

Submission of Evidence to All-Party Parliamentary Group on Trade Out of Poverty on the UK's Africa Free Trade Initiative (AFTi) by:

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The Compositional Effects of High Trade Costs on Developing Countries' Manufactured Exports

Summary

- Trade costs in Africa are relatively higher than those in other developing regions.
- These high trade costs affect not only the export volume but also the export mix of African countries.
- Reducing these costs would not only increase the volume of Africa's manufacturing exports, but would also help countries in this region to diversify their manufacturing exports and increase the share of more complex and trade cost-sensitive, manufactured exports.
- Infrastructure and institutional reform is central to a broad concept of trade facilitation, which will be required for export diversification and structural transformation in the Africa region.

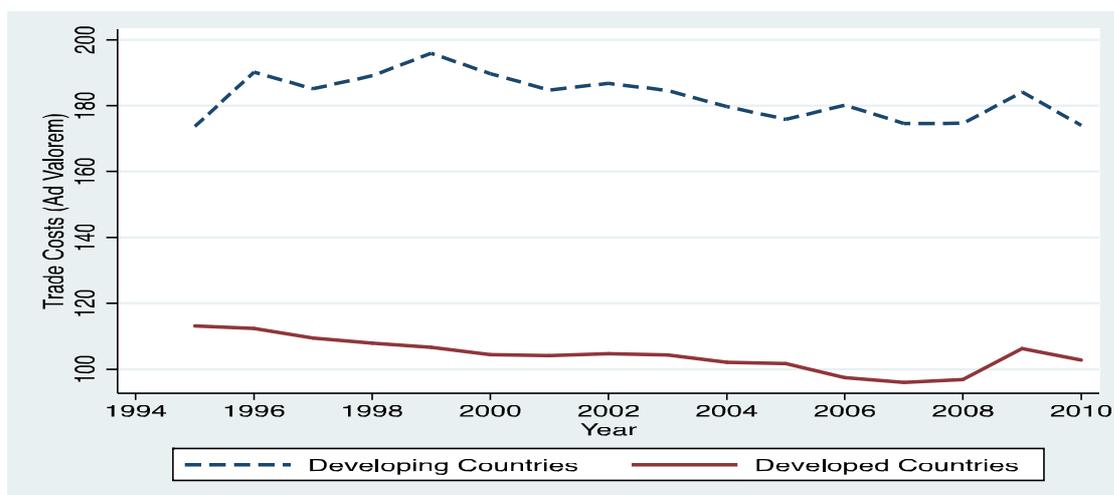
Evidence

It is now widely recognised that trade costs need to take account of both policy barriers and non-policy or natural barriers. The former includes tariffs and non-tariff measures, shipping line connectivity, and infrastructure performance, whereas the latter comprises geographical or natural factors, such as distance and the lack of common language, etc.

The main focus of research to-date has been on the trade volume effects of trade costs. The trade-detering effect of bilateral distance between trading partners (proxying for the effects of trade costs) is extensively identified in the gravity model literature. This literature has also explored the effects of specific types of trade costs (e.g. common borders, different languages, being land-locked, different currencies, port inefficiency etc.) on trade volumes. For example, Limao and Venables (2001) investigate the influence of poor infrastructure on the volume of intra- Africa trade.

