African Development Bank

Asian Development Bank

European Bank for Reconstruction and Development

Inter- American Development Bank

International Monetary Fund

World Bank

G8
Genoa Summit
July 2001

A GLOBALIZED MARKET— OPPORTUNITIES AND RISKS FOR THE POOR

GLOBAL POVERTY REPORT 2001

July 2001

Abbreviations

AsDB	Asian Development Bank
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
EU	European Union
GPR	Global Poverty Report
HIPC	Heavily Indebted Poor Country
IADB	Inter-American Development Bank
IMF	International Monetary Fund
Lao PDR	Lao, People's Democratic Republic
LDC	Least Developed Countries
PRC	People's Republic of China
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
US	United States of America
WTO	World Trade Organization

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EXECUTIVE SUMMARY

The Global Poverty Report considers the effects of globalizing markets on poverty in developing countries. It outlines the channels through which increased trade openness can affect poverty and examines the evidence from four regions: Sub-Saharan Africa, Asia and the Pacific, Eastern Europe and Central Asia, and Latin America and the Caribbean. Written at the request of the G8, the report is the result of a joint effort of the regional development banks, the World Bank, and the International Monetary Fund.

Increased openness can affect an economy in various ways, creating opportunities for the poor as well as risks. First, it can affect the prices of goods and services that the poor consume and produce, benefiting those who are net consumers of goods that become cheaper and those who can obtain higher prices for their products on international markets. Second, it can affect the demand for and returns to factors of production that the poor have to offer, such as labor. Third, it can affect government revenue and the resources available for antipoverty programs. Fourth, it can influence the potential for economic growth, which in turn affects poverty. Fifth, the short-term costs of transition, as well as the possible increased volatility of growth stemming from the opening up of markets, may increase the need for social protection mechanisms. Comprehensive trade reform can help reduce poverty when it is part of a set of reforms that improve the domestic macroeconomic and investment climate, enhance infrastructure and technology, and contribute to the provision of knowledge and skills. However, these effects vary significantly across countries, regions, and groups within countries, which makes it difficult to generalize about the effects of trade liberalization on poverty.

In spite of the varied experience across regions, comprehensive trade reform can be helpful in reducing poverty provided it is accompanied by appropriate enabling policies. In many countries in Africa, trade liberalization has been partial (e.g., tariffs remain high) and has not always spurred investment and growth because of weaknesses in the macroeconomic environment and in complementary policies for regulation, infrastructure, and human capital. Compared with other developing countries, most of the emerging economies of East and Southeast Asia have pursued comprehensive trade reforms and stable macroeconomic policies, and as a result have significantly reduced poverty over the last three decades. In Eastern Europe and the transition economies of the former Soviet Union, where extensive trade reforms went hand in hand with the freeing of domestic prices and privatization, the results have been mixed. In Eastern Europe, the short-term negative effects of reform on employment and poverty were largely overcome by the growth in private sector activity. In countries of the former Soviet Union, however, poor governance and weak legal and regulatory institutions have greatly hindered the transition to new competitive activities and jobs, resulting in increased poverty. In Latin America the link between trade and poverty is not well established. For some countries, trade liberalization has increased the returns to skilled relative to unskilled labor, contributing to higher income inequality. Its impact on absolute poverty, however, cannot be established on the basis of existing studies.

This report proposes actions by developed countries, developing countries, and international institutions to help the poor in developing countries benefit from an increasingly global market. For all parties, reforming and revitalizing the multilateral trading system, including the launch of a new trade round, is important to steer more benefits from trade toward those most in need.

- First, the report urges developed countries to remove some protective barriers to free trade in agricultural and manufactured goods, reduce subsidies, and allow access to their markets for goods from developing countries. It recommends that developed countries take into consideration the needs of developing countries when designing and implementing agreements on investments, intellectual property, and standards.

- Second, the report encourages developing countries to integrate trade reform into the broader development agenda that includes reform of institutions and the legal and regulatory environment, as well as improvements in macroeconomic policy, business climate, and infrastructure. These measures aim to level the playing field for poor people by increasing their asset-base (education, health, and land; making markets work better for poor people; and reducing social barriers that keep certain ethnic and racial groups or women in a state of disadvantage). The report calls for a careful sequence and mix of reductions of border barriers and domestic reforms so as to maximize the growth potential from trade liberalization while minimizing its adverse impacts on poverty. The preparation of poverty reduction strategies offers a vehicle for integrating trade reform into a comprehensive set of poverty reduction policies. To ensure that those affected by the short-term negative effects of transition are protected, the report urges developing countries to improve the efficiency of social safety nets and ensure that adequate funding is available for them.

- Finally, the report underscores that international institutions have an important role in helping poor countries to design pro-poor reforms that make trade an engine of growth. This requires support for reductions in border barriers and improvements in the domestic macroeconomic and investment climate, infrastructure and technology, as well as knowledge and skills. Mechanisms that help poor countries and poor people cope with the transition costs of trade reform have to be an integral part of trade liberalization if the benefits are to be shared. International institutions can also help countries with the costs and procedures of acceding to the World Trade Organization, so that they can participate fully in the global trading system. Regional development banks can help by fostering outward-oriented regional integration and by helping countries build up their trade capacity.

I. AN ANALYTICAL FRAMEWORK

A. Introduction

1. The Global Poverty Report (GPR) came into existence at the request of the G8 (Cologne Communiqué 1999). It is prepared jointly by the regional development banks, World Bank, and International Monetary Fund (IMF). The first GPR provided a status report of global poverty trends and the universal responsibility in reducing poverty, with more detailed discussions of trends and issues specific to each geographical region. This second report is prepared to inform the discussion of the G8 on development and poverty at the Genoa Summit.

