higher would raise GDP by 0.5 to 2 points in the long term.

Dollar and Kraay (2004) conduct a similar exercise on a sample of 100 countries during the 1980s and 1990s. The equations are estimated using first differences, with the dependent variable being the variation in the log of per capita income. To eliminate fixed effects, the explanatory variables are the lagged variations in income over the preceding decade and the variation in the openness ratio, measured as in the studies discussed above. The authors estimate that doubling the GDP share of trade would increase income by 25% in 10 years.

<sup>(2)</sup> Trade liberalisation is a *sine qua non* condition for reform because it establishes direct links between the domestic economy and the world economy, and because it forces the government to take action on other components of the reform programme, under pressure from international competition.



This paper has been criticised on several grounds:

- According to Rodrik (2000)<sup>(3)</sup>, institutional quality is a variable that determines the levels of both income and trade. If the quality of institutions changes over time (which is probable, as the data cover two decades), it will influence these two variables, and this influence will erroneously be attributed to the effect of trade. Any other variable specific to a given country that is omitted from the equation obviously raises the same type of problem.
- Rodrik (2000) and Nye, Reddy and Watkins (2002) put forward an additional argument: fixed country-specific factors that are unrelated to trade (such as geography and institutions) can also have different effects on trade volume at different periods. For example, structural change in the world economy or national economy can modify the effects of these factors; similarly, a decline in communication or transport costs can reduce the influence of geography on trade.

The “convergence clubs” approach developed by Ben-David (which is more rigorous than the approach used by Dollar and Kraay), is not subject to this criticism regarding causality (Ben-David, Nordström and Winters, 2000). In this approach, 25 groups of trade partners are defined, and a convergence equation is estimated for each group. Some convergence occurs in almost all the groups (unless the groups are randomly selected), but such convergence is observed only for the industrialised countries in the sample, not for any of the DCs studied.

From the economic policy standpoint, the operational value of these results is thus limited. They point to the conclusion that several different policies can be used – instead of mere lowering of trade barriers, as in the past – without really telling us much about their relative effectiveness. For example, there is no reason to think that a drop in transport costs or a rise in world demand directed towards a given country will have an effect any different from that of reducing tariff protection (Rodriguez and Rodrik, 2000).

## ■ Re-establishing the link between trade promotion and poverty reduction

This literature review suggests that a more realistic attitude is needed concerning the impact of trade on growth. Despite the successes of the emerging Asian countries, it is now accepted that the growth model based on production and export of labour-intensive products, recommended until recently by the Bretton Woods institutions as a universal solution for raising countries out of poverty, is invalid. The World Bank now recognises that trade liberalisation policies have had mixed results for the poor (World Bank, 2000). More generally, the costs of trade liberalisation, the obstacles that may prevent countries from reaping its benefits and the fact that certain countries or population groups will lose from liberalisation are better understood today (Stiglitz and Charlton, 2005). In view of these conclusions, it is regrettable that the Bretton Woods institutions evade these issues in the context of poverty reduction strategies (Cling, Razafindrakoto and Roubaud, 2003). They do not regard trade policy as an instrument for fighting poverty and consider that deepening free trade at the international level (for agricultural products in particular) is the best means of stimulating growth and poverty reduction in DCs (World Bank, 2005). Achieving a better understanding of the relationship between trade, growth and poverty, and of giving more consideration to this relationship in policy formulation, is more important than ever.

<sup>(3)</sup> Rodrik’s critique related to an earlier version of the paper, but is still applicable to the version published in 2004.

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# Aid for trade in developing countries: complex linkages for real effectiveness

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The World Trade Organisation (WTO), which governs virtually all of world trade, encourages its 151 member countries to adopt common rules to minimise the risk of "trade wars". In theory, the greater the number of countries that reform their trade policies, the greater the benefits. Donors thus have an interest in helping countries to join the WTO and reform their trade policies. However, accession to the WTO is costly, and most member countries carry very little weight in the negotiations. Despite tariff preference systems and professed market opening <sup>(5)</sup>, trade liberalisation has not brought the expected results. The least developed countries (LDCs) are falling further behind in terms of competitiveness; some developing countries (DCs) are making no progress on integration into the global market; and despite the efforts of their governments, inflows of foreign direct investment (FDI) are not about to arrive.

Recognition of this situation has initiated far-reaching changes in the formulation of aid policies. Aid for trade (AfT), which was officially endorsed at the 6th ministerial conference in Hong Kong in December 2005, is increasingly pointed to as a promising new tool for official development assistance (ODA).

