

Economic Diversification

Guidance Note

Trade and Competitiveness Global Practice
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Executive Summary

Economic diversification remains a key challenge for most developing countries. Indeed, diversification and rising per capita incomes go hand in hand up until incomes per head reach \$9,000, thereafter growth appears to lead to more concentrated economies. The challenge of diversification is greatest for countries with the lowest incomes and for countries whose economies are dominated by commodities or minerals. For these countries, economic diversification is inextricably linked with the structural transformation of their economies and achievement of higher levels of productivity as a result of the movement of economic resources, both within and between economic sectors.

The trade and competitiveness agenda is at the heart of a strategy for economic diversification. Providing the foundations for private sector-driven growth are the focus of attention for the T&C GP and an essential element in achieving a broader base of economic activities, especially around tradable goods and services. No country has experienced sustained growth and significant reduction in poverty without integrating into the global economy. Export diversification is closely associated with a broader range of production activities. But this agenda needs to be implemented together with other key elements of the development process requiring close coordination with other GPs and CCSAs.

Poverty-reducing trade-driven growth has been particularly difficult to achieve in countries whose economies are concentrated upon commodities and natural resources. The current global downturn in trade and the resulting decline in commodity prices poses a particular challenge for countries and subnational regions with a very narrow industrial and private sector base by which to generate jobs, exports and new sources of government revenues that can be invested to enhance productivity. But more broadly, stagnating global growth and the imperative in many developing countries to increase the number and quality of jobs in the face of a rapidly rising working population, call for effective strategies to diversify trade and production to support countries to regain growth momentum, raise productivity, and curb volatility.

Countries with concentrated economies have found it difficult to design and implement public investments and policy reforms that provide a framework for diversification. High commodity prices often lead to appreciated real exchange rates that undermine the competitiveness of potential new export activities. This is often coupled with lack of attention to distortions in product and factor markets that affects firms' ability to survive, export, and grow. Rent-seeking

and lack of transparency often lead to competition for the rents from resource extraction that leads to instability and then to internal conflict. Hence, strategies for diversification are often at the forefront in addressing fragility. The challenge that countries face is how to enhance the benefits from their endowments of natural resources, and to distribute them more widely, while providing a broader economic base for economic development and poverty reduction.

Small economies, where diversification is limited because of scale, face a particular set of challenges, as there is little opportunity to efficiently produce a high number of products. This is often compounded by poor connectivity as a result of being land-locked or an island economy. In these countries, regional and global integration plays a key role in overcoming limited size and addressing connectivity and especially through movement of persons to provide tasks and services overseas. There are also particularly close links with macro performance, as the optimal response to volatility lies more with the good management of fiscal, monetary and exchange rate policies than with attempts to diversify the structure of production.

While the current global environment is creating economic problems for resource dependent countries, there are new opportunities to successfully implement a strategy for diversification. The global economy of the 21st Century offers new routes and opportunities for poor countries to diversify. The spatial splitting up of production and the emergence and growth of regional and global value chains offers new opportunities for developing countries to export tasks and activities rather than having to specialize in whole industries. The changing technology of communications and the spiraling downward of transport and communications costs has created enormous opportunities for developing countries to export services, including back office processing. These developments bring not only opportunities to broaden the base of production but also to diversify the structure of employment and especially for women to find productive work, which can transform households, boost participation in education and hence long-term productivity and poverty reduction. But participation in international value chains also entails new risks from vulnerability in longer and more complex value chains or when the relationship with the buyer/key supplier is captive.

While there is no magic recipe for diversification, T&C can assist countries to put in place these key basic elements:

(i) *an appropriate incentive framework* through reforms to the business and investment climate, reviewing trade policies to remove bias against exporting and ensuring effective competition in product markets and in key backbone services such as transportation, energy and communications

(ii) *investments and policy reforms that reduce trade costs* – declining trade costs and efficient trade logistics were at the heart of the success of East Asian countries in integrating into the global economy and achieving more diversified economies with not only more, but also better jobs;

(iii) *effective policies to support adjustment and the reallocation of resources to new activities* – from declining sectors but also from the informal sector and new entrants to the job market. The

focus should be on supporting workers, identifying and overcoming constraints on mobility including gender related constraints, rather than jobs.

(iv) government interventions that target specific market, policy and institutional failures. T&C can help governments identify shortcomings in the marketplace and tailor interventions to target those problems. For example, information deficiencies and asymmetries are likely to be a key factor behind the comparatively low survival rate of new export flows. This includes lack of knowledge to comply with overseas market standards.

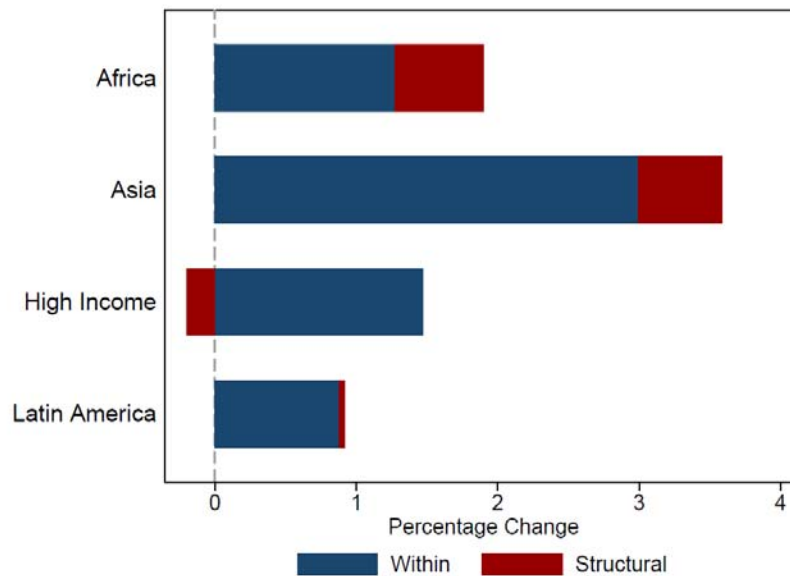
This note provides guidance to T&C teams as they engage with clients that seek to diversify their economies. A recent IEG report (World Bank, 2015) raised the concern that WBG engagements (country partnership frameworks, lending, analytical and advisory services) often call for economic diversification but struggle to define it. This note offers the following contributions: (a) it provides a definition that encompasses two related dimensions of diversification: trade diversification (exporting new or better products, or to new markets) and domestic production diversification (cross-sectoral rebalancing of output, driving the reallocation of resources across industries and within industries between firms to increase total factor productivity); (b) it raises awareness on the complexity of the diversification process and on the state of knowledge surrounding economic diversification; (c) it provides the background and the basis for the focus on these four key elements of a diversification strategy that T&C can support; and (d) it provides examples of the sort of analysis and advisory work, technical assistance and lending operations that the Practice can lead to support governments in their quest to deliver jobs and poverty reduction through economic diversification.

Why does Economic Diversification matter?

Economic Diversification is a key element of economic development in which a country moves to a less concentrated production and trade structure. Lack of economic diversification is associated with increased economic vulnerability such that external shocks can undermine the development process. Low income countries have the least varied economic structures usually with a heavy reliance on farming or minerals, such as fuel oils, gas, copper and other metals. This creates challenges in terms of exposure to sector specific shocks, such as weather related shocks in agriculture (droughts, floods, pest infestation, disease outbreaks) and sudden price shocks for minerals, as is happening now with the slowdown of growth in emerging markets. Growth also tends to be unbalanced in the case of mineral dependent countries or slow and difficult to sustain in agrarian economies. Poverty-reducing trade-driven growth has been particularly difficult to achieve in countries whose economies are concentrated upon commodities and natural resources. Diversification helps manage volatility and provide a more stable path for equitable growth and development.

Economic diversification and structural transformation, the reallocation of resources, within and across different sectors to higher productivity activities, are closely linked. Highlighted by Simon Kuznets, in his Nobel Prize address, as one of six characteristics that accompany modern economic growth, structural transformation refers to the shift from agricultural to nonagricultural sectors, and from industry to services. A broad and well documented trend has been the gradual decline of agriculture and increase in services, accompanied by an initial increase followed by decline in manufactures, that consistently shows across countries as a part of the process of economic development.¹ A useful way of understanding the relationship between economic growth and structural transformation is by decomposing the causes of increases in productivity into that due to factor reallocation across sectors (structural change component) and that due to changes in productivity within sectors (within component). Warnings that in a number of developing countries, particularly in Africa and Latin America, structural transformation was slowing down and that these countries were showing signs of 'premature deindustrialization' (the rate at which economies were diversifying and transforming their economies was not proceeding as fast as observed in today's advanced economies)² are losing steam. Using recent data, such as that use in Figure 1, shows that the structural transformation component is positive. Nevertheless, the challenge prevails for many countries to transform and diversify their economies. This task will likely be made more difficult as new technologies may encourage a reshoring of manufacturing production to advanced economies.

Figure 1: Productivity Growth Decomposition, 1970-2010



Technological change and globalization are generating new opportunities for resources to shift within agriculture to higher productivity activities, and services as well as manufacturing can drive diversification and structural transformation. Indeed, the lines between agriculture, manufacturing and services are no longer distinct.³ As a consequence, the shift of resources to modern agriculture, to manufacturing and to services should not necessarily be seen as competing routes but rather complementary ways of achieving diversification and structural transformation. Diversification of domestic production toward new activities within and between sectors can lead to better resource allocation and improve overall productivity. Diversification will tend to increase the demand for labor and deliver jobs, of particular importance in resource-dominated economies with large youth populations and high unemployment rates.

Successful diversification is all the more important now in the wake of stagnating global growth and the imperative in many developing countries to increase the number and quality of jobs. Rapidly rising working populations offer many developing countries an opportunity for a demographic dividend, similar to that experienced in east Asia in the late 20th century. However, without economic diversification and strong private sector growth to create jobs this could create a real demographic challenge for countries. The need for government action through well designed public investments and effective policy reforms that support a more diversified economy is particularly pertinent at this time since *the long-lived commodity bonanza is over and secular trends lead many analysts to argue that the stagnating global growth is the “new normal”*. Cyclical but also structural forces are at play with China’s economic transition, the over-supplied oil market, the decline in global productivity, and the widening global savings-investment gap dragging down global demand, oil prices, and world growth prospects. Traditional countercyclical macroeconomic policy is less effective. In advanced economies, interest rates are at rock-bottom levels and public finances are saddled with the debt overhang, high financing costs, and declining revenues. In emerging economies, fiscal and monetary policy are even more constrained.

While there is no blueprint for successful diversification, careful application of economic theory and available evidence can help policy-makers to avoid mistakes and learn from successful experiences. The role of government in reducing barriers to diversification and in addressing market failures that limit the movement of resources to new activities has always surrounded discussion of diversification strategies. While the earlier focus was on supporting specific industries, including through substantial import protection, the current dialogue is centred much more on finding a practical framework of public action that enables the private sector to drive restructuring, diversification, and technological dynamism. The challenge is to identify practical interventions for government in a second-best world⁴ combining the best use of the underlying but limited economic theory (economic nous), a careful understanding of the characteristics of the particular economy, available empirical evidence and relevant experience from elsewhere. Improvements in theory, especially with regard to understanding firm level dynamics, and a burgeoning empirical portfolio have built a much better base for informed policy advice on diversification.

A key aspect of this emerging knowledge is that the global economy of the 21st Century offers new routes and opportunities for poor countries to diversify. The spatial splitting up of production and the emergence and growth of regional and global value chains offers new opportunities for developing countries to export tasks and activities rather than having to specialize in whole industries. Developing countries can now participate in automotive value chains by providing parts and components. Previously, the capability to export cars would require foundries to forge engine parts, huge assembly lines and so on. The changing technology of communications and the spiraling downward of transport and communications costs has created enormous opportunities for developing countries to export services, including back office processing. While this creates new ways to diversify, participation in long and complex value chains or in cross-border trading relationships when the key supplier becomes captive to a global buyer can increase vulnerability, especially if the activities are concentrated in specific areas or regions of a country.