2. The theme "A Globalized Market—Opportunities and Risks for the Poor" presents issues that need to be considered to ensure that poor people are not left behind as global interdependencies increase. The increasing interconnectedness of the world means that creating and making use of opportunities, as well as safeguarding against risks, are relevant to developing and transition economies as much as to G8 and other developed countries. The report aims to shed light on some of the critical issues that arise for poor nations and poor people in a globalized economy.

B. Trade and Poverty

3. Trade is critically important for growth and poverty reduction. Poverty is primarily reduced by (i) creating an environment in which there are more and more opportunities for poor people to earn a living and to work their way out of poverty, and (ii) by putting in place supporting mechanisms that give them a voice in decisions that have a bearing on their lives. A globalized marketplace can help provide such opportunities for the poor, along with a stable macroeconomic environment, hospitable investment climate, efficient public services, and access to information technology.

4. Changes in the trade regime can affect an economy in various ways, presenting the poor with opportunities as well as risks. First, they can affect the prices of goods and services that the poor consume and produce. Second, they can affect the returns to factors of production in industries where the poor work. Third, they can affect government revenue and the resources available for anti-poverty programs. Fourth, they can influence the potential for economic growth, which in turn affects poverty. Fifth, each of these factors, as well as the possible increased volatility of growth stemming from the opening up of markets, may increase the need for social protection mechanisms. It is also important to keep in mind that the benefits and costs of trade reform do not flow simultaneously—adjustment costs are often borne over the short term while the benefits of reform are realized over the long run.

1. Prices of Goods and Factors of Production

5. The most immediate effect of trade liberalization is to lower the prices of imported goods, which affects the consumption and income patterns of the rich and the poor. The poor are particularly vulnerable to price changes, as their consumption-to-income ratio is high and their capacity to protect themselves from adverse price changes through the selling of assets or other defense mechanisms is small.

6. On the consumption side, benefits to the poor will be higher the higher the proportion of their expenditure on imported goods. On the income side, trade liberalization will affect the relative price of goods in different sectors and result in the reallocation of resources. To the

extent that the poor receive income from (i.e. work in) sectors or industries that are negatively affected (for example, import-competing sectors that were previously protected) they may suffer a decline in income. However, if the poor work in sectors or industries that benefit from liberalization (for example, sectors that use imported intermediate inputs) their incomes and employment opportunities will rise. Thus, the net effect of a liberalization of trade on the poor will depend on the balance of consumption and income effects.

7. On aggregate, declining prices on the consumption side can offset reduced incomes of the poor caused by lower prices for goods they produce. However, at the household level the capacity of poor producers to compensate for price changes may be limited, particularly when households are dependent on a small number of income sources with slim profit margins. In the extreme, poor producers might not remain in the market, if their traditional products compete with imported goods of cheaper price and/or better quality. If poor producers do leave the market, there could be efficiency gains from a national or global perspective, but such a change in the economy could entail adjustment costs for poor households, who might not be able to switch easily to other forms of income generation.

8. The effects of trade liberalization on prices, availability and quality of imported goods (including intermediate inputs and capital goods) can have a beneficial effect on the competitiveness of exports by enhancing economic efficiency. To the extent that poor producers participate in such exporting sectors, they may benefit from increased competitiveness in international markets.

9. The impact of trade liberalization on factor prices depends on the direct price effects, the location and flexibility of labor, and the initial pattern of protection, which determines the winners and losers of liberalization (ODI, 1999). Whenever trade liberalization results in higher demand for products from unskilled-labor intensive agriculture and industries, demand for this type of labor and employment will increase. The final effect on wages will depend on conditions in the labor market. Changes in factor prices can also induce changes in factor use. For instance, the removal of protection on capital goods may lead to greater investment and higher returns to skilled labor, which is a complementary input to more capital intensive production.

10. The transmission of price effects depends on institutions and on the functioning of and linkages between markets, agents, and distribution services. Imperfections in the functioning of markets (and agents) will affect the extent to which price changes are transmitted throughout the economy, including to non-traded goods. This illustrates the importance of concomitant reforms of institutions and domestic markets, as advocated by a number of researchers and development practitioners.

2. Government Revenue

11. Trade liberalization can affect government revenues in several ways. For example, reductions in tariffs could reduce government revenues and thus have an adverse impact on governments' capacities to deliver social services and antipoverty programs (even assuming that given adequate resources these services and programs are delivered effectively).

12. However, the effects of trade liberalization on government revenue are not necessarily negative. Trade liberalization may have positive effects on government revenue when: (i) unduly high tariffs have curbed the import of goods, and the lowering of these tariffs increases the import volume by more than the decline in tariff rates; (ii) the removal of tariff exemptions, often granted to the non-poor, increase revenues and reduces inequality in the structure of taxes; and

(iii) quotas, licenses, quantitative restrictions, and other barriers are replaced by more transparent tariffs; and (iv) the simplification of tariff structures increases efficiency, thus freeing public resources for better use elsewhere. On the negative side, as protection is progressively lowered revenues may be reduced, with might limit or reduce government spending on social services delivery and antipoverty programs. This can be prevented if public expenditure is prioritized toward benefiting disadvantaged segments of society and minimizing spending in unproductive areas. More importantly, tax reform can replace tariffs with less distortionary and more efficient across-the-board instruments such as the value-added tax, so that trade reform, even at the extreme, need not result in a loss of revenue.

3. Economic Growth Effects from Trade

13. While the precise quantitative impact of economic growth on the income of the poor depends on country-specific factors, there is now overwhelming evidence that growth is good for poverty reduction (World Bank, 2000a). Trade liberalization can lead to higher growth rates in a number of ways. It can lower the cost of capital and increase the efficiency of investment (for example through economies of scale), leading to higher rates of investment, and can facilitate the adoption or creation of new technologies that lead to the establishment of new firms and industries. This will often take place through increased foreign direct investment, which is usually closely linked to trade flows.[1] However, for economic growth effects to materialize, trade liberalization must be accompanied by other structural and institutional reforms (for example, investment in infrastructure, education and labor market reform), in addition to macroeconomic stability and an appropriate exchange rate regime, to assure an adequate supply response that leads to growth (IMF, 2001).

