



# Economic Premise

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## Trade and the Competitiveness Agenda

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*The global economic crisis has forced a major rethinking of the respective roles of governments and markets in the processes of trade and growth. Indeed, industrial policy seems to be back in fashion—or, at least, talking about it is. But a renewed “activism” by government in the trade and growth agenda need not mean a return to old-style policies of import substitution and “picking winners.” Instead, it may mean a stronger focus on competitiveness by unlocking the constraints to private sector–led growth. This note discusses the renewed role of government in trade and growth policy from the competitiveness angle, and it suggests some priorities for the new competitiveness agenda.*

### Export-Led Growth, the Crisis, and the End of an Era

The dramatic expansion in global trade over recent decades has contributed significantly to diversification, growth, and poverty reduction in many developing countries. This period of rapid export growth has been enabled by two critical structural changes in global trade: (1) the vertical and spatial fragmentation of manufacturing into highly integrated “global production networks,” and (2) the rise of services trade and the growth of “offshoring.” Both of these, in turn, were made possible by major technological revolutions; and they were supported by multilateral trade policy reforms and broad liberalizations in domestic trade and investment environments worldwide.

The global economic crisis came crashing into the middle of this long-running export-led growth party during 2008 and 2009. Between the last quarter of 2007 and the second quarter of 2009, global trade contracted by 36 percent. But as the recovery started to strengthen in 2010 (at least until the clouds began to form over Europe), the longer-term im-

pacts of the crisis on the policy environment regarding trade and growth were becoming more apparent. Indeed, in addition to raising concerns over the global commitment to trade liberalization, the crisis has also led to some serious rethinking of some of the conventional wisdom regarding the growth agenda—the most important result of which is the likelihood that governments will play a much more activist role in the coming years. There are three principal reasons why governments are likely to be more actively involved in industrial and trade policy in the coming years.

First, the crisis has undone faith in markets and discredited laissez-faire approaches that rely simply on trade policy liberalization. Instead, governments and local markets have been “rediscovered.” In this sense, the demand for activist government is likely to go well beyond financial markets and regulation, and it will affect the policy environment in which trade and industrial strategies are designed.

Second, the crisis has highlighted the critical importance of diversification (of sectors, products, and trading partners) in reducing the risks of growth volatility. The recent era of globalization contributed to substantial specialization of

many economies. Whereas this specialization was predicted by trade theory, what perhaps was unexpected was the degree of vertical specialization that emerged through “task-based” trade in global production networks. As the next era emerges, diversification will be at the top of the policy agenda in most developing countries. This will create further demand for government activism.

Finally, despite the dramatic rise of East Asia and India in recent years, many developing countries have failed to benefit from the opportunities afforded by liberalized trade over the past quarter century. Even with the benefits of preferential market access, few exporters from low-income countries are in a position to compete in international markets because of poor productivity, high trade costs, and the inability to benefit from internal and external scale economies.

### **The Coming Era of Government Activism: Old Industrial Policy or a New Competitiveness Agenda?**

The demand for a more activist approach does raise the risk of going back to old-style industrial policy associated with the import-substitution era. One risk here is that the heavy hand of government—in picking winners, in managing unrealistic exchange rates, and in attempting to derive demand through import substitution—will distort the market and undermine private sector competitiveness in the long term.<sup>1</sup> Further, such demand for protection—which inevitably would emerge through traditional industrial policies—eventually could undermine the gains made in trade liberalization over recent decades. On the other hand, greater active government commitment also opens up the possibility of countries adopting a more comprehensive, competitiveness-based approach to trade and growth. As Klinger (2010) points out, firm productivity is determined in large part by public inputs to firms’ production and the good functioning of the markets in which firms operate. Thus, government plays a critical role in overcoming market failures. If done effectively, government intervention can create the conditions that enable the private sector to respond to market opportunities. As discussed in Rodríguez-Clare (2005), Harrison and Rodríguez-Clare (2009), and Klinger (2010), these interventions can include both policies to induce discovery (as noted by Hausmann and Rodrik [2002]) and policies to promote the benefits of agglomeration (inspired by the seminal work of Porter [1990]).

