Tackling poverty through trade and foreign direct investment:

applying a market systems approach

Briefing

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The BEAM Exchange is a facility for knowledge exchange and learning about the role of market systems approaches in reducing poverty.

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Overview

This briefing note reviews the market systems development approach, and how it can help inform trade and investment policies and programmes. While it has a wider application, it has been commissioned by the BEAM Exchange in response to DFID's Bilateral Aid Review published in December 2016. The review articulates DFID's high ambitions for turbo-charging trade through a bold package of pro-poor trade policy, embedding development within UK trade policy, and encouraging job-creating foreign direct investment (FDI) in frontier markets – including through the new 'Invest Africa' programme. DFID's increased focus on trade and job-creating investment was further reinforced in DFID's Economic Development Strategy published at the end of January 2017.

The purpose of this note is two-fold: (i) to discuss possible priorities for DFID in using trade and FDI to tackle poverty in low-income countries; and, (ii) to explore how the key tenets of the market systems approach could help increase the prospect of DFID's and others' trade-related policies and programmes contributing to sustained economic development and poverty reduction.

1. Why trade and investment?

DFID's increased focus on pro-poor trade and FDI should be welcomed: in the right policy environment, trade and FDI can transform a country's economic prospects. While much debated, the weight of evidence suggests that greater trade openness is an important element in explaining growth, and has been a central component of successful development.[1] Trade and FDI can lead to lower prices for consumers and greater productivity through increased competition, economies of scale and technology spill-over. Increased productivity can, in turn, lead to better jobs and a structural shift towards higher value-added activities.[2] Lowering trade costs is particularly important for countries seeking to take advantage of the fragmentation of production through global value chains (GVCs), which offer new opportunities to generate growth and income gains through trade.[3]

But the benefits of trade and FDI are not automatic, and because trade liberalisation changes relative prices, it almost inevitably reduces some people's welfare.[4] Moreover, the majority of low-income countries' exports and FDI are in primary commodities, such as oil and mining products, which have not delivered the productivity gains, job creation or economic diversification needed to create sustainable and broad-based economic growth. Recent studies have argued that realising the benefits of trade – overall and for the poorest – depends to a large extent on national institutional settings[5] and factor mobility,[6] necessitating reforms to the enabling environment to improve macro-stability, governance, the business environment, the financing of new investment, the effective resolution of conflicts, and the ability to adjust and learn new skills.

2. The market systems approach

Market systems approaches seek to change the way markets work in order to improve the outcomes for the poor. They do this by trying to understand and tackle the root causes of market failure, rather than the symptoms.