Despite its apparent economic benefits, not all developing countries have pursued diversification and fewer still have been successful in their efforts to overcome the dominance of natural resources and primary commodities. In many developing countries the extractive industries sector is both shaped by and, in turn, influences political, economic, societal, and institutional dynamics. A focus by policy makers on short-term rents from resources and their allocation to ensure political survival has tended to undermine institutional building, distracted from policies and investments necessary to sustain growth in the long-term and increased internal conflict. All of which undermine diversification. Nevertheless, some resource-rich countries have been able to successfully diversify. Resource rich countries can tax the rents from commodity extraction to fund critical investments in human, physical and institutional assets (see Box 1). Thus shows that the political economy constraints that face developing countries when seeking to diversify are not insurmountable. There are lessons that can be learnt from these examples but in general we need to give greater efforts to understanding these political economy issues and how to deal with them.

Box 1. Chile and Zambia: A Tale of Two Diversification Paths

Chile and Zambia are both abundant in copper deposits. Their different economic trajectories illustrate that diversification can be achieved even in resource rich countries. Chile and Zambia have abundant deposits of copper and copper is their main export product. They also share similar population size. But they differ significantly in their income levels. Chile's per capita income (PPP) is over US\$21,000 while Zambia's is just over US\$3,800. Fifty years ago, both countries produced similar amounts of copper. Zambia even showed higher levels of production than Chile during 1960-1970. Both countries have also had similar patterns of copper deposit ownership (with their state-owned companies playing a major role). But their economic performance has been very different. Chile has steadily increased copper production while Zambia has remained stagnant, although there has been a recovery since 2000. Whereas Chile became less resource dependent, Zambia became more resource dependent. While copper currently represents 50% of Chilean exports, it is about 80% of Zambian exports.

Chile followed a two-track diversification strategy: (i) diversification "within" industry (increasing value added in the copper industry by improving the quality of copper extraction and exporting process and complementing it with the development of domestic ancillary/logistics services; and (ii) diversification "across" industries (development of fisheries: high quality salmon exports, increasing exports of high value-added agricultural goods such as fruit and vegetables). In addition, Chile set up mechanisms that allowed it to save the rents from mineral extraction and invest in critical growth expenditures during the commodity busts. Specifically: (i) a structural fiscal surplus rule that sterilizes the country's spending levels against copper fluctuations. This ensures macroeconomic stability and it also generates accumulation of wealth when copper prices are high; and (ii) sovereign funds to administer the rents saved during the commodity bonanza. Chile invested a significant amount of the boom savings on training in advanced skills (ie. scholarships to enroll Chileans into top global universities) and financing and mentoring to high growth start-up firms.

Unlike Chile, which enjoys a coastal location, Zambia is a landlocked country with high trade and transportation costs. Growth has not been inclusive and poverty in Zambia is widespread, with 61.2 percent of the population estimated to be living below the national poverty line. Rural poverty at 74 percent is more than double the urban poverty rate of 35 percent. Sustained growth and continued political stability have produced only modest improvements in livelihoods. The effect of economic growth on overall poverty reduction has been small, as much of the benefits of growth have accrued to those already above the poverty line. Growth has been primarily driven by mining, construction, and financial services and did too little to create jobs and expand opportunities beyond the relatively small labor force already employed in these industries. In fact, the income share of the bottom 40% fell from 2003-2010. Thus, for Zambia, economic diversification remains an essential objective to deliver more inclusive growth in the face of declining prices for copper, and to create employment for its fast growing, urban and youthful population.

Source: Meller and Simpasa (2011)

How is Diversification Defined and Measured?

Economic diversification is defined here as the shift toward a more varied structure of trade and of domestic production so as to increase productivity, create jobs and provide the base for sustained poverty-reducing growth:^{5,6}

- *Domestic production diversification* results from the shift of domestic output across sectors, industries, and firms. It captures the dynamics of structural transformation, because successful diversification of domestic production entails resource reallocation across and/or within industries from low productivity activities to those with higher productivity.
- *Trade diversification* occurs in three ways: (a) the export (or import) of new products (good or services); (b) the export (or import) of existing products to new markets, and (c) quality upgrading of exported (or imported) products.⁷

Trade diversification, quality upgrading and the sectoral diversification of domestic production are often closely linked. Trade is often the key factor behind economic diversification. Indeed, integration into the global economy lies behind the success of countries in east Asia in diversifying into manufacturing which in turn has driven unprecedented poverty reduction. Export diversification is an objective in itself to reduce vulnerability to adverse terms of trade shocks and stabilize export revenues, as well as driving output diversification. Indeed, export diversification appears to be associated with less output volatility in low-income countries as well as faster sectoral reallocation. The empirical evidence also shows that quality upgrading of export products is closely correlated with greater impact of domestic production diversification on productivity growth (IMF, 2014). The links between export and domestic output diversification are useful because in reality indicators of diversification based on export data are readily available and comparable across countries due to the consistency of international trade data. In contrast, the availability, quality and comparability of output, employment and firm level data varies across countries and across time and is notably absent or of poor quality in the poorest countries.

Economic diversification is no longer seen as simply requiring the emergence of new industries. In the past the focus was on industries and movement of resources between old (low productivity) and new (higher productivity) sectors. This typically required investments in all elements of production within a sector. In the 21st Century however, there are many more routes towards diversified economies:

- (i) firstly, there has been an increasing focus on firms and the process of reallocation of resources between low productivity firms and high productivity firms, including within existing industries. For example, there is now a considerable body of evidence to suggest that within sectors, firms that export have higher productivity, and pay higher wages, than those that do not;
- (ii) technological change and the reduction of transport costs has led to the splitting up of production and the emergence of regional and global value chains where distinct activities or tasks are undertaken in different countries according to where it is most efficient to locate activities and manage the value chain (see Box 2).
- (iii) Regulatory reform and the decline of communication costs has enabled developing countries to participate in the expansion of trade in services (beyond tourism) many of which provide relatively high productivity activities compared to traditional agricultural activity.

This entails that concentrating on the output of manufacturing sectors alone is not sufficient to identify the scope of opportunities for economic diversification. Further, the splitting up of value chains implies that countries should not just be looking to exploit opportunities to produce and export final products but also exploring possibilities with regard to intermediate inputs. Diversifying the range and quality of imported inputs can support quality upgrading and productivity growth in existing sectors and allow new varieties of products to be developed. Producers of inputs can explore the densification of their value chains (diversification toward new uses of a given product) to access new markets and reduce vulnerability to product-specific

shocks.⁸ This not only means a much richer menu for discussions on diversification but also the need for a more varied set of indicators of diversification.

Box 2: Global Value Chains and Diversification

GVC integration can drive diversification by linking firms to larger markets at finer levels of specialization. For developing and least developed countries for which large parts of the population are employed in subsistence agriculture, GVC integration is typically associated with large productivity and welfare gains. Even if firms engage in labor-intensive, low-skill tasks (ie. apparel; IT back office) GVCs can support the development of new skills and firm capabilities. Through GVC integration, firms from different countries work together in vertically integrated systems of production, sharing blueprints, technicians, and managerial practices. GVCs can give access to ‘accelerated learning’ and transfer of tacit knowledge at a rate unthinkable in a traditional trade setting. Integration to GVC may be especially beneficial for landlocked countries or island countries where domestic transport and shipping trade costs are high (Gereffi et al., 2011).

But GVC integration also entails risks. It increases exposure to global business cycles and to supply disruptions in far-away locations. Integration into a GVC with a relatively narrow set of skills implies that the competitive advantage is dependent on events in trade partner countries. For producers located in developing countries, export opportunities are to some extent driven by the policies of large buyers located in G20 countries (OECD World Bank 2015). If large buyers decide to concentrate on a few suppliers in order to simplify logistics or quality-control processes, there will be fewer opportunities for new entrants from developing countries (Cadot et al, 2014). Finally, competition to attract new investments exposes countries to a potential race-to-the bottom on domestic regulations or on granting quasi-monopsony control over assets to the foreign investor.

Risks are higher in longer and complex value chains or when the relationship with the buyer/key supplier is captive. The relative bargaining power of firms in developing countries as suppliers depends on how rare are their capabilities and whether the transaction can easily be shifted to a different supplier. GVC suppliers positioned in the lower tiers of the chain experience fierce competition with each other. This can lead to the lead firms or turn-key suppliers capturing the trade gains vis-à-vis lower tier suppliers. Lead firms’ knowledge in activities such as design, marketing and retail is often not easy to replicate, and therefore often becomes the source of their durably strong market position (Palpacueer, 2000). The gain capture by lead firms or turnkey suppliers can be mitigated through efforts by domestic firms to upgrade or “densify” tasks.

Services matter for diversification. Services offer opportunities for a wider range of exports (and technology such as the internet is making many more services tradable) and a broader base of domestic activities. Many developing countries have diversified into exports of tourism but are also moving into exports of professional services and sectors such as health and education. But services are also critically important as inputs into other economic activities. The quality and availability of health and education services play in key in determining the productivity and capacities of workers for new tasks. Access to efficient energy, transportation and telecommunications can be important for export diversification of goods. For example, access to efficient transport services allowed Mali to develop exports of mangoes to the EU. Another key change in the global economy is the increasing servicification of manufacturing, whereby manufacturing firms increasingly buy, produce, sell and exports services. These increasing

