The Linkages between Trade Liberalization and Poverty Reduction an Overview

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Abstract. The main purpose of this paper is to review and assess key analytical approaches that are used to understand the linkages between trade and poverty. We explore that: Economics takes an aggregate 'universalist' approach, measures poverty primarily on the basis of income, and is generally positive about the impacts of trade liberalization on poverty. If we want have more poverty reduction, it matters more what we export and how diversified us exports are than how much you trade. And trade liberalization is no panacea for poverty reduction. On the other hand Trade policy theory does not unambiguously suggest that protection has a negative impact on growth in developing countries.

Keywords: FTA, CGE Model, GTAP, WTO

1. Introduction

Increasing international flows of trade and capital are too often seen as a major cause of widening gaps in living standard between populations in the North and the South or within these regions. However, serious attempts at understanding the possible ways in which the two are connected are rare, mostly because measuring their reciprocal influence is quite difficult.

Apart from the complex public emotions related to these themes, two aspects make a serious study of trade and poverty particularly difficult. The first is that, in international trade analysis, it is essential to take account of the 'general equilibrium', in which everything affects everything else. Second, changes in trade volumes and international prices are determined – together with variations in poverty levels – by many different variables. Thus when looking at real world data, it is difficult to take account of all these variables, and a clear relationship between trade and poverty is hard to establish. Abstracting from specific country cases, East Asia and Latin America display two contrasting situations where increasing trade flows were accompanied respectively by lower and growing poverty levels.[1] Clearly, in such cases, the counterfactual should include not only lower trade flows but also variations in other variables (e.g. growth rates, technology, macro-balance stability, and levels of development) which, in turn, may interact with trade flows. In below some theoretical notions and the empirical evidence are explained.

2. Trade and Economic Growth

Also from a theoretical perspective, the welfare gains from trade liberalization and free trade agreements (FTAs) are not obvious. The economic theories broadly distinguish three categories of models. In the first, the 'static economic models', the removal of trade restriction expands GDP. However, this result assumes that markets function well and without significant distortions. Indeed, if there is 'market failure' then barriers to trade may increase GDP. In the second category of models, where growth is driven exogenously by technological progress, the long-run GDP growth rate is unaffected by trade policy. In the final category, technology change is central. With models of this category, it is possible to construct cases where a 'small country' grows faster by protecting a 'high-tech' sector from imports.

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3. Modeling Issues

CGE models are by far the preferred framework of economists to assess the implications of trade liberalization, be it unilaterally, in regional agreements or multilaterally under the umbrella of the WTO. CGE models have great virtues, such as bringing together demand and supply factors, a high degree of flexibility in managing alternative degrees of sectoral detail and factor and household classifications; they have clear simulation purposes, and are quite suitable to conduct counterfactual analyses, which allow for ex-ante assessments of the potential impact of trade liberalization on affected economies.[2] CGE models have strong theoretical foundations in neoclassical theory, but have evolved over time to capture differences in the structure and behavior of economies, among others, by assuming different macroeconomic closure mechanisms and rigidities in commodity and factor markets. CGE analysis used to be quite an undertaking, typically a multiyear project, but standardized and widely accessible frameworks plus great advances in solving algorithms and computer programs have greatly eased the work.[3] The numbers produced by the CGE models tend to have considerable influence in the public discourse about the effects of trade liberalization. The Global Trade Analysis Project (GTAP) provides a core trade modeling framework and database to a wide network of users and has enabled modeling of regional and global trade scenarios.

4. Macro Closure Rules

The implications of alternative macro closure rules on the outcomes of trade policy analysis are well known[4]. In CGE analysis typically two alternative external closures are considered: one can either assume that the trade balance is fixed and the real exchange rate adjusts to equilibrate aggregate exports and imports or that the real exchange rate is fixed and the trade balance is endogenous. In the type of CGE frameworks indicated above one should expect that trade liberalization will shift relative prices in favor of tradable and if the tradable goods sector has a higher average productivity and labor-intensity than non-traded activities, this should lead to an expansion of aggregate output and employment along the lines of the dependent-economy model.

5. Dynamics

Dynamic CGE models are increasingly being applied in general equilibrium analysis of trade reforms. However, in most cases the dynamics is rather rudimentary. Typically, a recursive framework is used to drive 'dynamics' in the form of updating stock variables, especially of capital and labor. The LINKAGE, GTAP frameworks often assume, in addition, that total factor productivity growth is endogenous, responding to trade openness. The latter assumption is admittedly ad hoc and not uncontested empirically, as discussed earlier. Also, and perhaps even more importantly, these CGE frameworks deal poorly with imperfect competition, as much as they are unable to handle activities shifting towards product differentiation or the introduction of entirely new activities; this may well be part of dynamic and diversification responses to trade integration.

