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What happens after trade agreements?

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Key points

- Countries cannot assume that trade agreements alone will automatically generate development benefits
- Evidence from Latin America suggests that the degree to which developing countries gain or lose from trade agreements depends on a broad range of policies
- Introducing complementary policies, both directly and indirectly related to trade, may make the crucial difference

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Trade agreements can alter trade. Trade can have an impact on development. And development can make it possible for countries to reduce poverty. None of these relationships is automatic. The immediate effects depend on a country's existing economy and policies, but the final effects depend on the right changes in policy. This paper will focus on the first link, from trade agreements to trade, but begins by justifying this in terms of the second, from trade to development.

Trade agreements can help countries implement existing development strategies and create opportunities for more ambitious goals. But in many cases the trade barriers they remove are not the only, or even the principal, obstacle to using trade effectively to promote development. To secure the potential gains from trade for development, therefore, the response to trade agreements must be strengthened by complementary measures. Which measures are most useful or easiest to implement depends on the type of agreement, the size of the potential benefits and the conditions in the countries making it.

This paper suggests a framework to identify ways in which a country can translate new trade opportunities into real trade gains, with a particular focus on Latin America.

The role of trade in development

Theoretical arguments

Trade has been recognised as a central element in development strategies since the 1950s. It is a source of increased demand and increased income, but also of new types of demand, allowing specialisation and encouraging technological change. Trade has grown at about twice the rate of national production in the last 50 years, so these effects are becoming more significant.

The conventional trade theory is that tariffs and other barriers to trade distort market signals. The removal of these distorting signals should lead to countries specialising in goods and services in which they enjoy comparative advantage, with mutually beneficial efficiency gains that, in turn, encourage development.

There is also a straightforward demand argument. If there is unemployed capacity, but administrative reasons or foreign exchange constraints mean that there is no way to increase domestic sources of demand, then raising exports will be the only way to stimulate growth.

An additional effect is on risk. Increasing the openness of a country to other economies reduces the impact of shocks within the country (a domestic drought can be alleviated by food imports) but increases the impact of external shocks (a drought in another country may reduce supply and increase food prices). While the impact of internal shocks is usually larger, external ones are more frequent.

Applying the theories

How these theoretical results determine the actual effects of a given trade agreements on trade cannot, however, be accurately estimated from first principles. There are many possible qualifications, but two stand out. The first is the nature of a country's existing relationships with international markets. Global trade is, at present, structured according to a patchwork of trade agreements, each involving barriers to some countries and measures to offset others' barriers. Therefore, the impact of a new agreement must be measured not against an abstract state of no trade or no trade policy, but against the combined effects of all the other trade policies affecting the members of the new agreement. And in most trade agreements, there will be two liberalisations affecting each country: what it does itself and what its trading partners do.

For trade agreements made with just one or a few other countries (bilateral or regional agreements), the effects are more complex and usually less beneficial than for multilateral agreements.

Box 1: What theory tells us

Trade changes what countries produce: In theory, it is possible to distinguish both static and dynamic components to the linkage between changes in border prices (through trade liberalisation) and their direct effects on an economy and its development potential. Static effects stem from the reallocation of resources and profits within an economic system at any given point in time. It is assumed that trade liberalisation will result in a reallocation of resources away from previously protected import-competing sectors and towards sectors in which the country enjoys comparative advantage. Dynamic effects are those achieved when the more efficient allocation of resources and the more open economy create opportunities to realise economies of scale and increase enterprises' exposure to technological improvements in productivity. Both the static and the dynamic changes may have short- to medium-term adjustment costs, such as possible job losses, but these are expected to be smaller than the gains.

Trade may make each type of production more efficient: Much of the policy discourse on the role of the external sector moves beyond these efficiency effects. The apparent association, since the 1970s, between high and growing exports and rapid growth of manufacturing and of total output suggested that a policy of opening an economy to external influences (liberalisation) or even a policy of deliberately biasing growth towards exports (export promotion) could improve investment and growth, and raise efficiency not only from reallocation of resources and increases in aggregate demand, but also by increasing the dynamic efficiency of the economy. The argument is that exposure to competition, from imports and in export markets, increases the efficiency of firms, not simply by providing information or access to technology (these can be done without trade), but because the threat of losing markets and profits is more of an incentive to change than the potential to increase them. This represents a particular view about the nature of incentives (that sticks are more effective than carrots) which is not adopted in other economic theory. This type of analysis strongly influenced the view that increased opportunities for developing countries to export could have a significant effect on their development.

The potential gains are smaller because the scope of the liberalisation is smaller, and there are potentially damaging effects both from 'trade diversion' and from increasing the costs of trading. Liberalising to only some trading partners means discriminating against the rest, diverting trade, so the balance of trading and production with those will be less efficient than before. Different arrangements with different trading partners impose additional costs of information and administration on traders. More seriously, they can increase the costs of production: to ring-fence the benefits of any regional or bilateral agreement, countries must ensure that goods traded are really from the designated trading partner and do not contain so much material from other countries that they are more like re-exports than home production. As globalisation increases the likelihood that any production chain will include inputs from more than one country, the costs of restricting the sources of inputs rise.