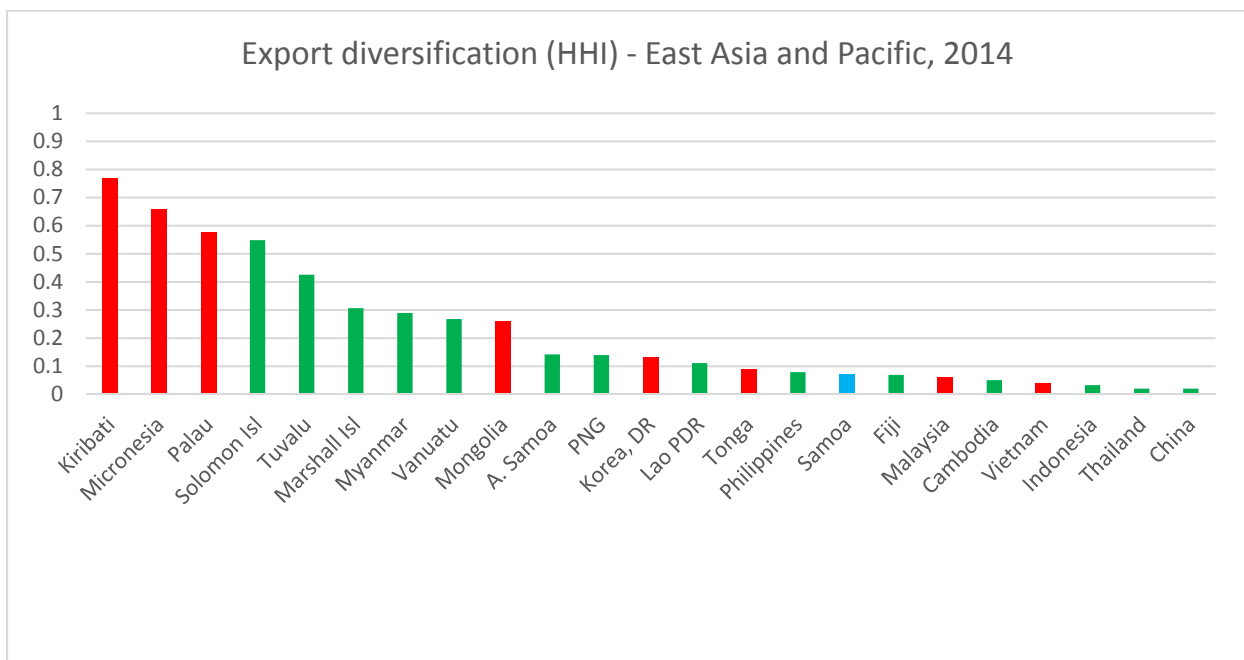
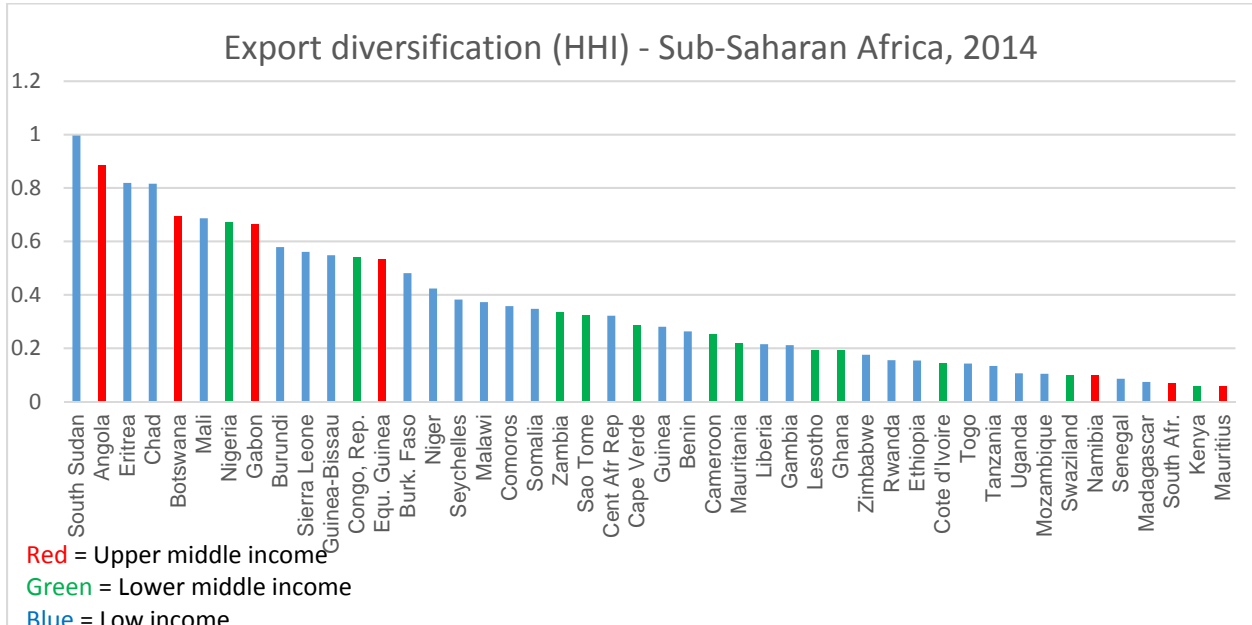
complementarities between trade in services and in goods entail that trade policies for goods and services should be jointly defined.

Export diversification is driven by the entry into exporting of new firms and by entry into new markets but often it is survival that is the main challenge. In general, developing countries are not markedly inferior to stronger performing countries in starting to export new products. Yet they remain less diversified and tend to send the products that they do export to a much small range of overseas markets than do more advanced countries. Recent analyses find that it is sustaining new exports that is particularly difficult for low income countries. Issues relating to the information and market knowledge needed for successful entry into exporting are likely to be important in explaining such high exit rates.

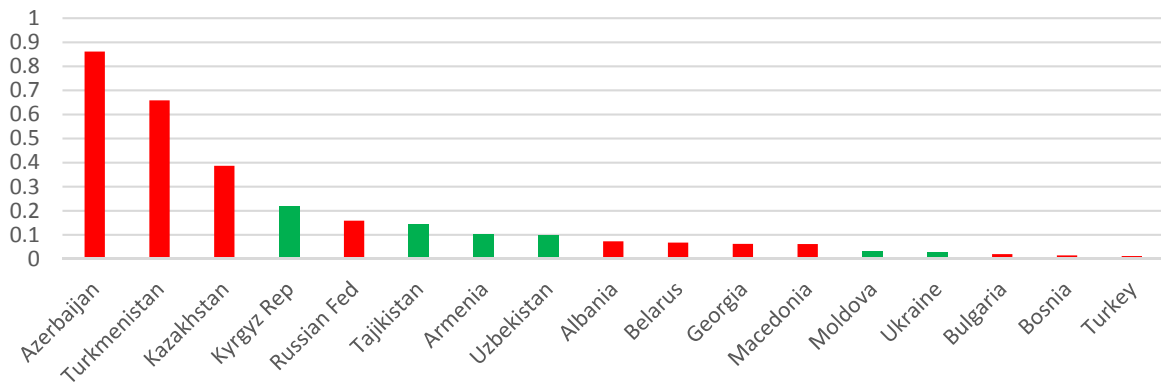
Measuring economic diversification at the sector level is often constrained in poor countries by limited data on output. Lack of industrial census and regular surveys of industrial activity mean that output data is often only available for a small number of broad sectors. While this does enable assessment of broad shifts between agriculture, mining and extraction, manufacturing and services, it limits analysis of the sub-sectors that are driving diversification. The reliability of such data is undermined by the very large share of activity across sectors that takes place in the informal sector and is not captured in standard data on output.

Measures of trade diversification are more readily available using information on exports and imports at detailed product and sector levels. This enables consistent comparisons of the extent of diversification both across countries and across time for individual countries. Measures of diversification can be obtained even for countries that do not regularly report trade data to the United Nations system using the mirror statistics reported by their trading partners. For example, it is possible to derive measures of export and import diversification for the DRC even though the country has not submitted its own trade data to the UN since 1986! Measures of export diversification of goods will be affected by unrecorded trade, which may be due to a large volume of trade activity undertaken by small-scale traders which is not feasible to capture in official statistics, due to under-invoicing to evade payment of duties, or informal trade avoiding official border crossings. Measurement of trade in services is less reliable than that of goods and information is often only available only at a broad sector level. The figure below provides a standard measure of export diversification for countries by region. Figure 2 highlights the particular challenges faced by low income countries, particularly in Sub-Saharan Africa.

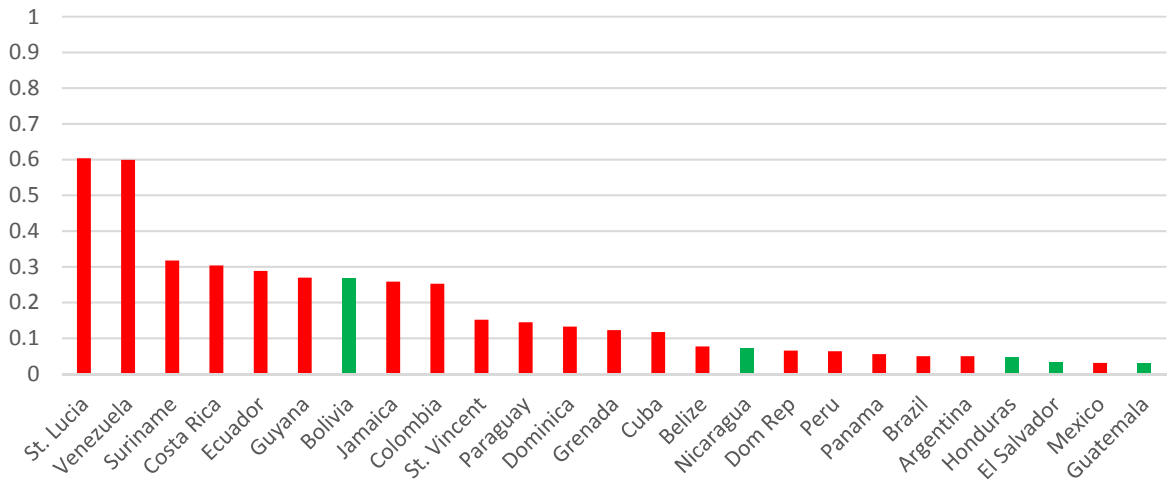
Figure 2: Export Diversification by Region, 2014



Export diversification (HHI) - East and Central Europe, 2014

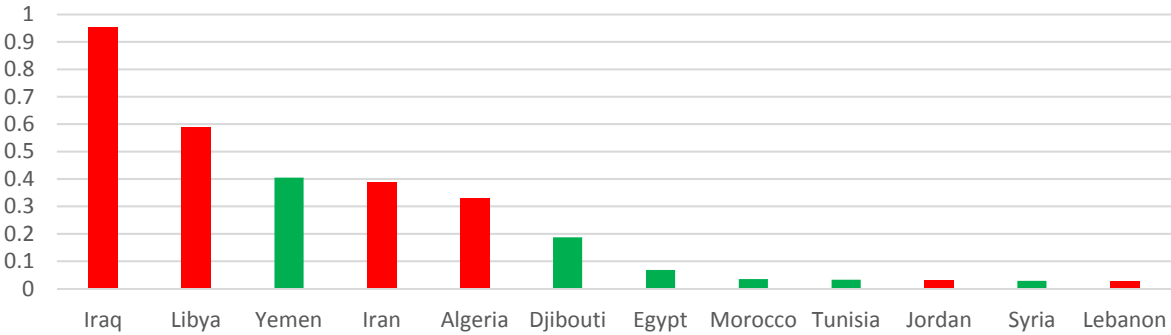


Export diversification (HHI) - Latin America & Caribbean, 2014

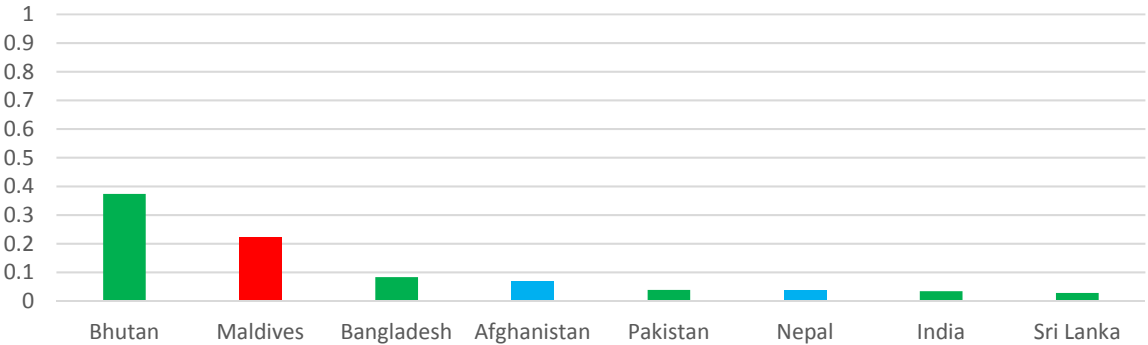


Red = Upper middle income
 Green = Lower middle income
 Blue = Low income

Export diversification (HHI) - Middle East & North Africa , 2014



Export diversification (HHI) - South Asia, 2014



The Policy and Institutional Framework for Diversification: The Trade and Competitiveness Agenda

There is no magic recipe for diversification. The success of diversification will depend on the mix, sequencing, and timing of investments, policy reforms and institution building, and on their consistency with the underlying assets and related comparative advantages of the country. Investments in skills, infrastructure, institutions and governance quality (ie. enhancing the transparency, accountability, and predictability of government decision-making) increase the likelihood of success of diversification but are in turn affected by the extent of diversification. Timing and sequencing may matter. For example, the available evidence suggests that implementing trade reforms before financial liberalization yields better growth outcomes. The optimal timing of diversification strategies for resource rich countries may depend on the global scarcity of resources, as reflected in relative prices in world markets. The current environment of low oil prices opens a window of opportunity to diversify, which require, inter alia, reforms that eliminate the constraints to mobility of resources (labor, capital) across sectors.⁹ Nevertheless, experience shows that, while important, a competitive exchange rate alone is not sufficient to drive diversification. A number of resource rich countries have seen sharp devaluations of their currencies with limited impact on exports since do not have much else to export. If trade and regulatory policies create a bias against exporting, if there has been a lack of investment in trade-related infrastructure and in necessary skills and institutions remain weak then a fall in the real effective exchange rate or attempts by governments to engineer diversification by repatriating financial assets stored abroad will be unsuccessful.¹⁰

