Dealing with challenges for making trade inclusive

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Dealing with challenges for making trade Inclusive

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Abstract: Trade has the potential to contribute to economic growth and to more and better jobs. Whether trade contributes to growth that is inclusive, in the sense that all people can contribute to and benefit from growth triggered by trade, is likely to depend on country specificities including institutional pre-conditions and policies applied in domains other than trade. This paper identifies specific challenges for making trade inclusive and identifies ways for dealing with them.

JEL Classification: F1

Key words: International Trade, Inclusive Trade

Contents

List of Tables

List of Figures

A. Identifying challenges

For the sake of discussing challenges to make trade inclusive, it is useful to make a distinction between challenges that occur during an economy's adjustment to more openness and challenges that may occur because openness has long-run implications for the economic structure and the role of different actors in the economy.

Challenges related to adjustment are typically linked to the challenges inherent to a process of reshuffling workers and capital from non-productive to productive activities. The source of gains from trade very much lies in the fact that openness contributes to a shaking up of the economy, as it allows the fittest firms and individuals to take advantage from new opportunities. As a consequence productive firms are likely to grow and expand. Jobs are created in the process and those who can take advantage of these new jobs will benefit. On the other hand, firms finding it hard to compete may lay off workers and eventually even close down. In many cases firm shrinkage and closure will be concentrated in particular sectors.

The adjustment challenge is likely to take the following form: as some parts of the economy suffer and others flourish, it will be important to ensure that those losing their jobs in the suffering part of the economy find employment in the flourishing part (Francois, Jansen, & Peters, 2011); Bacchetta & Jansen, 2003). Along similar lines, entrepreneurs having to give up their current activity because of competitive pressure, should ideally be able to enter a new activity as entrepreneur or employee. Haltiwanger (2011) describes a number of things that can go wrong in this reshuffling process. Barriers to entry and exit; regulations that deter job destruction; poorly functioning product capital and labour markets; weak rules of law; poor public infrastructure for communication and transportation; as well as problems with graft and corruption can all contribute to slowing down the adjustment path or to a situation where the activities that expand in an economy are not the most productive ones.[2]McMillan & Rodrik (2011) find indeed evidence that periods of openness have gone hand in hand with structural change that is not growth enhancing and therefore ultimately not beneficial for the economy.

Distortions can ultimately also be such that job creation and destruction get decoupled (Caballero & Hammour, 2000), i.e. situations where non-competitive firms are destroyed but productive ones do not manage to grow or are not created. Such a situation can lead to an increase in unemployment.

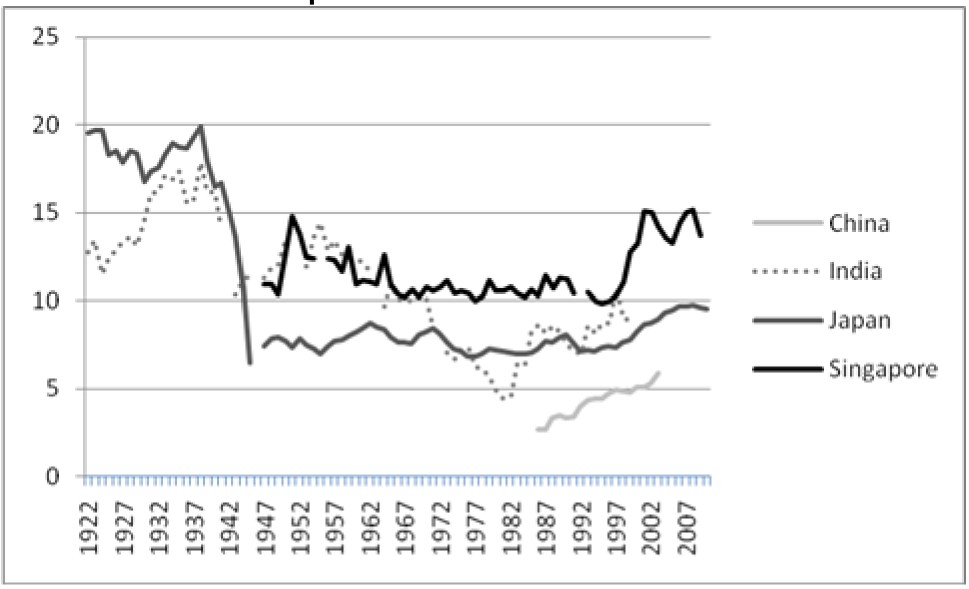
Early studies attempting to assess the economic costs of these reshuffling processes concluded that the adjustment costs of trade reform were low and around 5 per cent of the total benefits of trade (Magee, 1972; Baldwin, Mutti and Richardson,1980). More recent studies find that the adjustment phase may be more cumbersome than previously expected (Francois, Jansen and Peters, 2011b). Cosar (2011), for instance, points out that the adjustment phase may be much longer than previously thought and that it may be particularly difficult for elderly workers to adjust. Recent studies examining adjustments of the U.S. labour market to imports from China (Autor, Hanson and Dorn, 2012); McMillan, Ebenstein, Zhao andZhang, 2011)) also indicate that such adjustment may be significant and costly.

