

CHAPTER 5

ECONOMIC DIVERSIFICATION: LESSONS FROM PRACTICE

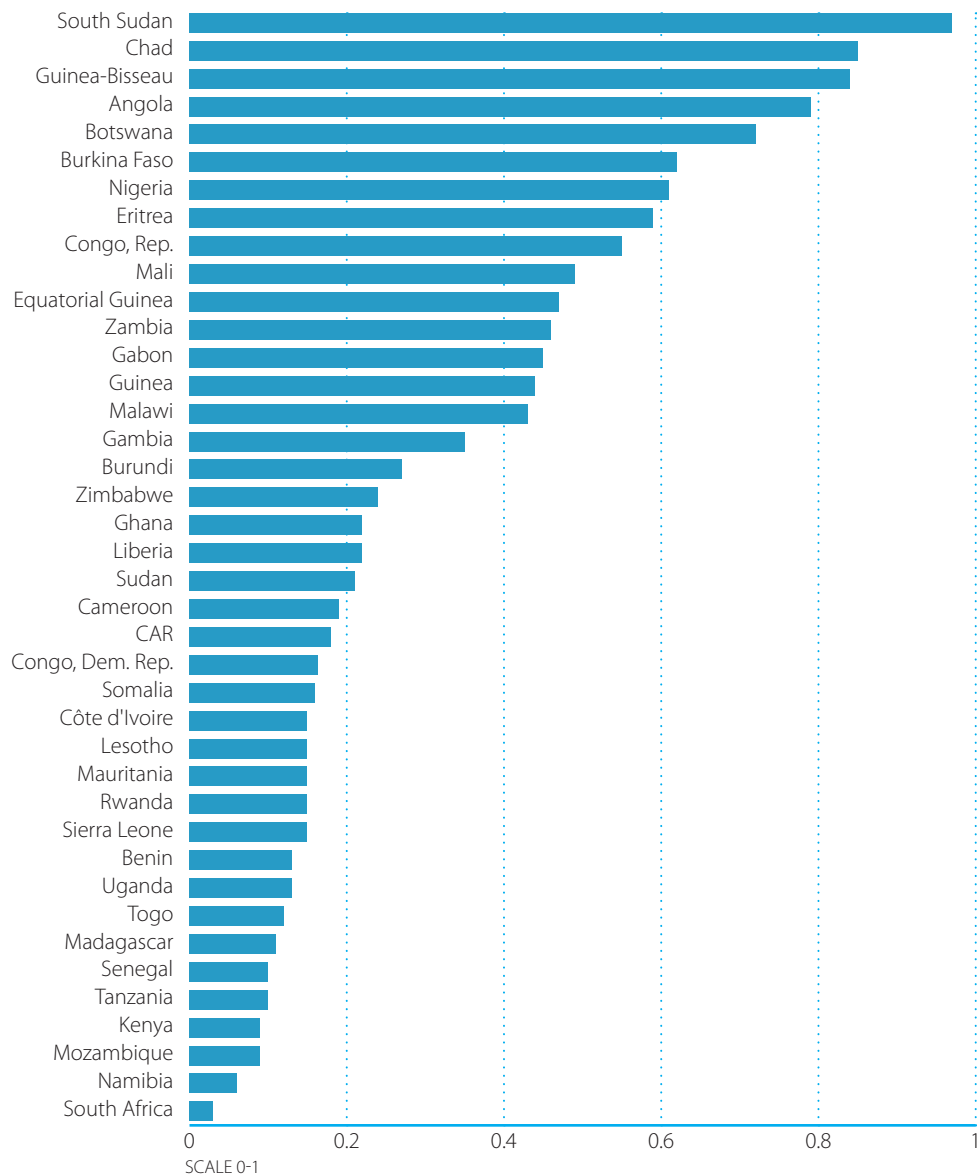
Contributed by the World Bank Group¹

Abstract: *Economic diversification remains a challenge for most developing countries and is arguably greatest for countries with the lowest incomes as well as for those whose economies are small, landlocked and/or dominated by primary commodity dependence. For such countries, economic diversification is inextricably linked with the structural transformation of their economies and the achievement of higher levels of productivity resulting from the movement of economic resources within and between economic sectors. Rooted in examples of World Bank Group support, this chapter traces the boundaries of any discussion of economic diversification by advancing a definition that encompasses two related dimensions of diversification: (i) trade diversification (i.e. exporting new or better products, or to new markets) and (ii) domestic production diversification (i.e. cross-sectoral rebalancing of output, driving the reallocation of resources across industries and within industries between firms to increase total factor productivity). The chapter raises awareness on the complexity of the diversification process and the state of knowledge surrounding economic diversification. While the current global environment creates challenges for poor, small, landlocked and/or resource-dependent countries, a range of new diversification routes can be followed. This however requires that policy attention be paid to four key determinants of successful diversification strategies, which development partners and International Organisations can support through targeted Aid for Trade interventions. These are: (i) the supply of appropriate incentive frameworks; (ii) investments and policy reforms targeted at reducing trade costs; (iii) effective policies to support adjustment and the reallocation of resources towards new activities; and (iv) government interventions directed at specific market, policy and institutional failures.*

