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Can Trade Reduce Poverty in Africa?

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While most economists accept that, in the long run, open economies fare better in aggregate than closed ones, many fear that trade could harm the poor. African countries, for example, have realized significant improvements in trade liberalization in recent decades, yet Africa remains the poorest continent in the world. It seems that the large gains expected from opening up to international economic forces have been limited in Africa, especially for poor people. Drawing on the findings of a recently published working paper (Le Goff and Singh 2013), this note argues that the benefits of trade are not automatic, but rather depend on accompanying policies aimed at developing the financial sector, promoting primary education, and improving governance. This accompanying policy agenda allows people to take advantage of the opportunities offered by freer trade, by reallocating resources away from less productive activities to more promising ones. Trade liberalization therefore should not be implemented on its own, but with the necessary complementing policies.

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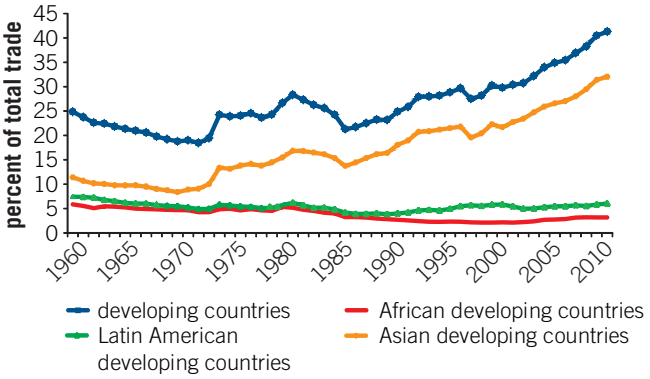
Trade and Poverty in Africa

Trade liberalization is being actively promoted as a key component of development strategies. Through greater efficiency in resource allocation, specialization in production, dissemination of knowledge and technological progress, and competition, trade liberalization should favor economic development and growth. How is this reflected in poverty? In theory, a more liberalized trade regime will make greater use of the factors of production that are most abundant, thus increasing their relative price. If poverty and relative low income stem from abundance of labor, greater trade openness should lead to higher prices for labor and a decrease in poverty.

Hence, the removal of tariff and nontariff barriers (export and import bans, restrictive rules of origin), which remain particularly high in Africa, and improvements in trade facilitation have been recognized as a means for supporting Africa's economic development. Recent attempts to consolidate trade integration within Africa—for example, the Common Market for Eastern and Southern Africa (COMESA), the East African Community (EAC), and the Southern African Development Community (SADC)—are testimony to African leaders' willingness to ease trade restrictions.

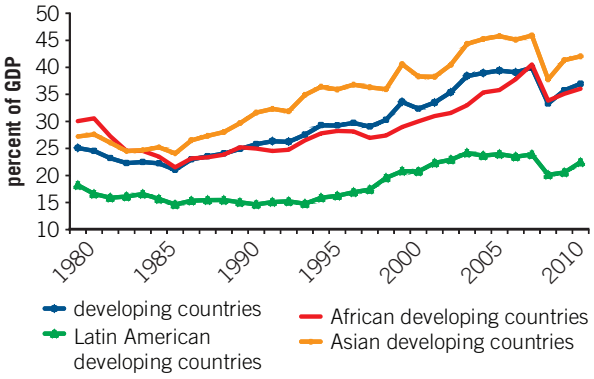
Although Africa's participation in global trade remains limited, trade to and from Africa has significantly expanded. The continent is still one of the least open regions of the world. In 2011, African trade accounted only for 3.5 percent of global exports and imports (down from 5.3 percent in 1980), compared to about 6 percent for developing Latin American countries and 32 percent for Asia (figure 1). Exports from African countries have nevertheless accelerated, expanding annually, on average, by 2.6 percent in the 1980s, by 8 percent in the 1990s, and by 15 percent in the 2000s. Over the last decade, this rate of increase for Africa outpaced the world average of 9.7 percent. During the same decade, the average yearly growth rate of African imports reached about 17 percent. This increase in both exports and imports has re-

Figure 1. Share in Global Trade by Region, 1960–2011



Source: UNCTAD statistics.