[2]Haltiwanger (2011) cites Banerjee & Dufloo (2005), Restuccia & Rogerson (2008), Bartelsman, Haltiwanger, & Scarpetta (2009a, 2009b) and Hsieh & Klenow(2009) in this context.

In the long run, challenges for inclusive trade can take two forms: the gains from trade may be unequally distributed and open economies must be able to cope with continuous change and unexpected shocks triggered by events in the outside world.

In recent years, numerous economies have experienced significant increases in income inequality. This is in particular the case for a number of Anglo-Saxon countries as discussed in Atkinson, Piketty and Saez (2011). In the United States the richest 1 per cent of households held 19.6 per cent of national wealth in 1928. That share fell to a low of 7.7 percent in 1973 and then steadily went up again to reach 18.3 per cent in 2007, i.e. before the start of the Great Recession. Figure 1 illustrates that also a number of Asian economies have seen inequality increase over recent years, although inequality levels do not appear to have reached pre-WWII levels.

Figure 1: Share of income of top 1 % income earners in selected Asian countries



Source: The World Top Income Database

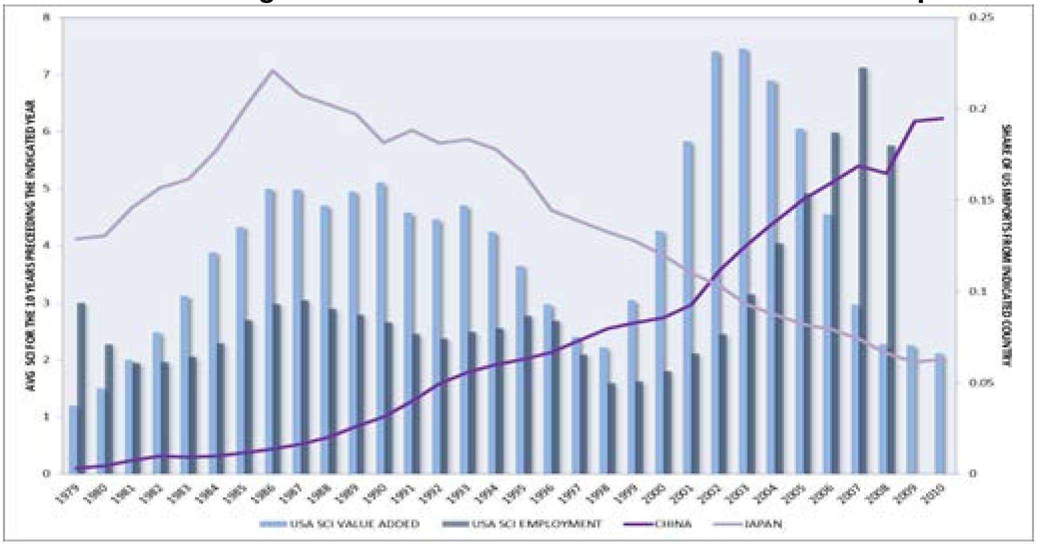
Different reasons for increased inequality have been discussed in the literature. Trade is only one of them and most economists would consider that trade is not the main driver (Pavcnik, 2012). Nevertheless the literature and the evolution of inequality patterns indicate that some may be better positioned to take advantage from globalization than others. Inequality can also hamper individuals' or firms' possibility to contribute to trade-induced growth and can as such negatively affect the growth potential from trade.