Thus, the demand for government activism need not lead to a return to the days of old-style industrial policy. Instead, it can result in a deepening of the competitiveness agenda and a strengthening of support for private sector-led growth by unlocking the constraints that discourage innovation, investments, and export diversification; and, at the same time, facilitating the capacity for economywide adjustment. What

might this competitiveness approach look like? Much of it would be familiar. For example, it would recognize the fundamental roles of human capital, sound macroeconomic foundations, and basic institutions—like property rights, the rule of law, and effective regulation—as the bases for long-term growth. But it would go beyond these basic foundations to address the *microeconomic environment* that shapes individual firms’ capacities and the incentives to which they respond. The competitiveness policy framework might be described as one established on the following three pillars:

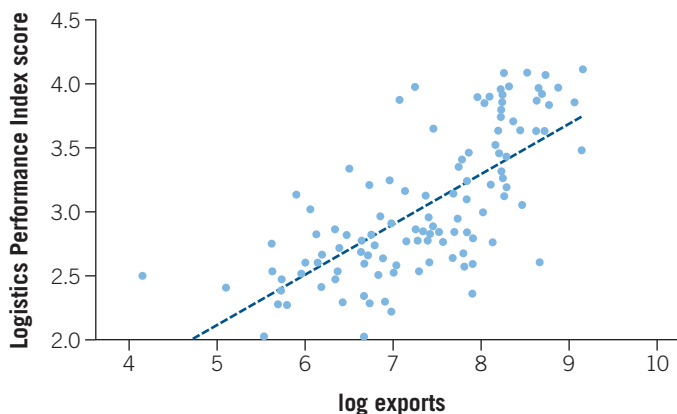
1. *Aligning macroincentives*—for example, removing economic biases arising from tariff and nontariff barriers, real exchange rate misalignment, and a distortive tax regime; and ensuring the overall fiscal health of the economy, efficient labor market operation, product and factor market conditions, protection of property rights, effective regulation, and ease of firm entry and exit.
2. *Reducing trade-related costs*—for example, improving backbone services and inputs such as energy, telecommunications, finance; improving the capacity and coordination of government agencies at the border, international transit arrangements, regional and multilateral agreements; and making policy reforms that ensure more competitive markets for international transport, logistics, and other services that facilitate trade transactions.
3. *Establishing proactive policies for overcoming government and market failures*—for example, promoting technology creation and adaptation, developing product standards and certifications, providing trade finance, supporting industry clusters, facilitating special economic zones and other spatial developments, and ensuring coordination of economic actors as well as links and spillovers to the local economy.

Many of the issues on the agenda within this broad framework of competitiveness are not new; indeed, governments have always played an important role in addressing some of them. However, with the growing postcrisis emphasis on more proactive policies, several issues are likely to emerge as priorities within the competitiveness agenda. These issues are discussed in the remaining portion of this note.

### **Targeting Transport and Trade Facilitation to Reduce the Costs of Bringing Goods to Market**

For exporters in many developing countries, competitive advantage at the factory and farm-gate is eroded step-by-step in the miles between production and markets. Distance aside, factors like transport and communications infrastructure, border-related processes, and local logistics markets will play critical roles in shaping exporters’ competitiveness through their impact on cost, time, and supply chain reliability. Data

**Figure 1. Relationship between Logistics Performance and Exports**



Source: Authors' calculations, based on data from World Bank (2010) and the United Nations Commodity Trade Statistics database (US\$ exports, 2008).

from the World Bank's *Logistics Performance Index* (World Bank 2010) show a clear relationship between logistics performance and exports (see figure 1). Empirical literature tracing the effect of transport and trade facilitation constraints on trade flows shows unequivocal impacts of time and costs on developing-country exports (Djankov, Freund, and Pham 2006) and on the composition of trade (Li and Wilson 2009).