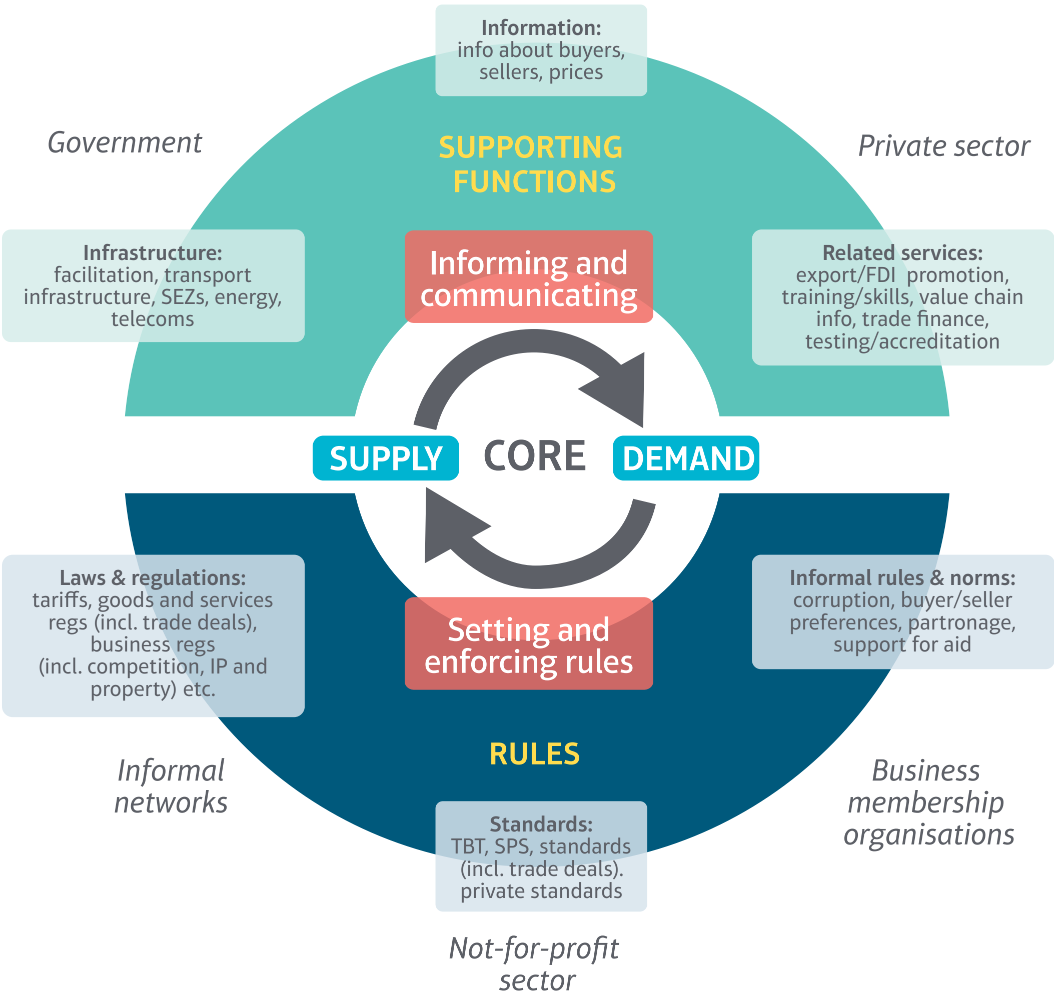
1 Higgins, K. and Prowse, S. 2010. Trade, growth and poverty: making Aid for Trade work for inclusive growth and poverty reduction. London: ODI
2 Farole, T. and Winkler, D. (Eds.). 2014. Making Foreign Direct Investment work for Sub-Saharan Africa: local spillovers and competitiveness in global value chains. Washington DC: World Bank.
3 World Bank Group and World Trade Organization. 2015. The Role of Trade in Ending Poverty. World Trade Organization: Geneva.
4 Winters, A. and Nartuscelli, A. 2014. Trade Liberalisation and Poverty: What Have We Learnt in a Decade? Annual Review of Resource Economics. Vol.6:1-550. pp 493-512.
5 See Haltiwanger, J. Globalisation and Economic Volatility. 2011; and McMillan, M. and Verduzco, I.. New Evidence on Trade and Employment: An Overview. 2011
6 Le Goff, M. and Singh, R. 2013. Does Trade Reduce Poverty? A View from Africa. Policy Research Working Paper. No. 6327

They focus on inventions that change the behaviour of businesses and other market players – public, private, formal and informal – in a way that reflects the genuine incentives and capabilities of the permanent players.

By stimulating replication or 'crowding in' others, they seek to ensure lasting and large-scale beneficial change for the poor within the market system.[7]

Market systems are defined as a multi-player, multi-function arrangement consisting of three main sets of functions: (i) the core market; (ii) supporting functions; and, (iii) rules. These three interlinked functions are often illustrated using the market system 'doughnut' which has been adapted for trade and FDI in Figure 1, and explained below with reference to a simple coffee value chain.

Figure 1: A stylised trade market system



The core market
At the heart of the market system is the exchange of goods and services. Often, these are more complicated than they first appear, involving multiple 'players' who are linked together and whose behaviours depend on their roles and functions, incentives and capabilities. This in turn shapes the availability, choice, price and quality of goods or services exchanged, ultimately determining the market's effectiveness for the poor. Even a relatively simple value chain, such of coffee, has multiple players at its core: the small-holder; the farm agent or cooperative; the exporter; the third country broker; the roaster/manufacturer; the supermarket or café; and finally the consumer.

