Export Diversification for Growth and Macroeconomic Stability

A Background Note for the Roundtable Discussions at the Ministerial Conference

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Central Asia Regional Economic Cooperation
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I. Introduction

- With support from the Asian Development Bank (ADB) and the International Monetary Fund (IMF), the CAREC Secretariat is organizing a roundtable discussion during the 17th ministerial conference in Ashgabat on 15 November 2018 to discuss new directions for diversification of exports in CAREC countries. The discussion intends to guide policy formulation and financing options to promote more diversified export baskets in CAREC countries[1] in terms of quality, scope and scale of products and services, as well as geographical reach.[2]
- CAREC countries are already supporting export diversification through national agendas to improve resilience against external shocks and promote sustainable economic growth. Greater export diversification also creates opportunities to move into new products and markets that can spur growth further.
- Recent data on trade composition show that some progress towards export diversification has been made in the CAREC region, especially in Kazakhstan, Azerbaijan, and Tajikistan. The UNCTAD concentration index[3] was, on average, 0.41 in 2016 for the CAREC region (excluding China) down from around 0.45 between 2012 and 2015. But there is still a considerable room for improvement to increase export diversification in CAREC countries, especially regarding moving to more sophisticated export goods and services.[4]

II. Export diversification: challenges for CAREC countries

- Resource-rich CAREC countries' overreliance on capital-intensive sectors has only few positive spillovers on tradeable goods and services and reduces their competitiveness resulting from the Dutch Disease. In fact, minerals continue to dominate most of the CAREC countries' exports[5]. Consequently, during the 2014 oil-price shock, these countries experienced reduced export revenues—giving rise to higher fiscal deficits, burgeoning external account deficits, and putting pressure on currencies, which led to significant exchange rate adjustments and countercyclical support programs to help restore economic and financial stability in these countries. Their accumulated sizable fiscal buffers from oil revenues, together with support from international development partners, allow these countries to run countercyclical expenditure programs that are supporting manufacturing and export diversification strategies.

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1 The Central Asia Regional Economic Cooperation (CAREC) Program is a partnership of 11 member countries and development partners working together to promote development through cooperation, leading to accelerated economic growth and poverty reduction. CAREC countries include: Afghanistan, Azerbaijan, the People's Republic of China, Georgia, Kazakhstan, the Kyrgyz Republic, Mongolia, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan.

2 In response to member country demands, in 2015, the International Monetary Fund published a Board Paper on diversification; in addition, two data toolkits on diversification were developed and published on the Fund's website. Since 2015, diversification issues have become a prominent part of policy discussions across all regions and types of countries.

3 The UNCTAD concentration index is a measure of the degree of product concentration. An index closer to 1 indicates that a country's exports are highly concentrated on a few products. A value closer to 0 reflects exports that are more homogeneously distributed among a series of products.

4 Middle-income developing economies had a concentration index of 0.07.

5 For example, minerals account for more than 70% of Kazakhstan's exports. Mongolia's and Azerbaijan's concentration of exports in minerals is even higher than that. Uzbekistan is heavily dependent on exports of commodities (e.g. gold, natural gas, and cotton), Turkmenistan exhibit an overreliance on gas exports.

- Net resource importers in the CAREC region also face issues in enabling new industries to emerge and in diversifying their export basket. Their limited fiscal space constrains their ability to import modern machines and equipment as well as funding infrastructure development for industries and providing appropriate incentives to exporters through suitable industrial policies. Moreover, these countries often rely heavily on remittances[6], which transmit economic volatilities from oil-exporting countries that traditionally receive their migrant workers (Russia in the case of post-soviet countries, Middle East in the case of Pakistan). Policies facilitating the productive use of remittances in the domestic economy may be economically beneficial, if the business climate is attractive for returning migrants to invest their skills and remittances in new businesses.

- Diversifying non-natural-resource products into distant markets for CAREC countries (excluding PRC) has proven difficult for a variety of reasons. First, the small scale of their manufacturing output and the resulting high transport unit costs makes it difficult to have competitive exports. A large share of CAREC countries' exports go to small number of neighboring countries[7], making exports vulnerable to shocks in trading partner countries. In general, CAREC countries' production capacity for large-scale manufacturing is below the capacity needed to access, for example, Chinese or European Union markets, unless they coordinate their efforts and create common markets.

- Second, a structural shift in the CAREC economies toward greater competitiveness in non-natural-resource tradable goods and services will be needed. The structural transformation in most CAREC countries has generally occurred from the agriculture sector directly to the service sector due to ineffective industrial policies. Consequently, the service sector has claimed the largest share of domestic value addition and the export basket has remained concentrated, mainly in primary commodities. Little investment and low productivity outside extractive sectors resulted in relatively high growth and employment creation in non-tradable or low-productivity sectors (e.g. construction, wholesale and retail trade etc.) and disincentivized diversification in tradable production and exports of high-value-added goods and services.

- Third, most economies in CAREC are dominated by a few large companies, mostly state-owned or supported, without facing sufficient internal or external competition. In fact, medium-sized enterprises contribute only a small share to GDP in most CAREC countries and concentrate in sectors with low value-added and non-tradeable goods and services. Many CAREC countries have found it difficult to create a level playing field for the private sector and generate an enabling business environment and policy framework for the private sector to lead the diversification effort.

- Finally, most oil-exporting and oil-importing countries also demonstrate institutional capacity constraints to successfully plan, design and execute industrial policies with appropriate incentive packages and sunset clauses to enable industry to stand on its feet and to prevent perpetual subsidy regimes and rent-seeking behavior by firms.