Figure 2. Trade Openness by Region, 1980–2011



Source: UNCTAD statistics.

sulted in greater trade openness in Africa, measured as the sum of exports and imports as a share of gross domestic product (GDP; figure 2).

Yet, with almost 50 percent of the population living below US$1.25 a day, sub-Saharan Africa remains the poorest continent in the world. The large gains expected from opening up to international economic forces have, to date, not been realized in many African countries, especially for poor people. It seems that countries are not equally able to make use of the opportunities arising out of increased access to international markets.

So, can trade actually reduce poverty in Africa? How could poor people in Africa benefit more from the economic opportunities offered by greater trade openness? Are there some complementary policies that could allow the benefits of trade to be more widely shared among the population?

What Does Trade Theory Tell Us?

Both theoretically and empirically, the impact of trade openness on poverty is ambiguous. Most economists accept that, in the long run, open economies fare better in aggregate than do closed ones, and that relatively open policies contribute significantly to development. Many analysts fear, however, that in the shorter run, trade may harm the poorer actors in the economy, and that even in the longer run, successful open trade regimes may leave some people behind in poverty.

Bhagwati and Srinivasan (2002) distinguish between two broad argument strands when discussing the effects of freer trade on poverty: static and dynamic. This note examines, in the former case, how freer trade effects poverty, taking resources and technology as given, and in the latter case, growth effects and the evolution of poverty over time.[1]

Following the static approach, the Stolper-Samuelson theorem, in its simplest form, suggests that the abundant factor should see an increase in its real income when a country opens up to trade. If the abundant factor in developing countries is unskilled labor, then this framework suggests that the poor (unskilled) in developing countries have the most to gain from trade. Krueger (1983) has used this insight to argue that trade reforms in developing countries should be pro-poor, since these countries are most likely to have a comparative advantage in producing goods requiring unskilled labor.

From a dynamic perspective, economic growth is critical to sustained poverty alleviation, and trade liberalization is argued to require increases in productivity to sustain growth. Freer trade provides greater incentives for investment, the benefits of scale and competition, limitation on rent-seeking activities favored by trade restrictions, and openness to new ideas and innovations (Berg and Krueger 2003; Grossman and Helpman 1991; Lucas 1988).

However, for comparative advantage to increase the incomes of unskilled workers, workers need to be able to move out of shrinking sectors and into expanding ones. Davis and Mishra (2006), Goh and Javorcik (2006), and Topalova (2006) suggest that labor in the real world may not be as mobile: there are too many barriers to entry and exit for firms, and too many barriers to labor mobility for workers. In this case, the expected benefits from freer trade may not materialize.

Trade openness may also increase the size of the informal sector (Goldberg and Pavenik 2003). Being more exposed to foreign competition, firms may be incited to reduce their costs by hiring temporary workers instead of permanent ones, or even to lay off workers, who may in turn obtain informal jobs. Depending on the wage differences between sectors, this could lead to an increase in poverty.

In addition, if the poor are mostly completely unskilled, and it is semiskilled labor that is in increased demand, poverty will be unaffected—or possibly, worsened. Trade liberalization may even be accompanied by skill-biased technical change, which can mean that skilled labor may benefit relative to unskilled labor. Lower prices for capital goods or increased competition following trade liberalization could encourage firms to import machines and increase their demand for skilled labor (Acemoglu 2003). Furthermore, many developing countries are rich in natural resources:

trade would stimulate this sector rather than the labor-intensive sectors.

Krueger (1983) shows through case studies that developing countries' manufactured exports were, indeed, labor intensive, but that the employment effects of freer trade policies were generally rather limited. A number of cross-country studies on poverty, while not dealing with trade explicitly, incorporate trade openness as a control variable and showed similar results: at best the benefits of greater trade openness seem to have bypassed the poor (Beck, Demirgüç-Kunt, and Levine 2007; Dollar and Kraay 2001; Guillaumont-Jeanneney and Kpodar 2011; Kpodar and Singh 2011; Singh and Huang 2011).

Toward a Policy Agenda

This lack of any clear correlation between openness measures and poverty indicators in aggregate may suggest that trade liberalization requires combination with other policies to have a significant impact on poverty. The sort of policies envisaged would be those that encourage investment, allow effective conflict resolution, and promote human capital accumulation (Winters, McCulloch, and McKay 2004).