14. The poor can gain from growth through employment in expanding sectors, particularly when new markets become available to the agriculture sector, generating jobs for the rural poor, and through indirect employment effects of growth-induced investments in other sectors such as infrastructure. However, direct employment opportunities vary across sectors. They depend on input-output coefficients and quality standards of the target market (including the domestic market challenged by international competition), which determine production and technology choices and, crucially, skills requirements. Technological changes in many sectors may reduce the advantage of cheap labor with lowest skill levels, and non-tariff trade barriers may require certain production standards be met to qualify for import certification. Both of these factors can work in favor of a higher capital-intensity of investments, and increase the demand for a minimum of education and skills that could be beyond that of the poor with limited or no basic education. However, whenever opportunities exist for an expansion of labor-intensive sectors, the poor are bound to benefit.

15. For small-scale producers, a critical aspect is whether they can withstand international competition when they compete for the same customers. Economies of scale, quality and prices, customer preference, and the capacity of local small-scale producers to diversify production and customer bases will affect the extent to which they may maintain their market share. A shrinking of this business sector would affect the poor as employment opportunities decline, and would place small-scale producers, who may not be poor today, at risk of falling into poverty.

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[1] For a different view see *Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence*, F. Rodriguez and D. Rodrik, University of Maryland, Department of Economics, College Park, 1999.

16. For economic growth to translate into poverty reduction, the degree of existing inequality matters. A study has shown that "in East Asia, for each percentage point of growth, the number of people in poverty was reduced by 3 percent. In Sub-Saharan Africa, the figure is slightly above 1 percent, while in Latin America it is below 1 percent. As a result, economies in the latter 2 regions would need to grow faster in order to reduce poverty at the same rate as East Asia" (OXFAM, 1997).

4. The Costs of Transition and Exposure to Shocks

17. The rapid pace of technological change and shifting comparative advantage is likely to lead to structural changes in an economy. This process of structural change will create greater opportunities for the poor in the medium-term, but may also entail short- to medium-term transitional costs that the poor cannot absorb. This is particularly true of trade reforms, where the adjustment costs often come up front, while the benefits are seen only over a longer period of time. In the first-best instance an appropriate mix, sequencing, and phasing of trade reforms can be used to minimize these costs. If this mix is not feasible the costs to the poor can be mitigated with appropriate social safety nets.

18. Trade liberalization may also make an economy more vulnerable to external shocks. However, these shocks may be both positive and negative. Just as an economy may suffer from contagion during times of crisis, it may also benefit from high rates of growth and innovation in its trading partners. Opening up to the international economy may also serve to diversify trading links and thereby to lessen the exposure to crisis in any one trading partner. However, opening up to global markets may lead to greater volatility in output and employment, and a greater need to adjust to changes in the international environment. The process of adjustment may also entail costs for the poor, which can be managed through functioning safety nets.

C. The Capacity to Manage Risks: Prevention and Ex-post Coping

19. Social safety nets provide a means to ease the tension between trade liberalization and social protection goals. Trade liberalization may leave economies more vulnerable to external shocks, the adverse impact of which can quickly overwhelm the poor. It is crucial that safety nets are already in place so that social protection can be provided in a timely and efficient manner. Major types of social safety net programs include: cash or in-kind transfers, price subsidies, public works, fee waivers for social services, supplemental feeding and nutrition programs, targeted human development programs and microfinance programs, or social insurance programs adapted to the needs of the poor.

20. Establishing social safety net programs requires adequate planning for possible future shocks, including those associated with trade liberalization, based on timely and reliable information on vulnerable and poor households. The aim should be to design programs that expand and contract automatically as the need arises and that do not crowd out existing informal safety nets (such as intra-family support), recognizing the limitations on the extent to which formal safety nets reach those in the informal sector and rural areas. In most cases, planning has been inadequate and social safety nets have concentrated on adapting existing programs employing simple targeting methods. The design and implementation of social safety nets and the use of resources for this purpose should be transparent, with independent and periodic program evaluations and information on different programs and eligibility criteria made publicly available.

II. REGIONAL EXPERIENCES

A. Africa

21. The recent performance of Africa's economies shows significant improvements. In the 1980s and early 1990s, per capita income declined consistently. Since the mid-1990s, however, per capita incomes have increased in a number of countries. Nevertheless, the growth rates registered in the past few years are much below the rates required to have a significant impact on poverty reduction. As a whole, if Africa is to reduce the incidence of poverty by half by 2015 as proposed in the International Development Goals, it needs to achieve and sustain a growth rate of 7 percent per annum (UNECA, 1999).

22. Global markets provide opportunities for growth. However, for Africa to benefit from participation in globalized markets, macroeconomic and structural policies that inhibit competitiveness, the poor socioeconomic conditions in Africa, and suboptimal relations with its major trade partners must be addressed.

23. To generate sustainable growth, African countries need to import capital and consumer goods, but high import tariffs have been a constraint on imports. These tariffs, averaging 25 percent, are three times higher than those of the fast growing exporters and more than four times the developing country average (World Bank 1999). Non-tariff barriers also remain high in the region. Further, the sustainability of capital and consumer goods imports can be guaranteed only if African exports grow at a fast rate. The export performance in Africa has been unsatisfactory; African exports have grown at less than half the rate of growth of other developing countries. Africa's share in world exports declined from 3.9 percent in 1980 to 1.5 percent in 1997 (World Bank 2001a). The poor performance in export growth is attributed to the region's inability to maintain its market share in the production of key primary commodities, lack of diversification in its exports, the persistence of protectionism in the trade of some commodities, and previously overvalued exchange rates that adversely affected agricultural exports.

