



Breaking into New Markets, Raising Quality, and Improving Services: Neglected Avenues for Export Diversification

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Expanding international trade is an important avenue for growth and development in low-income countries. In addition to increasing the quantity of existing export flows, many countries seek to diversify into production and export activities that provide a higher return to the labor and capital resources employed. Export diversity also reduces a country's vulnerability to pronounced price swings in international markets.

As experience over the past 50 years demonstrates, there is no magic recipe to promote export diversification in developing countries. While some developing countries have been very successful in diversifying their exports, others have lagged behind. These divergent developments give rise to several questions: How do different forms of export diversification affect growth? Do particular market and policy failures inhibit diversification in low-income countries? How can governments in developing countries foster productive diversification without overstressing their administrative capacity?

This note reviews the findings of a series of papers on the diversification process contained in Newfarmer, Shaw, and Walken-

horst (2009). The analysis suggests that there has been too much focus on simply adding new products to export portfolios, which often underscores the use of industrial policies. While such actions are important, a more comprehensive view of diversification—and hence a more comprehensive trade policy—is needed that improves the quality of *existing* exports, breaks into new geographic markets, and increases services exports. These often-neglected avenues of diversification offer untapped opportunities for many low-income countries. The note argues that a broad array of policies can help a country's exporters upgrade existing products, break into new geographic markets, and launch and consolidate new lines of business abroad; such policies range from getting the incentive structure right, to lowering the costs of transportation, telecommunication and other backbone services, to proactive interventions by governments. The underlying objective is to raise international competitiveness and help the most productive firms overcome market and policy failures that constrain their ability to exploit export opportunities, without trying to pick winners from the outset.

Potential diversification into new, higher-quality markets and services

Many developing countries, including some of the poorest, have significantly diversified the goods that they produce and export over the past two decades. Some initially upper-middle-income countries, like the Republic of Korea and Singapore, have even begun producing and exporting high-tech products. On the other hand, not all countries have successfully broadened the range of export products and a few, poorly performing low-income countries have made almost no progress. This has led to much research on how lagging countries can diversify exports.

Two empirical observations are particularly relevant. First, most export growth derives from expanding the *intensive* margin—that is, exports of existing products to current markets. Second, within the *extensive* margin (that is, new export flows) the export of existing products to new geographic markets has accounted for a greater share of developing countries' export growth than the export of new products.

The first observation implies that ignoring growth potential at the intensive margin will miss important opportunities for export expansion—and for propelling economic growth. Further, it supports the view that more important than the type of goods a country produces is how the available bundle of products is produced (see box 1). *Of particular importance is the capacity to raise the quality of existing products over time.* Mauritius, for example, has created an environment that has enabled clothing producers to improve quality and advance from simple assembly to more integrated production. In many low-income countries, agricultural products offer important opportunities for quality improvements and product differentiation. Often, however, improvements are

constrained by infrastructure, regulatory, informational, and logistical weaknesses.

At the extensive margin, diversification of existing products into new markets is likely just as effective for growth as developing new export products, and arguably easier to achieve. *For many developing countries, the potential for further geographic diversification is substantial,* given how few markets these exporters actually have been serving. A country's exploitation of market opportunities for its existing set of export products can be measured through the *index of export market penetration* (IEMP). For a given range of exports, the IEMP will be higher for exporting countries that reach more of the international markets that import the type of products they export. Looking at cross-section data, the IEMP is positively correlated with GDP per capita (see Brenton and Newfarmer 2009).

Countries with relatively low per capita incomes tend to do less well in exploiting available export markets. For example, Korea has been a much more effective exporter than Kenya, where income per capita is just one thirtieth of Korea's. Korea's IEMP score doubled from 21 percent in 1985 to 42 percent in 2005, while Kenya's score only increased from 6 percent in 1985 to 8.5 percent in 2005, even though Kenya's lower market penetration should have facilitated geographic expansion of the country's exports. High trade and transaction costs are likely a key reason why low-income countries cannot better exploit opportunities for geographic expansion.

In addition to the potential in geographical diversification, *there are emerging opportunities for diversification into services exports.* Nearly all of the literature and policy discussion on diversification focuses on merchandise exports. Yet, recent studies show that services can contribute to growth and export diversification in several ways:

Box 1. Does the sophistication of exports matter?