Taking up the competitiveness agenda, governments will play an increasingly active role in trying to overcome transport, trade facilitation, and logistics constraints. This action will start by putting in place the hard and soft infrastructure to facilitate the movement of goods. But it will also involve more active efforts to identify and develop transport corridors, to improve coordination across border clearance agencies (both internally and in concert with trading partners), to strengthen competition in local logistics markets, and to work with the private sector to overcome coordination failures in export logistics and facilitate greater scale and predictability. In addition, given that export of services is a key element of the trade diversification strategy in many developing countries, an expanded trade facilitation agenda also must contemplate telecommunications and connectivity because maintaining and upgrading both the quantity and quality of communications infrastructure are crucial for ensuring the possibility of engaging in services trade.

### Retooling Export Promotion to Support Improved Export Survival

Government support for export promotion is based on the significant information externalities and coordination failures that affect the private sector with respect to export markets. Export promotion agencies (EPAs) have a long history in both high-income and developing economies. Although they often have been criticized, recent research shows they have generally had a positive effect on export

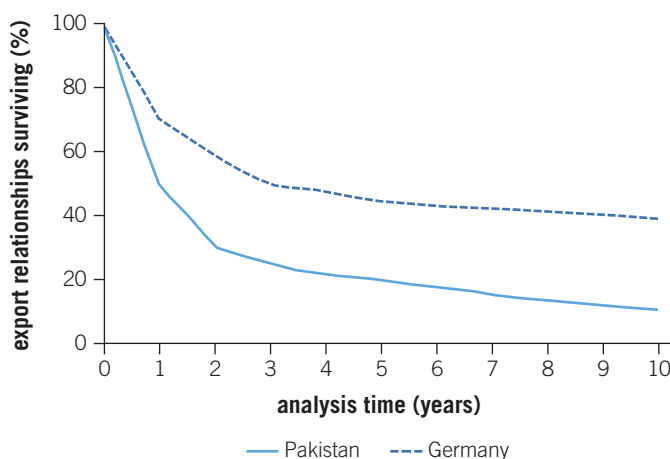
performance in developing countries (Lederman, Olarreaga, and Payton 2009). In light of the changing trade dynamics discussed in this note, however, there is likely to be a need for EPAs to shift from their traditional focus on finding new export market opportunities to supporting new and existing exporters to increase survival rates during the first few years after beginning to export. Indeed, as illustrated in figure 2, survival rates in developing countries can be dramatically lower than in high-income countries as a result of the many additional barriers to competitiveness that they face (compare Brenton, Pierola, and von Uexkull 2009).

Addressing the agenda of sustainability will require governments to address a much wider set of issues. For example, competing in high-value (usually perishable) agricultural exports may require support to ensure that standards and certification requirements are met on an industrywide level to facilitate market access for new exporters. In the services sector, which suffers from notorious information asymmetries, collective action on licensing and accreditation may be necessary to enable competitiveness. Across virtually all sectors, access to trade finance is critical to enable exporters to enter and sustain participation in international markets. All of this is likely to imply significant institutional changes in the approach of EPAs—in particular, taking on a greater coordination role and working more closely with other public and private sector actors.

### Using Special Economic Zones and Clusters to Facilitate Externalities

As task-based trade and investment patterns have become engrained in the global production system and the sources of competition are highly globalized, addressing the chal-

**Figure 2. Comparison of Survival Rates of Exporters in Pakistan and Germany**



Source: Authors' calculations, based on data from the United Nations Commodity Trade Statistics database, using the World Bank's World Integrated Trade Solution software.

lence of upgrading in developing countries will require facilitating better links between foreign direct investment and the domestic private sector. This will require a greater emphasis on skills development. Beyond skills development, however, there is an important role for governments to facilitate spillovers by promoting collaboration between local producers and foreign buyers and by overcoming gaps in coordination between the local private sector and institutions. In this regard, governments are likely to put greater emphasis on spatial industrial policies in the years ahead.