24. In addition to further multilateral or unilateral liberalization of trade, strengthening the ongoing effort toward regional integration should enhance Africa’s integration into the global economy. Regional trading arrangements can lead to economic benefits by increasing the size of markets and the level of trade between participants. However, these arrangements should also promote open trade policies toward third countries to maximize benefits. In this connection, it would also be desirable to rationalize the existing structure of regional arrangements in Africa by reducing the number of overlapping trading blocks.

25. In general, the adjustment process involves winners and losers. In some cases, the consequences with respect to income distribution could be significant. In Zambia, some maize growers lost as a result of trade liberalization within the domestic economy, whereas in Zimbabwe, the effect of liberalization was positive (OXFAM, 1999). In principle, losers from trade liberalization and other adjustment programs may be compensated through the provision of safety nets. In many parts of Africa, however, the high incidence of poverty, the large number of potential beneficiaries and the high financial requirements hinder the sustainability of safety net programs. In the near future, some of the budgetary constraints may be alleviated as the result of debt relief for heavily indebted poor countries (HIPCs), the majority of which are African.

26. Furthermore, Africa faces high protectionism with respect to its exports to the developed country markets. According to a recent World Bank study (2001e), if all trade barriers to African exports in the Canada, the European Union (EU), Japan, and the United States (US) were eliminated, non-oil exports would expand by 14 percent. It is also estimated that greater access to the agricultural markets of developed countries would increase real incomes in Africa by US $ 6 per person per year by enabling producers to sell their commodities at higher prices and in greater volumes (Biswanger and Lutz). Therefore, it is crucial for developed countries to lower their own effective protection to African exports, especially on agricultural products, in order to contribute to pro-poor growth in African countries. Although it would be preferable to do this in a multilateral setting, recent initiatives to provide duty- and quota-free access to the exports of poor countries could be extended as widely as possible.

27. The rise in global markets is attributed partly to improvements in communication technologies that are knowledge and skill intensive. At present, Africa's human capital base is quite low. In addition, the HIV/AIDS pandemic is robbing African societies of some of its productive members (UNAIDS, 2000). Given that some of the victims of the pandemic are well-educated members of society, in addition to the human toll, Africa's competitiveness both in the national and global economy is being undermined. In the short-run, it may not be possible for Africa to take full advantage of the growth in global markets. In the long run, however, some of these problems can be addressed both at the national and international level. At the national level, not only should African governments increase spending on primary education and preventative health care, but they should also enhance the efficiency of such spending. The international community may also help by financing the development and provision of international public goods such as vaccines for HIV/AIDS and malaria, the effects of which affect the productivity and well being of the poor in Africa disproportionately.

28. While globalization offers a number of opportunities for addressing problems of poverty in Africa, African countries should recognize that strong national economies are prerequisites for effective participation in the global markets. To strengthen their domestic economies, policy makers must reform the policy environment even further to attract more investment and promote pro-poor growth. Efforts in this regard should include strategies towards good governance, a more stable macroeconomic environment, structural reform that enhances external competitiveness, diversification of exports, development of human capital (especially by reversing the harmful effects of the HIV/AIDS crisis), promotion of the private sector, effective negotiation with trading partners in developed countries for access to their markets, and efficient and equitable use of money saved under the HIPC initiative for financing targeted safety net programs.

B. Asia and Pacific

29. The experience of countries in the Asia and Pacific region contains a broad range of examples[2] concerning both trade liberalization and poverty reduction. Countries include those best known for their successful integration into a globalized economy and concomitant positive results in poverty reduction (for instance, the Republic of Korea, Singapore, and Taipei,China). They are closely followed by Indonesia, Malaysia, and Thailand: countries that progressed well in opening markets and in improving the living standards of many of their citizens. These

[2] The diversity of experiences in Asia combined with the lack of comprehensive data and analyses does not allow easy generalizations. Therefore, this section of the report draws on a number of country-specific analyses to illustrate certain policy measures and their consequences.

countries have shown remarkable economic growth rates over the past 30 years, accompanied by an increasing deregulation of trade and declining incidence in poverty. While greater integration in a globalized market exposed these economies to external shocks, as manifest in the Asian crisis of the late 1990s, trade openness also played an important role both in growth before the crisis and in the ensuing recovery as exports grew rapidly. The People's Republic of China (PRC) and Vietnam, which achieved outstanding reductions in poverty levels over a short period of time, are increasingly opening their economies to international trade. In the PRC these trends are accompanied by increasing income disparities, whereas in Vietnam no major changes to income distribution have been observed. But, the region also includes countries that have introduced trade liberalization measures reluctantly or not at all, economies with great potential for participation in globalized markets and those that are isolated. Above all, Asia is home to the largest number of poor people in the world.

30. The PRC has made enormous strides toward reducing poverty: "between 1978 and 1999, 227 million people were lifted from absolute poverty" (AsDB, 2001a). A number of sources acknowledge the PRC's achievements in reducing poverty as a major contribution to the global decline in the proportion of people in poverty. The country's growth performance is partly explained by its progressive trade opening, although foreign investments and technology transfers played an important role. Trade was liberalized gradually, testing measures that were introduced and adjusting policies as necessary (UNDP, 2001). Early reforms of trade and non-trade barriers were inadequate to promote large-scale production of manufactured goods for export. Subsequent liberalization of imports of intermediate inputs and capital goods related to export production increased the competitiveness of exports. By the turn of the century, only a few products are still subject to state trading, including some agricultural commodities of "importance for the peoples' livelihood and national economic development" (World Bank, 2000d). But, the positive trends in trade liberalization and poverty reduction were also accompanied by increasing inequality. This approach to selective trade liberalization parallels the earlier experience of the Republic of Korea, where an export orientation was accompanied by policies to support domestic industries and to build human resource capacities through extensive education programs, before the domestic market was opened to imports. These investments in human capital and land reforms also helped reduce income inequality in the Republic of Korea.