7 BEAM Exchange. https://beamexchange.org/market-systems/key-features-market-systems-approach/

Supporting functions
Value chains can only develop and function with the right supporting functions in place, including services, information/resources and infrastructure. Continuing with the coffee example, supporting functions would include irrigation; agricultural inputs and credit; finance; insurance; price information; transport infrastructure and logistical services (both domestically and internationally); and, potentially export promotion support. In the context of GVCs, the existence and quality of these supporting functions can have a major impact on whether the exchanges happen at all, and if they do, the benefits that accrue to the poorest.

Rules
Value chains and supporting functions are subject to an institutional context or business environment that influences when, how and where exchanges take place. These include standards, regulations, laws, social rules, and behaviours. Applying this to coffee, such rules include standards accreditation and mutual recognition (public or private, and potentially domestic and international); any export taxes or – more likely - third country tariffs; and, whether market liberalisation and competition policy prevent monopsony buying power. In international trade and GVCs, local, national and international rules will influence the exchange.

3. Trade policy and poverty

DFID's Economic Development Strategy confirms that DFID's approach to trade policy will continue to centre on poverty reduction. At the multilateral level, this means DFID maintaining its commitment to the multilateral trading system; keeping its markets open to the world's poorest countries; encouraging others to do the same; and, helping poor countries to get the best out of global trade negotiations. To this end, among DFID's first priorities should be to ensure the UK replicates the EU's Generalised System of Preferences and Everything But Arms programme which provides duty free quota free access for the world's least developed countries (LDCs). Any interruption in these arrangements could have serious consequences: without Everything But Arms, the world's poorest countries would face £323m in additional tariffs each year, with some countries particularly exposed – such as Bangladesh, which sends 10% of its exports to the UK and Cambodia, which sends 7% of its exports to the UK.[8]

Over time, there is scope to improve upon the EU's preference regimes. A relatively easy win would be to introduce more flexible rules of origin (which are used to determine the origin of products and therefore whether they are eligible for preferential treatment. This could include both low thresholds for domestic content and flexible cumulation rules for LDCs, to facilitate their participation in regional and global value chains. There is scope also to simplify the Generalised System of Preferences, while distinguishing between LDCs and small-vulnerable economies, other lower-income countries, and more competitive developing countries. In the UK's self-interest and to enhance the benefits of preferences granted to poor countries, transparent criteria should be used to exclude the most competitive developing countries, from which the UK should demand reciprocal concessions through multilateral or bilateral negotiations. Reducing or eliminating price-distorting agricultural subsidies and allowing greater access to low-income countries services' professionals should be a longer-term priority, but these are likely to be too sensitive in the short-term at least.

Replicating the EU's Economic Partnership Agreements (EPA) could be more complicated than its unilateral preference regimes, as their negotiation has been contentious and replication could be blocked by countries in regional groupings with little to lose, or simply where domestic politics prevent rapid ratification of the new arrangements. In the absence of new EPAs, DFID should make the case for introducing temporary unilateral preferences for countries that would otherwise lose out.

The UK government has signalled its intent to be a global leader in free trade which is usually interpreted as agreeing ambitious free trade agreements (FTAs) with the largest and most dynamic

8 Mendez-Parra, M., Willem te Velde, D., Winters, A. 2016. The Impact of the UK's Post-Brexit Trade Policy on Development. London: ODI

economies. While few of these are DFID priority countries, some such as India are. Furthermore, many more are ODA-eligible countries which could be afocus for FCO Prosperity Fund support, including China, Mexico, Indonesia and other important trading partners. FTAs with these countries will deliver the greatest economic impact if they are deep and comprehensive, addressing inter alia tariffs, non-tariff barriers, services trade, intellectual property, procurement, investment and competition policy.

But such deals will not benefit everyone. Most ODA-eligible countries contain a significant number of poor people which may be impacted by future trade deals with the UK. The poor in the UK may also be affected, particularly if trade deals lead to decreased wages and jobs losses due to increased competition from lower cost manufactured products and food. It is important that DFID leads thinking to ensure that UK-third country FTA impact assessments are robust and focused on the poorest. DFID should work hard to ensure the negative effects of trade liberalisation are minimised in the design of FTAs, and that adequate compensation and support mechanisms are in place for those who may lose out (including through preference erosion, whereby lowering the costs to one country impacts on the competitiveness and market-share of another).