There are multiple paths to successful diversification. In countries at very low levels of economic development the priority is to get the basics right to support gradually the diversification of the economy. As countries develop, multiple diversification paths may become available. Malaysia, for instance, was previously a primary-based economy. Today it is integrated into global value chains across a wide range of industries, has expanded into new products and markets and upgraded the sophistication of its export mix. Chile, opted for upgrading its traditional resource-dependent export industry (i.e., development of ancillary and logistics services to support the expansion of the copper exporting industry); and for domestic diversification toward new agricultural exports (i.e. development of the salmon and wine exporting industry). Dubai is a country well-endowed with an efficient bureaucracy, stable macro framework, good infrastructure, and a privileged location, followed a diversification strategy focused on exporting new business services, exploiting agglomeration externalities and building a low-cost business platform.¹¹

The trade and competitiveness agenda is at the heart of a strategy for economic diversification. Providing the foundations for structural transformation and private sector driven -growth is an essential element in achieving a broader base of economic activities. No country has experienced sustained growth and significant reduction in poverty without integrating into the global economy. The T&C GP can assist countries to put in place these key basic elements:

(i) *an appropriate incentive framework* through reforms to the business and investment climate, reviewing trade policies to remove bias against exporting and ensuring effective competition in product markets and in key backbone services such as transportation, energy and communications

(ii) *investments and policy reforms that reduce trade costs* – declining trade costs and efficient trade logistics were at the heart of the success of East Asian countries in integrating into the global economy and achieving more diversified economies with not only more, but also better jobs;

(iii) *effective policies to support adjustment and the reallocation of resources to new activities* – from declining sectors but also from the informal sector and new entrants to the job market.

(iv) *government interventions that target specific market, policy and institutional failures*. T&C can help governments identify shortcomings in the marketplace and tailor interventions to target those problems.

Effective collaboration with other GPs and the CCSAs is essential to support the implementation of this framework. There are a range of issues that require working together across the Bank, for example, on addressing infrastructure constraints that raise trade and logistics costs in coordination with reforms that reduce trade barriers and increase competition among the providers of services along that trade-related infrastructure. Effective implementation of reforms that address policy failures requires a careful assessment of governance restrictions and political economy constraints. Efficient reallocation of resources across sectors or firms depends upon labour market policies and access to finance, among other things.

(i) The incentive framework for diversification

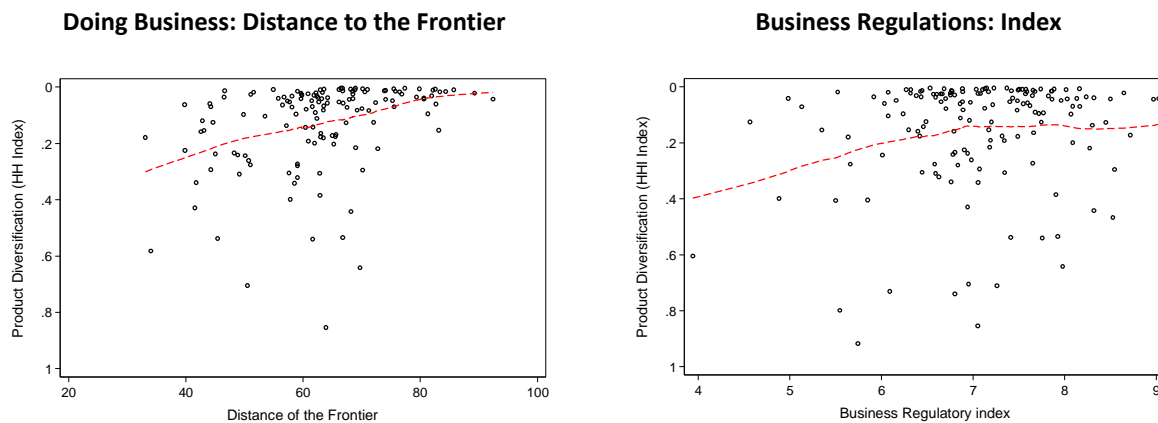
There are 3 key areas of economic incentives that intersect to affect the framework for diversification and where T&C has extensive experience that can be leveraged to support governments pursuing diversification:

A. Business Regulations and Investment Policy

Clear, transparent and predictable business regulations that provide a level playing field among investors (small and large, foreign and domestic) are essential for economic diversification. Business regulations - such as those governing the credit market, hiring and firing workers, quality standards, the procedures and licenses required to start a business, contract enforcement and insolvency – are an essential part of the incentive framework to encourage investment in new activities. In environments with a poor investment climate, the lack of domestic competitive suppliers, combined with inefficiencies in factor markets and institutional capacity constraints, hinder diversification.¹² Simple empirics confirm that countries whose firms operate within an effective regulatory environment exhibit more diversified (see Figure 3). There are 3 key areas in which business regulations and the investment climate condition the incentives towards diversification:

- (i) *By reducing the costs of investing in new activities and by improving the efficiency by which resources move from declining firms and sectors towards more dynamic firms and sectors.* The time and cost of opening a business can affect entrepreneurship and the ability of firms to respond to emerging opportunities within existing and in new industries. Similarly, effective bankruptcy regimes that facilitate exit and encourage risk-taking constitute an important incentive for entry of firms. The effectiveness of entry and exit regulations can also foster competition among incumbent firms and their incentives to invest and innovate. Exit regulations affect how quickly resources trapped in unviable firms can be reallocated to more efficient uses. Restrictive entry regulations disproportionately penalize industries characterized by greater experimentation, such as ICT-intensive sectors.¹³
- (ii) *By affecting day-to-day business operations and investment decisions.* These include tax regulations, credit market and labor market regulations. The extent to which these regulations are evenly applied matters for the efficiency with which resources are allocated across different sectors and firms. If discriminatory regulations allow less productive firms to survive and expand at the expense of more productive ones, diversification efforts will likely fail.¹⁴
- (iii) *By proving a predictable and transparent business environment, reducing the risks associated with testing new products and markets.* Effective enforcement of rules and sound property rights enables firms to internalize the economic benefits of innovation, encouraging investment. A transparent and non-discriminatory regulatory environment, including appropriate investor protection laws, can promote investment in riskier activities that have potentially long-term payoffs. An emerging literature on economic policy uncertainty suggests a positive effect of predictability on investments, especially for large firms and sectors characterized by irreversible investments.¹⁵

Figure 3: Quality of the Businesses Regulations and Export Diversification (Average 2012-2013)



Source: Export diversification is proxied as the diversification of countries' export basket. Quality of the business environment is proxied by (i) the distance to the frontier of the Doing Business indicator measures the efficiency and strength of laws, regulations, and institutions relevant to domestic small and medium-size companies throughout their life cycle, and (ii) by the business regulation index from the Fraser institute, measures the extent to which business regulations restrain entry and reduce competition

B. Trade policies

The nature and structure of protection in overseas markets shape the opportunities for export diversification by developing countries. This is especially so if overseas protection is biased towards products in which the country has a comparative advantage. For example, it has been long argued that tariff escalation (the cascading of import taxes according to the degree of processing) in advanced countries in Europe, North America and Japan has constrained opportunities for developing countries to add value to and develop additional activities around agricultural products.¹⁶ Similarly, for light manufacturing, tariffs on products such as clothing and shoes are much higher than those on textile fabrics and leather. To some extent, this constraint has been alleviated by multilateral trade liberalization through the WTO which has reduced tariff peaks in rich countries and through unilateral tariff preferences for developing countries. Although the latter are often undermined by restrictive rules of origin.¹⁷ Nevertheless, an important challenge for developing countries, especially low income countries, is *how to better leverage trade preferences to drive export diversification?* Expertise in the T&C GP can support countries in defining and integrating plans for exploiting trade preference schemes such as AGOA and EPA into overall export strategies. This also underpins the importance of the WTO to developing countries both in terms of providing discipline on the use of protection in developed countries that would adversely affect opportunities for export diversification and in pushing for further reduction in peak tariffs and tariff escalation.¹⁸

Regional integration can be an effective mechanism to increase new market opportunities for exporting firms. Diversifying exports to higher income markets is relatively more difficult than diversifying exports to regional markets. Standards are often higher, requiring larger investments to raise quality and the ability to meet higher health and safety requirements, and buyers may demand very large consignments, requiring substantial investments in capacity. Diversification through exports to nearby countries with similar tastes and regulatory requirements may be easier. Empirical evidence suggests that when trading differentiated products, proximity, common language and cultural similarities may help in matching international buyers and sellers.¹⁹ Regional trade agreements can help overcome informational gaps. The search costs associated with trading differentiated goods are higher than those associated with homogeneous goods. This explains why the former are being traded mostly where networks are already in place. Regional markets can then provide the springboard to the large global market once experience with exporting has increased and awareness or product requirements in other markets has been accumulated.

Tariffs on imports can act as a constraint on export diversification. The level of import protection determines the incentives to produce exportable goods by directly raising the domestic price of imports relative to exports. It has long been known that there exists a symmetry, or an equivalence, between the effects of an import tariff and an export tax on domestic relative prices.²⁰ Import tariffs also indirectly alter the price of exports relative to the prices of (non-traded) goods produced solely for the domestic market. Since a tariff raises the price of imports, consumers will shift consumption toward non-traded goods and raise their price if these two types of goods are substitutes. Thus, a tariff on imports will reduce the price of exports relative to nontraded goods and shift production away from exports.²¹ Also, tariffs on intermediate inputs used by exporters increase the cost of producing goods for export and therefore, will reduce output of exportables.²² High import duties on imports of fabrics, for example, will

constrain the development of exports of apparel. In India, almost a third of new product varieties introduced between 1989 and 2003 can be attributed to access to new inputs following trade liberalization.²³ In Indonesia, imports of intermediate goods helped manufacturing firms to diversify and climb the value chain.²⁴ Tariffs on intermediates are of particular importance to successful participation in regional and global value chains. Tariffs, non-tariff barriers and export restrictions affect the efficient functioning of GVCs and raise costs and can put producers in a country at a disadvantage if these restrictions are more severe than elsewhere.

It is important to address non-tariff barriers as part of a diversification strategy. Rules and regulations in overseas markets governing issues such as border procedures, technical regulations and standards can raise trade costs and limit entry by new exporters, especially when they are designed and/or implemented in a way that discriminates against trade. Lack of information and uncertainty regarding these requirements for exporting can undermine survival of those firms that do export. Standards can facilitate exports, and product upgrading, by codifying the requirements that are necessary to export to markets where demands for health, safety and for quality differ from the domestic market. Non-tariff barriers that limit imports to the domestic market can also undermine exports by limiting competition among suppliers of key inputs and therefore access to new technologies. The WTO provides some discipline on discriminatory regulatory measures and a forum for increasing awareness of regulations that can impact on trade through the notification requirements of the TBT and SPS Agreements. More recently, the WTO Trade Facilitation Agreement provides a mechanism for global adoption of best practices regarding customs procedures. Regional integration agreements that include provisions for harmonization or mutual recognition of product standards can reduce the costs associated with different regulatory regimes and support diversification.