31. India, another country with a significant number and proportion of poor people, started market-liberalizing reforms in 1991. However, trends in economic growth, opening the economy, and poverty reduction have not followed a single pattern. While economic growth and deregulation increased, income poverty fell rapidly from the mid-1970s (a time of relatively high protection and low growth rates) to the early 1990s and less rapidly in the second half of the 1990s, although poverty trends are unclear, partly because of data problems. The fact that the poor may not have benefited as much as expected reflects the failure of accompanying measures and enabling conditions—e.g. infrastructure, human capital—and incomplete reforms (especially in the agriculture sector) as illustrated by other research (New School, 2000). The same study shows that the partial removal of restrictions to agriculture exports did not result in higher growth rates in the sector. Also, the removal of protection from agriculture prices resulted in price hikes that hurt the poor (as net consumers), while also affecting the non-poor (who benefited from ill-targeted subsidies). Employment in the agriculture and in non-agriculture sectors has been sluggish, if not declining in the organized and informal sectors,[3] without

[3] The report defines the "organized" sector as state-owned enterprises and private sector enterprises with more than 10 employees. The "informal" sector refers to casual and self-employed labor.

adequate social safety nets to compensate for the loss of sources of income. The only exception was that of urban female workers, whose steady employment rates rose after 1991, albeit at wage levels equivalent to rates paid to men for casual labor. The limited achievements in the agriculture sector are explained by the lack of concomitant reforms to agriculture and other policies and the failure to remove agrarian inequalities that affect rural areas where the majority of India's poor can be found.

32. Small economies can benefit greatly from an expanded array of goods available at lower prices because of import liberalization. Liberalization would benefit poor and nonpoor consumers and producers in as much as they use imported goods. Small, low-income countries can potentially progress rapidly when favorable trade agreements help boost labor-intensive sectors such as textiles in Cambodia, a country that also introduced parallel reforms to promote investments. A similar small economy, the People's Democratic Republic of Laos (Lao PDR) (with a relatively low level of protection for a low-income country) adopted policies to introduce greater trade liberalization by lowering tariffs for production equipment, and raw and intermediate materials used in export processing. However, in the Lao PDR rules are not applied consistently, with the many exceptions creating distortions that impede full growth potential. Further, these small countries will invariably be more specialized and therefore more vulnerable to external shocks. This circumstance emphasizes the need for good macroeconomic management. Access to long-term international capital, including private foreign direct investment will also help expand economic opportunities and mitigate the impact of external shocks. It should also encourage development of a flexible, well-trained labor force able to participate in the dynamic opportunities arising from greater openness.

33. The Asian crisis emphasized the increased vulnerability of open economies—in countries most affected, the incidence of poverty increased sharply after the crisis, threatening the achievements in poverty reduction in Indonesia, the Republic of Korea, Malaysia, and Thailand. Even in countries not affected by the crisis, the transformation of society requires adopting new social protection mechanisms for preventing and coping with risks. The economies in the Pacific remain extremely vulnerable to external shocks, particularly with the phasing out of special treaties, and do not have the economic base to provide for extensive social protection. The main challenges in developing mechanisms adequate and affordable to countries in the region lies in the fact that 60 percent of the population is rural, many of whom are poor and live in remote areas and are difficult to cover under formal protection schemes. In urban areas, a large proportion of poor remains in non-registered sectors of the economy, making it hard to include them in formal protection arrangements. The diverse needs for social protection challenge governments in the Asia and Pacific region to find new roles, and partnerships with the private sector to develop formal and informal safety nets. Some countries finance extensive, but poorly targeted support mechanisms, which remain ineffective as the benefits do not accrue to the intended groups. As a number of governments in the region recognize these weaknesses, the Asian Development Bank is adopting a strategy to support its developing member countries to address labor market issues, social insurance, social assistance and welfare services, micro- and area-based schemes, and child protection (AsDB, 2001b).

C. Central and Eastern Europe, the Baltic States, and the CIS

34. In no region has the liberalization of trade and the integration into global markets over the past decade been more radical and far-reaching than in the transition economies of eastern Europe and the former Soviet Union. In 1989, only around 40 percent of total foreign trade in eastern Europe and 10 percent of trade in the former Soviet Union was conducted with market

economies outside the Soviet block. By the end of the 1990s, these shares had increased to 75 percent in eastern Europe and to around half of the total in the former Soviet Union (EBRD, 1999).

35. These changes have gone hand in hand with comprehensive domestic price liberalization, privatization and far-reaching institutional reforms, making it analytically difficult to separate out the effects of trade liberalization on people's welfare in the region. Nonetheless, at a conceptual level, the transition can be represented as a process of adjustment following a large relative price shock, similar to the effects of trade liberalization, but on a much larger scale. As a result of this price shift, heavy industry has given way to the expansion of the services sector. The result has been a dramatic downsizing of the labor force employed in manufacturing. At the same time, state-owned enterprises were forced to contract by the reduction in state subsidies and the rise of competition, particularly from imports.

36. The most apparent immediate effect of the transition was a large decline in aggregate output, as a result of adjustment costs associated with sunk capital, imperfect labor markets and disorganization effects. Thus, although welfare should have improved with the availability of a wider range and of goods and services of better quality, the social costs of early transition were large. As outlined in the GPR 2000, the number of poor people has greatly increased across the region and, while aggregate incomes have fallen, their distribution has also become more unequal. At the same time, it is worth pointing out that many people have gained from new opportunities in the private sector and the chance to make better use of their skills and talents (World Bank, 2000b).