By combining its trade and development policy, there may be the opportunities for the UK to negotiate a new generation of bespoke FTAs with low-income countries that truly reflect the priorities and incentives of both parties. These could: (i) respect low-income countries' desire to nurture domestic industries and increase domestic value-addition from FDI; (ii) while providing the UK with preferential access for FDI and trade in services, benefiting the UK commercially while also increasing the competiveness of the partner country; and, (iii) improving the alignment of the UK's Aid for Trade programmes with these new trade arrangements to maximise the gains from two-way trade and investment, particularly for the poorest. These programmes should not be tied directly to the UK's interests, but the indirect benefits could be significant.

DFID's strategy documents also signal a continued commitment to tackling barriers that hamper poor countries' ability to trade. Whether or not linked to trade deals, the UK's Aid for Trade programmes should continue to invest in targeted, trade-related infrastructure (trade facilitation and hard-infrastructure) programmes. Evidence shows that trade-related infrastructure, port efficiency, customs, the regulatory environment and services sector infrastructure all have positive and statistically significant relationships with trade flows[9] and product diversification. There is scope however, to improve their targeting at the needs of the poorest, including informal traders (over 70% of whom in Sub-Saharan Africa are women[10]) and those cut off from markets. This will require effective and deep cooperation across sectors, government ministries and agencies, business and wider stakeholders.

How can a market systems approach improve the impact of DFID's trade policies?

Although few MSA programmes are supporting cross-border trade directly, the market systems analytical framework can be applied equally to international trade or FDI markets as it can to domestic or local markets. Three key tenets of the market systems approach stand out as being particularly relevant to DFID's trade policy:

- Firstly, and very simply, the approach is focused explicitly on the poor. While DFID is clear that its approach to trade will centre on poverty, there is a risk of this being diverted during implementation towards the UK's national interest. A market systems approach helps retain a focus on the poorest in design and throughout implementation.

- Secondly, market systems approaches can help identify the root causes of market failure and deal with complexity. The approach can be used at the outset to help identify the root causes of why the overall market (see Figure 1) fails the poor. Each of these market

9 Wilson, J. S., Mann, C. L. and Otsuki, T. 2005, Assessing the Benefits of Trade Facilitation: A Global Perspective. World Economy, 28: 841–871. doi:10.1111/j.1467-9701.2005.00709.x

10 Southern Africa Trust. 2013. Regional Cross-Border Trade Dialogue: http://bit.ly/2n5YdJL

failures – for example, burdensome and costly customs procedures – are also markets in their own right. The approach can be used to analyse each one in order to identify how the market operates, who the major players are, and how the market system needs to change to work for the poor. The approach has a number of possible toolkits for identifying the root causes of the system's failure and prioritising the most pressing.

- Thirdly, market systems approaches recognise that while aid funding can have a powerful influence, the desired behaviour changes must reflect the genuine incentives and capabilities of permanent players to succeed in the long-term. Too often trade agreements are blocked by vested interests that could have been understood and potentially influenced at the outset. And 'best-practice' trade-related reforms, such as customs modernisation programmes, fail to deliver sustained impact. This is often ascribed to 'weak capacity' which may be part of the problem, but the root cause may instead be found in the incentives of the market players to subvert reform. By influencing genuine incentives and capabilities, a market systems approach can increase the prospect of facilitating lasting and sustained change.

The case study below (Box 1) illustrates how the approach has been applied in practice to supporting the garment industry in Myanmar.

Box 1: Business Innovation Facility – Myanmar garment industry case study

As a labour intensive industry, the Myanmar garment sector has great potential to empower the poor through creating access to new, sustainable economic opportunities. The sector currently employs approximately 126,000 people, and is estimated to have the potential to employ over 1 million if it can integrate successfully into global value chains (GVCs).

Business Innovation Facility (BIF) began by carrying out a comprehensive analysis of the potential of garment factories to deliver economic and social improvements for workers through increased productivity, process and quality improvements, as well as improving pay, job quality and job satisfaction in the short-term. BIF's market analysis identified:

- Constraints around the quality of jobs, including an apparent inability to pay workers more, reduce overtime, improve health and safety, stop using low paid under-age workers, and invest in other areas of worker welfare; and
- Constraints to the industry being able to achieve potential growth and thereby create significantly more good quality jobs.