Regarding the need for economies to continuously cope with changes imposed through external events, it is useful to distinguish two types of changes. The first type would be temporary shocks, for instance due to bad harvest caused by bad weather or economic downturn in one of the main trading partners. The second type is permanent change, due to changes in market conditions, like the introduction of new technology or the rise of a new competitor.

For some countries, the recent Great Recession took the form of a temporary trade shock as imports and exports were temporarily hit by a fall in demand in partner countries like the United States. Country experiences during the Great Recession (Jansen, von Uexkull, 2010) and during the earlier Asian crisis (Islam, Betcherman and Luinstra, 2000) can provide useful insights into how countries can prepare themselves for such shocks.

Regarding the second type of change, related challenges are very similar to the challenges described above when discussing economies' adjustment to trade reform. Indeed, open economies will constantly need to adapt to changes in the global environment. One of the most important changes in the past decade was probably the opening up of China and its rise as a global trading power. Figure 2 indicates that structural change in the U.S. economy has been significant during the period of increased Chinese exports.[3] The U.S. economy went through a similar phase of adjustment when Japan rose to the position of a global trade.

Figure 2: Structural change in the United States and the rise of new competitors.



Source: UNSD National Accounts Estimates of Main Aggregates, Groningen Growth and Development Centre Database and UNComtrade.

This pattern of structural change can also be found in other industrialized economies like Germany and the United Kingdom. An example of an Asian country that has also been characterized by significant levels of structural change in recent years is India, as reflected in Figure 3. It is important to emphasize in this context that high levels of structural change are only damaging for inclusive growth if the process is distorted along the lines of what was discussed in previous paragraphs.

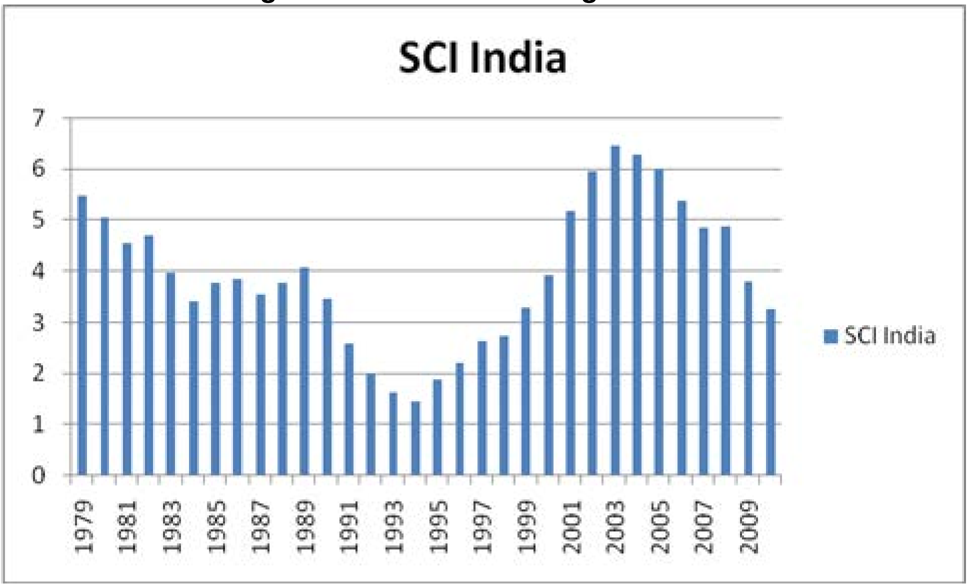
[3]Figure 2 and 3 reflect structural change in the United States and in India where structural change is measured by the so-called structural change index (SCI). The SCI is typically measured as half the sum of the absolute value of the differences in value-added sectoral shares over time: SCI = $\frac{1}{2}\sum_i \left| x_{i,t} - x_{i,t-1} \right|$.Information on 7 sectors has been used to construct the SCI in figure 2 and 3: agriculture, hunting, forestry and fishing; mining, manufacturing, utilities; manufacturing; construction; wholesale, retail trade, restaurants and hotels; transport, storage and communication; other activities. Higher levels of disaggregation would have led to equal or higher values of SCI. See Bacchetta & Jansen (2003) for more information on the index.

