Trade and Poverty: A Survey of Recent Studies

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Abstract: This survey of recent literature examines the link between trade policy and poverty. Evidence from a variety of sources supports the idea that open trade regime decreases poverty incidence if it stimulates the economic growth. Trade reform affects the poor through relative prices, employment level, income, wages and government revenue. Since the features of countries, households and markets are different, the outcome of the trade reform will be different. Because of the some factors such as the distribution of endowments, characteristics of labor market, policies associated with trade reform, initial conditions, risks and vulnerability to external shocks, there will be both gainers and losers after the trade reform.

Keywords: Poverty alleviation, trade liberalization, trade reforms

INTRODUCTION

Globalization is a crucial concept as an important development in economic, social, cultural and political life. In fact trade is the driving force in this new globalized economy. The volume of world trade has grown every year and this trend has been accelerated since the end of the Cold War. Developments in transport and communications technologies stipulated developments in world trade and globalization. The increased ease of movement of goods, services, capital, people and information across national borders led to a rapid trend in globalization. These trends have both economic and social consequences especially for the poorer economies in the world economy.

Most of the economists argue that trade and economic growth are closely associated and that income poverty is reduced when per capita income rises. It is the fact that policies influence how much the poor benefit from growth. Generally empirical results show that open trade policies which include subsidies, a competitive exchange rate and low tariffs are more desirable to growth than protectionist trade policies. However it is important to say that the existence of open external markets and open trade policies does not guarantee success in trade-based economic growth and poverty reduction. Other factors are also crucial, such as human resources, investment, valid macroeconomic policies and administration to take full advantage of the opportunities from world markets.

The aim of this study is to review the recent studies that analyze how trade policies affect poverty and to review the empirical analyses which examine the relationship between growth, poverty and trade. In this sense section 1 includes a brief summary of the historical trends in trade and poverty across the countries. In section 2 the sources of benefits from trade reform is discussed. Additionally in this section the relationship between trade, growth and poverty
is presented by reviewing the empirical analyses. Section 3 outlines the key factors which affect the outcome of the trade reform. Finally the conclusion is presented in section 4.

1. HISTORICAL TRENDS IN GLOBAL POVERTY AND TRADE

The world-wide transport revolution in the 19th century had an important role to accelerate global trade. In fact ease of transportation and decrease in the cost of international trade affected the commodity price and factors of production price. Following the developments in transportation and reduction in the transport cost, world economy was significantly integrated in 1914. Economic historians point out that, in the nineteenth century and up to 1914, the world economy experienced a rapid increase in trade and capital. This era was ended by the First World War and the Depression of the 1930s. During the war period, because of the protectionist policies and barriers to integration, world economy was disintegrated. After the interwar period, there were some movements for economic integration and the loss arose during the interwar period had been recovered (O'Rourke, 2001; Williamson, 2000). During the period from the end of the war to 1980, most developing countries such as Africa, Asia and Latin America experienced import substitution industrialization strategies to encourage the growth of domestic firms. The process of closer economic integration accelerated in the post-1980 period with dramatically declining transport costs, improving communications and the development of complex international financial markets. Also growing faith in international markets and growing connections between poor and rich nations were the other main forces to increase in trade and capital flows across the countries (Summers, 1999).