## What is aid for trade?

AfT is a component of global ODA, just as food aid is, accounting for 21% of total ODA in 2006, or about \$22 billion. The purpose of AfT is to strengthen the trade capacity of DCs, particularly the LDCs. It can be broken down into six categories.

Two of these categories (trade policy and regulations, trade development) involve traditional forms of aid, namely technical assistance and trade capacity building. These are listed in the joint WTO/OECD Trade Capacity Building Data Base (TCBDB <sup>(6)</sup>). The other four forms of AfT are concerned with trade-related infrastructure, building productive capacity, trade-related adjustment and other trade-related needs.

<sup>(4)</sup> This article is based on AFD Working Paper 57 (January 2007), by Marilyse Huchet Bourdon, Anna Lipchitz and Audrey Rousson.

<sup>(5)</sup> The member countries have pledged to reduce customs duties on goods.

<sup>(6)</sup> <http://tcbdb.wto.org>. <http://oecd.org/dac/trade>

## ■ Trade policy and regulations

Development projects that seek to facilitate integration into the global trading system by giving DCs better knowledge of trade policy and regulations are classified in the “*trade policy and regulations*” category.

The cost of accession to the WTO is all the higher today because the rules have already been set. Accession to the WTO, monitoring negotiations and implementing the outcomes all require strong analytical capacity, but most countries lack personnel with the qualifications to measure the economic and social impacts of trade agreements. It is difficult to accumulate knowledge in this area because of the high rate of turnover among officials, who leave for better-paid posts. To determine their strategic interests, governments therefore often call on international consultants, whose studies are costly and generally unsuited to the local context. As a logical consequence of their poor understanding of trade issues, DCs do not regard trade as a development tool. This leads them to conclude trade agreements belatedly, and the agreements are not necessarily suitable for them. The need for analytical capacity building was explicitly mentioned in the declaration that opened the Doha Round in 2001. To this end, DCs need to learn to form alliances (for example, through common analytical tools) and to make greater use of the WTO Dispute Settlement Body (DSB).

Compliance with norms and standards poses a considerable barrier to DCs’ integration into international trade. The proliferation of standards is due not only to the increase in global wealth, but also to the reduction of tariff barriers, which has the effect of encouraging countries to raise non-tariff barriers. Research conducted to evaluate the losses due to norms and standards <sup>(7)</sup> always finds that these losses are substantial, though the findings vary from sector to sector.

## ■ Trade-related adjustment

Liberalisation entails immediate costs for DCs. Types of aid classified in the “*trade-related adjustment*” category are aimed at reducing these costs.

Speaking of the long-term gains from liberalisation amounts to asking how liberalisation would improve resource allocation. However, advances in economic analysis and the lessons of history have shown the limitations of such reasoning. Economists are in agreement about neither the global gains from liberalisation nor the distribution of these gains; they take different views depending on the liberalisation scenarios considered and the modelling assumptions made (assumptions concerning production factors, such as the mobility of land and labour, assumptions used to model services, etc.). At all events, a number of studies show that these gains, if any, are small, amounting to less than 1% of world GDP <sup>(8)</sup>. Moreover, they do not necessarily lead to significant poverty reduction and are dependent on the situation of each country (output structure, level of development etc.).

While there is disagreement on the overall impact of liberalisation on DCs, there is no doubt that trade liberalisation entails short-term adjustment costs for these countries. Stolper and Samuelson (1941) <sup>(9)</sup> showed that trade growth can have a considerable impact on income distribution; low-skilled workers in industrialised countries, for example, have a great deal to lose. The costs of trade liberalisation and the obstacles to a liberalisation process that would be profitable for all are better understood today, and the losers are more clearly identified (Stiglitz and Charlton, 2005 <sup>(10)</sup>). Liberalisation entails adjustment costs for both the private sector (e.g. labour markets) and the public sector (loss of tax revenue). The costs of labour market reallocation are particularly high in DCs having a large labour force.

(7) UNIDO (2006), “Capacity-Building to Meet International Standards as Public Goods”, Working Paper.

(8) For a review of the literature on this subject, see the article by J.-P. Cling in this issue. The key works are: Anderson K., Martin W. and Van Der Mensbrugge D. (2005), “Agricultural Trade Reform and the Doha Development Agenda”, World Bank; Fontagne L. and Decreux Y. (2006), “A Quantitative Assessment of the Outcome of the Doha Development Agenda”, Working Paper, CEPII; Polaski S. (2006), “Winners and Losers: Impact of the Doha Round on Developing Countries”, Carnegie Endowment.