Trade policy reforms influence the dynamics of firm level productivity and can have a complex set of effects on firms' participation in foreign markets, the quality of their products and the number and variety of products exported. New insights into the impacts of trade policies on heterogeneous firms show how reforms that reduce trade costs reduce the fixed costs of exporting and allow additional firms to enter export markets – firms who were previously not productive enough to export.²⁵ Similarly increases in import competition or access to new technologies and intermediate inputs through importing can increase the average productivity level of firms and enable more firms to export. Recent literature on multiproduct firms shows how trade liberalization leads firms to diversify, rationalize their production and improve their productivity. In the United States, for example, trade liberalization induced compositional changes within firms by making them drop their least-successful products.²⁶ The effect of tariff reductions on quality upgrading depends on where in the quality ladder the firm is located. For firms at the technological frontier, foreign competition can motivate them to innovate and export better products. Yet, for firms distant from the frontier, lower tariffs may actually discourage quality upgrading.

Services trade policy can spur diversification through the expansion of exports in services. It can also promote the diversification of goods exports through improved access to a wider range of more efficiently produced services inputs. High cost of energy, telecom, logistics, and finance, erodes firms' competitiveness and deter them from diversifying their production and exports. As countries develop, service sector liberalization can help firms to meet supply requirements, diversify, and integrate into global value chains. Efficient services are also crucial for taking advantage of modern distribution

channels and diversify exports. E-commerce is a good example. Chinese producers are increasingly rely on e-commerce and sell directly to consumers in industrial countries through web-based outlets. However, diversification toward service exports can be hampered by regulatory diversity. Regulatory heterogeneity affects the fixed cost of entry a new market as well as the variable costs of servicing that market.²⁷ To address this challenge, service sector reforms are moving beyond trade openness and focusing on simplification, harmonization, or mutual recognition of regulations.

Box 3. Trade Diversification in Africa: Challenges and Opportunities

African exports are less diversified than the rest of the world. Africa is home to some of the world’s most concentrated export baskets (Angola, Nigeria, Guinea Bissau, Equatorial Guinea, and Gabon). While some African countries have been successful in diversifying their exports by bringing more firms and more products to the global markets in traditional and new markets and sectors, others have lagged behind. Though a number of African economies have achieved greater export diversification over time, with a few exceptions, the trade structures of most resource-rich countries have become more concentrated (Brenton and Shahid, 2016).

Table 1: Export Diversification (proxied by Herfindahl Index) of resource rich and resource poor countries (2002 – 2014)

Resource Rich countries which became <i>less diversified</i>	Chad, Angola, Congo, Rep., Gabon, Cameroon, Ghana, Guinea, Guinea Bissau, Mauritania, Sierra Leone, Togo, Zambia
Resource Rich countries which diversified	Benin, Equatorial Guinea, Liberia, Mozambique, Namibia, Nigeria, Rwanda, Congo, Dem. Rep.
Resource Poor countries which became <i>less diversified</i>	Burkina Faso, Cape Verde, Gambia, Kenya, Lesotho, Niger, Sao Tome and Principe, Seychelles, Swaziland, Zimbabwe
Resource Poor which diversified	Burundi, Botswana, Central African Republic, Cote d’Ivoire, Comoros, Ethiopia, Madagascar, Mauritius, Mali, Malawi, Senegal, Tanzania, Uganda

Source: Brenton & Shahid (2016)

Africa can tap into regional opportunities for diversification. Regional integration can be an important driver of export diversification, especially when demand in Europe and key markets like China has dried up. This includes policies that not only make it easier for goods and services to cross borders, but also improve connectivity between people and markets within and across countries. There is great potential for Africa to expand agriculture exports, a sector responsible for 32 percent of the GDP and 65 percent of jobs. There are some emerging agricultural firms that have shown export growth and signs of integration into regional value chains. Brenton and Shahid (2009) find that over the past few years, Namibia expanded its export base (concentrated on copper, diamond and uranium exports) toward beef and frozen fish exports. Mozambique’s export basket, heavily reliant on aluminum exports, also expanded its agricultural exports (tobacco, rough wood, sugar, cotton and cashew).

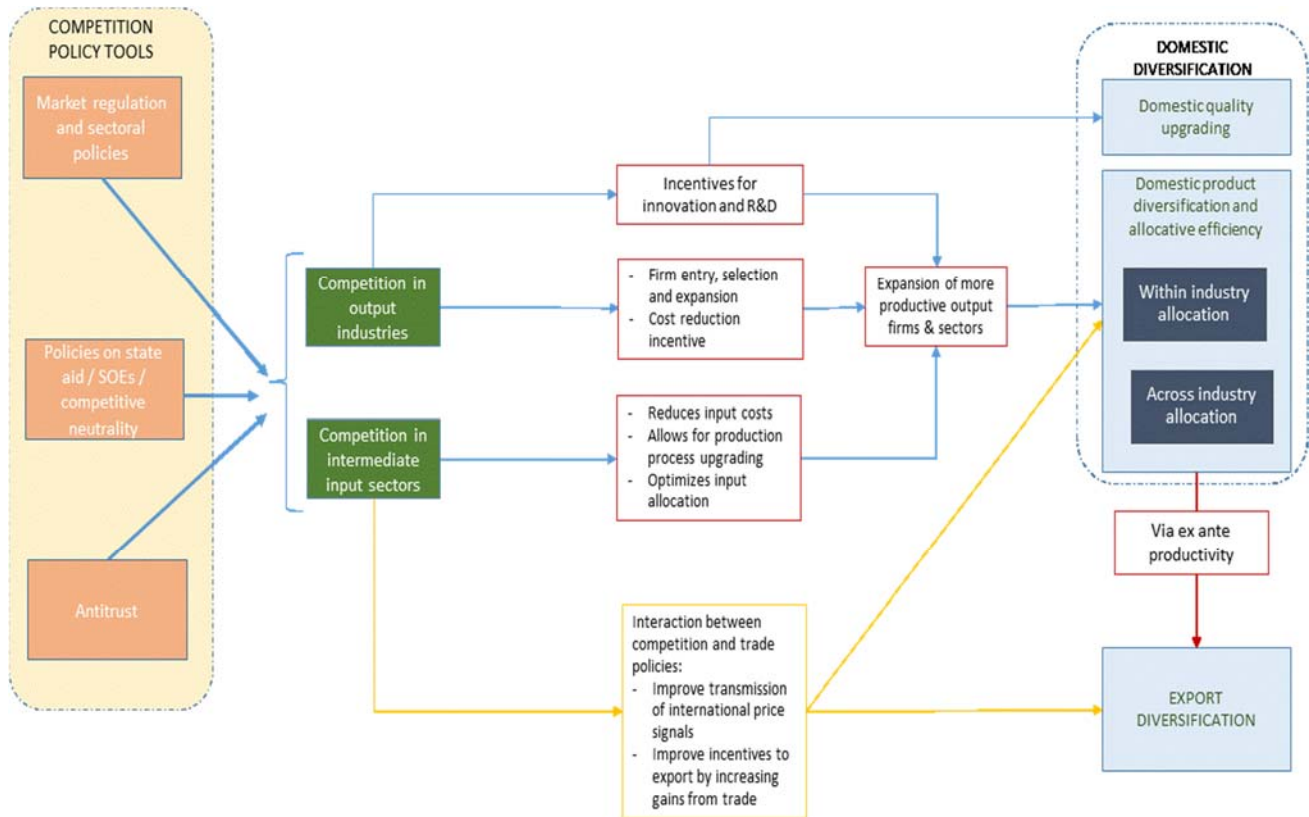
A number of challenges need to be addressed to maximize the impact of diversification. Some of the major challenges that need to be overcome include high trade, energy and transport costs, prevalence of non-tariff barriers, lack of competition in the services sector, and poor usage of trade preferences. The rural and the informal sectors continue to play an important role in African economies. Also, Africa’s demographic trends reveal that more poor will be concentrated in fragile states. In these context, it would be difficult for diversification to be successful in the absence of parallel efforts to invest in human, physical and institutional capital. There are also political economy challenges that hinder progress on key diversification reforms (vested interests in some cases hinder tariff and non-tariff reforms, service regulatory reforms, and competition policy reforms).

Africa’s trade policy agenda in support of export diversification focuses on : (i) integrating into regional and global value chains, which requires investments in infrastructure combined with domestic regulatory reforms, and trade and investment liberalization and facilitation; (ii) reducing trade costs: this requires efforts to have an open, transparent, neutral and predictable, trade policy and business climate; pursuing tariff and non-tariff barrier reforms; promoting service exports, which requires supporting the reform of logistics services and increased market competition; and exploring trade preferences: regional and multi-lateral agreements can be leveraged to ensure access to larger markets (Examples include: Transatlantic Trade and Investment Partnership (TTIP), Trans Pacific Partnership (TPP), EAC, COMESA, SADC, Continental Free Trade Areas

C: Competition Policy

Competition policy plays an important role in the expansion of an efficient and diverse private sector that goes beyond implementing a legal framework for addressing dominant positions, collusion, unfair competition, and antitrust investigations to cover legal enforcement, competition advocacy and institutional effectiveness Anti-competitive behavior can limit the scope and incentives to innovate and diversify (see Figure 4). Clear antitrust and competition laws and their effective and predictable enforcement are necessary to complement regulations that enable firm entry and rivalry. Left undetected, cartel agreements and abuse of a dominant market position can raise prices and discourage firms from investing in new or better products. Empirical evidence shows that on average, stronger market competition encourages innovation. In addition to increasing firms' incentives for "process innovation", promoting competition serves to encourage "product innovation". Competition policy can also support "disruptive innovation", for example in service industries based on mobile technologies. Competition policy can enhance the impact of innovation programs on economic diversification. In Moldova, for example, the introduction of competition principles (transparent allocation criteria) into R&D incentive programs reduced the scope for selectivity bias toward connected firms, allowing less connected start-ups to access these programs. The application of rules that guarantee competitive neutrality in markets with state-owned enterprises can help firms to enter, expand and diversify based on their merits. By contrast, rules that discriminate against certain firms in favor of vested interests, can hinder economic diversification. Lack of political will or institutional capacity constraints can limit the efficacy of competition policy reforms.

Figure 4: Competition policy and economic diversification



Competition policy can also play a key role in increasing the efficiency of domestic input supplying industries and support greater backward and forward linkages that foster diversification. Reforms that boost competition in input markets have spillovers on downstream firms. In many developing countries, input markets (such as fertilizer, cement, energy and telecommunication markets), are often saddled with entry barriers and anticompetitive behavior, due to economies of scale, network effects and the presence of state-owned enterprises. Competition policy reforms can have tangible impacts on diversification, as the following examples show:

- In India, downstream manufacturing firms diversified production following the services reforms enacted in the 1990s that promoted competition in key input markets (in particular, the liberalization of telecommunication, transport and energy markets).
- In Kenya, competition policy reform was central to the emergence of mobile banking services. The entrance of Mobile Virtual Network Operators into the banking industry led to the introduction of new banking products and helped entry of new small businesses.
- In Honduras, competition policy reform promoted entry of new firms in agricultural input markets (fertilizers and pesticides). The reform eliminated discretionary procedures and reduced the registration time from three years to ninety days. Since the reform, three hundred new products were registered, and the price of some pesticides fell by 9 percent.
- In Philippines competition policy reform in the transport sector prevented incumbent operators from discouraging new companies from serving certain routes. The reform is expected to

generate five percent savings in logistics costs. In addition, new entry into the shipping industry may improve the quality of shipping services and promote diversification toward new industries, such as refrigerated shipping services.

- The sugar sector is protected in many developing countries and often characterized by limited competition. This in turn constrains the development of the food processing sector, a key opportunity for diversification.