During the long periods in the 20th century, many developing countries experienced protectionist policies under the import substitution strategy. The main aim of the protectionist policies is to protect newly emerging manufacturing sector in order to industrialize at the early stage of the industrialization. Especially the debt crisis as a result of the limited direct investment at the beginning of the 1980s showed that the inward oriented strategies were not sustainable. Many developing countries started to move away from protectionist and restrictive trade policies to open foreign trade regime. It was expected that openness to international trade allowed developing countries to solve problems in balance of payment and to provide technological progress and economic growth. This change in strategies led to significant increase in trade integration of developing countries. Moving away from inward oriented strategies to outward oriented strategies did not change only the amount of trade; it also changed the composition of trade between the countries, the developing countries exports have shifted toward manufactures (Dollar, 2004).
Today integration is thicker than before and foreign trade is very large. Trade is one of the most important aspects of globalization. The shares of developing countries in the world trade increased from 19 percent in 1971 to 29 percent in 1999. Developing countries’ share of world merchandise exports reached to 36 percent in 2006. But there is a great variation among the major regions in terms of the external trade. For instance, while the industrialized economies of Asia have a large share of external trade, in Africa external trade could not grow (IMF 2000). As it could be observed in Figure 1 and 2, both the shares of exports and imports in different economies classified by their income have been grown. While the percentage of exports of goods and services was at about 12% in 1986, it rose to almost 35% in 2007 for the low income countries. Imports as a share of GDP have been rising strongly for all groups of countries with different level of income.

It is important to say that open trade regime may have different effects on countries’ income and poverty rate. Dollar (2004) emphasized on the five trends in the global poverty and inequality:

“…(1) growth rates of developing countries have accelerated in the past 20 years and are higher than rich country growth rates; (2) there was a decline in the number of the poor in the world between 1981 and 2001, the first such decline in history; (3) measures of global inequality (such as the global Gini coefficient) have declined modestly since 1980, reversing
along historical trend toward greater inequality; (4) there is no pattern of rising inequality within countries, though there are some notable cases in which inequality has risen and (5) there is a general pattern of rising wage inequality (larger wage increases for skilled workers relative to those of unskilled workers.” (Dollar, 2004, pp. 12)

Dollar (2004) found that the growth rate of the poorest countries was 4.0% in the period between 1980 and 1997 while it was 1.8% in the period between 1960 and 1980. Also he argued that the growth rate of the richest countries declined from 3.3% to 1.7% for the same periods. His analysis for the five countries such as Bangladesh, India, Uganda, Vietnam and China showed that the growth rate of GDP led to decrease in incidence of the poverty in the poor countries. Also Chen and Ravallion (2004) analyzed poverty rate developing countries due to the $1 poverty line and they concluded that the incidence of poverty was decreased from 40.3 percent in 1981 to 21.3 in 2001.

Figure 3 shows the regional poverty for different groups of countries, it uses the shares of people living on less than 2005 PPP $1.25 a day. Global poverty has been decreasing since the 1980s. The greatest reduction in poverty occurred in East Asia and Pacific, where the poverty rate declined from 78 percent in 1981 to 17 percent in 2005. Much of this decline was explained by China. Poverty rate in South Asia fell from 59 percent in 1981 to 40 percent 2005. However, the poverty rate fell only slightly in all other groups of countries.

Figure 3: Share of people living on less than 2005 PPP $1.25 a day (%)


2. BENEFITS AND GROWTH IMPACTS OF TRADE

One of the sources of benefits from trade reforms is investment. If the domestic reforms are effective, the level of investment is increased by private traders. Higher investment and expansion in the economic activities create new employment opportunities for the unskilled labor, especially in the agriculture which does not require the high skill (Badiane and Kherallah, 1999). Wacziarg (1998) argued that investment has an important role to increase growth in the case of open trade. He found that the impact of the open trade regime on the economic growth was largely explained by investment and more than sixty percent of the total effect arose from investment.
Another source of benefit from trade reforms is the technological progress. Open trade regimes induce the economic growth by the way of technological progress. New inputs, new technologies, new management techniques become available to domestic producer. Generally it is accepted that increase in technology and knowledge lead to higher productivity.

Grossman and Helpman (1991) claimed that the total factor productivity can be increased by either increase in inputs or higher input quality. Open trade allows to provide higher quality inputs and increases productivity. Also Edwards (1998) constructed ten years averages of total factor productivity growth for 93 advanced and developing countries and he found that more open countries experiences faster productivity growth. But also they argued that the relationship between growth and open trade was ambiguous because of the some country specific factors. For instance; some countries may not have human capital which is skilled enough to use foreign technology available with open trade regime.