(9) Stolper W. and Samuelson P. (1941), “Protection and Real Wages”, *Review of Economic Studies*, vol. 9.

(10) Stiglitz J. and Charlton A. (2005), *Fair Trade for All: How Trade Can Promote Development*, Oxford University Press, New York.

**Table 1:**  
Adjustment costs connected with trade liberalisation

Private sector	Labour	<ul style="list-style-type: none"> <li>• Opportunity cost of unemployed labour</li> <li>• Obsolescence of skills and country-specific forms of qualification</li> <li>• Decline in wages and salaries</li> <li>• Costs of re-qualification</li> <li>• Personal costs (e.g. mental suffering)</li> <li>• Other costs (e.g. rent-seeking behaviour)</li> </ul>
	Capital	<ul style="list-style-type: none"> <li>• Opportunity cost of under-employed or idle capital</li> <li>• Costs of obsolete capital (capital destruction)</li> <li>• Transition costs of transferring capital from one activity to another</li> </ul>
Public sector	<ul style="list-style-type: none"> <li>• Change in the tax base</li> <li>• Social protection expenditures (e.g. unemployment benefits)</li> <li>• Erosion of advantages stemming from preferential trade treatment</li> <li>• Efforts to maintain macroeconomic stability</li> <li>• Costs of implementing trade reform</li> <li>• Concerns unrelated to trade: food security, support for rural areas, environmental concerns</li> </ul>	

Source: Fernandez de Cordoba et al. (2005).

Fernandez de Cordoba *et al.* (2005)<sup>(11)</sup> provide a bibliography of the literature on measurement of adjustment costs. Most of the works listed concentrate on a few specific adjustments, using models developed specifically for this purpose<sup>(12)</sup>. The reason is that general or partial equilibrium models do not capture short-term adjustment costs, as their output consists of long-term results. Moreover, such models are static, providing only a snapshot of the economy before and after the tariff shock, and hence give no indication as to intermediate effects on output and employment. In particular, they do not estimate the duration of unemployment, as they do not always model the labour market, or lack the data

to do so. Lastly, there are few studies of the cost of adjusting to liberalisation in the DCs, and of these, many are *ex post*, descriptive works.

The economics literature (Lippoldt and Kowalski, 2005<sup>(13)</sup> Alexandraki and Lankes, 2004<sup>(14)</sup>) shows that the impact of erosion of tariff preferences<sup>(15)</sup> is very difficult to assess, as it varies with countries' macroeconomic situations, and more specifically with their ability to make budget transfers (and hence their debt/GDP ratios), labour market rigidities and exchange rate systems.

(11) Fernandez de Cordoba S., Laird S., Maur J.J., Seren J.M. (2005), "Adjustment Costs and Trade Liberalization", paper presented to UNCTAD, Geneva, January 2005.

(12) Labour market models estimate these losses at 12% of the gains stemming from liberalisation over the five years following implementation of the trade agreement (Magee S.P., 1972, "The Welfare Effects of Restriction on US Trade", *Brookings Papers on Economic Activity*, 3, pp 645-701) and the duration of unemployment can be as long as 31 weeks (Bale M.D., 1976, "Estimates of Trade Displacement Costs for US Workers", *Journal of International Economics*, no. 6, pp. 245-250).

(13) Lippoldt D. and Kowalski P. (2005), "Trade Preference Erosion: Expanded Assessment of Countries at Risk of Welfare Losses", OECD Trade Policy Working Paper 20, OECD, Paris.

(14) Kostecki M. (2001), "Technical Assistance Services in Trade Policy: a Contribution to the Discussion on Capacity Building in the WTO", ICTSD Resource Paper 2. The international financial institutions have mechanisms to finance the cost to DCs of tariff preference erosion. In April 2004, for example, the IMF adopted a trade integration mechanism (TIM) that it will make available to countries sustaining unforeseeable pressure (such as tariff preference erosion) on their balance of payments. The costs of adjustment could also be borne by existing facilities: the Growth and Poverty Reduction Facility (GPRF) and the Extended Financing Facility (EFF).

(15) Gradual market liberalisation, via reduction of duties imposed on goods from the rest of the world to most-favoured-nation level, has a direct impact on the level of preferential margins.

## ■ Trade-related infrastructure

All AfT relating to commercial transport, communication and energy is classified in the “*trade-related infrastructure*” category.