A recent argument suggests that countries exporting goods associated with higher productivity levels will grow more rapidly than countries with exports associated with lower productivity levels. Hausmann, Hwang, and Rodrik (2006) measure this “notion of the productivity” of products in terms of the income levels of countries that export a particular product, weighted by each country’s revealed comparative advantage in that product (defined as the variable *PRODY*). For each exporter they then calculate a measure of the overall productivity of their export bundle by weighting each of the *PRODY*s by the share of the product in that country’s total exports. They find a strong correlation between (i) this measure of the productivity of a country’s export bundle and per capita income and (ii) initial values of the measure and subsequent growth. Rodrik (2006) suggests, on the basis of this measure, that China is an outlier in terms of export sophistication because it exports products normally associated with countries that have per capita incomes three times higher. This apparent capacity to make advanced, high-productivity products is then seen as having been an important factor in China’s strong recent growth.

However, recent studies have challenged this view by taking into account differences in product quality. By ignoring the quality of products, the Hausmann-Hwang-Rodrik measure tends to overestimate the importance of sophisticated products in low-income country exports. Since product quality is correlated with income, correlations between the measure of export productivity and per capita income are likely to be biased, it is argued. For example, Xu (2006) conditions the Hausmann-Hwang-Rodrik measure by relative unit values of exports, which are used to proxy relative quality. This analysis shows that once product quality is taken into account, the structure of China’s exports appears consistent with its level of development. Minondo (2007) finds that the relationship between initial export sophistication and subsequent economic growth no longer holds once differences in quality are taken into account.

In addition, emerging global production chains complicate the analysis of an export basket as in the Hausmann-Hwang-Rodrik measure. Technological change and declining transport costs have led to a splitting of the production chain for many processed products and the reallocation of production throughout the world. Successful exporting in many developing countries, especially those in East Asia, has been driven by the importation of parts and components for further processing and assembly. However, the trade data used in these measures of diversification and export sophistication relate to gross exports and do not capture the impact of outsourcing. For example, China’s export of sophisticated iPods largely reflects assembly activities, while most of the advanced, high-productivity activities that are combined to produce the iPod take place in other countries.

by expanding exports of existing services to existing markets; by developing new services exports or exporting existing services to new markets; and by lowering input and transaction costs to make merchandise products more competitive in international markets. Services exports have grown dynamically, driven recently by the ongoing trend of outsourcing back office and information technology functions to take advantage of advanced skills and lower labor costs of specialized service providers in a growing number of developing countries. However, developing trade in services is a complicated process, for which many countries do not have an explicit policy.

Many of the endowments that drive countries’ comparative advantage in cross-border services trade are amenable to policy action. Key conditions for success are competition in “delivery” services such as telecommunications and transport, higher education systems that are capable of providing a large number of graduates with advanced skills, and regulatory institutions that can credibly signal quality to foreign buyers. It is illuminating to contrast the successes of Brazil and India in growing exports of business services with the relatively poor performance of, for example, Sri Lanka, Pakistan, or Zambia, where the pool of highly qualified individuals is shallow, the

telecommunication infrastructure is deficient, and the financial sector and business climate are insufficiently developed. Addressing and overcoming these impediments is of crucial importance for developing an export-oriented services sector.

Tourism can be an important element of services exports. The experience of Mauritius, for example, underlines the proactive role that government can play in encouraging tourism development, through ensuring a stable and secure business environment, establishing a sound regulatory framework for the sector, playing a coordinating role among stakeholders, and protecting the environmental resources essential for providing tourists with a positive experience.

Market failures in the export cycle are difficult to pin down and address

Export diversification is encouraged by ensuring the quality of institutions that support trade, by relying on the market to determine prices where private firms internalize costs and benefits, and by addressing market failures where feasible. Compared to institutional and pricing problems, market failures are more difficult to define and more controversial to address.

In developing countries, within-the-frontier innovations can generate valuable social knowledge. Successfully exporting a product for the first time (from a given country) generates valuable information on the structure of foreign demand and production costs, and facilitates imitation. While imitation has a positive social benefit, it can also reduce the return to first movers, who in the case of within-the-frontier discoveries cannot be protected by intellectual property rights. The result is a tendency to underinvest in innovation (Hausmann and Rodrik, 2003).