Generally, people living in urban and well connected areas can benefit from trade liberalization, while the poor in the rural areas can not benefit because of the lack of infrastructure. Also since the poor have limited financial source, they can not enter the new market. Thus government should implement some supporting policies with the trade liberalization to create opportunities for the poor.

There are not so many evidence of the poverty impact of the trade policy while the many empirical evidences show the important role of trade liberalization in generating economic growth. Thus it is useful to examine the link between openness and growth and the link between growth and poverty. Harrison (1996) tested the relation between openness and growth for developing countries. He found that greater openness was associated with higher growth and the strength of association depended on the data specification. Also he argued that the direction of the association was not certain, higher growth rate may lead to more open trade regime and also more open trade regimes may increase the growth rates.

Adams (2003) analyzed the impact of economic growth on poverty for 50 developing countries and he found that growth has an important role to reduce poverty in developing countries. He emphasized that if the economic growth is measured by survey mean income (consumption), there is a strong statistically significant relation between growth and poverty reduction. In his analysis, a 1 percentage increase in economic growth produced a 2.59 percent decrease in the proportion of people living in poverty ($1 a person a day). On the other hand if the economic growth is measured by GDP per capita, the statistical relationship between growth and poverty reduction is no longer strong but it still exists. Also he argued that economic growth has little impact on income inequality because economic growth raises incomes for both the rich and the poor.

Also Dollar and Kraay (2004) analyzed the relationship between growth in average incomes and growth in incomes of the poorest and they found a strong relationship between them. Also he emphasized that there is no systematic effect of trade volumes on income inequality while the greater trade increases economic growth. They concluded that trade openness leads to faster growth and poverty reduction in poor countries.
3. IMPACT OF TRADE POLICY REFORMS ON POVERTY

Individuals both as consumers and producers may be affected by trade policy because of the changes in prices and changes in technology. Since households are not homogenous, some of them are lose from trade. Trade reforms have varying effects on the poverty. For instance; a trade policy which increases the food crop price affects negatively the net buyers while the net sellers are influenced positively. Also producers which compete against the imported goods lose from trade liberalization while the exporters may gain. The important matter is the ability of the household to respond the changes which arise from the trade reform.

Open trade leads to identical effects on factor prices and income distributions for the countries which have the identical technology, same factor mobility and same trade structure. In fact trade liberalization is not a poverty reduction strategy but it may have positive and negative effects on poverty in the long run and short run. It is important to say that the distribution of endowment, the features of factor market, different trade policies, initial conditions and the management of the risks may change the impact of trade on poverty.

3.1 Distribution of Endowment

Heckscher-Ohlin trade theory implies that trade liberalization increases demand for abundant factors of production while it decreases demand for scarce factors of production. In this sense open trade regime leads to increase in prices of abundant factors of production and to decrease in prices of scarce factors of production (Hertel and Reimer, 2004). For instance; if the country is abundant in skilled labor, trade will increase skilled wages and inequality. Due to the lack of education and marketable skills, generally poor people work as unskilled labor (Agénor, 2002). Thus trade in skilled abundant countries does not increase the average income of the poor and it has not a positive effect on poverty. On the other hand, if a country is abundant in unskilled labor, trade will increase unskilled wages and then it decreases inequality and poverty rate.

Harrison and Hanson (1999) analyzed the evidence on the relationship between trade reform and wage inequality for the case of Mexican trade reform. Their findings are consistent with Heckscher-Ohlin trade theory. The impact of the trade liberalization on between country inequalities is vague. It was emphasized that globalization helps the countries for convergence. But generally the most crucial factor for convergence is migration. Trade has minor role on distribution between countries but it is important for the distribution within country (O’Rourke, 2001).

Another important point is that the effects of trade may be different due to the endowments distribution (Winters, 2002). For instance; increase in agricultural trade decreases poverty if the land belongs to poor farmer rather than rich land owners (O’Rourke, 2001).