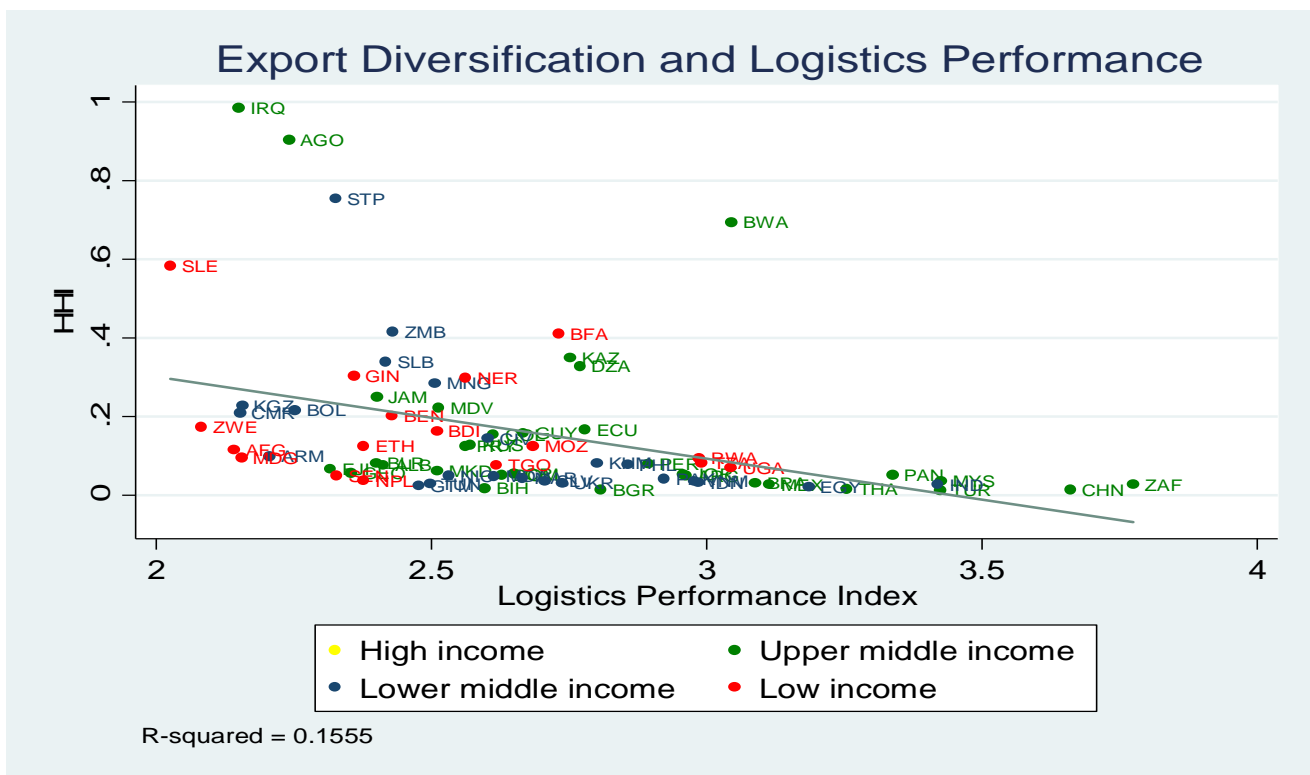
(ii) *Investments and policy reforms that reduce trade costs*

Investing in trade-related infrastructure, coordinated with relevant policy reforms and better governance, reduces trade costs and supports more diversified exports and imports.²⁸ In the least developed countries the focus is on basic port, border and connecting transport infrastructure. Best practices from trade and development projects implemented by the Bank and other donors shows the importance of coordinating such infrastructure interventions with (i) measures to simplify border procedures and improve the standards of treatment of traders and officials, including through training and other capacity building support and (ii) programs that address institutional weaknesses and governance failures among those ministries involved in trade issues and border clearance agencies, for example, by introducing performance based management of agencies operating at the border.

Trade logistics services are a critical determinant of countries' connectivity to regional and global markets and their competitiveness. The importance of trade logistics has increased with the splitting up of production on a global scale and the increasing sensitivity of trade to transport and logistics costs. The decisions of firms on the country in which to locate, from which suppliers to buy, and which consumer markets to enter are influenced by the quality of logistics. Thus, the cost, range and quality of logistics services available to exporters can define the scope for export diversification. For example, slow and costly logistics can prevent entry of otherwise competitive suppliers into *just-in-time* supply chains. Good trade logistics are crucial for the competitiveness of activities which rely upon imported inputs.

Logistics performance remains poor in many developing countries, constraining efforts to diversify their economies. Figure 5 suggests that export concentration is associated with poor logistics. A range of studies have shown the importance of logistics for competitiveness and the development of the light manufacturing sectors that can drive diversification such as apparel, leather products and agribusiness.²⁹

Figure 5: Export Diversification and Logistics Performance



The trade logistics sector is often characterized by regulatory and institutional fragmentation and lack of coordination which can be just as costly to supply chains as direct transport costs. The sector provides a large set of activities which includes all modes of transportation services and a range of related ancillary services including freight forwarding, distribution, packaging, warehousing services, transport management services, and supply chain consulting services. Logistics services providers also require access to critical transport infrastructure (ports, airports, roads) in a non-discriminatory manner and are dependent on the time and cost of satisfying border procedures. This implies that logistics services are subject to many rules and regulations under the responsibility of different regulatory authorities, each with different regulatory objectives, and often with little coordination. Such fragmentation compromises the underlying network increasing costs and reducing efficiency.

Regulations that support greater competition in the logistics sector and simplification of the requirements to meet legitimate policy objectives can reduce the cost of trade logistics, raise quality and variety and so support a more diverse production and export base. While high barriers still remain in a number of countries, there has been a degree of liberalization of transportation services in developing countries that has reduced barriers that restrict foreign participation or discriminate against foreign providers. Other components of the logistics services chain, such as cargo handling, freight forwarding, still confront high barriers to entry. In addition, the regulatory framework governing the operation of logistics services is often complex. While regulations are often necessary to achieve objectives such as safety, they may be designed with the aim of protecting the interests of domestic

industries. Research confirms that the higher the level of restrictiveness of the regulations affecting logistics services the worse the performance of the sector in terms of significantly lower average quality and competence of service providers.³⁰

(iii) Effective policies to support adjustment and the reallocation of resources to new activities

The labour market is often key to the adjustment process. The extent and speed with which labour moves between occupations, firms, industries and locations, as well as the size of the adjustment costs borne by adversely affected workers, is to a large extent determined by the functioning of the labour market. In general, investing in education and skills contributes positively to economic diversification – take the growth of India’s software industry and the increased sophistication of China’s exports.³¹ However, high enrollment rates in secondary and tertiary education do not automatically translate into high-quality learning. Skill development depends on the quality of educational inputs and focus on learning outcomes, as illustrated by the successful diversification reform that allowed South Korea to transition from primary commodity extraction to the production of hi-tech manufactures. Secondary schools and universities may produce graduates with narrow skills or a specialization in fields that are no longer in high demand. Alignment with labour market demand is critical to address skill mismatches and support economic diversification.

There is still much to understand about how labour market policies impact on adjustment and mobility in developing countries. While there has been a substantial amount of work on how labour market policies impact on adjustment to globalization in advanced countries, analysis of developing countries and the role of labour market policies in supporting poor people in getting jobs in emerging sectors is scant. As a general point, investing in skills (secondary and tertiary education and on-the-job training) can help workers and firms to adapt to new tasks. But labour market policies in many countries often restrict movement both vocationally and geographically. This is particularly important in facilitating the shift from informal to formal employment.

Improving public-private coordination is required to better identify the skills needed for current and future labor needs. Despite improvements in the overall level of education among workers over the past five decades, firms continue to struggle to find workers with the required skills. Many countries have education and training systems that are not developing the kinds of skills needed by the private sector. These are the skills that allow firms to deliver the products and services demanded by the increasingly globalized markets in which they operate. Therefore, longer-term education and labor reform needs to be accompanied by improved systems for skills development. These systems need to be informed by the private sector so that they can deliver the range of skills that are relevant to the sector and to the firms that have the potential to deliver growth and productivity gains in the near and medium term.

Gender inequalities act to undermine efforts to diversify. High levels of gender inequality are associated with lower levels of export and output diversification and the available evidence suggests that gender inequalities are a cause of low diversification.³² Inequalities of opportunity, for example in education, constrain the pool of human capital upon which diversification can be driven. While discrimination that

limits the volume and nature of labour force participation by women narrows the pool of talent from which employers can hire and limits the number of female entrepreneurs. Hence, identifying and addressing gender disparities and constraints in education, training and the labour market can be an important element of a diversification strategy.

Investments in education are delivering larger numbers of educated youths but national economies are struggling to deliver the jobs they seek – part of the answer may lie in enhancing freedom of movement of workers. In Rwanda, for example, in 2012 over 1 million children aged between 13-18 were attending secondary school. Hence, a large number of youth with higher skill levels than their predecessors will be entering the labour market in the next few years. However, the economy is not generating anywhere near enough of the type of jobs that these entrants into the labour market will require; the annual inflow of students with secondary education is about 250% of the entire stock of jobs in established firms for which workers had at least a secondary education. This reinforces the imperative of diversification toward activities that will create more and better jobs.³³ Freedom of movement within the region will provide an important mechanism to allow people to move to areas where the demand for workers is highest.

A well-functioning financial sector is essential to support diversification. Financial instruments, intermediaries, and markets can facilitate the trading, hedging, and pooling of risks that firms take when they opt to diversify. More developed financial institutions support diversification into more complex goods and greater varieties, by allowing firms to access long-term capital financing and by funding riskier investments. In Africa, for example, the shallow financial sector has been a major obstacle in efforts to diversify economies. These obstacles include complex credit application procedures, lack of collateral, high lending costs, and short maturities in the backdrop of low financial capability which prevent firms from accessing finance.

(iv) *Government interventions that target specific market, policy and institutional failures*

Export promotion Agencies

Export promotion agencies and initiatives can address information failures that affect firm entry and survival in foreign markets. Low entry and/or low survival rates of exporting firms may result from information asymmetries (difficulty in gaining information on costs and product standards at destination markets). These can be mitigated when there is a greater presence of exporters of the same country operating in the same export markets or with more experience in exporting the same product. When this information is not present, there is a case for the intervention of export promotion agencies. These institutions can address information gaps for firms operating in non-traditional sectors, even if they are not yet exporters.

However, export promotion agencies have a mixed record in promoting diversification. Some of them made strong contributions to the export performance of their sponsoring countries, among them those in Australia, Finland, Ireland, New Zealand, and Singapore. But these models are not always easily replicable. Empirical evidence points to several features that contribute to successful export promotion. First, it works in policy environments that do not exhibit a strong bias against exports (such as an overvalued exchange rate or high tariffs that provide nominal and effective protection, or high trade costs). Special procedures, such as export processing zones or special export finance facilities, can shield exporters from poor trade policy environments but they need incorporate sunset clauses, and reward rather than pick winners.³⁴ Second, export promotion agencies work best when they function autonomously, flexibly, and maintain open dialogue with private actors to support a demand-driven strategy (ie. having their boards made up mostly of recognized exporters and headed by a respected business leader). Third, export promotion activities are best financed through general revenues rather than taxes on exports.

Investment policy and promotion efforts can support diversification by attracting FDI. Good practice recommends to refrain from using mandatory local content requirements; to promote policy coherence between FDI linkages and investment incentives; to facilitate market entry to foreign suppliers; and to support investor “after-care”. Fewer procedural steps required to establish wholly foreign-owned, domestically-incorporated companies, and fewer restrictions to the FDI arbitration process are associated with higher FDI stock.³⁵ International investment agreements, if ratified, may increase FDI to participating countries. But restrictions on foreign acquisitions, discrimination in licensing, restrictions on the repatriation of earnings, and inadequate legal framework to appeal decisions can deter foreign investment.

