

Does More International Trade Openness Increase World Poverty? (Part 2 of a [four part series](#))

There is no greater problem facing the world at the beginning of the 21st century than that of world poverty. This section first looks at what happened to world poverty over the past decade. It then asks how greater openness to trade might affect poverty by its effect on economic growth, a critical condition for poverty reduction. Here the evidence suggests that more openness has a positive effect on per-capita income, and therefore should tend to reduce poverty. But openness to foreign trade is far from being the only or most important influence on economic growth, and so the temptation to overstate the importance of globalization (as its more strident opponents and supporters tend to do) should be resisted. The next section considers how greater trade openness might affect poverty through another channel, its effect on inequality.

World poverty trends over the past decade?

Progress on poverty reduction over the past decade was troublingly slow. The number of people living on US\$1 a day or less fell slightly from about 1.2 billion in 1990 to 1.1 billion in 2000 (This paper concentrates on the income dimension of poverty). Because the population of developing countries rose over this period, the proportion of the population living in poverty – the poverty rate – fell, from 28 percent to 21 percent. (See Table 1.) The trends for people living on less than US\$2 a day were similar: absolute numbers rose slightly from 2.65 to 2.74 billion between 1990 and 2000, while the poverty rate fell from 61 to 53.6 percent.

Poverty reduction performance was also extremely uneven as was the distribution of world income. World Bank President James D. Wolfensohn told the Bank's annual meetings in Dubai in September that one billion people controlled 80 percent of the world's Gross Domestic Product while another billion people struggled to live on less than one dollar a day. "This is a world out of balance," Mr Wolfensohn said. Poverty fell by most in East Asia, whose 1.8 billion people represent over a third of the population of developing countries. Here the poverty rate was halved, while the number of people earning US\$1 a day or less was reduced by some 209 million, the largest and most rapid reduction in poverty in history. Though much of the reduction in poverty occurred in China, most countries in the region shared in the steep fall. Poverty rose in 1998 in the countries hit by financial crisis, but by less than had been initially feared. An unexpectedly strong rebound in growth in the region in 1999, raised hopes that poverty in East Asia would resume its historical decline.

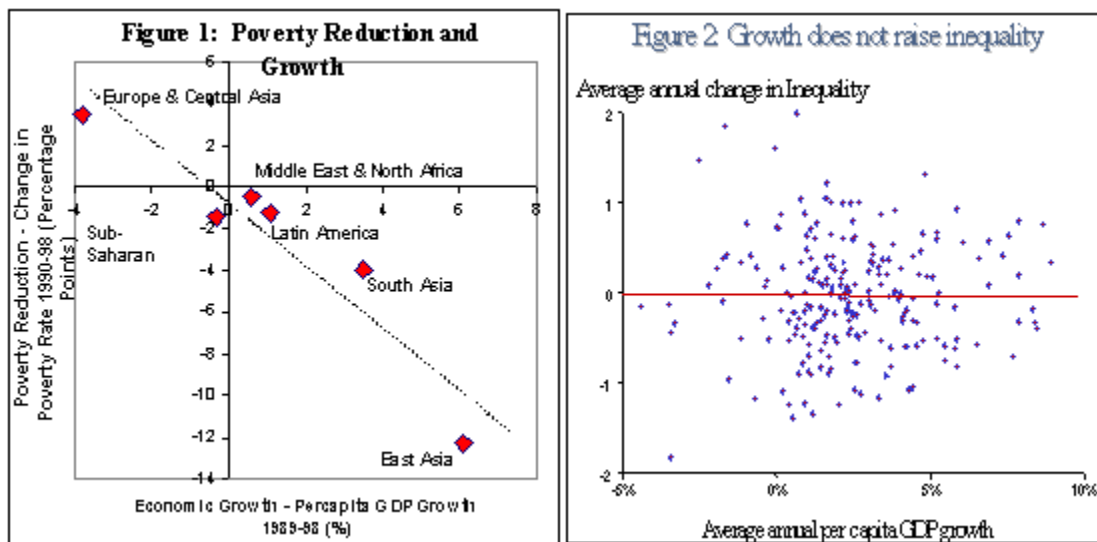
Table 1: Population living below US\$1 per day in developing countries 1990 and 1998				
	Number of people below US\$1 a day (millions)		Poverty Rate (%)	
	1990	2000 (estimate)	1990	2000 (estimate)
East Asia	470	261	29.4	14.5
Excluding China	110	57	24.1	10.6
South Asia	466	432	41.5	31.9
Sub-Saharan Africa	241	323	47.4	49
Latin America	48	56	11	10.8
Middle East/N.Africa	5	8	2.1	2.8
Europe & Cent. Asia	6	24	1.4	4.2

Total	1237	1100	28.3	21.6
Source: World Bank. Global Economic Prospects 2004. (2003).				