3.2 Features of Labor Market

Actually trade reforms affect the poverty incidence largely by the ways of employment and wages. The changes in the employment and wage levels depend on the nature of the labor market. Employment is an essential factor in the fight against poverty. There should be enough jobs for all people who are available and looking for work. Not only the quantity of employment and the quality of employment is crucial for poverty reduction. Improving the quality of employment with training and education increases the mobility of labour force. Trade liberalization may
lead to raising new sectors which requires skills and technical knowledge. Since the poor are less mobile because of the lack of education and skill, they are not able to switch jobs on new employment opportunities. Thus trade liberalization may increase skilled labor demand and skilled labor wages rather than unskilled labor wages (Agénor, 2002; O'Rourke 2001).

But it is important to say that the implication of trade liberalization in the short run can be different than long run implications. Because in the long run, rising specialized and science based industries leads to higher growth rate of GDP which reduces the incidence of poverty. Also there will be a significant poverty benefits in the long run if the investment in training is increased. Thus the supporting policies are very important to create benefits for the poor.

Other factors protections and workers rights increase strength of the labor force against the poverty. Communication between workers, employers, institutions and policy makers is another crucial factor shaping labor market structure. All these factors mentioned above change the productivity, mobility and strength of workers. Thus effects of trade reforms on poverty depend on these factors determining labor market.

3.3 Trade Policies

Also the effects of trade on poverty depend on the policies. For instance; government implements the policies for real exchange rate depreciation to reallocate resources toward tradable sectors. Real exchange rate depreciation promotes a reallocation of resources toward agricultural export activities and this leads to increase in income of poor farmers and decrease in poverty. On the other hand because of the reallocation in the tradable sector, real exchange rate depreciation decreases the demand for labor in the non-tradable sector and, it leads to lower employment and nominal wages. Thus the real wages decreases and poverty increases (Agénor, 2002).

Also real exchange rate depreciation increases domestic price of imported goods. Generally developing countries import capital goods. Demand for skilled labor decreases because of the increase in price of capital goods. Thus unskilled labor becomes substitute of skilled labor and average income for the poor increases. However if the country experiences a liberalization program which leads to a serious decrease in tariff, cost of imported capital goods may decrease. As a result demand for skilled labor increases while the demand for unskilled labor decreases. Thus average income of the poor decreases and the rate of poverty rises (Agénor, 2002).

3.4 Taxes and Revenue

In fact, trade liberalization leads to reduction in tariff rates which lessens the government revenue. Also open trade reduces government’s tax revenue, because some mobile factors can not be taxed (Winters, 2002; McKay et al, 2000). If the decrease in government revenue is compensated by the new taxes on consumption goods, this trade policy affects the poor negatively.

Another point is that reduction in government revenue decreases the government expenditures to alleviate the poverty rate. It is important to say that a cut in transfers to low income households as a result of low government revenue mostly affects the urban poor (Agénor, 2002). Rural poor can protect themselves from the effects of cut in transfers through consuming agricultural product which is produced by rural poor.
Actually the decrease in tax revenue can be compensated with the domestic tax reform and government can continue to redistributive activities by the other instruments such as asset redistribution, reducing exposure to observable and exogenous risk, efficient provision of public services and reducing discrimination (McKay et al, 2000).

3.5 Initial Conditions

It is the fact that some countries may not adapt the transition period for the open trade regime. Generally the economic performance of the liberalized economy depends on the initial conditions which give information about the ability of the economy to meet requirements of the globalization. Policy makers should take into consideration the features of the initial conditions to follow a successful transition path. It is important to say that the policies which are not appropriate to initial economic conditions lead to decrease in credibility of the policies. Thus the economic performance of the countries is affected negatively.