To understand the second set of constraints better the BIF team designed an intervention to help the local industry find out from regional supply-chain actors the potential for growth, and what would be needed to achieve this. The analysis further identified that the relationships between buyers, particularly those serving EU and US markets, and many garment factories in Myanmar were non-existent, or very weak. This was critical: opening up the EU and US markets would be essential if Myanmar was to become a large-scale supplier and create many new good quality jobs in the industry.

Three landmark garment industry conferences were organised by BIF, contributing to the development of the 'Myanmar Garment Industry 10-year Strategy 2015 – 2024' and the bringing together of global brands (e.g. GAP, Tesco, Next, Adidas) and factory representatives. Having successfully broken down the information gap and aligned market players, the BIF team has stepped back from this process.

4. FDI policy and poverty

DFID's BAR and Economic Development Strategy signal DFID's commitment to creating an unprecedented number of labour-intensive manufacturing jobs. Global Value Chain FDI could make a significant contribution by creating new and better jobs in the short-term, and in the longer-term by enabling shifts to higher productivity jobs and higher value-added activities through technology and know-how transfers, and the crowding in of government and private sector investment.

The recent wave in trade globalisation driven by GVC manufacturing trade saw developing countries' share of global manufacturing more than double, but it largely passed the poorest countries by, including most of sub-saharan Africa. Rising costs in China and most of East Asia and the growing importance of trade in 'tasks' (intermediate goods and services) creates new opportunities for FDI-led growth in low-income countries.

For most low-income countries the greatest opportunities are likely to be found in job-intensive basic manufacturing sectors, such as garments and textiles, agro-processing/horticulture and consumer goods. China is the most promising source of GVC FDI in these areas. But this does not preclude UK firms from benefiting. UK retailers can benefit directly from cheaper or higher-quality products produced by these GVC investments. And there may be opportunities for win-win-win benefits whereby for example, a Chinese firm invests in a special economic zone to produce automotive parts; UK firms supply advanced manufacturing tools and design services; and, the host country benefits from the manufacturing investment. DFID could help by facilitating business-to-business linkages and joining up its own export and investment promotion activities with those of low-income countries and GVC investing countries.

Recent analysis shows that there are a number of key enabling conditions that need to be in place in order to attract and retain FDI.[11] Firstly, policies targeting investment and trade flows must address infrastructure, connectivity, investment and trade policy. Of these reliable energy is particularly important – with over a third of international manufacturing firms identifying this as a major constraint to doing business in Africa.13 Secondly, policies must support the investment climate, business environment and institutions, including investment promotion agencies which can play an instrumental role in attracting investors through marketing, fostering linkages and making it easier to establish overseas and develop local value chains. Thirdly, policies need to target the quality and conditions of input and output factors, which flow through education, skills development, product standards, innovation, and environmental, social, and labour standards. In particular, GVCs can create new opportunities for labour on the demand side, but the supply side requires an integrated response from government in partnership with the private sector to upgrade skills and enhance social cohesion.

DFID's Economic Growth Strategy commits DFID to supporting export processing zones where there are opportunities for doing so. Many low-income countries have sought to get around the infrastructure and bureaucratic deficits by introducing special economic zones and export processing zones. These 'competitive space' enclaves tend to have different rules of business, with streamlined customs, regulatory and administrative procedures and favourable tax conditions. The strategy has succeeded in a number of countries, including China, South Korea, Mauritius and more recently Ethiopia (see Box 2 for a case study that shows both the potential and challenges of attracting and retaining FDI in low-income countries). However, most studies have found that the linkages to the local firms are minimal, with domestic trade remaining very low and technology spill-overs rare.[12]

11 Taglioni, D. and Winkler D. 2016. Making Global Value Chains Work for Development. Washington DC: World Bank
12 Ibid

Box 2: Chinese investment in shoe production in Ethiopia

In 2012, Huajian – one of China's largest shoe manufacturing companies – opened a factory near Addis Ababa. By 2013, it was already employing 3,500 people and producing 2 million pairs of shoes. Huajian has committed to jointly invest US$2bn (£1.3bn) over the next decade to create a light manufacturing special economic zone in Ethiopia, and aims to create 30,000 jobs in Ethiopia by 2020, with exports reaching US$1–1.5 billion.

