<u>Trade Liberalization and Poverty in South Asia,</u> (Editors) Jayatilleke S. Bandara, Prema-chandra Athukorala and Saman Kelegama, Routledge, London 2011, pages 195.

Sarath Rajapatirana

Prologue

This compendium of essays on this single theme edited by three distinguished Sri Lankan economists is a welcome addition to the economic literature of South Asia. The subject matter is of great import to policy makers and academics alike and poses a considerable challenge to both the editors and the individual authors to get at sometimes elusive links between trade and poverty alleviation. Nevertheless, it is a highly competent, high quality study with contributions from well recognized authors mostly from the countries themselves. No serious researcher, policy maker and advanced student could afford to ignore it. No country can hope to reach higher levels of growth by neglecting its foreign trade or not sustaining trade reform once it is initiated. Equally, it is not a magic bullet but only one in the arsenal of policy makers to raise the rate of economic development and reduce poverty.

Introduction

The study covers the seven South Asian countries: Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. It stretches over three decades starting with the earliest episode of Sri Lanka and the later efforts of Maldives and Bhutan. The main trade reform efforts are concentrated in the two decades of the 1980s and 1990s. Some of the work that underpins these studies is known but much is unknown about the link of trade to poverty. This study addresses that crucial issue and fills a gap in our knowledge with a specific focus on the region.

The study has nine chapters. Chapter 1, Trade Liberalization and Poverty in South Asia: Reforms, Stylized Facts and Preview, provides both an introduction and a crisp summary of the whole study by the three editors. Chapter 2, Trade and Poverty, Theory Evidence and Policy Issues by Jayatilleke S. Bandara provides a *tour de force* of the issue confronting the analysis of the trade and poverty nexus and an impressive survey of different methodologies ranging from cross country regressions to computable general equilibrium models to partial equilibrium and cost of living analysis. It arrives at a number of inferences and notes the difficulties of establishing an empirical link between trade and poverty, depending as it does on special structural characteristics of the country in question, the ambiguity of the results of empirical work that range from positive links to negative ones. To this reviewer, the chapter is well- balanced, soundly analyzed and presented. It is worth a careful read to spare oneself the drudgery of reading some poorly motivated and badly done modeling exercises on the topic in the general literature. The remaining seven chapters (3 to 9 chapters) deal with the country cases.

Country cases

Chapter 3 on Bangladesh is by Selim Raihan. It provides an overview of the path of progress in trade liberalization in the country. The important phase of the liberalization was supported by a structural adjustment program of the World Bank and an enhanced structural adjustment facility by the IMF. The path followed is the now familiar pattern in most countries, moving from a highly restricted import regime based on quantitative restrictions to replacing them with tariffs and reducing tariffs, thus reducing the bias against exports and reducing the variance in protection over time. Between 1991-2 and 2004-5 the un-weighted average tariff was reduced significantly. But some tariff reductions were accompanied by new import taxes or para-tariffs imposed over and above customs duties. Para-tariffs were aimed more at raising revenues than raising protection. But without equivalent excise duties they had a protective effect. Nor was the bias against exports reduced significantly. Bangladesh supported particular industries by exempting them from the value added tax. Econometric investigations of the link between trade and poverty at the national level did not show a conclusive positive relationship between the two. But it found a positive relationship for some industries. The method used was a dynamic CGE model subject to its own limitations as discussed in chapter 2. The short term impact of reducing tariffs was to reduce welfare and increase poverty. However, in the long term, there was a reallocation of resources towards more efficient sectors that raised welfare and reduced poverty. One is not sure whether the short term losses are fully over-ridden by long term gains in poverty reduction. Perhaps many other factors would have been present to make this relationship more complicated in Bangladesh. These are inadequacy of the accompanying policies, limited commitment to implement the program, floods and political uncertainties. They would have played their roles to keep income growth low and poverty reduction more difficult.