For example, Sindzingre (2005) suggests that institutions could help explain the heterogeneity in the globalization-poverty relationship. She argues that domestic political structures and institutions (such as oligarchic or predatory regimes) may prevent the poor from benefiting from globalization. Similarly, Bolaky and Freund (2008) show that trade reforms actually lead to income losses in highly regulated economies. Excessive regulations restrict growth because resources are prevented from moving into the most productive sectors and to the most efficient firms within sectors.

More recently, Haltiwanger (2011) and McMillan and Verduzco (2011) argue that benefits of trade depend to a large extent on national institutional settings. The process of trade-induced growth entails a continual reallocation of resources away from less productive activities to more productive ones. Many things can go wrong in this reallocative process if economies are distorted, for instance, if transportation or communication infrastructure are not sufficiently developed, if ineffective (or nonexistent) competition policy cannot prevent large firms from abusing their market power, or if financial markets are not sufficiently developed to fund new and expanding businesses. In such distorted economic environments, there is little chance that the benefits of greater trade openness will materialize and—in extreme cases—a "decoupling" may take place, that is, where policy reforms induce some firms to downsize or exit the market, but do not lead to the expansion of other firms.

Similarly, reviewing the new wave of research under the International Collaborative Initiative on Trade and Employment, Newfarmer and Sztajerowska (2012) conclude that the benefits of trade do not accrue automatically, and that policies that complement trade opening are needed. To reap the potential wage, employment, and income gains associated with trade, trade reforms should be accompanied by policies that ensure (i) macroeconomic stability and a sound investment climate; (ii) protection for workers; (iii) maintenance of high-quality working conditions; and (iv) facilitation of labor transitions.

What does this literature entail for Africa? This note, based on Le Goff and Singh (2013), argues that the effect of trade openness on poverty in Africa depends on complementary reforms that help a country take advantage of new opportunities. Working with pooled cross-country and time series data for 30 African countries averaged over five-year periods from 1981 to 2010, Le Goff and Singh (2013) provide new evidence on the links between trade liberalization and poverty reduction in Africa. Their results uncover an interesting pattern of reform complementarity: trade openness tends to reduce poverty in countries as their financial sectors grow deeper, their education levels higher, and their governance stronger.

These results correspond to a certain logic. Three dimensions (finance, education, and governance) capture an economy's ability to reallocate resources away from the less productive sectors to the more productive ones. This, in turn, allows countries to take better advantage of the opportunities offered by trade.

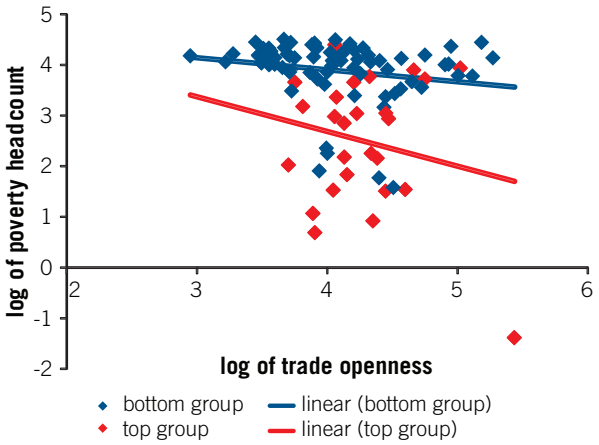
A more developed financial sector, as measured by the private sector credit-to-GDP ratio, allows banks and investors to quickly identify new and promising sectors and to redirect credit. A more educated population, as measured by primary completion rates, would be more able to acquire the new skills sought by growing sectors and adjust more rapidly to the new conditions of the labor market. Finally, better governance, as measured by the rule of law, would facilitate the entering into and dissolution of contracts and make conflict resolution easier.

It's easy to imagine how any of these factors could help pull people out of poverty. An easy-to-get business loan could help a new grocery store open and create new jobs, for example. A literate worker would be better able to transition from low-paying agriculture work to a job in a new factory. And foreign investors, observing that a country's government enforces contracts, might be more willing to invest in a new plant and hire local workers. If these conditions are not met, however, greater openness to trade could be associated with higher levels of poverty.