Huajian was attracted by a combination of cheap labour, cheap electricity, other financial incentives and duty-free access to the US market. The average wage in Huijian's Ethiopian factory is around US$40 per month, compared to an average manufacturing wage of over US$500 in China. US import tariffs on shoes made in China range from 6 percent to as much as 35 percent.

These benefits are balanced by the high cost and uncertainty of manufacturing in Ethiopia. These include power cuts, bureaucratic inefficiency, transportation and logistics costs as much as four times as expensive as China's, and productivity levels perhaps a third of China's.

This raises an important challenge for policy-makers, including DFID: since GVC participation alone does not automatically generate development, what can be done to maximise its economic and social impact? Evidence suggests that this will depend in a large part on the absorptive capacity of local firms and the quality of the transmission mechanisms, including:

- linkages to the local economy either through forward linkages (sales to the local economy which spur productivity) or backward links (purchases of local inputs, spurring productivity);
- technology spill-overs (through foreign R&D and know-how becoming available to companies in the value chain or the wider economy);
- skills upgrading (including through training and the demand for skilled labour); and,
- minimum scale (where FDI investment may stimulate investment in infrastructure or local production in other sectors which would not have happened otherwise).[13]

While there can be no GVC-led growth without securing the investment in the first place, it is important that DFID considers economic and social upgrading transmission mechanisms up front and centre in programme design and throughout implementation. Leaving this until the FDI has landed, risks the GVC firm driving decision-making and governments having limited leverage to integrate the firm in the domestic economy. Moreover, while export processing and special economic zones can bypass many of the market impediments to attracting greater FDI and crowding-in wider investment, efforts should be concentrated over time on eliminating the gap between these and the wider economy's rules and supporting functions.

How can a market systems approach improve the impact of DFID's FDI policies?

The value of a market systems approach in improving the impact of trade policies (set out in section 3.1) apply equally to FDI. Moreover, the approach provides two further guiding principles that can increase the impact and sustainability of FDI-supporting programmes:

- Firstly, a market systems approach is explicit that interventions should play a catalytic role to facilitate different players within the system to make change happen without

13 Ibid

becoming part of the system itself, for this risks distorting market systems, creating dependency and a lack of ownership. In FDI programmes, there could well be a need for temporary support to SMEs for upgrading to meet the standards of multinationals, and GVC-seeking countries will most likely need to offer an incentive package to compete successfully with others doing the same. A markets systems approach can help guide policy-makers and programmes to facilitate market players with the right incentives and capacities to provide the goods or service, and ensure that any subsidies, grants or industry protection are well targeted and time-bound to avoid the adverse selection of beneficiaries, aid-dependency and the stifling of competition and innovation.

- Secondly, by addressing sustainability at the outset in analysis about which players are performing or paying for market functions currently, realistic scenarios can be prepared about who will undertake and pay for these functions in the future. Most of the core functions in attracting FDI fall naturally to government. DFID should explore the scope for facilitating the market, so that private sector players can provide some of the services traditionally fulfilled (often poorly) by governments or donor projects, such as export support and training on meeting global standards.

5. Conclusion

With its ambition to turbo-charge trade and the prospect of new bilateral trade arrangements on the horizon, the UK has a unique opportunity to increase its poverty impact by aligning its trade and investment policies with programmes that help improve the overall enabling environment, including its Aid for Trade programmes. This includes a potential window of opportunity for fresh-thinking on free trade agreements with low-income partners. This could open the UK market to their exports, while facilitating increased outward FDI and services trade from the UK, along with increased FDI value-added for partner countries.

Adopting a market systems approach can help DFID policy-makers break down the complexity of the international trade market system and identify the underlying causes of market failure. It can also help with identifying the incentives of market players, thereby avoiding market distortion, increasing the potential for scale, and improving the prospects of trade and FDI reforms being sustainable. Finally and importantly, its explicit focus on the poorest can help ensure DFID's trade policy truly remains 'pro-poor' while also delivering in the UK's national interests: a true win-win-win for the UK, its developing country partners and the poorest.