Chapter 4 on Bhutan is by Chencho Dorji. Although Bhutan opened the country to foreign influence as early as 1960, it began to integrate with the world through trade only in the 2002-2007 period. Its land-locked status and bilateral free trade agreements with India and Bangladesh determine its overall trade status. Its participation in world trade is more through India and Bangladesh than directly with those outside the region. Custom tariffs were introduced in the 1970s. Outside the free trade agreements, its tariffs range from zero to 100 per cent. Before 1990 there had been quantitative restrictions (QRs) on trade outside the two free trade agreements. Bhutan liberalized its trade regime by replacing QRs with tariffs. However, given the virtual free trade with India and Bangladesh there have been large trade leakages. Consequently, customs duties did not bring sufficient revenues even as trade expanded significantly. Hence a seven slab sales tax of zero to 50 per cent has been introduced. A large part of trade of Bhutan is the export of electricity to India. This perhaps explains that with trade liberalization, exports have increased more than imports. Meanwhile GDP growth averaged 8.3 per cent a year during 1998-2008 period. Bhutan's per capita income reached $ 1900 in 2008. Fast GDP growth was associated with the large hydro-electric projects while more labor intensive activities-agriculture, livestock and forestry grew slowly. Their aggregate share declined. Head count poverty declined from 36.3 per cent to 23.2 per cent of the population over this decade. Like in other parts of South Asia, poverty in Bhutan is a rural phenomenon associated with low agricultural productivity, small land holding, low levels of education, ill health and vulnerability to food shortages and insecurity. The link between trade and poverty is more difficult to study for Bhutan due to the lack of time series data. The author makes the point that Bhutan's comparative advantage lies in natural-resource and capital intensive activities such as hydroelectric power. Thus an increase in trade does not lead to higher employment, so that wages remain low and hence poverty reduction needs more active policies to distribute the gains from electricity and resource incentive exports. And, he makes the vital point that it does not mean that Bhutan will gain from restricting trade.

Chapter 5 on India is by Rashmi Banga and Shruthi Sharma. India is a most interesting case for the study. It has been an arch-type restricted economy starting with the early five year plans based on the Soviet model of a command economy to achieve rapid industrialization through import substitution. Serious trade liberalization began only after the macroeconomic crisis in 1991 with high inflation and unsustainable current account deficits. On the poverty front, India has the largest number of poor in the world for a single country given its population size and low productivity in the rural sector. India could not have addressed the issue of poverty seriously at the low growth rate that prevailed during the dirigiste period as economic growth barely exceeded population growth. Raj Krishna called it the "Hindu rate of growth". But following the trade liberalization and other accompanying policies when the "license raj" was largely dismantled, economic growth took off reaching 7-8 per year. While poverty began to be reduced, it did not happen at a fast rate. The authors estimate the impact of trade on poverty using wages of unskilled labor in the manufacturing and agricultural sectors. This is an indirect measure since national sample surveys do not give a direct measure of comparable poverty head counts over time. Agriculture supports some 60 per cent of the population both directly and indirectly. Despite some liberalization of agriculture trade, there are still some import and export controls through tariffs, state trading, export and import licensing among others. India had continued protect agriculture by keeping bound tariffs much higher than applied tariffs ; the average bound agriculture tariff is 114%, with 100 % for primary products, 150 per cent for processed products and 300 per cent for edible oils. Some items have lower bound rates. Meanwhile, QRs have been removed in 2000 and 2001 and the sector has benefitted from price alignments from manufacturing sector reforms. However, agriculture remains relatively untouched by reforms. Consequently, agriculture growth has been low and the sector has low productivity with its implications for rural income growth and hence for poverty reduction in the rural sector. In contrast to agriculture, the manufacturing sector has gone through strong reforms. The simple average tariff rate for manufacturing had fallen from 82 per cent in 1990 to 29 per cent in 2002 and the peak rate for non-agricultural goods came down to 12.5 per cent in 2006-07. As a result of, trade liberalization and associated policies, growth in manufacturing rose as did productivity and competitiveness. Like manufacturing, services also saw strong liberalization under commitments to GATS. Between 1990 and 2000, trade in services grew by 6 per cent per year. And, in terms of output growth services grew by 7.9 per cent between 1994 and 2004 whereas agriculture grew by only 3 per cent and manufacturing by 5.3 per cent per year. State-wise incidence of poverty, the more reliable measure, recorded a decline in the poverty head count index from 35.97 per cent in 1993-94 to 26.1 in 1999-2000 per cent. Because there are no reliable and consistent measures of poverty at the national level, the authors examine the impact of trade on the wages of unskilled labor as an indirect measure of poverty. A regression model has been used with demand for unskilled labor equation and a wage rate equation to stand for the supply side of labor. The results show that after controlling for inter-industry differences, export intensity of the industry has a positive and significant effect on unskilled wages. However, imports of the product do not have a significant impact on unskilled labor in the industry. In the case of agriculture, the impact of trade liberalization has no impact on its export activities. However, higher imports have led to lower wages of unskilled labor in those activities. Thus the results are ambiguous as they differ by sector, product and between export and import activities. It is surprising that the authors do not draw the inevitable conclusion that for poverty reduction to take place faster, India has to reduce agriculture protection.