B. Those potentially facing disadvantages to contribute to trade induced growth

- Small and medium enterprises

Recent trade literature emphasizes the role of trade costs as a determinant of trade costs (e.g. Hummels, 2007) and there is a certain agreement that small and medium-sized enterprises find it more difficult to overcome those trade costs.[4] Foellmi and Oechslin (2012) elaborate on this idea in a theoretical model showing that smaller firms find it harder to overcome credit constraints when financial markets don't function well. It is as a result of this malfunctioning of credit markets that smaller firms end up not investing in the best technologies. Exposed to competition from abroad they find it hard to survive. By extension Foellmi and Oechslin's (2012) model could be assumed to reflect the informal economy that finds it hard to take advantage from openness because it does not have access to cutting edge technologies.[5]

Figure 3: Structural change in India.



Source: UNSD National Accounts Estimates of Main Aggregates

- Enterprises and individuals located in remote areas.

Distance from major ports and airports increases the cost of participating in global exchanges, in particular if transport networks within the country are weak. Table 1 illustrates that many countries in the region are characterized by a high share of employment in agriculture. Agricultural activities often take place in rural areas and such areas are often remote. In the absence of adequate physical (e.g. roads, railway) and communication (e.g. phones, internet) infrastructure, firms and workers located in such regions will find it hard to contribute to trade-related activities.

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[4] In the 'Melitz-model' (Melitz, 2003) firm size reflects efficiency with small firm size reflecting relatively low levels of productivity. Small firms can therefore not overcome the fix cost of trading and will only serve domestic markets or even disappear under foreign competition.

[5] See Bacchetta, Ernst, & Bustamante (2009) for more information on the relationship between trade and the informal economy.

Table 1: Employment share per sector

Country	Year	Agriculture	Industry	Services
Bangladesh	2005	48.1	14.5	37.4
Cambodia	2011	55.8	16.9	27.3
China	2010	36.7	28.7	34.6
India	2010	51.1	22.4	26.6
Indonesia	2011	35.9	20.6	43.5
Korea, Republic of	2010	6.6	17.0	76.4
Malaysia	2010	13.3	27.6	59.2
Philippines	2011	33.0	14.9	52.2
Thailand	2011	38.7	20.7	40.7
Viet Nam	2011	48.4	21.3	30.3

Source: Key Indicators for Labour Markets (KILM), International Labour Office.

C. Those potentially facing disadvantages to benefit from trade induced growth

- Trade-displaced workers

Workers losing their job because of trade reform will undoubtedly face some disadvantages at least in the short - to medium-run. It is however, not clear, whether trade-displaced workers go through more hardship than workers displaced for other reasons. Kletzer (2001) finds for the United States, and the OECD (2005) for 14 EU countries, that the share of re-employed workers after two years is only slightly lower in sectors with high import competition. These studies also look at the characteristics of dismissed workers and find that, on average, the groups appear quite similar in terms of education and work experience, though the trade-related unemployed are slightly older, have more tenure and slightly higher earnings related to the lost job. Previous studies found that being older and having less formal education is associated with greater post-displacement difficulties (see OECD, 2005).