The first step to maximising the benefits of a trade agreement must therefore be a complex calculation to understand what will actually change.

Moving from trade agreements to trade

The second major influence on how trade agreements actually affect trade is the capacity of a country to respond to new market opportunities arising from liberalisation and to mitigate the costs of this adjustment. A key conclusion in contemporary research is that trade reform alone is often seen as a necessary but insufficient condition for development. Even if an agreement does offer significant benefits for many developing countries, providing opportunities and incentives to trade is not enough.

Developing countries face particular difficulties in trading. All producers face poor infrastructure, thin product chains, lack of familiarity with standards or ability to meet them and weak public and private institutions. Unlike suppliers to the home market, exporters must compete with those in developed countries who do not have these disadvantages. They are more likely than producers in developed countries to need to change to new products and markets (the essence of development), and, therefore, to need new information about legal and commercial requirements and new services to reach new markets. They need to increase their exports rapidly to be able to import the necessary physical and technological inputs.

A variety of intermediary institutions and processes, both external and internal, will therefore determine firstly how clearly the price signals resulting from a trade policy change are transmitted to all actual and potential traders, and secondly how well they are able to respond to these signals. The way in which the change in border prices is transmitted will depend on good information and good access to information. How strongly traders respond is determined by internal factors: the supply conditions within each economic sector, but also by more general ones including the level of education and skills, the ability to obtain access to credit, the availability of communications and transport services, the existence of affordable mechanisms to offset production or consumption risk and the quality of all other economic and social institutions in the country.

There are a few cases where a trade agreement can have a direct and immediate effect on trade, for example, when a country already producing a product and exporting it successfully to one market negotiates the end of barriers in another potential market. But these are rare. The rest of this paper suggests a range of ways in which governments can strengthen the effect of trade agreements on trade, starting from those with relatively low cost, so low risk, but also suggesting some that require substantial government guarantees or investments. These could only be beneficial if an agreement offers significant new opportunities, so calculating the real value of the agreement has to be the first step.

Examples are taken from agreements that have produced significant increases in trade, and these are linked to the current World Trade Organization discussion on how to ensure that all countries benefit from any Doha Round settlement and to the parallel discussions among donor agencies on how to increase trade-related capacity building. These have identified areas where aid is likely to be needed to complement any trade reforms. Although directed at aid policy, their results are equally relevant to guiding action by countries' own governments. The WTO criteria for Aid for Trade (Box 2) indicate the areas in which government intervention can operate.

Traders and potential traders must know about an agreement

To officials who have spent years thinking about and negotiating an agreement, it may seem inconceivable that anyone is unaware of the details, but surveys of exporters in all countries (developed and developing) show that few are well informed about normal provisions for trading, let alone special regional or bilateral rules. This is not surprising, as the interest and skills of good producers lie in production, not in legal rules, and only the largest firms can afford policy advisers. In some cases (for example, NAFTA and the recent negotiations of Peru with the US), controversy over signing the agreement may publicise its provisions. In those cases, existing exporters, at least, may understand that they need to learn more.

Where an agreement does not hit the headlines, or for a producer who does not yet trade so believes that trade agreements are not relevant, the agreement will only be used if there is active intervention by one of the governments to show producers how to reap the benefits of the agreement. Chile has combined its policy of bilateral agreements with as many trading partners as possible with a deliberate programme of public information about each new agreement. The US has had information and training programmes for producers in the countries to which it gives trade preferences. These would fall under WTO category b.

Markets and suppliers must share information

Within countries, producer associations, industrial organisations, and chambers of commerce exchange information among their members about relevant government policies. In the new market created by a trade agreement, encouraging the development of cross-border collaboration among such organisations can increase information about agreements and trading opportunities. The years following the signing of the Mercosur agreement saw a growing number of contacts between industrial organisations, particularly between Brazil and Argentina. In these countries, the organisations themselves were able to take the initiative; in other regions, government assistance might be needed. WTO category b.

A successful agreement must be flexible

If an agreement does have an impact on trade and development, new exports and new traders will emerge with new needs. Producers will find new ways to use their access to inputs from the other countries in an agreement and will then find that the trade agreement does not cover everything that they want to do. If an agreement is to continue to have dynamic effects, the governments need to accept that it will need to evolve. Outside Latin America, the changes in Europe from the Customs Union of 1956 to the Single European Market provide a particularly strong example. Most current Latin American regions or bilateral agreements are probably at too early a stage to need substantial amendment, but there are examples: the evolution of Mexico–US trade from the *maquiladoras* on the border, introduced in 1966, led to a demand for other export processing zones, to the new approach to trade seen in Mexico joining GATT in the 1980s and then the beginning of NAFTA in 1994. The changes over the last 40 years in the Andean, Caribbean and Central American regional arrangements show responses to increasing regional integration, as well as to changing national policies. WTO category a.

Box 2: The WTO typology of Aid for Trade

(a) Trade policy and regulations, including: Training of trade officials, analysis of proposals and positions and their impact, support for national stakeholders to articulate commercial interest and identify trade-offs, dispute issues, institutional and technical support to facilitate implementation of trade agreements and to adapt to and comply with rules and standards.