Chapter 6 on Maldives is by Jagath Dissanayake and Suwendrani Jayaratne. Like Nepal, Bangladesh and Bhutan, Maldives is defined as a least developed country by the United Nations, despite its per capita income of $ 4059 in 2008, the highest among the seven South Asian countries. It is also a small island economy, another category promoted by the United Nations. Given its small size, it has little option than to engage itself with the rest of the world. Nevertheless it has had high tariffs, mostly as a means to raise revenue and it also has a complex tariff structure with ten bands ranging from zero to 200 per cent. The latter increases the variance in protection to the detriment of a better allocation of resources. Maldives started its trade liberalization in 1989 by replacing QRs with tariffs. Staple food enters duty free and is subject to import quotas. The authors note that following the trade liberalization there was impressive growth of exports and imports but experienced a 15 per cent decline in exports in 2005 due to the end of the Muti-fibre Arrangement (MFA). But export growth resumed later. Following trade liberalization, GDP growth rose to 13 per cent. The authors note the difficulties of analyzing poverty over time in Maldives due to the absence of time series data. However they note that poverty reduction in the country in three decades has been exceptional. Use of the absolute poverty line of US $ 1.00 in Purchasing Power Parity terms revealed that the incidence of poverty in Maldives was only 4 per cent of the population in 2005. Following trade liberalization, overall employment increased with some job losses due to reallocation of resources. Trade liberalization had a positive and direct impact on reducing poverty. The authors are concerned that its exports are not diversified, its resource base is narrow and that income inequality between the main island and other islands has increased. These developments are to be expected given the endowments and trade liberalization being only one and the wrong instrument to have addressed those issues.

Chapter 7 on Nepal is by Yuba Raj Khatiwada. Like Bhutan, Nepal is a landlocked country. Its foreign trade takes place mostly through India. The Nepal Rupee is closely linked to the Indian rupee and there is free trade with India. Indian prices determine to a large extent Nepal's prices, incomes and employment. Like other countries in the region, Nepal had a restricted trade regime during the 1956-85 period. And, it began trade and market oriented reforms during the 1990s. In this respect its policies were parallel to that of India given the close link between the two economies. While trade had grown fast from a low base by 19 per cent and 18 percent for exports and imports respectively, it accelerated to 28 per cent and 20 per cent respectively, following the liberalization and returned to more sustainable levels after the spurt. There were also significant changes in the structure of trade. The share of primary goods in exports declined rapidly from nearly 70 per cent in 1980 to 22 per cent in 2007. The share of manufacturing goods, mostly woolen carpets and readymade garments, rose to more than 70 per cent in the 1990s. With the rescinding of the MFA, Nepal's readymade garments declined. However, the structure of imports changed less much less. Capital goods imports remained close to 25 per cent over this period. Meanwhile, Nepal's GDP growth around 4-5 per cent in the 1980 and 1990 did not change significantly. Yet, the country's poverty rate declined from 42 per cent below the poverty line in 1996 to 31 per cent in 2004. However, its GDP per capita was $ 380 in 2007 and has remained the lowest in South Asia. Despite the trade liberalization, the shares of exports and imports in GDP have not increased markedly. What happened were changes in the compositions of these variables. Thus, though poverty has decreased significantly in the country, the contribution from trade to that outcome was apparently limited. This maybe well be a statistical problem in that large parts of trade are not reported given the 1800 mile long border with India so that both these variables are understated. The other reason for the apparent lack of a strong relationship of trade to poverty reduction is the importance of remittances to raising incomes particularly in the rural areas.

Chapter 8 on Pakistan is by Rehanna Siddiqui. Like other South Asian countries, Pakistan's trade regime went through different phases. The first two phases 1947 to 1980s saw a move from relatively liberal trade to attempts at industrialization through import substitution with increasing levels of protection. Towards the middle of this period, Pakistan attempted to give greater incentives to export growth using an export bonus scheme based on a dual exchange rate. During the 1988-93 period the country began to liberalize the trade regime supported by a structural adjustment program of the World Bank. Tariffs were progressively reduced from a maximum of 225 per cent that prevailed in 1986/87 to 70 per cent in the 1990s to 25 per cent in 2000s. Tariff dispersion was also reduced to four slabs. And, by the 1990s only 2.7 per cent of the imports faced QRs. Despite these efforts, the import to GDP ratio did not change significantly but the composition of both imports and exports changed indicating a reallocation of resources. Meanwhile the exchange rate regime was changed to a managed float from a fixed regime. National poverty incidence based on income and expenditure estimates declined from 32.6 per cent in 1998-9 to 22.6 per cent in 2006. The poverty rate was 27 per cent in rural areas and 13.1 per cent in the urban areas. Using simple regression models (given the paucity of data for other ways to model the link between poverty and trade) for the period 1973-2005, a robust relationship was found between growth and poverty. However, the relationship of openness and poverty was not uniform. The rises in the import to GDP and the trade ratio played an important role in poverty reduction whereas other indicators of trade liberalization such as the average tariff rate and export to GDP ratio depended on the production structure, particularly on the export side. To sum, there was a positive relationship between trade liberalization and poverty reduction but it depended on the structure of the particular industry and other factors.