37. A major way in which the shock of market liberalization (including trade liberalization) has been transmitted to the population has been the adjustment in the labor market. Here, significant differences have emerged across the region. In the more advanced countries of eastern Europe, employment initially fell rapidly, but has recently picked up again as a result of growing private sector activity. Real wages have been hit far less than aggregate output and while the dispersion of earnings has increased, it has been contained at a level similar to that of western Europe.

38. By contrast in the Commonwealth of Independent States (CIS), employment has declined more gradually and the brunt of adjustment was initially borne by measured real wage declines. This has led to a dramatic fall in earnings among those still employed in the old sector and has given rise to the problem of the working poor. For example in Ukraine, by 1997 80 percent of all workers were earning a wage below the subsistence level. At the same time, far fewer private sector jobs have been created in the CIS, leaving many workers stuck in dead-end employment. Wage dispersion has grown dramatically, while aggregate labor productivity has failed to recover. Many have been pushed into multiple job holdings and work in the informal sector with little security. By the late 1990s, for instance, around one fourth to one third of workers in CIS countries reported being engaged in informal subsistence work, against only 4 percent in Poland (EBRD, 2000).

39. Trade liberalization negatively affected government revenues in most transition countries, as it led to the dismantling of the system of implicit trade taxes (and price distortions) that characterized trade under the Council for Mutual Economic Assistance before. Governments have tended not to replace it with explicit trade taxes, as tariffs have generally been relatively low (although export taxes have been used in several CIS countries), while indirect taxes on household consumption and income have only gradually replaced the old corporate sales tax. The ability of governments to provide social safety nets has therefore been

severely limited, particularly in the less advanced transition economies. Moreover, the evidence suggests that existing benefits and transfer systems are often highly inefficient, as a result of universal entitlements, privileges to special groups, and administrative inefficiencies. The result has been that only in the most advanced transition economies have social safety nets provided a cushion against the shock of transition and contained the associated rise in inequality and poverty.[4]

40. The experience of the first decade of transition points to the following conclusions. First, the negative effects of restructuring on people's livelihoods cannot be adequately addressed by keeping inefficient companies alive; rather policies that promote entry of the new private sector seem to be the key to a socially and economically sustainable transition. Note that the reduction in the tax burden that entry-friendly policies might entail need not lead to lower revenues overall, if private companies can be encouraged to operate in the official economy.

41. Second, the absence of social safety nets may have been one of the factors delaying enterprise restructuring in the CIS, as workers had few alternatives to remaining in old state sector jobs. Even with limited government budgets, it should be a priority for governments and international finance institutions to consider ways of providing temporary support for those made redundant through restructuring. The support for small and medium-sized enterprises, the financing of severance packages, and investments in re-training should all be part of such policy measures.

D. Latin America and the Caribbean

42. Since the mid-1980s, many countries in Latin America and the Caribbean introduced market-friendly reforms. Among the most salient changes are those that took place in the area of trade. Average tariffs fell from close to 50 percent in 1985 to around 10 percent in 1996, and maximum tariffs fell from an average of 84 percent to just 41 percent. By 1996 nontariff barriers affected only 6 percent of imports, while in the pre-reform period they affected 38 percent (IADB, 1998).

43. To the extent that openness contributes to higher economic growth, it is beneficial for poor people, unless trade reform causes inequality to rise to such an extent that the positive effects of growth on the incomes of the poor are offset. In principle, basic trade theory predicts that trade liberalization would result in an increase in the demand for low-skilled labor, thereby improving the relative earnings of this group compared with the more skilled. Everything else being equal, such a process would contribute to lower overall income inequality, but the data show that for most countries inequality was approximately equal in the 1990s to the levels observed in the 1980s. However, in seven out of the 18 countries that were analyzed inequality increased, in four of them sharply (IADB, 2001b). The experiences of Chile and Mexico (particularly since the North American Free Trade Agreement) also illustrate the benefits that greater integration with the world economy might bring.

44. Is there a link between observed trends in inequality and trade liberalization? Cross-country analysis shows that reforms on average have had little effect on income distribution. Openness to international trade in particular appears to benefit poor people as much as

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[4] An interesting Polish example is given by Keane and Parsad ("Inequality, Transfers and Growth: New Evidence from the Economic Transition in Poland", IMF Working Paper, 2000.), who argue that the state pension system almost fully offset the increase in inequality during the early transition years.

everyone else (World Bank, 2000a). However, reforms may have very different effects on specific countries and what happens on average provides no guide. In the case of Mexico, for example, inequality rose sharply between 1984 and 1994 and rising returns to skill accounted for 20 percent of the increase in the inequality (Gini coefficient) in household per capita income (IADB, 2001a). To what extent did this widening gap in the returns to skill result from trade liberalization?

45. One study by Hanson and Harrison (1999) found that the reduction in tariffs and the elimination in import licenses in Mexico can account for 23 percent of the increase in the relative wage of skilled labor over the period 1986-1990. As an explanation for this result—which runs contrary to the simplified version of theoretical predictions—the authors argue that Mexico offered relatively high protection to the unskilled-intensive sectors (such as apparel) during the inward-looking development stage and, hence, those were the sectors hardest hit with the removal of barriers. In addition, although Mexico is abundant in low-skilled labor when compared with, for example, the US, Mexico may have an intermediate abundance in skilled labor vis-à-vis other developing countries, such as the PRC.