For many years, the volume and distribution of a country’s international trade were attributed to the presence or absence of barriers, such as customs duties and subsidies. In fact, the determining factor is the cost of trading (Limao and Venables, 2001<sup>(16)</sup>). About half of world trade is transacted between countries no further than 3,000 kilometres apart. For DCs, transport costs can be several times higher than in the developed countries, owing to the distance between markets and suppliers, as well as to infrastructure problems or the geographical situation of some countries. Landlocked countries face transport costs 50% higher than similar economies that have a seacoast, and doubling transport costs reduces trade flows by approximately half.

Apart from high freight costs, problems arise due to the unpredictability of the time required for transport (due to unreliable transport services), which is particularly a problem for landlocked countries. Owing to these uncertainties, a landlocked country should trade less and have lower growth rate than a country with an outlet to the sea (Arvis *et al.*, 2007<sup>(17)</sup>). A day’s delay in delivering goods is estimated to be equivalent on average to a decline of over 1% in trade. In reality, the impact of unpre-

dictability depends on the nature of the good traded (the impact is greater for DCs that trade in perishable products; see Melitz, 2003<sup>(18)</sup>) and on the size of the supplier country (which determines whether it is capable of influencing the world price of the good). There are other barriers to trade, such as corruption, excessive regulation and private sector inefficiency, but they are less important than the lack of reliable, predictable transport services.

Access to world markets thus depends as well, and indeed primarily, on physical constraints. Whence the importance of trade-related infrastructure. According to the model developed by Djankov *et al.* (2006)<sup>(19)</sup>, cutting the transport time from factory gate to cargo ship from 48 to 10 days would increase sub-Saharan Africa’s exports by 10%. At the global level, improvements in port efficiency and customs regimes, as well as rationalised and/or harmonised regulatory policy, can be highly beneficial for trade. International coordination is essential in order to avoid under-investment in transport infrastructure. Advances in port efficiency, regulatory systems and international transport infrastructure bring a relatively greater increase in exports than in imports (Wilson, Mann and Otsuki, 2004<sup>(20)</sup>).

## AFD’s aid-for-trade activities

Apart from the activity of multilateral organisations and trust funds<sup>(21)</sup>, the majority of AfT programmes are designed by bilateral donors. AFD, whose AfT activities amounted to

€139 million in 2006, accounts for about three-fourths of total French contributions (for the first two categories: trade policy and regulations and trade development). This total of

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(16) Limao N. and Venables J. (2001), “Infrastructure, Geographical Disadvantage, Transport Costs and Trade”, *World Bank Economic Review*, 15, pp. 451-79.

(17) Arvis J.F., Raballan G. and Marteau J.F. (2007), “The Cost of Being Landlocked: Logistics Costs and Supply Chain Reliability”, *World Bank Policy Research Working Paper* 4258.

(18) Melitz M. (2003), “The Impact of Trade on Intra-Industry Reallocations and Aggregate Industry Productivity”, *Econometrica*, 71, pp. 1695-1725.

(19) Djankov S., Freund C. and Pham C. (2006), “Trading on Time”, *World Bank Policy Research Working Paper* 3909.

(20) Wilson J.S., Mann C.L. and Otsuki T. (2004), “Assessing the Potential Benefit of Trade Facilitation: A Global Perspective”, *World Bank Policy Research Working Paper* 3224, Washington.

(21) Bilateral and multilateral donors finance projects; they also contribute to certain trust funds used to conduct joint projects. More specifically, to help the LDCs incorporate trade issues into their national development plans and poverty reduction strategy papers, an “Integrated Framework of Trade-Related Technical Assistance for LDCs” was created in 1997, in the wake of the action plan for LDCs. This framework is also used to provide trade-related technical assistance in accordance with the needs identified by the countries themselves (LDCs only). It brings together six multilateral organisations (World Bank, IMF, UNCTAD, WTO, UNDP and the International Trade Centre) and 17 contributors.

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€139 million was used to support 14 projects, with 11% provided in the form of grants and 89% in loans.

For the 2000-2006 period, and the first two AfT categories, 90% of activities were concerned with trade development. AFD engages in very few activities to incorporate trade into poverty reduction strategy papers or to improve education and training on trade. Its involvement in such activities is expected to increase, however; its contributions to UNCTAD and the UN Economic Commission for Africa (ECA) are made for this purpose. In 2003, the ECA set up an African Trade Policy Centre (ATPC) to strengthen trade capacity in Africa. One of the centre's tasks is to build African experts' analytical capacity by providing them with the tools and methods they need. AFD joined this effort by signing a partnership agreement with the ECA in 2007.