Chapter 9 on Sri Lanka is by Deshal de Mel and Ruwan Jayathilaka. Sri Lanka had a liberal trade regime from independence to around 1960 when it began to use strong trade restrictions based on both balance of payment reasons and the ideological change that came about with the victory of the Mahajana Eksath Peramuna in 1956. After a brief interlude the United National Party (UNP) came into power in 1965 and attempted to undertake a partial liberalization of the economy, mainly through an export bonus scheme imitating the Pakistan's export bonus scheme. The UNP was defeated in 1970 which led to another left of center coalition that included Marxists parties, as well as those with left leanings with a nationalist veneer. The 1970-1977 period saw the strongest inroads into goods and factor markets and liberal trade spurred by balance of payments problems, (specially following the first oil shock and many years of trade tightening) and a strong dose of ideology than even before, which made the country one of the most controlled economies outside of the Soviet Union. When the UNP came into power again in 1977, it liberalized the economy and the trade regime significantly again on ideological grounds, in the wake of the success of East Asian economies and the very poor economic performance of the earlier government. Sri Lanka was the first country in South Asia to liberalize the trade regime in a strong manner. By 1982 the liberalization program lost its steam with the Government committed to undertaking large public expenditure on the Accelerated Mahaweli Development Project. Due to huge expenditures and consequent budget deficits leading to high inflation, exchange rate appreciation and balance of payments deficits, the government slowed the progress towards further liberalization. Another mild liberalization was attempted in 1989 with little impact. Then in 1994 the UNP lost power again. The new left of center government did not pay as much attention to the liberal agenda but seemed to continue with what was there. Over time, the average tariff rate had fallen to 11.2 per cent in 2006. It reflected the weighted average of 9.2 per cent for manufactured goods and 23.8 for agricultural goods. However, due to the civil war more revenue was raised by across the board increases in domestic taxes on imports and exports with the use of para-tariffs and charges on exports, respectively. There were adjustments to the tariff schedule following return to peace. However, Sri Lanka today has a very complex trade regime. It is unpredictable, protects agriculture significantly and has deviated from the earlier near uniformity in protection. In fact with the 2010 "reform", effective protection rates may have increased. With the liberal trade regimes instituted in 1977 and continuing with low tariff and no export taxes, both exports and imports grew rapidly. Import growth was 13.9 per cent per year during 2003-2007 period. Export earnings were buoyed by high prices of tea and continued strong demand for apparels. These authors also are concerned about lack of diversification by product and market. The national headcount index of poverty had fallen from 26.1 per cent in 1990/91 to 15.7 per cent in 2007 (excluding the North and Eastern provinces due to the civil war). However, rural poverty (where 80 per cent of the people live) declined at a slower rate over the same period. On the other hand, poverty in the estate sector increased from 30 per cent in 2002 to 32 per cent in 2006/07. The authors find that the trade liberalization had an important impact on poverty reduction mainly through its impact on tea and garments and beyond trade, supported by tourism and export of labor to the Middle East. Econometric investigation of the trade poverty nexus leads to the following results. Sector-wise differences in poverty impact depend on communication and general access to international markets. More generally, trade liberalization has resulted in significant employment creation which in turn has contributed to poverty reduction. This relationship holds primarily in the urban sector where manufacturing is located. There is a positive relationship between trade, employment and poverty reduction but they hold primarily in urban areas. On the other hand, the persistence of poverty in the estate sector suggests that trade will not help to reduce poverty if more competitive and flexible labor markets are absent.