46. Other countries show a similar pattern in terms of rising wage disparities. Country studies done for Brazil, Chile, Colombia, and Venezuela show that the premiums paid to skilled workers have increased in all them (World Bank, 2001f). Several forces, some associated with trade liberalization, may lie behind this trend. There is evidence that during the 1990s low-skilled labor ceased being the most abundant production factor in Latin America (Spilimbergo et al, 1997). The shift was provoked by the entry of several large unskilled-labor abundant countries into the international market. A study by Robbins (1997) found that trade liberalization accelerates physical capital flows and technology transfers in a sector-biased pattern, and that capital-skill complementarities and bundled technology raise the relative demand for skilled workers. Another cross-country study for Latin America found, however, that wage gaps have increased because of the lower relative price of capital induced by financial liberalization more than by trade liberalization *per se* (IADB, 2001b).

47. Even if trade liberalization results in a higher wage premium for the workers who are more skilled, this should not be used as an endorsement for reversing the liberalization process. First, the evidence suggests that the contribution of trade liberalization to overall inequality is rather small. Other factors, particularly skill-biased technical change, play a larger role. Second, a large part of the unequalizing effect is transitory, the result of a "once-and-for-all" shock of encountering more competition for industries that could not survive it. Third, the medium-term strategy to reduce the inequality stemming from skill-differentials should be investing in upgrading the skills of the low-skilled workers and educating the children who live in poor families. Since private incentives to acquire higher skills will rise, programs that will provide loans for skill acquisition may be effective.

48. Nevertheless, even in the cases where trade liberalization has no effect on the distribution of income, there will still be losers and winners from reform. Some of the losers may already be poor or people who become poor (while others may get out of poverty) as a result of liberalization. The fact that during the transition there will be losers that are or become poor points to the importance of social policies to ease the burdens that reforms impose. This is particularly important for the poor whose assets, particularly the human capital of their children (such as nutrition and education), can be irreversibly affected by negative shocks on the household's income, even if the shocks are temporary. At present, Latin America and the Caribbean countries still need to improve their mechanisms of social protection to address the transitional costs of opening up their economies.

E. Regional Summary

49. The experience of the various regions shows the working of the linkages between trade and poverty reduction highlighted in the first chapter. In Africa, trade liberalization has not always spurred an investment and growth response because of constraints in regulations, infrastructure, and education levels. In many Asian countries, trade has helped reduce poverty through a strong impact on growth. In the transition countries of the former Soviet Union, governance and regulatory factors greatly limited the process of transition to new competitive activities and lost jobs were not replaced, at great costs in terms of unemployment and increases in poverty. In Latin America this link is not as well established; changes in the relative demand for skilled and unskilled labor have contributed to an increase in the returns to skilled labor relative to those to unskilled labor. In some countries, such as Mexico, this has contributed to wider income inequality and decreased the poverty-reducing impact of growth. The next chapter discusses policy actions that increase the potential to gain from globalized markets for poor people and poor countries.

III. POLICY ACTIONS TO HELP POOR PEOPLE GAIN FROM GLOBALIZED MARKETS

50. Globalized markets and the World Trade Organization (WTO) system have recently been subjected to strong criticism. Challenges to the WTO system come from nongovernment organizations in the North, who ask for greater transparency in decision-making and for a voice to influence processes. Governments in the South ask for a seat at the table and for technical assistance that can allow them to be full participants in negotiations and reap the benefits of trade liberalization.

51. From the perspective of the poor, there are risks that justified concerns about their interests are manipulated to support a return to protectionism. This would slow world growth and would likely harm the poorest most. Reforming and revitalizing the international trading system, including the launch of a new trade round, is important to harness trade for development and poverty reduction.

52. Equally important is the integration of trade policies in the broader development agenda that includes institutional development, such as adequate regulatory frameworks, both nationally and internationally, appropriate mechanisms to deal with labor and environmental issues separately from trade issues, and appropriately sequenced capital account liberalization. Such reforms are a continuing process, expected to benefit poor people in developing countries, but need to be consolidated. Actions by developed countries, developing countries, and aid agencies are needed.

A. Actions by developed countries

53. Estimates of gains for developing countries from full merchandise trade liberalization worldwide exceed US$100 billion per year. This is more than twice the official development financing, which amounted to US$47.1 billion in 2000. Estimates that take into account full services liberalization and productivity responses are much higher, over US$400 billion (World Bank 2001c, IMF/World Bank).

54. The EU's *Everything But Arms* initiative, recently ratified by the Council of Ministers, is an important step forward in opening up markets to the 49 least developed countries (LDCs). All imports, except arms, from these countries will enter the EU free of duties and quotas. Tariffs on

sugar, rice, and bananas will be phased out over the next eight years. New Zealand and Norway have also committed to providing duty- and quota-free access for exports from LDCs. Among G7 countries, Canada, Japan, and the US have also implemented initiatives to increase market access for LDCs, but they fall short of liberalization across all products. Recent World Bank studies show that if Canada, Japan, and the US, in addition to the EU, gave free access to imports from the 49 LDCs, these countries' net exports would increase by about 11 percent (2001d). Non-oil exports from sub-Saharan Africa would expand by 14 percent (2001b). The costs to other countries of such preferential access would be minimal. Developed countries should fully open their markets to developing countries.

55. Agriculture subsidies in developed countries undermine developing countries' exports by depressing global prices and pre-empting markets. For example, developed countries give some US$266 billion annually for farm subsidies (1997-1999), which accounts for about 35 percent of gross farm receipts. This amount is more than five times the level of all official development assistance to developing countries. Developed countries should progressively reduce the agricultural subsidies and high tariffs on agricultural goods that make it difficult for developing countries to penetrate markets of developed countries.

56. Developed countries are not only challenged to further liberalize trade, they also face important responsibilities to work toward a more robust international financial architecture. A strong international architecture that can help prevent and manage financial crises is a global public good that would benefit all countries and peoples, including the poorest, who have fewer resources to fall back on when crises strike. developed countries should continue to support initiatives to ensure the stability of financial markets. In addition, they should continue to help improve the external sustainability of the heavily indebted poor countries by actively supporting and participating in the HIPC initiative.