**Its goals are as follows:**

- *in the medium term*, to establish *trade policy analysis units* based on teams of experts having benefited from the ECA's capacity building programme,
- to involve these *analytical units* in thinking on development issues, in conjunction with decision-makers,
- *in the long term*, to transform these *analytical units* into centres for the creation, sharing and dissemination of knowledge on economic analysis of trade policies, bringing together government officials and both senior and junior research staff.

The partnership also seeks to bring these analytical units into contact with one another, through regular discussion meetings. A seminar for this purpose was held on 6 February 2008 at AFD headquarters <sup>(22)</sup>.

A sector breakdown of AFD's aid in the **trade development** category shows that this AfT category is channelled to the banking and financial sectors and to agriculture, in different proportions from year to year (in terms of volume, number of projects or percentage for the year). AFD's contributions are primarily directed towards Africa (49.5% of total volume for the 2001-2006 period; 53 projects out of 81), especially sub-Saharan Africa, and to a lesser extent to Asia (37.3% of total volume for 2001-2006; 21 projects out of 81).

If the definition of AfT were broadened to include all six categories, the percentages by category in 2006 would have been as follows: nearly 54% for trade-related infrastructure, 39% for trade development and trade policy and regulations, and 7% for trade-related adjustment.

## ■ How should AfT priorities be set?

All donors agree on the need for trade capacity building and have announced increases in AfT. The European Union will raise its contribution to ? 2 billion annually by 2010. The United States will double its AfT to \$2.7 billion in 2010, and Japan has announced it will contribute \$10 billion over three years. This means that there is a need for harmonisation, one of the actions called for by the Paris Declaration, which in turn makes it necessary to formulate a strategy.

Despite the progress made by the TCBDB, donors do not coordinate well among themselves. Their aid suffers from an overall lack of strategic planning, and their operations are poorly coordinated. As the Integrated Framework had proved inadequate, an "Enhanced Integrated Framework" was launched in 2007.

This strategic framework should make it possible to set AfT priorities on the basis of:

- identification of the needs of beneficiary countries, which can be done using a standard nomenclature;
- the activities and comparative advantages of the various donors, which illustrate their specific features: resources allocated, expertise, priority operational areas, etc.;
- comparison between the needs of beneficiaries and the existing or potential supply of aid, for the purpose of drawing up poverty reduction strategy papers, by classifying the operations of each donor by mode of aid delivery (AfT categories, operating methods etc.) and by country or region.

(22) The discussion papers are available on the AFD website ([www.afd.fr](http://www.afd.fr)), in the section dedicated to the Research Department.

To develop a strategy on the supply side, it is essential that the actual demand for aid be clearly identified. This is not easy, however. To illustrate the difficulty involved, let us consider the example of the Integrated Framework, which was supposed to centralise the AfT needs of LDCs and thus to make the AfT of the various donors more effective. It did not succeed in this, as demonstrated by the fact that, whereas the aim was to encourage awareness of the importance of trade in national development plans, trade is still not sufficiently integrated into these plans.

To identify countries' trade needs, the International Trade Centre is conducting research on indicators to be used to develop nomenclatures for multiple study areas. We have developed a nomenclature for the 50 countries to which AFD provides AfT, drawing inspiration from existing indicators and focusing on the three objectives of AfT. In order for DCs to become integrated into international trade, they need to produce, to have access to world markets and to be able to transport their goods and services. Our analysis is thus based on the five main categories of AfT <sup>(23)</sup>.

**Table 2:**  
Indicators selected for the various AfT objectives and categories

Category in the AfT nomenclature	AfT objective	Indicators selected
Trade development	Support for trade-oriented production	<ul style="list-style-type: none"> <li>• Trade balance</li> <li>• Population growth</li> <li>• Export concentration index</li> <li>• Time required to start a business</li> </ul>
Building productive capacity		
Trade policy and regulations	Support for integration into the world trading system	<ul style="list-style-type: none"> <li>• Evaluation of the need for training in trade negotiations</li> <li>• Share of intra-regional trade</li> <li>• Geographical diversification of imports</li> <li>• Geographical diversification of exports</li> <li>• Share of customs revenue in government revenue</li> </ul>
Trade-related adjustment		
Trade-related infrastructure	Strengthening trade-related infrastructure	<ul style="list-style-type: none"> <li>• Time required for export</li> <li>• Cost of exporting</li> </ul>

For each indicator, each country receives a score from 1 to 4: a score of 1 is assigned to countries most in need of AfT in regard to the variable considered, and a score of 4 to those least in need. The panel of countries is thus divided into four groups (quartiles) for each variable. For each country, the scores were reported for each AfT objective: "Support for trade-oriented production",

"Strengthening trade-related infrastructure" and "Support for integration into the international trading system". The score for each of these aspects was calculated by taking the average of the scores assigned for the variables in each category. The results by country are shown in *Figure 1*.