One such policy instrument that has been used in many developing countries are special economic zones, most commonly export processing zones. Such special economic zones have played a valuable role in catalyzing industrialization and trade integration, particularly in East Asia. However, the traditional export-processing-zone model that was implemented in most countries<sup>2</sup>—one reliant on low wages, trade preferences, and substantial fiscal incentives—paid too little attention to facilitating dynamic links with the local private sector. A more innovative approach to using spatial industrial policy will be part of the new agenda to support industrial upgrading in developing countries. This approach will involve the use of more flexible and integrated zones that combine cluster-based development models with a host of policies designed to facilitate links between foreign investors and the local private sector. It will also involve support for the development of public-private institutions that promote public goods (for example, training, joint research, certification, and market information) linked directly to local clusters.

### Strengthening Competition Policy and Institutions to Support Adjustment

Central to the aims of the trade policies discussed in this note are facilitating and managing the dynamic process of economic adjustment that is inherent in capturing the benefits of trade. This requires redeploying resources (capital, labor, institutions) to higher-value activities. The ability of economies to adapt to a changing environment depends on their degree of flexibility, not only at the more conventional macroeconomic level, but also at the microeconomic level. The foundations of long-run adjustment are, of course, human capital and innovation.<sup>3</sup> But beyond this agenda (and, indeed, intrinsically linked to it), governments will focus their industrial and trade policy increasingly on competition and other actions to promote firm entry and exit. They also will support adjustment capacity more broadly by building and sustaining dense networks of high-quality and flexible economic institutions.

Competition policy plays a critical role in facilitating entry and exit (both in product and factor markets), which

Aghion and Howitt (2006) show to be the primary channel through which economic adjustment processes occur in a Schumpeterian growth paradigm. But competition, although generally acknowledged as an important element of the growth agenda, is often relegated to a kind of second- or third-priority level. And industrial policies that engage in building “national champions” are frequently at odds with competition policy—thereby contributing to their long-run welfare deficits.

Finally, delivering on the competitiveness agenda will rely on the existence of effective institutions, including those of the state, of the private sector, and of civil society. Acemoglu, Johnson, and Robinson (2004) argue that institutions—the “rules of the game” in a society (North 1991)—are the fundamental “deep determinants” of economic growth and development differences across countries because they ultimately shape incentives for innovation and entrepreneurship and set the main constraints for societies to adapt. Indeed, the fundamental role of institutions in a society—to facilitate cooperation and collective action among individual (economic) agents—is to address the market and coordination failures that are the bases for the “new” competitiveness agenda discussed in this note. But institutions are endogenous, and so can also act as barriers to adjustment by blocking reform (Aghion, Alesina, and Trebbi 2002; Acemoglu and Robinson 2006). And weak institutions may have negative influence on the provision of public goods and on the development and delivery of policies aimed at improving skills or innovation capacity or other potential sources of growth. Therefore, the development of “thick” networks (Amin and Thrift 1994) of flexible and reform-minded institutions that promote cooperation and knowledge sharing across the public and private sectors will be the key to establishing a governance framework that is suited to the new era of competitiveness.

### Notes

1. Noland and Pack (2003) survey a series of studies showing that, contrary to popular belief, industrial policy in East Asia was not successful in supporting high-growth sectors. The sectors that received the most support in terms of subsidies, tax breaks, and protection in Japan, the Republic of Korea, and Taiwan, China, were not the ones that later showed the most growth.

2. It is worth noting that many of the successful East Asian countries (most notably Korea and Malaysia) did implement much more dynamic models of special economic zones, with an explicit focus on facilitating spillovers.

3. See Glaeser (2003, 2008) for an ample discussion of the role of human capital in cities’ recovery from and adaptation to external shocks—particularly, how it helped Boston, Massachusetts, reinvent itself.

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