Poverty outcomes were much less positive in many other developing regions. Total numbers under US\$1 a day increased in most other regions. While South Asia, which contains over a quarter of the developing world's population, did experience a nine percentage point decline, poverty rates were broadly flat in Latin America, Sub-Saharan Africa, and the Middle East and North Africa. Both poverty numbers and poverty rates increased sharply in the Europe and Central Asia region, in particular among the countries making a difficult transition from socialism to a market economy.

Economic Growth and Poverty Reduction

Why were there such large differences in poverty reduction around the developing world – and what have these differences to do with globalization? Part of the answer to the first question is poverty is significantly affected by economic growth, the pace of increase in the total output of goods and services in the society. Figure 1 illustrates how the pace of poverty reduction in different developing regions in the 1990s was associated with growth. Poverty fell most in East Asia, the fastest growing region. It rose most in the Former Soviet Union, where per-capita income fell the most. A recent World Bank study of a large sample of countries estimates that, on average, growth in the income of the poor (defined as the bottom fifth of the population) rises about one-for-one with the growth rate of overall per-capita income in a country. (Dollar and Kraay, 2000)



However poverty is affected by many factors other than growth. For example, poverty may increase even where there is growth, because there is an increase in inequality. Gaining a deeper understanding of other influences on poverty, including changes in inequality, is a vital task for research. However there is no reason to think that the beneficial effect of growth on poverty reduction will be *systematically* offset by increases in inequality.

Figure 2 shows the lack of any systematic association between growth on the one hand and changes in inequality (measured by the Gini coefficient) on the other for a large sample of countries over several decades. The widespread fear that in poor countries growth must come at the expense of equity is not supported by the facts. The evidence

also suggests that the positive link between overall growth and incomes of the poor has not changed in recent decades, when globalization was more pronounced, than in earlier ones when it was less so.

More open trade raises per capita incomes – and the incomes of the poor

The World Bank has argued that the round of trade talks launched in November 2001 in Doha, Qatar, marked the first time that developing country interests were placed at the center of a multi-lateral round of trade negotiations. The Bank favors lifting the protectionist measures that have locked low-income countries out of rich-country export markets. A Bank report *Global Economic Prospects 2004: Realizing the Development Promise of the Doha Agenda*, outlined the benefits that would flow to developing countries and the world's poor from a liberalization of international trade. It estimated that a Doha agreement that substantially lowered agricultural and manufacturing tariffs and ended agricultural subsidies could cut the number of people living in poverty by eight percent by 2015.

There is a growing consensus in empirical studies that greater openness to international trade has a positive effect on country per-capita income. (Figure 3. Trade openness in the figure is adjusted to remove the influence of geographical factors.) A study by Frankel and Romer (1999) estimates that increasing the ratio of trade to GDP by one percentage point raises per-capita income by between one-half and two percent. Numbers of other studies reach similar conclusions, though the estimated size and statistical significance of the effects vary. (See for example, Edwards (1998) or, for a more skeptical assessment, Rodrik (1999).)