(23) The category "other trade-related needs" is excluded, as this category has been only sketchily described and has no specific objective.



Figure 1:  
Countries' needs in terms of support for trade-oriented production  
and strengthening trade-related infrastructure

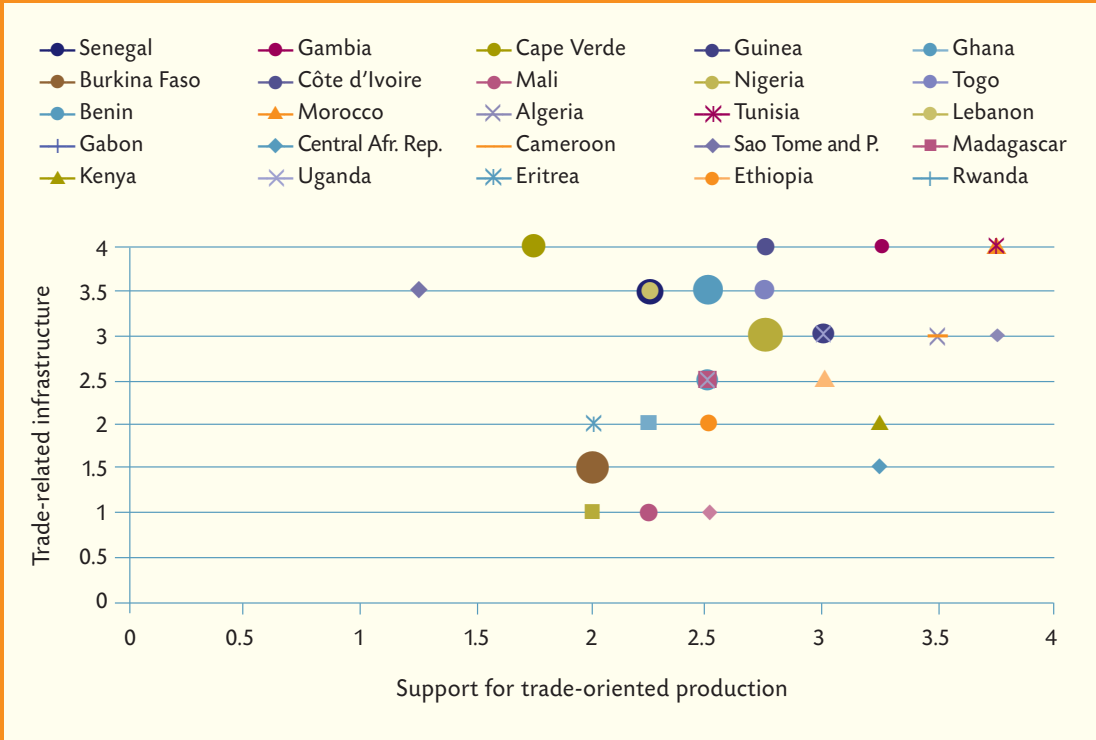
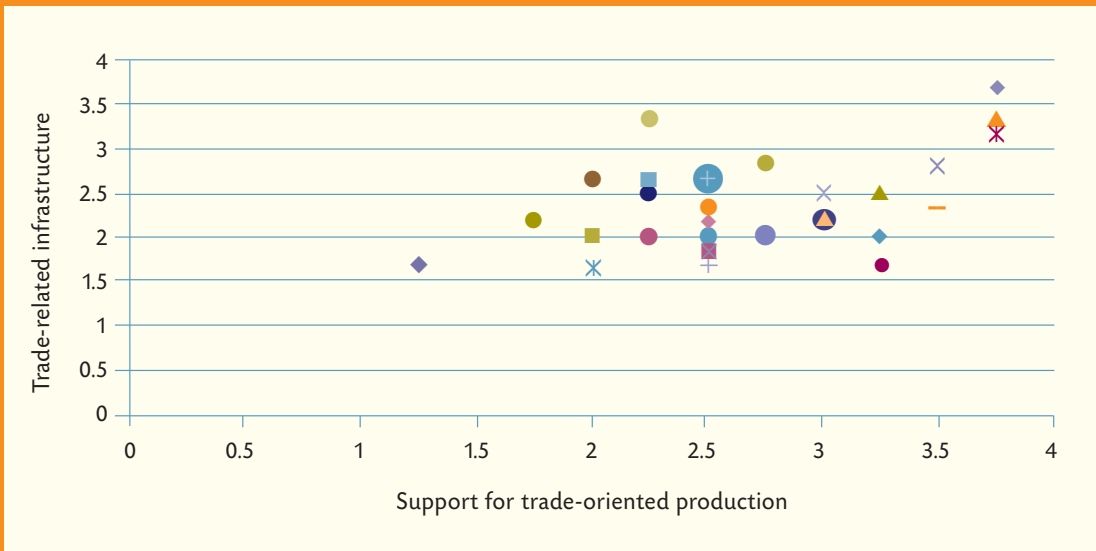