For instance; the initial conditions of Caucasus and Central Asian countries led to very poor liberalization effort for these countries. These countries moved from state-ownership and central planning to private ownership. In these countries policies for liberalization could not be adapted successfully to provide the institutional, legal, political and administrative change of the economic system (Dogruel and Dogruel, 2000).

Greater openness to external trade may have different effects on inequality and poverty because of the initial level of economic development. Ravallion (2001) found that initial level of income and openness of trade have a negative interaction effect on the inequality across the countries.

3.6 Risks and Vulnerability to External Shocks

Generally economies are subject to both foreign and domestic shocks. Open trade regime increases the foreign risk relative to domestic risk. Economy becomes more vulnerable to the external shocks. Opening of the economy to trade and foreign direct investment is still desirable policy but some restructuring reforms are necessary to make institutions stronger and to manage risks in the international market.

Also some trade policies may affect the governments’ ability for stabilization. Governments which stabilize the prices by varying trade policies can not stabilize the price level under the implementation of a fixed tariff. Thus domestic instability increases and if the economy is inflexible, increasing instability may increase the poverty (Winters, 2002).

Moreover economic crisis is one of the important aspects of the open trade regime. One of the reasons of economic crisis is exchange rate misalignments experienced by the countries which implement the fixed exchange rate regime. For instance; Argentina experienced a fixed exchange rate regime which pegged the peso to the dollar at a one to one exchange rate regime. Thus the currency board system guaranteed that Central Bank could not increase supply of peso without an increase in dollars. This led to rise in credibility and encouraged the foreign trade and investments. But, it is the fact that there is a trade off between the short-term advantages and long-term disadvantages of this trade policy. Because of the exchange rate policy, monetary policy was not flexible to respond the recession at the end of the 1990s (Yenturk, 2002).
Since the fixed exchange rate regime affected vulnerability of Argentina to external shocks, Argentina could not escape from the impact of Asia crisis in 1997 and Brazil’s devaluation in 1999 and competitiveness of Argentina worsened as the dollar strengthened. Especially, devaluation in Brazil reduced the Argentina exports which became relatively more expensive than those of the other countries. Also, as the dollar rose relative to other currencies, the peso became overvalued. Overvaluation of peso led to increase in purchasing power of consumer in the short run, but because of the pressure on competitiveness producers were no longer able to produce. Lower export earnings and slowdown in economic activity worsened the economic performance of Argentina (Eichengreen, 2001).

4. CONCLUSION

Developments in transport and communications technologies accelerated world trade and globalization over the past two decades. Evidence shows that absolute poverty for globalized developing countries has fallen in the past two decades. This historical trend toward decline in poverty and increase in world trade induced researchers to examine the link between trade policy and poverty.

Trade reform is not a direct strategy for poverty reduction but it has some negative and positive effects on the poor. Cross country evidence supports the idea that trade liberalization leads to higher economic growth, if the other supporting policies associated with the trade reform are implemented effectively. Also it is generally accepted that economic growth has a beneficial impact on poverty.

Trade reform affects the poor through relative prices, employment level, income, wages and government revenue. Since the features of countries, households and markets are different, the outcome of the trade reform will be different. Because of the some factors such as the distribution of endowments, characteristics of labor market, policies associated with trade reform, initial conditions, risks and vulnerability to external shocks, there will be both gainers and losers after the trade reform.

There are no general conclusions about whether trade will increase or decrease poverty. Economy has many channels to explain the relationship between trade and poverty. Thus understanding these channels may help to design liberalization to promote poverty alleviation. Government should implement some supporting policies to protect the poor from the adverse effects of the trade reform and to increase the benefits that the poor obtain from trade reform. Supporting policies associated with the trade reforms should promote efficient and equitable growth. In this sense institutional and policy reforms should expand not only the economic activities but also they should create opportunities for the poor to benefit from trade reform. Efficient financial markets and improved infrastructure play the key role. Also investment for technological improvement and training are the other crucial factors to obtain sustainable growth and poverty reduction in the long run.
REFERENCES