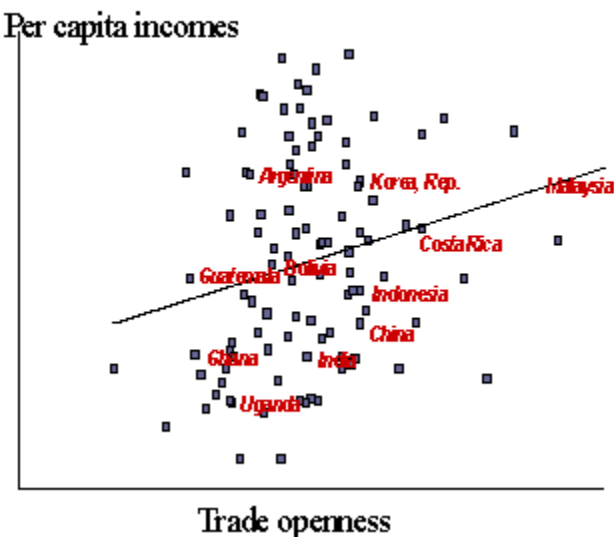
The proposition that greater openness to international trade has a positive effect on country per-capita income is consistent with economic theories going back at least 200 years. The oldest and most widely agreed is that trade lets an economy make better use of its resources, by allowing imports of goods and services at a lower cost than they could be produced at home. In particular trade enables developing countries to import capital equipment and intermediate inputs that are critical to long run growth, but which would be expensive or impossible to produce domestically. From this perspective exports are the price the economy pays to get access to these valuable imports. Other possible benefits include more intense competition, which obliges local firms to operate more efficiently than under protection, and greater awareness of new foreign ideas and technologies.

What of the impact of freer trade on the incomes of the poor? As noted above, recent work suggests that higher average incomes in a country are generally associated one-for-one with higher incomes of the poor. The same work finds that this link applies to income increases caused by more trade: in other words, the impact of trade on the income of the poor is

generally the same as that on per-capita incomes. Thus, for example, a 10 percent increase in the trade to GDP ratio could ultimately raise per-capita income by five percent (cautiously taking the lower bound of the estimates by Frankel and Romer), and one would in general also expect a five percent rise in the income of the poor.

But it is important to underline that there is nothing guaranteed about this outcome. Many other factors can influence both growth and poverty. Further, the success of a trade

Figure 3: Trade raises incomes...



opening is itself often affected by the macroeconomic climate, the quality of institutions and other factors.

Improving the payoff from trade opening, minimizing unemployment

Trade liberalization 'works' by encouraging a shift of labor and capital from import-competing industries to expanding, newly competitive export industries. The unemployment caused by trade opening is, in most cases, temporary, being offset by job creation in other sectors of the economy. The loss of output due to this transitional unemployment (called the social adjustment cost of trade opening) is also usually small relative to long-run gains in national income due to opening. Or, put another way, these adjustment costs are expected to be small compared to the costs of continued economic stagnation and isolation that would accompany a failure to open up.

The limited amount of existing empirical work on the employment effects of trade liberalization in developing countries broadly confirms these expectations. (See World Bank, 1997; Matusz and Tarr, 1999). Nevertheless, while adjustment costs are usually small in relative terms, they can still be a serious issue in many countries because they are often concentrated in a geographical area or in a few industries. They will also tend to be felt 'up front', while benefits will tend to be spread out over future periods. Carefully designed social-safety net and educational or retraining programs to help the most vulnerable affected groups are thus an important complement for trade reforms in many cases.

The potential costs of trade opening can also be either reduced or worsened by the overall context of policies in which reform is undertaken. High macroeconomic instability (big fiscal deficits, high and volatile inflation, volatile real exchange rates) can aggravate the unemployment costs of trade opening by fostering uncertainty, which can prevent firms from investing in the export sectors that are supposed to create new jobs.

A premature capital account liberalization in a country with large fiscal deficits can have a similar effect, by inducing large capital inflows, causing the country's exchange rate to rise, thus making its exports uncompetitive. The collapse of structural reforms in the 'Southern Cone' countries of Latin America at the end of the 1970s is partly attributed to this kind of inappropriate sequencing of reforms. Extremely stringent job security regulations may prevent firms hit by import competition from laying off workers, driving them into bankruptcy, as appears to have been the case in Peru in the 1980s.

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This series of **World Bank Briefing Papers** looks at how to define globalization and then assesses three leading questions about globalization by looking at the evidence from a large number of countries. Is globalization increasing world poverty? Is it worsening world inequality, perhaps by destroying jobs and lowering wages among the poor and unskilled? Is it causing deterioration in environmental standards? These papers concentrate on the international trade dimension of globalization. Subsequent Briefing Papers will look at other dimensions and questions about globalization, including the impact of foreign investments by multinational corporations, and of other capital market flows to developing countries.

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