Comments on Generic Issues

There are many challenges to a study of this nature. First the subject matter is difficult given that the link between trade and poverty is multi-dimensional. The concept of trade liberalization itself is subject to different definitions and the concept of poverty is clearly more difficult given that it is a truly multidimensional concept. Poverty refers not only to low income but to other aspects such as the access to assets (both human capital and financial), access to services from health, education and to social security, not to mention limited or lack of empowerment in the political dimension. Nevertheless, the volume confronts these challenges in a practical and clear way and the editors have done a good job in putting together this valuable volume. South Asia serves as a good laboratory to study the link between trade liberalization and poverty. First, all the countries have moved towards more liberal trade regimes albeit at different speeds and intensities. The outcomes of their liberalizations therefore have to be different, providing a variety of experience. Second, these countries began at different initial conditions with respect to poverty levels , their convergence to an average poverty indicator for the region (the present headcount index that measures the proportion of those falling below the accepted poverty line of US $ 1.25 a day) have to be different and not necessarily smooth. But no such indicator has been developed, nor was that necessary given that the uses to which such and indicator could to be put are limited. Third, many other factors impinge on the poverty outcome other than trade; both economic and non-economic factors are at play. Hence a proper correspondence of trade liberalization variables to poverty outcomes has to be carefully sorted out. Fourth, trade liberalization has not been an unidirectional phenomenon given that there have been many reverses and some advances over the period, starting with the earliest in Sri Lanka in 1977 to the latest in Bhutan in mid 1990s. Finally, South Asia region has the largest number of poor in the world, given its large population that have had low productivity in the dominant agricultural sectors, limited access to public services and backward in terms of social indicators with respect to education, health and status of women.

To some extent South Asia's liberalization path has been stronger and quicker than other regions, namely the Middle East and Sub-Saharan Africa. The latter had faster liberalization in the 1990s starting with highly restrictive regimes but quickened the pace in the 1990s with little to show for it in terms of growth and poverty reduction. The Middle East was slower and the extent of liberalization smaller. Latin America liberalized faster but has not able to hold on to a straight path. East Asia was first with strong trade reforms in the early 1980s and showed huge gains in terms of poverty reduction. China and India today have reduced poverty during the last two decades faster than probably any other time in modern world history. They have a lot to show for it in terms of the number of persons moving out of poverty. However, India still has the largest number of poor people in the world (although the actual poverty numbers are disputed by Surjit Bhalla as overstating poverty). The present study should be able to help policy makers see the importance of consistent and strong trade reforms accompanied by other reforms to help move resources from less productive to more productive areas and maintain good macroeconomic stances while doing so. The study is also a sobering reminder that the path of reform is neither easy nor equally rewarding among countries in the same region. It is also a reminder that trade liberalization is not a magic bullet but only one in the arsenal to get economies more efficient to contribute to higher growth to help poverty reduction. In this regard, the South Asia Region has continued to protect agriculture which has contributed to the persistence of poverty in the rural areas, the main component of the poverty problem.

Comments on Country Issues

Guided by the editors, the country authors have produced a highly informative and credible analytical work exploring the nexus between trade and poverty reduction. Many of the findings in the individual country studies are new and they should provide valuable grist to policy makers in the countries. The authors should be complimented for their work in not overstating or understating the findings but keeping to their brief in exploring the nexus carefully. Also, the authors show good judgment to use a particular way to explore the nexus between trade policy and poverty reduction. Thus they have used CGE models (Bangladesh) to simple regression analysis (Sri Lanka) to historical analysis (Bhutan) to discuss the link between trade and poverty reduction.

Nevertheless, the present reviewer found some weaknesses in a few areas. A short list includes the following: (a) the neglect of the type of exchange regime in which the trade liberalization took place. As is well known, the exchange regime can make a big difference to the success or failure of trade liberalization or the extent of the productivity increase it would bring about. After all, the price of tradable to non-tradables or the real exchange rate is clearly affected by the exchange regime and unskilled wages constitute an important component of non-tradable goods. What happens to this price or exchange rate is a determinant of the poverty outcome. Thus Pakistan changed its trade regime from a fixed rate to a managed float and maintained the stability of the real exchange rate through fiscal and monetary policies. Similarly, Sri Lanka's trade liberalization of 1977 could not bring its full benefits because the exchange appreciated due to the "Dutch disease" associated with the Mahaweli River Valley Development project. (b) Some authors went beyond the scope of the work to be concerned about regional distribution of gains and losses of trade liberalization. In this regard, it was up to the Government that implemented the trade liberalization to provide a cushion to those who were adversely affected as some have to be. (c) It is also not correct to define trade openness based on the trade ratio (i.e. the sum of exports and imports divided by GDP). Thus Maldives has a high trade ratio because it has a narrow resource base and not because it was a liberal trade regime. (d) One would have expected to see good analytics with respect to the countries' endowments, the motives and ways in which trade was liberalized to evaluate the outcomes. Not all country studies have done this.

Overall, the present reviewer found the work to be original, of high quality and a worthy addition to the growing literature on South Asia. It is strongly recommended to the policy makers and scholars alike. It is hoped that the findings of the study will be used by policy makers when they consider the next stage of their trade reform, whatever point they happen to be at the time. It is also hoped that scholars will carry this work further refining the analysis, bringing new data that becomes available over time and using this contribution as a standard reference on the subject.

SR July 31, 2011