The difficulties trade displaced workers face are also likely to depend on whether lay-offs are due to a temporary trade shock (e.g. the trade shock linked to the Great Recession 2008/09) or to a permanent trade reform or change in global market conditions. In both cases, broadly targeted social protection systems as discussed below are effective in providing rapid assistance and in contributing to a smooth functioning of labour markets.

- Workers, in particular the low-skilled

Workers stand to gain from trade because trade contributes to reducing the prices of consumption, to provide access to a larger variety of goods and is expected to contribute to growth. Many workers will also experience an increase in wages and working conditions (e.g. Newfarmer and Sztajerowska, 2012). But there are a number of reasons why workers, in particular low-skilled workers may lose in the medium to long-run in relative and possibly even absolute terms. Trade may reduce the relative demand for labour, in particular low or medium-skilled labour. Much has been written about the role of this phenomenon for industrialized countries (see the summary in Pavcnik, 2011). The notion that (low-skilled) labour may also suffer in low-income country has mainly been discussed in the context of Latin American experience and only very recently in the context of Asian experiences.

Recent literature has highlighted three phenomena that affect the gains from trade for workers and that may be important determinants of the inclusiveness of trade in the future:

- Increasingly trade goes hand in hand with technological change implying that trade affects income labour markets through its effect on technology choice and productivity. This implies that positive growth effects of trade may be more systematically accompanied by inequality increases than thought in the past (e.g. Vogel, 2011; Constinot et al., 2012) and that the development of new activities becomes increasingly important to guarantee sufficient job creation and avoid job-less growth traps given that successful exporters will not necessarily create an awful lot of jobs (e.g. Muendler, 2010).

- Recent decades have been characterized by a significant liberalization of capital flows leading to an increase in FDI. This increased global mobility of capital contrasts starkly with the immobility of labour - in particular low skilled labour – and has probably affected the distribution of bargaining power and taxation choices. Both have an effect on within country income distribution (e.g. Boix, 2011).

- Both economic theory and empirical work indicate that size matters when it comes to trade (e.g. Melitz, 2003). Larger companies find it easier to perform in global markets and are able to capture larger profits. An establishment's position in a particular segment of the value chain will also determine profits. Those working in establishments with significant profit margins will take advantage in the form of higher wages. The location of large production or management hubs or of value chain segments capturing high gains therefore matters for income distribution.

- Women

Trade expansion has in many cases brought substantial increases in employment for women workers in low income countries in labour-intensive export-oriented industries. Berik (2011) argues that while these jobs have contributed to women's economic autonomy and status in the household, the conditions of work in these industries have often been poor, marked by persistent low wages, gender wage inequalities, extremely long hours and job instability. Berik (2011) also argues that despite narrowing gender wage gaps – due to increasing education levels – women appear unable to reap the full benefits of their rising education levels as the discriminatory part of the gender wage gap is persistent, or has even increased in some developing countries where trade has expanded. A possible explanation for these trends – she argues - is that trade liberalization is accompanied by other policies, and global processes, that undermine women workers' bargaining position in wage setting – even as women increase their schooling level relative to men. Decentralization of global production, increased corporate buyer and investor mobility, and increasing competition from other low-cost countries may adversely affect wage growth for workers who are concentrated in export sectors. Berik (2011) also describes that, after the initial benefits from trade expansion, women have been struggling in countries that have managed to combine strong export performance with significant growth rates. In East and South-East Asian countries that moved up the technology ladder and diversified exports, women's relative employment opportunities have often declined. This outcome may be, just like the gains in the first place, partly linked to sectoral effects, as women may have limited job-specific skills in the new sectors.