However, the threat of new imitative entry may not in fact reduce first-movers'

profits or discourage discovery. If demand in global markets is practically limitless—normally the case for an exporter in a developing country—then expanding supply from new entry will have minimal, if any, adverse implications for the first-movers' profits. Moreover, new entry often brings economies of agglomeration and lowers transportation costs for all firms in the industry. Thus, the presence of a critical mass of firms producing similar products or using common inputs allows firms to move down the long-run cost curve and expand and diversify exports. In Peru, the success of the initial asparagus producers demonstrated the industry's viability, attracting many new farmers into the industry, and the greater scale consequently lowered costs of transportation, standards administration, and logistics for all farmers. In Kenya, pioneer call center operators reported that new entry would help them by widening the pool of available, flexible labor to respond to fluctuating demand. Also, survey evidence suggests that imitation is not a major concern for exporters in the Middle East and North Africa, and indeed exporting firms are eager to share information to achieve economies of agglomeration.

Discovery is only one phase of the export cycle. Once a new export has been sold abroad, ensuring that it grows and can eventually be placed in other markets may be the more important obstacle. Recent research has shown that while the number of new export flows tends to be larger (relative to income) in low-income than in middle- and high-income countries, average disappearance rates are also higher. This is consistent with the available information on the dynamics of exporting at the firm level.

The reasons for the high “death” rates in what should be the growth phase of an export product have not been fully researched but clearly relate to the uncertainties, especially with regard to costs, of undertaking new activities in foreign markets. Another

cause for premature “death” of exports may be instability in the business environment, including, for example, unpredictable delays in customs, changes in tax policy, or unanticipated rent-seeking from officials expecting payments. In any case, low survival rates for initially small flows suggest caution in public policy interventions that are aimed specifically at exporters that start small.

A portfolio of policies is needed to foster export growth and diversification

How can countries best position themselves to take advantage of new opportunities in the global market and the available avenues for diversify exports? The emerging lessons from country experiences suggest a range of policies that focuses on reducing trade costs and improving competitiveness and that considers both the intensive and extensive margins. Clearly one size does not fit all. Diversifying exports is a complex process and obstacles are specific to countries. Policy makers in every country have to craft a portfolio of policy and institutional reforms based on a country’s level of income, initial policy framework, supply-side assets, and binding constraints.

Three elements of a *strategy for competitiveness* appear essential in helping countries exploit opportunities in international markets:

- *Getting the incentives right.* A key challenge for policy makers is ensuring that domestic resources are channeled to their most productive activities. Creating a modern incentive framework that spurs national competitiveness requires careful analysis to ensure that land, labor, capital, and technology are moving to sectors in which the country has a long-term capacity to compete and to the most productive firms within sectors. This necessitates

a clear understanding of how trade, tax, investment promotion, and labor market policies interact to affect investment and trade decisions.

- *Lowering the costs of backbone services and of doing business in general.* Of great importance in today’s globalized economy is domestic firms’ access to efficiently produced, critical, “backbone” services. Firms that pay more than competitors for energy, telecommunications, transport, and logistics, finance, and security will find it hard to compete in domestic and overseas markets. Reducing policy barriers to competition and improving regulatory effectiveness in these services lies at the heart of the policy challenge. In many developing countries lack of infrastructure is a critical constraint on the availability and cost of backbone services.
- *Being proactive in supporting trade.* Both market and government failures tend to afflict low-income countries trying to expand exports and growth. In many cases these constraints to competitiveness require specific interventions and institutions. For example, export deaths and weak IEMP performance tend to underscore the importance of export promotion agencies—and even economic officers in foreign embassies—in overcoming informational asymmetries.

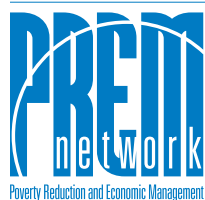
In tackling government and market failures, trade ministries are typically weak and their policy purview limited to border barriers. Large domains of policy that affect competitiveness reside outside the normal trade minister’s ambit—investment policies, infrastructure services, and transport, to name a few. It is important to bring these initiatives together in a *strategy for competitiveness* rather than as a series of unconnected interventions. . In isolation trade agencies

tend to focus on narrow objectives, some of which may even be inconsistent with a broader competitiveness strategy.

Implementing such a comprehensive competitiveness strategy is very demanding and requires effective mechanisms to review and coordinate policies. Criscuolo and Palmade (2008) discuss how specialist reform teams have often been at the heart of successful growth performance in developing countries. One option is to create an inter-ministerial council on competitiveness with the mandate of analyzing the existing policy framework and reviewing policies before they are put in place. A second approach is to set up a consultative group that involves the private sector in identifying policies that impede diversification or information or coordination gaps that the government could fill. In any case, given the country-specific nature of constraints to competitiveness and export diversification, policy makers need to craft a set of institutional arrangements that is tailored to their particular situation.

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