Figure 2:  
Countries' needs in terms of support for trade-oriented production  
and support for integration into international trade



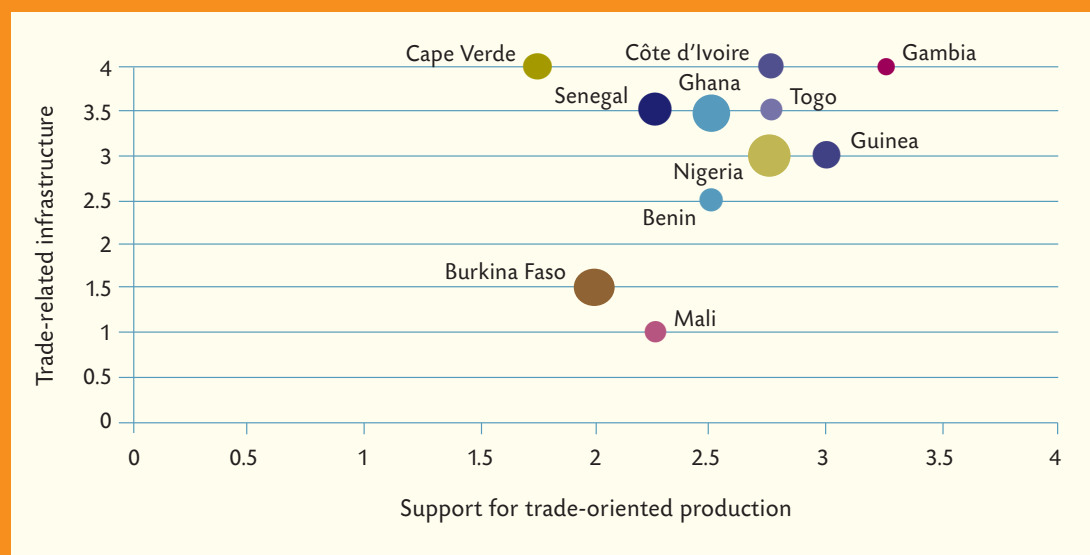
Source: Authors' calculations.

This nomenclature indicates the disparity of AfT needs between different countries and regions (e.g. West Africa and Southern Africa). It reveals that West and East Africa have substantial needs, and that the need for trade-related infrastructure is considerable in all the countries considered. Lastly, expanding intra-regional trade is an important issue that will require rethinking of donors' traditional tools, which are overly geared towards the national level.

We will now examine in more detail the results for West Africa, the sub-region containing the largest number of countries. Burkina Faso and Mali need special attention. Burkina Faso faces major population issues, indicating that

its future needs will be very large, and the time required to export is too long. Mali displays the same characteristics, and its exports are still undiversified. Considering the importance of customs revenue in its budget, Mali may face high adjustment costs unless it undertakes tax reform. Benin will also have to bear substantial adjustment costs. Sierra Leone (not represented here owing to lack of data) is another priority country for AfT. It specialises in mining (diamonds and gold), its need for training on trade is considerable and it suffers from low diversification of its trade partners.

Figure 3:  
AfT needs of West African countries




Source: Authors' calculations.

**NB:** The size of the dots is proportional to countries' need for support for their integration into global markets. The larger the dot, the greater the need for training in trade negotiations or for help in diversifying their economies, becoming integrated into the regional market or absorbing the costs of adjustment to liberalisation.

## ■ Conclusion

Increasing the effectiveness of aid for trade will require more in-depth coordination among donors, and between public and private stakeholders. It will also require better knowledge of actual demand, which is the purpose of the proposed nomenclature. Lastly, it will require building the analytical capacity of countries and regions. This will enable countries to improve their market positioning and donors to improve targeting of beneficiaries. It will then be possible to rehabilitate the link between trade and poverty reduction.