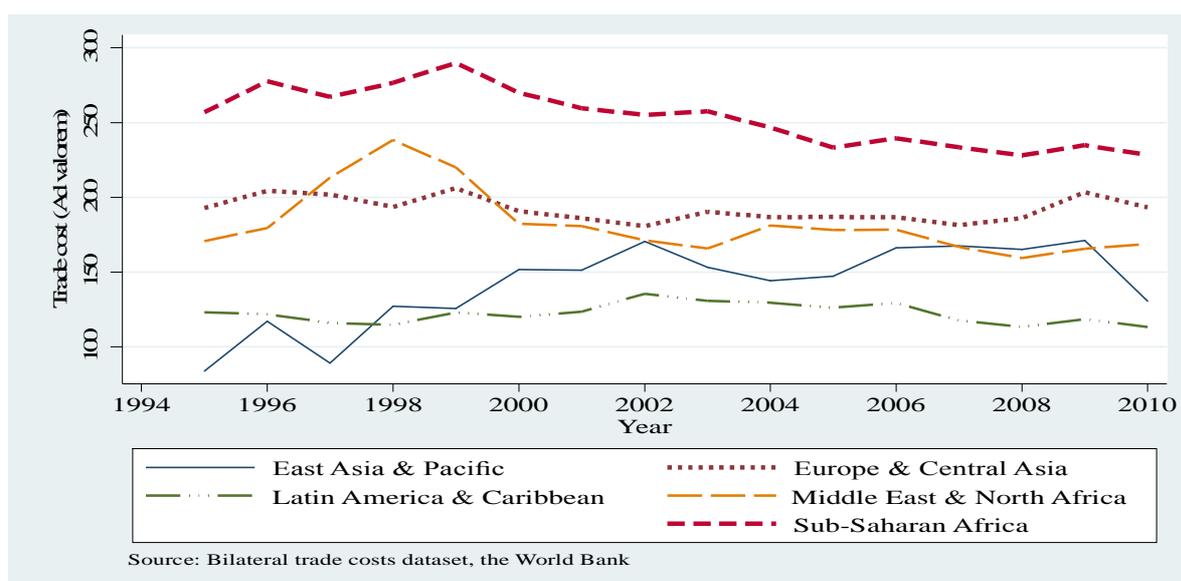
One area which has received much less attention is the impact of trade costs on the composition of trade. Earlier work by Milner and McGowan (2013) found that trade costs influence the manufacturing export mix of a set of mainly industrial countries; industries located in lower trade cost countries capturing relatively higher shares in the multilateral exports of manufactured goods, the production of which is more sensitive to trade costs. Given that trade costs are considerably higher in general in developing countries (see Figure 1) and variable across and within developing country region and that the composition of exports can be expected to have greater implications for the growth and development prospects of developing countries. Further, Sub-Saharan Africa is a particularly high cost trade cost region among the developing countries – see Figure 2 below.

Figure 1: Trade Costs in Developed and Developing Countries (% Ad Valorem Equivalent)



Source: Authors's working using World Bank's trade costs dataset

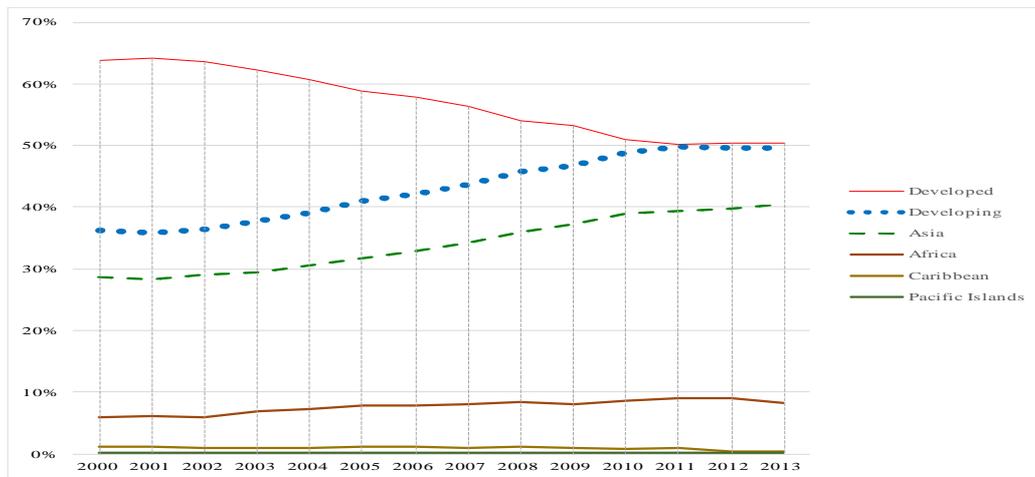
Figure 2: Evolution of Trade Costs by Region over Time



Source: Bilateral trade costs dataset, the World Bank

Over the past two decades, the share of developing countries in global merchandise exports has increased from around 30 percent to 50 percent. This shift is mainly driven by Asian economies, the contribution of African countries has increased marginally from six percent in 2000 to nine percent in 2013 (Figure 3).