(b) Trade development, including: Investment promotion, analysis and institutional support for trade in services, business support services and institutions, public-private sector networking, e-commerce, trade finance, trade promotion, market analysis and development.

(c) Trade-related infrastructure, including: Physical infrastructure

(d) Building productive capacity

(e) Trade-related adjustment, including: Supporting developing countries to put in place accompanying measures that assist them to benefit from liberalized trade.

(f) Other trade-related needs

Source: WTO (2006) Recommendations of the Task Force on Aid for Trade, WT/AFT/1.

Removing tariffs is not enough

Trade policy is implemented not by treaties, but by application. It is essential to re-examine other trade policy and regulations in light of any new agreement and to train customs and other officials who will implement the new agreement. Existing trade agreements have generated reforms in areas such as customs documentation, but also more fundamentally in relaxing rules for cross-border transportation (NAFTA liberalisation of road transport). WTO category b.

Selling to new markets requires adequate finance

For all small and medium enterprises (SMEs), securing working capital, to fund the period of production, and financing short term credits to buyers, between the time of delivery and payment, can be problematic. They may not have good access to bank credit on reasonable terms, or to insurance against the risks of a customer's failure to pay. These problems become more difficult across borders, because banks and other lenders may have legal and practical reasons not to finance international transactions. They become more urgent if an exporter seeks new and unfamiliar purchasers under a new trade agreement. There are general programmes (for example from the Inter-American Development Bank) to provide guarantees for small banks across borders, but governments may also need to find ways of supporting such credits. WTO category b.

Poor or wrong infrastructure can restrict trade

Some trade agreements arise out of existing strong trade relations among their members. In these cases, the infrastructure for trade may be in place, and any adaptation to increased volume can probably be handled without major changes in policy or spending. But others are intended specifically to promote trade, and all types of liberalisation may lead to new opportunities. Mercosur and the Andean countries, for example, have seen much faster growth of trade in manufactures among their members, compared to more commodity-based trade with the rest of the world. Some US bilateral agreements have particularly promoted individual industries (apparel, electronics for Central America). A change in the composition of trade may require different types of transport. A particularly clear example of the need for new types of linkage is that recent liberalisation and redirection of energy markets has led to increased use of cross-border pipelines in South America.

Major companies can often make their own arrangements or the volume of their trade may provide the incentive for new suppliers of transport to emerge. But where elements of the transport or communication system are provided by governments (roads and ports, for example), where industries are highly regulated (as in energy), or where potential new traders are small companies, with initially small demands for the new types of transport, the government may need to make new investments. The economic return will come from the increased economic activity and, eventually, higher tax revenue). WTO category c.

Governments can support producers or traders in other ways

The dividing line between helping companies trade and helping them produce is never clear. The economic objective is to promote development, with trade policy as one tool to be used in coordination with others. Therefore, all the normal ways that governments can help companies are potentially relevant to help them to adapt to a new trade policy. What WTO calls Trade Development and Building Productive Capacity would be called industrial development in any standard policy analysis. In national policy formulation it is unusual to see any of these as trade policies or to target them directly at a trade agreement. The same is true of education and training policies. But a national government that does not have such policy tools or does not redirect them to newly important sectors is unlikely to gain the full potential from any trade agreement. WTO categories b, d.

Development requires country-wide support

Restructuring an economy will not benefit everyone equally, and may cost the jobs and enterprises of those whose output is replaced by imports or by new products. Trade adjustment support to individual workers or localities who might be hurt by trade policies has been provided in developed countries. It may seem less common in developing ones, but in fact it has been offered implicitly by limiting the application of trade agreements or by delaying them. The incorporation of special arrangements for cars and sugar into Mercosur and the designation of some products as 'sensitive' and therefore to be liberalised only 15 or 20 years after the initial signing in both Mercosur and NAFTA set the examples for Latin America. If a trade agreement is expected to benefit the economies of its members, such measures are less efficient than providing for direct compensation to the losers, using part of the expected gains, as has been done by inter-country transfers in the EU and compensation to displaced workers in the US. WTO categories e, f.

Conclusions

Countries cannot rely on the benefits of trade agreements to development to appear automatically. This is particularly true for SMEs whether they are exporting already or have the potential to emerge to take advantage of new opportunities. The costs of entering a new market are greater for them than for large companies when compared to their potential revenue, but their demand for new services will be smaller relative to the supply of such services. It is less likely, therefore, that market responses on their own will provide the necessary complementary changes.

The degree to which developing countries gain or lose from trade agreements and how those gains are distributed depend on a range of policies related to regulatory structures, infrastructure provision, and financial markets, and, less directly, on complementary policies related to aspects other than trade (e.g. education or safety nets). The complex nature of existing trade arrangements means that the potential benefits of an agreement may be small or in very specific areas. The adequacy of these complementary policy measures may, therefore, determine not only the size but even the direction of the effect of trade liberalisation on development.

Project information

Trade and Poverty in Latin America (COPLA) is a two-year project funded by the UK Department for International Development. It explores the linkages among trade, poverty and social exclusion in the region.

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