- To better address these challenges, policy dialogues on export diversification should clearly identify: (i) main motivations for export diversification in the CAREC region (e.g. natural resource dominance, projected resource depletion, demographic pressure to create jobs or increasing competition from other countries; (ii) why efforts of CAREC countries so-far have not resulted in a major break-through on export diversification; and (iii) key continuing

[6] For example, remittances account for the equivalent of 26% of GDP of the Kyrgyz Republic and 29% for Tajikistan in 2017.

[7] For example, more than two thirds of exports of Mongolia go to China; Russia and Kazakhstan are major trading partners for the Kyrgyz Republic; Kazakhstan and Turkey for Tajikistan etc.

reasons for the lack of export diversification (e.g. poor infrastructure, lack of finance, especially for small and medium-sized exporters, low human and physical capital, high cost of doing business, limited market access or weak export competitiveness); and and the reasons why countries are keen on increasing diversification.

III. Policy advice to increase diversification in CAREC countries may take the following approaches

(i) Level playing field and conducive environment for private sector participation

- The private sector is a key engine for economic diversification. Bottom-up diversification strategies rely on a competitive private sector structure with innovative medium-sized enterprises at its core. Promoting private sector development includes state support for basic and product specific research for innovation, quality technical and vocational training, sector and competition regulation, as well as export promotion, insurance and access to finance.

- Reducing barriers to trade and promoting regional and global integration can further enhance connectivity to markets and among producers, create more predictable trading environments and increase competition in the region. Beyond open trade policies, other policy choices such as adequate institutions and rule of law are crucial for lowering transaction costs. Sound macroeconomic and investment policies, such as exchange rate and FDI policies, to alleviate the allocation of resources to increasingly productive sectors also matter for export diversification.

- Finally, CAREC countries with a comparative advantage in tradable high-value-added services can enhance export diversification in the services sector by benefitting from the largely unexploited potential of services export. Falling costs of travel, communications and information technology and increasing access to the internet can make diversification in the services sector easier. CAREC countries may export a diversified range of services, both within and outside the region, such as information-technology related services, communication, logistics services.

(ii) Industrial and investment policy type measures for specific sectors

- Experience of countries that have successfully diversified their economies show that state support for creating a level-playing filed for the private sector has often been complemented by export-oriented industrial policies that typically support domestic firms in selected sectors to access markets beyond the small domestic economy. Such support can be in the form of incentives for global manufactures, protecting infant industries from imports, and subsidized technology transfers. For example, well-targeted incentives and easing access to finance, may help firms, especially SMEs, reduce risks of entering a new sector or adopting a new technology. Sunset clauses to terminate support in a finite time are important. Good governance is critical in industrial policies as targeting specific industries open the door to opportunities for political capture and rent seeking.

- Supporting efficiency-seeking investments may encourage production for export, introduction to new export markets and integration to global value chains. Efficiency-seeking FDI, while more difficult to attract in CAREC countries, is very important for export diversification, more diversified jobs' creation, expertise and technology transfers and innovation.

Table: Mapping some successful strategies in Asia

Major Directions for Industrial Policies	Detailed actions	Countries
Sequencing	The first phase of the export program focused on the development of light industry. The second phase was driven by the export-orientation program with concerted efforts to move into higher value-added areas through complementary investments in human capital and infrastructure.	South Korea
SMEs as pillars of export growth	Export orientation strategies based on a combination of a developmental state and many economically dynamic SMEs, alongside a powerful big business sector.	Taipei, China
Foreign capital and R&D to promote technological transfer	For example, through the creation of free trade zones.	PRC, Indonesia, Malaysia
Export subsidies, tax breaks or easing access to finance	Strategies focused on SME development through export subsidies and tax incentives paired with measures to hold firms accountable for their export performance.	Indonesia, Malaysia, Thailand
Investments in high-productivity industrial sectors	Starting from a low technology base and even without prior comparative advantage, the export sophistication is achieved by focusing on specific manufacturing clusters that led to an upgrading of technology.	Malaysia, Indonesia
Build a high-skilled workforce	Making investments in training workers and upgrading their skills and sponsoring workers for foreign training to ensure the availability of high-skilled workers.	Malaysia, South Korea
"Waves" of supportive reforms	Diversification of production and exports in the agriculture sector, followed by opening of the economy to FDI to diversify beyond agriculture (oil sector, real estate, food processing, heavy and light industries).	Vietnam
Agriculture-led industrialization	Major share of agro-industry at early stages of industrialization. Scaling-up agro-industry and agro-processing before testing out other manufacturing sectors through infrastructure and institutional development.	Thailand

Sources: Felipe, J., Asia's Industrial Transformation: The Role of Manufacturing and Global Value Chains (Part 2), ADB Economics Working Paper Series No. 550, July 2018. Callen T. et al., Economic Diversification in the GCC: Past, Present, and Future, IMF Staff Discussion Note, December 2014.

IV. Questions for Discussion

- Why have CAREC countries, despite strategic prioritization and state efforts, been less successful in promoting export diversification?

- What can governments do to promote diversification?

- In which ways should diversification strategies and policies of resource-rich CAREC countries differ from other CAREC countries?

- How can regional cooperation be a force for export diversification?

- In what ways can a regional platform such as CAREC support policies and programs for export diversification in member countries?

- How can small- and medium-sized companies be catalyzed to play a large part in national export diversification plans? And how can large companies be incentivized to develop exports?

- What is the potential of greater diversification in the service sector of CAREC countries?