D. Policies and institutions to make trade inclusive

- (1) Connecting people to markets: the crucial role of infrastructure plus export promotion

Policies that help to connect people to foreign markets can play an important contribution to making trade inclusive. Such policies are likely to be particularly useful for those located in remote areas. Examples of relevant policies are infrastructure investments but also the provision of information about aspects like price developments, about changes in foreign demand and distribution networks. Employer organizations and export promotion agencies can play an important role in this context. More generally, export promotion policies can be useful to assist firms to enter foreign markets (Cadot, Fernandes, Gourdon, & Mattoo, 2012). Lederman, Olarreaga, & Payton (2009) contains useful information about possible strategies and set-ups of such agencies and Bacchetta & Jansen (2003) provides useful insights into how export promotion policies can be designed that are in line with WTO commitments.

- (2) Facilitating domestic investment: access of SMEs to finance

Because credit markets do not always function efficiently, individuals and companies may face credit constraints and not be able to obtain the funding necessary for adjustment-related investments, even though they would be able to pay the loans back. Clearly in such a situation, the adjustment process can be severely hampered (e.g. Haltiwanger, 2011); Bacchetta and Jansen, 2003)). A rich body of evidence suggests that small companies suffer from credit constraints more often than larger firms. Ensuring that financial markets function effectively and – if appropriate – putting emphasize on access to credit for small and medium enterprises is therefore an important component of a policy package aiming at making trade sustainable. Along similar lines, Sinha (2011) points out that policies facilitating access to capital for informal firms would have a positive impact on their productivity and facilitate their integration into national and possibly international markets.

Recent research based on new-new trade models (Melitz, 2003), Foellmi and Oechslin, 2012)) has triggered the discussion whether public interventions in the area of credit supply should focus on companies close to the technology frontier that will often be medium rather than micro enterprises. The reason for this would be that such companies stand a higher chance of becoming competitive and of surviving in the medium to long-run without special assistance.

- (3) Facilitating technological upgrading: the role of attracting FDI and disseminating information about new technologies

Integration into global markets is likely to provide access to new technologies either through FDI or to technologies embodied in imported intermediate goods. The benefits of these technology transfers are likely to be largest if they are well-disseminated. Policies that facilitate access to new technologies to small and medium enterprises and to enterprises in remote locations can have high pay-offs. Examples, for instance, exist of agricultural ministries relying on a network of local representations to transmit information about new seeds or new harvesting techniques to small holders, thus contributing to productivity increases among them.

- (4) Protecting the vulnerable: Introducing social safety systems

Trade reform affects labour markets and so do changing market conditions in countries that are open. Both result in job changes for individual workers. The transition period between the last job and the next one can be terribly difficult for workers with low savings and in the absence of a social protection system, i.e. in the situation typical for low-skilled workers in low income countries. One possible result is that workers cannot afford waiting for the job that suits their aspirations or qualifications but accept the first job available. This in turn can result in significant loss of human capital, a waste that developing countries cannot afford. Social protection systems adapted to local conditions can go a long way in facilitating transition phases resulting from job turnover and in avoiding human capital loss.

For a long time, social protection systems were thought to be a privilege for those working in industrialized countries. The so-called Bachelet Report,[6] however, illustrates that there is by now a wealth of experience with the design and the funding of social protection systems in low and middle income countries. Programs tend to differ across countries in their components (e.g. pensions, cash transfers, employment guarantee schemes, unemployment benefits schemes) and in scale and beneficiary selection. Their funding mechanisms will also differ. Examples exist of countries funding social protection through mineral based taxation (Bolivia, Botswana, Brazil), social contributions (Brazil, Costa Rica, Lesotho, Namibia, South Africa), increases in general taxation (Brazil, Lesotho, Thailand) or through Official Development Assistance (Namibia). These examples illustrate that low income countries can afford social protection systems. Social protection systems reduce the risk that workers fall into poverty or suffer significant human capital loss as a result of job churning induced by trade reform or trade shocks. Governments may therefore want to consider to accompany steps in the direction of more openness by investments in social protection (Jansen and Salazar-Xirinachs, 2012).