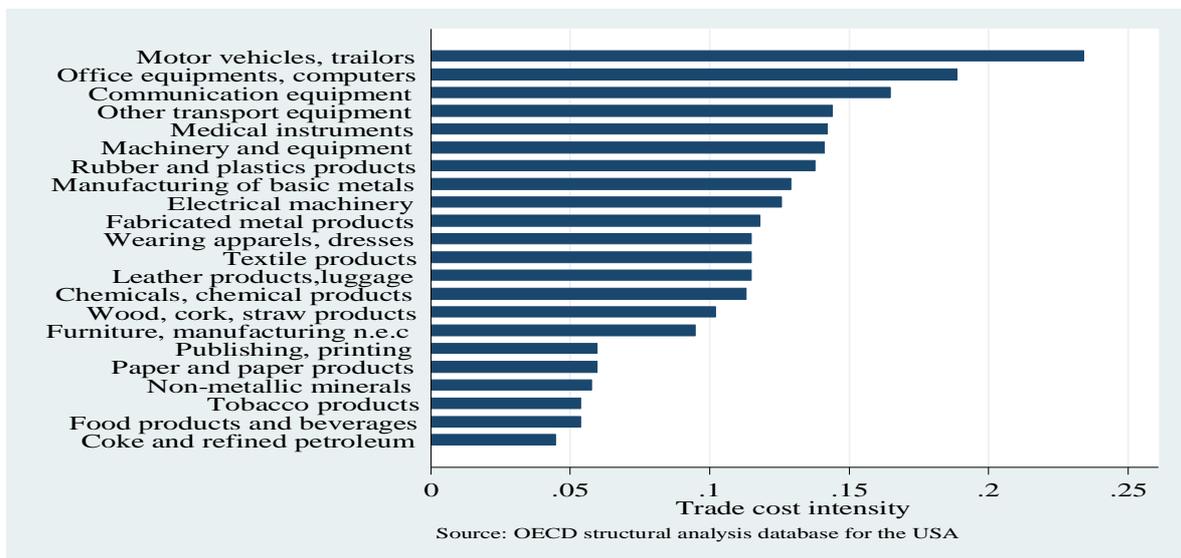
Figure 3: Relative Share of Various Country Groups and Regions in Trade Flows



Source: Authors' calculations based on UNCTADStat

The main challenge in increasing exports of African countries lies in making it broad-based and more diversified, as primary commodities supplied by a handful of African countries currently dominate their exports. Reducing trade costs have implications for export diversification prospects of commodity-exporting African countries (Ali, 2016).

Figure 4: Variation in Trade Cost Sensitivity across Industries (2008)



Recent work by Ali and Milner (2015) exploits the variation in trade costs of developing countries and the variation in trade cost sensitivity across industries in the identification strategy to explore how trade cost affect the mix or composition of manufactured exports by developing countries (including African countries). A key pillar of the identification strategy, namely sensitivity to trade costs, varies

across industries as well as over time. The proportion of imported inputs used in manufactured goods for each industrial category is used to proxy this variable. Figure 4 graphs this variable across industries for the year 2008. As this diagram illustrates, the motor vehicles, office equipment, and the telecommunication sectors are relatively high trade cost intense, whereas the food and mineral sectors are low trade cost intense.

Using the trade costs dataset of the World Bank for the period 1995 to 2010, Ali and Milner (2015) investigate the influence of trade costs on the export composition of developing countries. They find that despite substantial reduction, trade costs in developing countries are still very high and vary widely between developing countries (from 30% ad valorem to 600% ad valorem). Most importantly, they argue that these high trade costs influence the comparative advantage of these economies. Other things controlled for, an industry located in a higher trade cost country gains a relatively smaller share of that country's exports of manufactured goods compared to the same industry in lower trade cost countries, and that this effect is greater the more trade cost- intense or sensitive is the production of the export. This statistically significant negative relationship holds for sub-samples of countries (including importantly the Sub-Saharan Africa region) and industries, different estimation techniques, alternative common trading partners, and even to the inclusion of other sources of comparative advantage, such as factor endowments and institutional quality variables. The study generates, therefore, robust econometric evidence about how international trade costs systematically fashion the composition, not just the volume, of exports of the developing countries.

The evidence that trade costs fashion the composition of developing countries' exports in a systematic manner has important development policy implications, including in Africa. The design and implementation of trade policies, including export promotion measures, in developing countries needs to recognise relative national trade costs and differences in trade cost intensity across industries. Selective export promotion measures are less (more) likely to be effective in promoting exports by trade sensitive industries in higher (lower) trade cost countries.

The exports of some industries (such as autos, telecommunication, machinery and equipment) are shown by the present analysis to be relatively more sensitive to trade costs. This is because these industries are more dependent on imported intermediate inputs, and higher trade costs push up the costs of these inputs as well as increasing the direct costs of exporting. This means that reducing trade costs will generate a higher export response in these industries compared to less trade cost sensitive ones.

This heterogeneity of the response across industries to trade cost reductions has implications for economic growth in developing countries, because the mix of goods a country exports is likely to have important implications for its development. Literature shows that all goods are not similar in terms of their economic significance; specialising in some products brings higher growth opportunities than specialising in others for both demand and supply-side reasons. Since the response to trade cost reduction by more trade cost sensitive sectors is shown by the current work to be relatively large, the

lowering of developing countries' trade costs can be expected to disproportionately promote exports of more trade cost sensitive and technologically sophisticated goods by these countries. This offers an opportunity for increasing the growth-enhancing effects of export expansion.

References

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