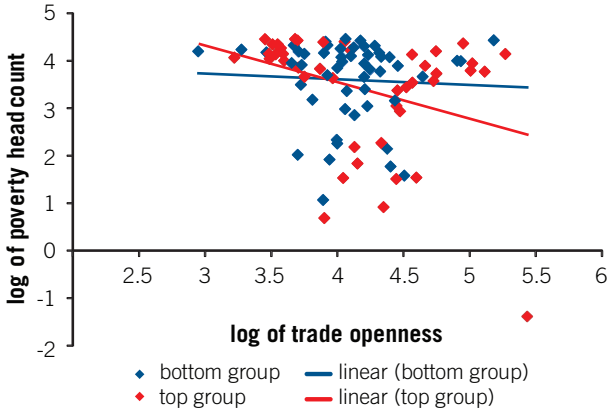
Eyeballing the data seems to confirm this intuition. Figure 3 compares the trade-poverty relationship in the top and bottom country groups in terms of financial development, education, and governance.[2] These charts suggest that for each conditional variable considered, the relationship be-

Figure 3. Poverty and Trade Openness for Top and Bottom Reformers

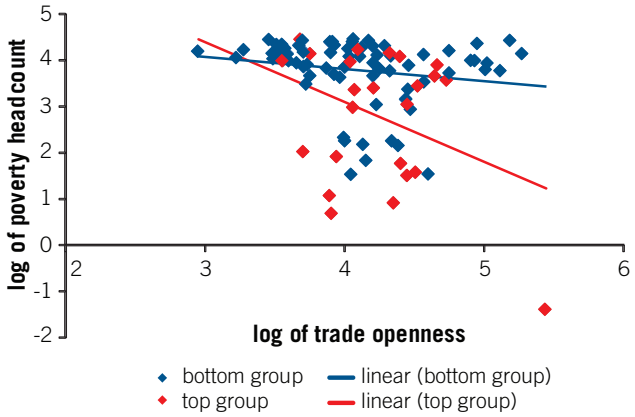
a. Trade and poverty depending on financial development



b. Trade and poverty depending on the quality of institutions



c.Trade and poverty depending on education level



Source: Authors' calculations and the International Country Risk Guide for institutions; UNESCO for primary education; and IMF for financial development.

tween trade openness and poverty appears negative and more pronounced in the top group than in the bottom group. This would suggest that trade does tend to reduce poverty, but only when the conditions are right: in countries where financial sectors are deep, education levels high, and governance strong.

A more rigorous examination of the data confirms these observations. Following the same approach as Chang, Kaltani, and Loayza (2009), analysis starts with a linear regression specification and then extends the regression to account for interaction terms between an openness measure and proxies for various country characteristics (financial depth, education, and governance). While, on average, trade does not seem to be associated with lower poverty in Africa, this observation hides important nonlinear relationships. First, the poor start benefiting from trade when the development of domestic private credit reaches a threshold of 17.7 percent of GDP, which is far below the sample average. Second, trade openness starts being favorable to the poor when the share of the population over age 15 with completed primary education exceeds 46.7 percent. Third, trade openness could be favorable to the poor when institutional quality (measured by the law and order variable) reaches 3.3 (on a 0–6 scale, 6 indicating high-quality institutions).

The good news is that these results suggest that many African countries meet these conditions and are well positioned to take advantage of the opportunities offered by trade. On average, however, while the financial sector is deep enough and the level of education high enough for countries to benefit from trade, institutions are generally too weak. Countries below these thresholds will need to enact a wide range of policies designed to harness the power of trade for economic development. Inadequate policies and institutions, weak human capital, and limited financial development are not only bad for a country's welfare, they also hold back the poor, denying low-income residents of developing countries the opportunity to benefit from freer trade.

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Notes

1. See Winters, McCulloch, and McKay (2004) for a detailed discussion on the possible channels for freer trade to affect poverty.
2. Countries are classified in the top (bottom) group if they belong to the top one-fourth (bottom three-fourths) of a rank distribution given by each conditional variable (financial development, education level, and quality of institutions).

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