57. Related to trade issues that are the focus of this report, agreements on investment, intellectual property, and standards should also take into account the needs and implementation capabilities of developing countries. Greater attention needs to be given to the effects on developing countries of changes in standards—many developing countries are not adequately equipped to deal with product standards, including sanitary and phytosanitary standards (Wilson 2000)—and to the creation of mechanisms to facilitate participation by developing countries in the setting and enforcement/implementation of standards. Ongoing legal action on trade in pharmaceuticals and debates on how to deal with environmental and labor standards are key tests of whether the existing system can find answers to new problems in ways that are least harmful to trade.

B. Actions by Developing and Transition Countries

1. Broadening the Trade Agenda

58. Today, the trade reform agenda in developing countries goes well beyond border measures. To leverage trade into faster growth and poverty reduction, complementary actions that address broader issues are needed. Trade liberalization alone may not bring benefits if it is not accompanied by improvements in the macroeconomic and business climate, transportation and communications infrastructure, standards, and technical regulations. Policies to reduce border barriers—tariffs, nontariff barriers, and customs inefficiencies—need to be integrated with policies to address domestic issues. Without actions on the domestic front, the economy may not be able to respond to opportunities offered by increased access to foreign markets.

Moreover, domestically, jobs lost to foreign competition may not be replaced, with high costs for those who worked in previously protected industries.

59. The proper sequence and mix of reductions of border barriers and domestic reforms needs to be examined carefully, as the impact of trade liberalization on the poor varies depending on country-specific factors. The extent to which the poor benefit from trade reforms depends on the initial nature of protection, the structure of production and effects on relative prices and demand for labor (especially unskilled labor, the basic asset of the poor), the characteristics of the poor, and the extent of good governance (World Bank, 2001f). As Chapter II showed, the ease with which private sector firms can create new jobs and the level of education of the poor are important determinants of whether trade reforms increase demand for labor among the poor. A case for phased liberalization accompanied by complementary reforms and social protection mechanisms may exist, if a series of reforms is needed to ensure that the poor are able to benefit from opportunities created by trade liberalization. Access by the poor to new opportunities in globalized markets may be helped by changes in business regulations, support for small and medium-sized enterprises, increased access to credit, and training (World Bank, 2001f).

60. Similarly, it may be necessary to make changes in a country's revenue collection systems to ensure that trade liberalization is not accompanied by a significant reduction in the resources available to fund key expenditures in education, health, infrastructure, rural development, and other sectors.

61. Governments and people in developing countries need to own this broader trade and structural reform agenda; without domestic support, reforms cannot succeed. In low-income countries, the Poverty Reduction Strategy approach offers an opportunity to integrate trade in country-owned poverty reduction strategies and to forge broad consensus around reforms through participatory processes.

2. Regional Integration

62. Developing countries would also benefit from reductions in trade barriers between themselves. The average tariff of developing countries to imports from other developing countries is 20 percent higher in agricultural products and three times higher in manufacturing compared with barriers that protect markets of developed countries (Hertel and Martin, 2000). The removal of these barriers would provide additional access for poor countries to the fastest-growing developing country markets.

63. Regional trade has played an important role in many of the developing regions. Gains from expanding regional trade and from further regional trade integration should be exploited. Regional agreements often include more than trade issues and can increase the credibility of reforms, thus making the liberalization process more acceptable to domestic stakeholders. They may be less costly and not as cumbersome to negotiate as global reforms. If properly designed, they have the potential to stimulate global trade, and can become stepping stones to more effective participation in a globalized market. However, regional trade agreements need to be designed carefully, since they may artificially shift import supply from countries outside to countries within the trade area and lead to reduced efficiency if displaced external suppliers provide goods at lower cost.

C. Actions by International Institutions

64. A first area where development finance institutions and aid agencies can assist client countries is in the design and implementation of pro-poor reform programs that make trade an engine for faster growth and poverty reduction. This requires support for both reductions in border barriers and improvements in the domestic macroeconomic and investment climate, infrastructure and technology, as well as knowledge and skills. This support should be based on country-owned poverty reduction strategies that lay out priority actions and areas of intervention.

65. In addition to helping integrate trade policies into the broader pro-poor development agenda, development finance institutions can assist countries in identifying the effects of reforms on the poor. This would help select the best options to combine growth and antipoverty policies among alternatives, and set in place or strengthen social safety nets and other mechanisms that address associated adjustments costs, especially when these costs fall on the poor or would cause previously non-poor groups to fall into poverty.

66. The Integrated Framework for the Least Developed Countries aims to increase the overall capacity of LDCs to respond to the opportunities afforded by the world trading system by improving the effectiveness of trade-related technical assistance. As part of efforts to invigorate the framework, six United Nations agencies[5] are working together in a pilot scheme to help several LDCs integrate trade and related assistance into their development and poverty reduction strategies. The framework should receive full support from participating agencies and the international aid community.

67. The international community should also encourage the WTO to make the accession process quicker and more transparent. Countries acceding to the WTO are expected to undertake a broad spectrum of reforms that require wide-ranging analyses, call for institutional strengthening, and possibly entail substantial costs. Poor countries may not be able to meet these costs, nor the cost of bringing disputes to the WTO. To help with the WTO accession process, the framework calls for providing technical assistance to LDCs.

68. Regional development finance institutions play an important role in assisting regional integration not only in terms of trade liberalization, but also in building capacities and networking countries in various subregional groupings. The regional orientation and membership of these development finance institutions provide a focused forum to discuss and arrive at regional agreements as intermediate steps in the process of global integration.

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[5] International Trade Center, IMF, United Nations Conference for Trade and Development, UNDP, World Bank, WTO.

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