6. Poverty Analysis

Finally, the CGE frameworks have problems in adequately capturing poverty effects. One major reason is that they incorporate rather aggregate, representative household groups and labor categories. Distributional effects thus are limited to the between-group income distribution of those categories.[5] Important, within group distributional detail thus tends to be missing to make appropriate assessments of the implications for income poverty. Some CGE model frameworks (references) include distribution functions to capture such effects, but these may miss out important aspects as well, since trade liberalization is expected to induce structural change and shifts in the composition of labor demand and hence such distribution functions cannot be expected to be stable. Hence, assuming given distribution functions may still beg the question regarding the distributive effects either.[6] For instance, if trade opening leads to less unemployment it may matter who in the overall distribution will find a job; similarly, if higher productivity sectors demand more workers, a question to be answered is which workers are most likely to move to such sectors. This will require more detailed modeling efforts.

7. A Conceptual Framework to Analyze Trade Liberalization and Poverty Linkages

In this part, we limit our attention to the specific issue of how trade liberalization and poverty levels may be linked within a given developing country. The link between trade and poverty reduction would depend in the first place on the implications for income levels and economic growth, which have been a major concern of empirical studies of the welfare implications of trade reforms. The poverty implications will further depend on whether trade policies will also change the distribution of income. In particular the paper focuses on what economists have to say on the following chain of linkages: trade policy affects trade flows which modify the prices of goods and factors; increased trade, in turn, influences growth and income distribution; these changes alter poverty levels. The Chart schematically represents these linkages (with arrows), ignoring a series of other important issues such as the feedback effect of increased poverty and inequality on growth and trade, and global issues such as the world distribution of poverty or the determination of international prices for traded goods. It also assumes a concern with a money-income concept of poverty (e.g. numbers of people falling below a given income level) and it takes no account of many other dimensions of poverty. A policy of trade liberalization can produce positive effects on GDP growth and income distribution and, abstracting from the possible complex links between growth and inequality, it should thus help reduce poverty.[7] Furthermore, the effects of liberalization appear stronger on income distribution than on growth, and poverty is very sensitive to income distribution.
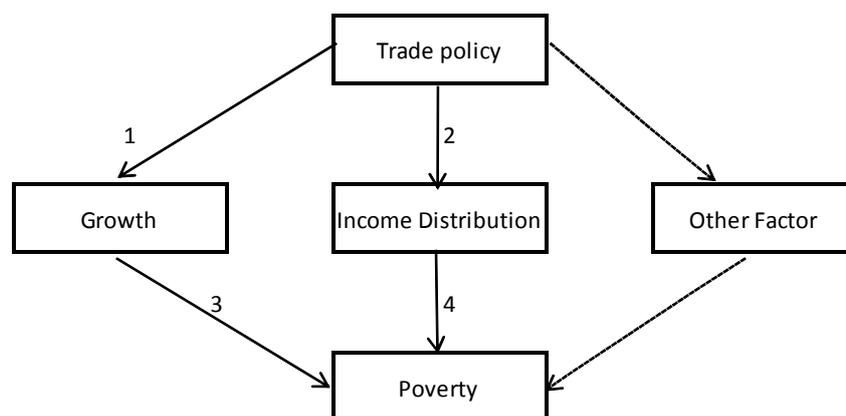

Fig.1: Schematic representation of Trade Policy and Poverty linkages

8. Conclusions

The results of this paper are summarized in below:

- More trade and thus trade opening on balance tends to generate positive aggregate income effects, but clearly not all countries and groups within countries benefit to the same degree and some stand to lose.
- Even if these effects are positive they tend to be relatively small, especially when looking ahead at new trade agreements.
- We have further learned that if you want to grow faster, it matters more what you export and how diversified your exports are than how much you trade.
- It is also clear that trade liberalization is no panacea for poverty reduction.

Average welfare gains are mostly small and in many instances has been inequality enhancing.

- Trade policy potentially affects poverty through its effects on both growth and income distribution. The effects of trade on income distribution have been more firmly established than its impact on growth. This is significant given that poverty reduction is very sensitive to income distribution.
- Trade policy theory does not unambiguously suggest that protection has a negative impact on growth in developing countries.

9. References

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