- (5) Skills for competitiveness: introducing skill policies and institutions that allow for adaptability

Education and skills policies can contribute greatly to the social sustainability of globalization, as they determine whether people acquire the capabilities required to share in the gains from globalization (Woessmann, 2011). Workforce skills determine countries' ability to absorb new technologies (Hoekman and Winters, 2005) and to move into new export markets (Cadot, Carrere and Strauss-kahn, 2011). Yet, designing successful policies remains a challenge.

One way to prepare the young for the challenges of their future working environment is to ensure that they have a good basic knowledge and strong competencies in such general domains as reading and understanding, mathematics and science, and the ability to employ this knowledge in different settings. Research has shown that countries performing better in international student achievement tests focusing on those skills are also characterized by a higher growth rate (Woessmann, 2011). The more open countries are, the more important

[6]Bachelet, Michelle: Social Protection Floor for a Fair and Inclusive Globalization, Report of the Advisory Group chaired by Michelle Bachelet and convened by ILO with the collaboration of WHO, Geneva: 2011.

the contribution of education to growth is found to be. Investments into early stage education have been shown to be key to such results.

But ensuring that young people have a skill set that makes them “adaptable” is unlikely to be enough for them to find a job, in particular when they first enter the job market. In hiring processes, employers are typically looking for candidates that have a set of skills specific to the job, or to the sector or subsector the company is active in. Successful integration of the young into labour markets, is therefore likely to depend to a significant extent on whether the cohorts of young entering the labour market have the set of specific skills that roughly corresponds to what is demanded in the market at any specific point in time. Given that education and training decisions are taken well –often years – ahead of the moment of labour market entry time-inconsistency problems may arise, i.e. situations where education and training decisions today do not match skills demand of tomorrow.

To minimize this problem and to reduce the occurrence of skills mismatches, it will be increasingly important for governments to strengthen skill anticipation mechanisms in their economy. This implies strengthening the collection of information about current and possible future skill demand by employers and to ensure that this information is passed on to training and education institutions and to students. It also implies that the transmitted information influences education and training supply.

Employers well-placed to know about current and possible future skill demand and the involvement of employers in skills anticipation is therefore likely to be important in order for skills anticipation policies to be successful.

Successful institutional and logistical set-ups to organize such public-private sector collaborations are likely to differ across countries. Examples from the Asia-Pacific region include South Korea's network of vocational schools—called “meister” schools, from the German for “master craftsman”—to reduce the country’s shortage of machine operators and plumbers (Economist, 2012). In China, Vocational Training Holdings specializes in matching students with jobs in the Chinese car industry by keeping masses of data on both students and companies (Economist, 2012). One characteristic these initiatives share is that most of the private-public dialogue or collaboration takes place at the sectoral or even sub-sectoral level (Gregg, Jansen and von Uexkull, 2012)

- (6) Ensuring that women can contribute to trade-induced growth

Berik (2011) argues that a more equitable gender distribution of benefits from trade expansion can only be achieved if gender differences in employment are low with respect to the distribution among sectors, occupations and skill levels. If women are stuck in low-skilled low paying jobs, the impact of trade will inevitably be different for men and women. A policy recommendation for governments would therefore be to pursue general gender equity policies with the objectives to increase women’s employment options through education, childcare provision and alleviation of unpaid work load.

E. Looking forward

While trade has a tremendous potential to increase economies' wealth it also creates significant challenges when it comes to ensuring that the vast majority of people can actively contribute to and benefit from trade. The nature and extent of challenges will differ across countries and so will the policy solutions to overcome the challenges. Recent research provides useful guidance, though, for policy makers who want to ensure that trade leads to inclusive growth in their economy. It also provides useful guiding principles for effective policy design to overcome the main challenges ahead.

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