The role of FDI as an enabler of diversification depends on *the type of investment*. Not all foreign investment is the same as far as positive spillovers to the rest of the economy are concerned. Mining shows fewer of them than agribusiness. Joint-ventures between foreigners and local entrepreneurs unleash greater spillovers than projects financed and run only by foreigners. So do projects that involve investors from neighboring countries — they know the receiving country better — and those who seek

to create new markets — they are filling a vacuum.³⁶ The literature distinguishes four types of FDI: (i) *natural resource-seeking* investment (focused on exploiting natural resources); *market-seeking* investment (serving large domestic or regional markets); *strategic asset-seeking* investment (driven by investor interest in acquiring strategic assets through mergers and acquisitions); and *efficiency-seeking investment*.

Efficiency-seeking FDI is particularly conducive to diversification. This type of investment is typically export-oriented and leverages local factors of production to reduce production costs. It involves the transfer of production and managerial know-how, access to distribution networks and sources of finance. Low middle income countries that succeed in attracting “efficiency-seeking” FDI have greater success in diversifying their export structure. In Honduras, FDI played a role in jumpstarting the country's light manufacturing sectors and in the diversification of exports over the last decade. Thanks to FDI and its linkages with domestic firms, Mexico developed its aerospace industry in less than two decades.

The impact of FDI on diversification also depends on the *host country*. Countries with less education or larger technological gaps have a harder time extracting spill-overs from the foreign investment they pull in. The impact that foreign investment has on the overall economy ultimately depends on the quality of business environment is. Other factors being equal, countries with good business regulatory environments tend to be more attractive to FDI. This explains why foreign investments in Chile’s mining, Vietnam’s agriculture, and Mauritius’s apparel have helped raise diversification of production and improve the productivity of workers and firms that operate outside the FDI attracting sectors.

Spatial Policies

Spatial Policies (SPs) can play an important role when growth is not regional balanced and certain areas lag behind. SPs involve policy interventions which aim to stimulate the economic development of specific locations within a country by attracting the emergence of productive and innovate firms. The key characteristics of SPs are that they 1) target a specific area; 2) are tailored to the specific context and history of a locality; 3) often aim to overcome coordination failure between different actors and 4) frequently involve stakeholders at the national and local level in the assessment, design and implementation stages. These interventions can be organized around the following

- (i) **Growth Poles** where growth emanates from a core location, where one or more critical industries or a group of firms are located. This core is frequently identified with a city or area where substantial agglomeration economies occur, allowing dynamic industries to exchange and diffuse new knowledge, innovation, share pools of skilled labor and infrastructure, minimizing the costs of providing public goods and services. In growth poles strategic investments in infrastructure (sometimes specific to the key industries) can help to unleash the economic potential of selected locations and generate a catalytic effect on upstream and downstream industries. Additional economic activity, innovation and economic growth are subsequently expected to propel the economic dynamism of neighboring areas through the diffusion of these activities.

- (ii) **Special Economic Zones** (SEZs) have been used to support diversification, particularly in East Asia. SEZs are typically established to achieve one or more of the following: (i) attracting foreign direct investment; (ii) serving as “pressure valves” to alleviate large-scale unemployment; (iii) supporting a wider economic reform strategy; and (iv) acting as experimental laboratories for the application of new policies and approaches.³⁷ SEZs, such as export processing zones or industrial parks, are typically offer a mix of financial incentives (e.g. tax breaks, subsidies), infrastructure facilities (e.g. uninterrupted electricity supply), trade facilitation (expedited customs procedures, duty free access to imported inputs), access to land, and protection from government interference, to induce a critical mass of private firms to enter, invest, and diversify economic activity. However, the empirical evidence on their effectiveness is mixed. SEZs have been successful when they have attracted investment that exploits a key source of comparative advantage—typically low-cost labor in developing countries. For example, in addition to successful examples from China and Malaysia, countries such as the Dominican Republic, Honduras, Republic of Korea, Madagascar, Mauritius, Taiwan and Vietnam have seen a significant number of manufacturing jobs created through export processing zones. However, there is also a substantial literature of examples of failed special economic zones that did not generate new economic activity.³⁸ The success of SEZs requires a flexible approach that is not based solely on fiscal incentives, limited labour regulations and wage restraint but encompasses a broader approach to providing an effective business environment and building firm-level competitiveness, linkages with the local economy, innovation and social and environmental sustainability.
- (iii) **Economic Corridors** are characterized by the linear connection of two economic centers through connective infrastructure. The aim of developing a corridor is to leverage and intensify the growth potential of the two nodes at each end of the corridor by promoting the agglomeration of economic activity between the two nodes, along the physical infrastructure connecting them. Economic corridors may encompass several smaller nodes along the way and could, in certain cases, evolve into a branch shaped structure. Economic corridors can be subnational in nature (connecting to sub-regional hubs, such as the Sulawesi Economic Corridor in Indonesia), national or even international (such as the East-West Corridor connecting Myanmar, Thailand, Laos and Vietnam). Most corridors are multi-sectoral, although sector specific corridors, such as agriculture focused corridors, also exist. Specific policy interventions within an economic corridor approach typically encompass public and private investments. Crucial to the development of the corridor is the transport infrastructure investments – often multimodal – connecting the two economic nodes. Private sector investment projects, combined with trade and regulatory policy reforms to improve the overall business environment of the corridor either take place simultaneously to the development of the basic infrastructure or ensue shortly after. Furthermore, the development of sectoral development plans can help boost the competitiveness of specific industries located within the corridor.

(iv) **Clusters** are geographic concentrations of interconnected companies and institutions in a particular field. Prominent examples are the financial industry in London, the IT cluster in Bangalore and the leather sector in Italy. A typical cluster is comprised of firms in the same or closely related sectors, networks of specialized suppliers and service providers as well as by the existence of infrastructure tailored to the specific needs of the firms and industries in the clusters. One of the essential characteristics of a cluster is the presence of strong collaborative links between all the stakeholders in the cluster, including firms, industry associations, government agencies, and universities and research centers. In clusters private companies tend to collaborate with one another by, among other mechanisms of collaboration – investing in research institutes that conduct research on topics and generate knowledge that contribute to the advancement of the sector or related sectors at the heart of the cluster or by pooling together resources to enhance the quality of the cluster products and improve their commercialization and marketing. Local research centers, universities or consultancies also often provide industry specific training programs and basic and applied research relevant to the cluster, while government agencies support the provision of infrastructure and a sound regulatory environment. Firms in well-functioning clusters benefit from the agglomeration economies, described above, through pooled labor markets, forward and backward linkages and knowledge spill-overs.

Some clusters can appear spontaneously, as a consequence of the functioning of market forces. In other cases, however, clusters require careful planning and support in order to emerge and take off, especially in areas which lack sufficient economic density or where the coordination among different stakeholders is difficult, because of limited density, a distance to the technological frontier or institutional deficiencies. In these cases, cluster policies are needed in order to prompt the creation and consolidation of new and emerging clusters, as well as the further specialization of existing ones. Facilitating networking platforms in order to improve coordination and generate knowledge spill-overs, investments in specific infrastructure and programs for academia-private-sector collaboration are examples of specific policy interventions that may help to trigger cluster formation or propel the economic dynamism of existing clusters.

Effective government interventions require a fluid dialogue and close coordination with non-governmental actors. Appropriate institutional arrangements are needed to elicit information from the private sector about potential opportunities for economic diversification; about existing bottlenecks that prevent a country from taking advantage of such opportunities; and about concrete actions and policies that may remove such obstacles. Moreover, institutions must be able to cope with the challenge of sustaining interventions over time and coping with the risk of capture and rent seeking inherent in public-private collaboration. As institutional capabilities vary greatly across countries, policymakers must be mindful of policies that match their existing capabilities.

Proposed WBG offerings to support economic diversification

This section provides a menu of WBG offerings that can support economic diversification, and fall within the mandate and core expertise of the Trade and Competitiveness Global Practice. Depending on the nature of our client engagement and the country context (stage of development, income level, asset endowments, and reform appetite), the choice and scope of WBG offerings will vary. These offerings range from global knowledge products; country knowledge products; and country operational engagements (lending and advisory services). In many cases, they involve close collaboration and/or co-leadership with other Global Practices (see Annex 1 for details).

1. Knowledge and Advisory Services

The WBG can offer robust diagnostics and hands-on technical assistance to support economic diversification through Reimbursable Advisory Services (RAS), country ASA (knowledge products) or through TA advisory projects. Some examples below.

Trade diagnostics. Too much emphasis has been placed on simply adding new manufactured products to export portfolios ('discovery'). While important, trade diversification assessments look for opportunities from: (i) improving the quality of existing exports; (ii) breaking into new geographic markets; (iii) increasing service exports; (iv) expanding output of goods and services that are inputs into export production. FDI and integration in GVCs can also play an important catalytic role in diversification: demand for upstream inputs, as well as source of exports, and linkages with the domestic economy. In addition, trade diversification assessments can look into exporting firm dynamics (determinants of export entry, survival and growth rates). These trade diversification assessments look into the ability of exporters to survive and then thrive (how to support not only the *discovery* phase but also the *acceleration* phase). Trade diversification assessments look into new market opportunities for export services (such as tourism, health, ICT, consulting and other professional services).

Examples: economic diversification assessment (Qatar RAS); export diversification strategy (Jordan); export diversification and firm upgrading assessment (Poland RAS); economic diversification and productivity in land-locked African countries; export of ICT services (Ghana, Nigeria); cross-border mobile banking in Southern Africa; trade in financial services in West African Monetary Zone; Africa regional tourism strategy.

Reviews of investment policy (including FDI policies). WBG is supporting governments in several hydro-carbon rich countries that are seeking to diversify their production base. Employing the investment life cycle approach, WBG has helped clients identify particular policy challenges and reforms to improve the attractiveness of the domestic investment environment. The approach seeks to maximize the "treatment effect" of FDI policies (Wagner, R, 2016). This framework includes: (i) achieving strategic clarity about the type of investment countries should attract and the consequent policy environment amenable to them; (ii) devising reforms to remove legal, regulatory, institutional and administrative impediments to attracting and retaining FDI in intermediate goods and services; and (iii) creating an environment where

new efficient firms can emerge domestically. There are very specific reforms which can be undertaken at each point of the investment lifecycle to support diversification. Some of them include: (i) the elimination of screening on FDI entry; (ii) improving market access by removing sector barriers to entry; (iii) adjusting incentive regimes to reflect diversification objectives; and (iv) focusing retention efforts through investor aftercare services (Qiang et al, 2015)

Examples: review of the investment policy and incentive framework in Greece; in Sri Lanka; in Myanmar

Competition policy and institutional assessments. WBG offers clients the following analytical and diagnostic products to support competition policy design, enforcement and advocacy. Core offerings include: (i) Competition Policy Assessments: including: Evaluation of product market regulations; Sectoral competition assessment; Antitrust and State Aid frameworks assessment; Assessment of anticompetitive subnational regulations; Estimations of the effects of lack of competition on key variables (e.g. productivity, poverty, and consumer welfare); (ii) Competition Policy Notes: including a focus on specific topics (e.g. competitive neutrality, anticompetitive regulations); Review of competition law framework and by-laws; Policy notes with priorities for new governments; (iii) Institutional Effectiveness Review: Functional review of competition agency and its institutional effectiveness; Evaluation of implementation policies and guidelines; (iv) Impact and Advocacy Reports: M&E for competition interventions.

Examples: competition policy assessments for economic diversification in South Africa, Mexico, Moldova, Kenya, Kazakhstan, to name a few.

Innovation, entrepreneurship and productivity assessments. WBG can provide granular diagnostics focused on the “microeconomics” of economic diversification - at the country, industry, and firm level. This type of analysis can entail looking at opportunities to diversify domestic output for higher productivity growth (ie. assessment of allocative efficiency across industries) and trade (typically integrating the analysis of exporting firm dynamics that trade assessments can provide). These assessments can also look at distortions in key input, product and factor markets that are critical for successful diversification strategies.