Further trade liberalisation alone, however, will not be enough to generate high growth. Although trade policy has its importance, factors such as political stability, the business environment, physical infrastructure, institutions and human capital play a fundamental role. In particular, coherence between trade, sectoral (agricultural, industrial, competition, etc.), macroeconomic and tax policies is essential, within each country and each region. In this context, support for innovation could be

a component of aid for trade. These conditions would enable countries to become more integrated into regional and global markets; would create a favourable climate for investment, job creation and diversification of economies towards high-growth activities; and most important, would generate income for local populations. ■

## “ The trade capacity building programme ”

**Anna Lipchitz**  
Economist,  
AFD Research Department

Integration of developing countries (DCs) in the global trading system is a powerful lever for growth and poverty reduction. Technical cooperation in connection with trade capacity building for DCs has become one of the objectives of the multilateral trading system. France has therefore put a plan in place to strengthen DCs' trade capacity. The plan combines multilateral contributions with a bilateral Trade Capacity Building Programme (*Programme de renforcement des capacités commerciales – PRCC*).

The PRCC was established in 2002 and funded 20-odd projects over the 2002-2005 period, such as development of ecotourism in Mauritania, training for trade counsellors in Vietnam, the introduction of geographical indicators in Cambodia and Laos, and the development of equitable trade in Guinea.

The programme was renewed in April 2006 for a three-year period (PRCC 2), with funding to provide ? 25 million in subsidies. The programme is funded jointly by the General Directorate for the Treasury and Economic Policy (DGTPE) of France's Ministry of the Economy, Finance and Infrastructure and by the Agence Française de Développement (AFD), which implements the programme in accordance with its own procedures.

Support to trade capacity building seeks to improve countries' ability to assimilate the rules governing inter-

national trade as well as their export performance. The DGTPE-AFD agreement is geared towards strengthening trade capacity in terms of activity, and in particular towards development of exports. Support is provided in the form of technical assistance, training and awareness-raising services; sectoral or feasibility studies; and, where necessary, financing of small but essential items of training equipment or facilities.

Operations are directed, for example, towards bringing production and distribution up to standard, improving control and inspection systems, corporate upgrading and adaptation of export support mechanisms.

All countries in which AFD Group conducts operations are eligible for the PRCC. At least 70% of the funding allocated under PRCC 2 must go to operations concerning the countries in AFD's "priority solidarity zone" (*zone de solidarité prioritaire – ZSP*). For greater effectiveness, the programme has a PRCC Implementation Support Fund, intended to be used for pre-identification of projects and support for complementary activities. Projects financed by PRCC 2 generally require participation by the beneficiary. Apart from states and public bodies, financing agreements may be signed with local authorities, trade associations or consular bodies, or other bodies; private bodies are eligible, as long as they meet the conditions of provision of public services relating directly to opening up the country to international trade.

Projects are identified and monitored by French trade missions and AFD's local agencies. The choice of joint implementation reflects a concern for taking a balanced approach to the "trade and development" issue. Joint

implementation makes it possible to harness all forms of expertise that are useful in approaching this cross-cutting topic, which is relatively new and of growing

importance. The originality of its project approach demonstrates the PRCC's ability to promote innovative activities.

## Development of export promotion tools for Madagascar

*Export development in Madagascar is hampered by many local constraints, including limited production capacity and lack of infrastructure. The specific objective of this project, which is implemented under the PRCC, is to help increase Malagasy exports by building the internal capacity of export firms, improving prospecting for trade markets and promoting Madagascar's image in certain foreign markets. The PRCC finances export promotion tools within three existing mechanisms:*

- creation of an export window to provide individualised support to exporting companies,
- financial support to the France-Madagascar Chamber of Trade and Industry for the development of export-promotion activities,
- co-financing, with USAID's Business and Market Expansion (BAMEX) programme, of an institutional campaign to promote ecotourism and Madagascar's natural products.

## Support for promotion of Cambodia's textiles exports

*The textiles sector is vital to the Cambodian economy, accounting for 95% of the country's exports and employing 200,000 people, 90% of whom are women. In this context, the PRCC sought to ensure the sustainability, and subsequently the development, of textiles exports, which were endangered by the end of the quota system. It was supposed to enhance the country's comparative advantage via the development of a socially responsible industry, thus strengthening the textile industry's market position with respect to buyers, who are increasingly concerned with employment conditions.*

**First component of the project:** improvements in competitiveness and qualification of workers; introduction of a computerised customs tax rebate system on imports; launch of training plans; financing of studies on specific topics; creation of a fashion observatory.

**Second component:** increasing non-cost competitiveness through the development of a socially responsible industry; support to the Garment Sector Project of the International Labour Organisation (ILO), which organises, among other things, controls and audits of corporate compliance with labour standards.

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