Examples: productivity and innovation diagnostics in Brazil, Croatia, Colombia, and Poland; Review of public spending of innovation programs in Poland and Western Balkans; entrepreneurship and productivity flagships. These analytical and advisory services are often complemented with lending operations that support firm technology extension, investment readiness, and seed and venture capital funds to support early stage innovation financing.

Sector-level diagnostics. Globalization, technological change and the increasing importance of skills have made redundant the traditional ‘linear’ approach to economic diversification followed by developing countries in the previous century; where economies moved from agriculture and informal economic activities where value-addition is low to light manufacturing and to heavy industries and finally to services where productivity is higher. Furthermore, the nature of global value-chain activities, means that the capacity to appropriate value from a specific industry is determined by the policies of foreign competitors as well as domestic strategy. Not all value chain activities can act as a stepping stone to the

next. Indeed, each value chain activity has different potential to catalyse economic development and productive transformation. Therefore, as we move into a new phase of industrialization, it is important to understand how value is created and by whom and how to maximize the impacts in terms of job creation and poverty reduction. This approach can inform WBG project design or provide insights to WBG clients as part of WBG's ASA offering.

Examples: Concept design for Grain Storage and Information for Agricultural Competitiveness Project (Mexico), Integration into Global Value Chains ASA (Uruguay), Vendor-Supplier Diagnostic design and strategies for implementation (Rwanda), Competitiveness and Jobs (Serbia), Tourism Strategic Plan for Sri Lanka.

Special economic zones. WBG can help clients build the analytical foundations for the application of SEZs (and other spatial solutions). Support may include assessment of private investment potential, establishing location-based benchmarks (utilities, logistics, labor costs, etc.), institutional capacity assessments, and assistance in developing public-private dialogue. WBG can also inform policy design by helping the client identify coordination failures, constraints in the existing legal and regulatory framework, infrastructure constraints, land market dynamics and the potential for induced labor migration, as well as support to green and low-carbon concepts (e.g. by developing industry guidelines and action plans on how to optimize energy and resource use).

Examples: In Ethiopia, the WBG is providing a \$ 270 million loan to finance the implementation of the country's Special Economic Zone policy. The team has so far supported the revision of the SEZ policy framework including its investment promotion institutions. The project will also implement an SME linkages program to increase local and global spillovers. T&C is also supporting the Government of Mexico, with a Special Economic Zone policy to address the regional economic inequalities and underdevelopment in the southern states. T&C is supporting the policy design, implementation structure and a linkages program to encourage and foster spillovers.

2. Development Policy Financing (with embedded advisory support)

The WBG offers development policy financing in support of economic diversification. T&C core mandate and expertise in this type of policy-financing instrument lies in supporting policies (prior actions and indicative triggers) that enhance the functioning of input and product markets, and improve allocative efficiency across sectors and firms. Examples include trade and competition policies, favorable investment climate, support to national innovation systems, firm-upgrading and integration into global value chains. See Annex 2 for examples of T&C policy actions that can help economic diversification. Complementary policies for economic diversification supporting prudent fiscal management and transparency, and improving the efficiency of factor markets (land, skills, finance, and infrastructure) fall within the purview of other GPs (Macro and Fiscal GP, Governance GP, Finance, Agriculture, to name a few).

(a) Development Policy financing at the country level (CF4G): countries affected by the falling external demand, commodity price slump and exchange rate realignments have a strong incentive to broaden their sources of growth. Success depends in part on complementary efforts to redirect fiscal policies to enable private sector-led growth, for instance, by reorienting public spending from subsidies to growth-oriented expenditures, shifting away from resource revenues, and attracting private financing for infrastructure. In these countries, the joint T&C-MFM product, Competitiveness and Fiscal Reform for Growth DPLs seek to achieve three complementary objectives:

- promoting diversification through economy wide reforms including exchange rate, trade, and competition policies, investment climate reforms, and national innovation systems. In some cases, sector specific or spatial efforts could be support in these operations
- rebuilding fiscal space -- efforts to diversify revenues (for instance, away from an over-reliance on natural resource revenues), unwind energy subsidy mechanisms, and PPP efforts to leverage private finance for public good provision
- managing exposure to fiscal risks -- active oversight and management of debt, contingent liabilities, and other fiscal risks, as well as sound fiscal rules and other countercyclical measures

Examples: DPF series in Georgia, Jamaica, Kazakhstan, Nigeria, Tanzania, Sri Lanka, Suriname, Colombia, Peru, and Bolivia.

(b) Sub-regional Development Policy financing: in some subregions, the WBG is supporting commodity exporters with multi-country trade and connectivity DPFs to improve access to markets. Lower trade costs encourage diversification and support intra-industry trade.

Examples: Burkina-Cote d'Ivoire DPF (DPF series that support trade and connectivity related reforms, such as improving the competition in the trucking markets); APEI DPF

3. Results based financing and Investment financing

The WBG also offers lending instruments that provide direct financing to ministries and agencies that support the implementation of economic diversification reforms. These implementing agencies range from the Ministry of Economy, Ministry of Trade, Ministry of Industry, Ministry of Entrepreneurship or Ministry of Agriculture, to name a few. Depending on the instrument, the disbursements support the execution of capital expenditures (investment financing or IPF) or the results of a reform implementation plan achieved by the implementing agency (results financing or PfoR), or both (IPF with a results-based financing component).

(a) Results based financing for industrial and/or firm upgrading and spatial and city development – PfoRs (program for results operations) and IPF operations with results based modalities are relevant for governments (either at national or subnational level) that support cluster development and agglomeration efforts (around urban centers and/or special economic zones) and support to trade and innovation programs for firm upgrading and GVC integration.

Examples: Pakistan Punjab P4R (state level competitiveness efforts that combine economy wide

investment climate reforms with refurbishment of industrial estates and upgrading of clusters), Ethiopia IPF and Bangladesh around light manufacturing through SEZ development, and results based financing supporting trade quality, export promotion, and innovation in Serbia and Armenia; Cote d'Ivoire IPF on City competitiveness and economic diversification; Kazakhstan SME support IPF.

(b) Investment financing operations to support within-industry and within-firm diversification.

The WBG offers investment financing for capital investments and technical expertise in support of trade quality, export and FDI promotion, integration into GVCs (downstream and upstream) in the agricultural and service sectors; and innovation financing. T&C is also financing several projects that directly build and strengthen the institutional capacity of WBG clients to support value-chain upgrading at both the local and global level

Examples: Armenia IPF (trade quality and promotion), Tanzania (IPF on agricultural diversification; Macedonia and Albania IPFs on tourism development; Croatia IPF on venture capital; Lesotho, Malawi, Mozambique and Tanzania IPFs mainstreaming trade and diversifying exports; Croatia, Kazakhstan, Tunisia and Haiti (institutional capacity building)

¹ Herreford, Rogerson and Valentinyi (2014)

² See MacMillan, Rodrik, and Verduzco-Gallo (2014)

³ The shift from traditional to modern agriculture requires the increasing use of a range of value-added services, including finance, logistics, management, and integration into long and sometimes complex value chains. Some of the growth attributed to services is the result of the outsourcing of activities previously undertaken within manufacturing firms. In contrast, manufacturing firms are increasingly delivering a package comprising manufactured products and services activities. For example, Rolls Royce is renowned for making world-class engines, but it is increasing earning its revenues by selling "power by the hour" a complex set of services and manufacturing that keeps its customers' engines running (The Economist (Jan. 8th, 2009)). Analysis of this servitization of both agriculture and manufacture suggests that it may be an important source of increased efficiency with firms that start selling services showing an increase in their profitability, employment, total sales and sales of goods (see for example, Crozet, M and E. Milet 'Should everybody be in services? The effect of servitization on manufacturing firm performance', CEPII Working Paper, 2015-19).

⁴ The theory of second best simply shows that in the presence of multiple market failures removing one of those failures may not necessarily increase welfare and could lead to worse economic outcomes. More formally, if all the conditions for an optimal allocation of resources are met with one exception it cannot be guaranteed that this will be the second-best solution to the optimum.

⁵ This two dimensional definition (trade diversification and domestic production diversification) is adapted from the IMF Position Paper on "Economic Diversification and Structural Transformation in Low Income Countries" (IMF, 2014).

⁶ A different, but not necessarily uncomplimentary, approach, especially for natural resource abundant countries, is to look at the broadening of a country's underlying asset portfolios leading to "diversified development" (Gill et al (2014)). The three main asset categories identified are natural resources, built (human and physical) capital and national institutions. The approach puts emphasis on underlying investments in areas such infrastructure and education as well as institutional development.

⁷ See Newfarmer et al (2009)

⁸ In Zambia, for example, firms are exploring densification of uses of "cassava" (food-security crop) that can help develop new sources of demand for the product as an input (brewing, metals extraction, ethanol production, starch making, animal stock feed).

⁹ Timmer (2016)

¹⁰ See the reply of De Rosa and Bartsch (2016) to Timmer.

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- ¹¹ See (Gelb, 2014).
- ¹² (Farole and Winkler, 2012)
- ¹³ (Andrews and Cingano, 2014; Aguion et al, 2006)
- ¹⁴ (Scarpetta et al, 2013; Hseih and Klenow, 2009)
- ¹⁵ (Baker et al, 2015; Bartelsman et al, 2010)
- ¹⁶ UNCTAD (2002) suggests that steep tariff escalation in advanced countries on products such as coffee, tea and spices, and also for fruits and vegetables, limits opportunities for diversification into processing activities for developing countries.
- ¹⁷ For example, EU rules of origin for clothing under the GSP prevent the developing country exporter from using fabrics from the most efficient suppliers in Asia such as China.
- ¹⁸ Osnago et al (2015) show that uncertainty over trade policies can affect the probability of exporting to a particular market and the volume of exports. Agreement at the WTO that further reduces the gap between bound and applied tariffs (the degree to which countries can raise tariffs without violating their WTO commitments) and provides greater discipline on the discriminatory use of regulatory policies to restrict trade can thus support greater export diversification. Similar impacts can be achieved through regional agreements that lock-in market access and constrain the use of non-tariff barriers.
- ¹⁹ Rauch (1999).
- ²⁰ Dating back to Lerner in 1936.
- ²¹ For particular sectors characterized by imperfect competition and scale economies, import protection by limiting the domestic market to domestic firms may allow those firms to expand and reach a scale of operation and lower marginal costs that then allows them to export to the global market. However, this depends on the structure of costs of the industry and there are scenarios in which import protection undermines exports.
- ²² Import tariffs on inputs used by exporters leads in effect to negative rates of effective protection for exports because there is no policy that raises the price of their output but protection raises the price of the inputs they use (see Tokarick (2006)).
- ²³ Goldberg et al (2010)
- ²⁴ Rahardja and Varela (2014)
- ²⁵ The new theory of trade and firms was initiated in a series of papers by (Melitz, 2003,).
- ²⁶ Eckel and Neary, forthcoming; Bernard, Redding and Scott, 2006.
- ²⁷ Kox and Nordas (2007) find a negative link between regulatory diversity and market entry and subsequent trade flows.
- ²⁸ Recent estimates from nine Latin American countries suggest that a 10 per cent decline in average transport costs would be associated with an expansion of more than 10 per cent in the number of products exported (Moreira et al, 2008).
- ²⁹ See Huria and Brenton (2016) for a summary of the available literature
- ³⁰ See Kunaka et al (2013)
- ³¹ Agosin et al (2011)
- ³² See Kazandjian, R., L. Kolovich, K Kochhar, and M Newiak (2016) 'Gender Equality and Economic Diversification' IMF Working Paper WP/16/140
- ³³ Rwanda Jobs Study, World Bank, 2016
- ³⁴ Lederman et al (2010; Newfarmer et al (2009)
- ³⁵ Qiang et al (2015)
- ³⁶ Giugale (2014)
- ³⁷ Farole (2011)
- ³⁸ Lederman and Maloney (2012),