WHY ECONOMIC DIVERSIFICATION MATTERS

Economic diversification is a key element of economic development in which a country moves to a more diverse production and trade structure. A lack of economic diversification is often associated with increased vulnerability to external shocks that can undermine prospects for longer-term economic growth. The world's poorest countries, many of which are often small or geographically remote, landlocked and/or heavily dependent on primary agriculture or minerals, tend to have the most concentrated economic structures. This creates challenges in terms of exposure to sector-specific shocks, such as weather-related events in agriculture or sudden price shocks for minerals.

Figure 5.1. Export diversification in Sub-Saharan Africa, 2017



Source: Authors' calculations.

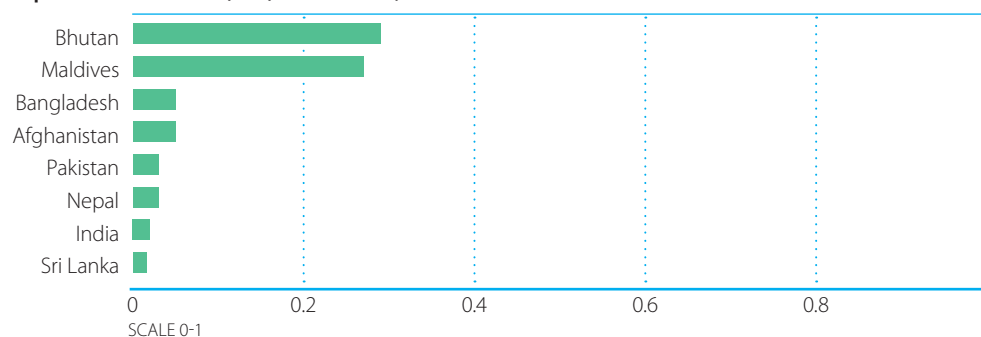
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Growth also tends to be unbalanced in the case of mineral dependent countries or slow and difficult to sustain in agrarian ones. Poverty-reducing, trade-driven, growth has been particularly difficult to achieve in countries whose economies are heavily dependent upon primary commodities. Countries whose geography implies a punishing lack of connectivity to regional or world markets are also at a distinct disadvantage in attempting to diversify their product and export mix. Figures 5.1 and 5.2 offer a snapshot of diversification levels across regions of the developing world, using Herfindhal-Hirschman indices of market concentration.²

Figure 5.2. Export diversification in selected developing country regions, 2017

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Export diversification (HHI) - South Asia, 2017



Export diversification (HHI) - East and Central Europe, 2017

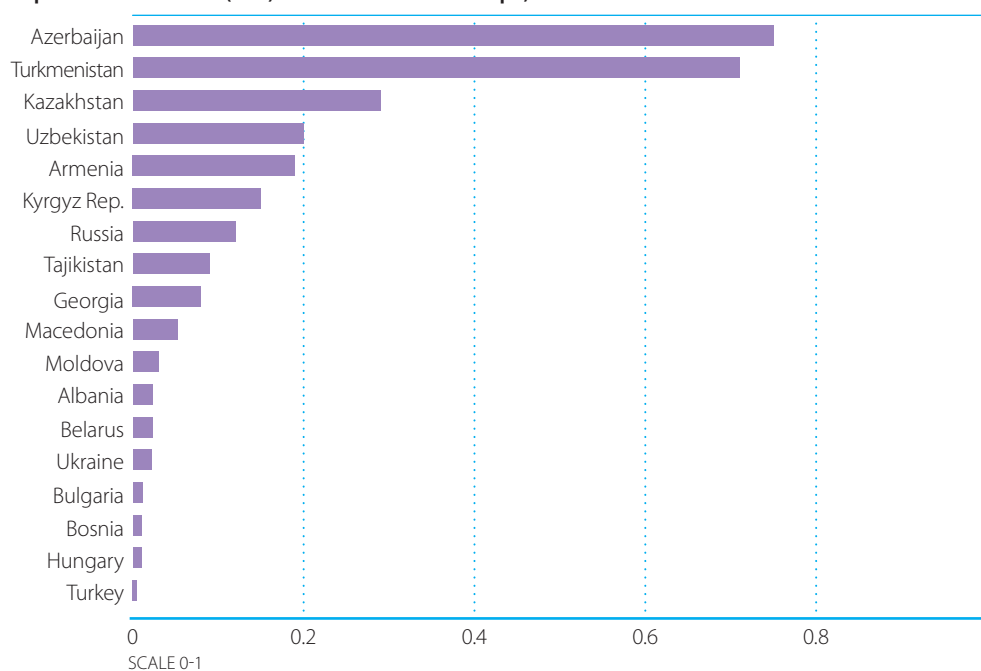
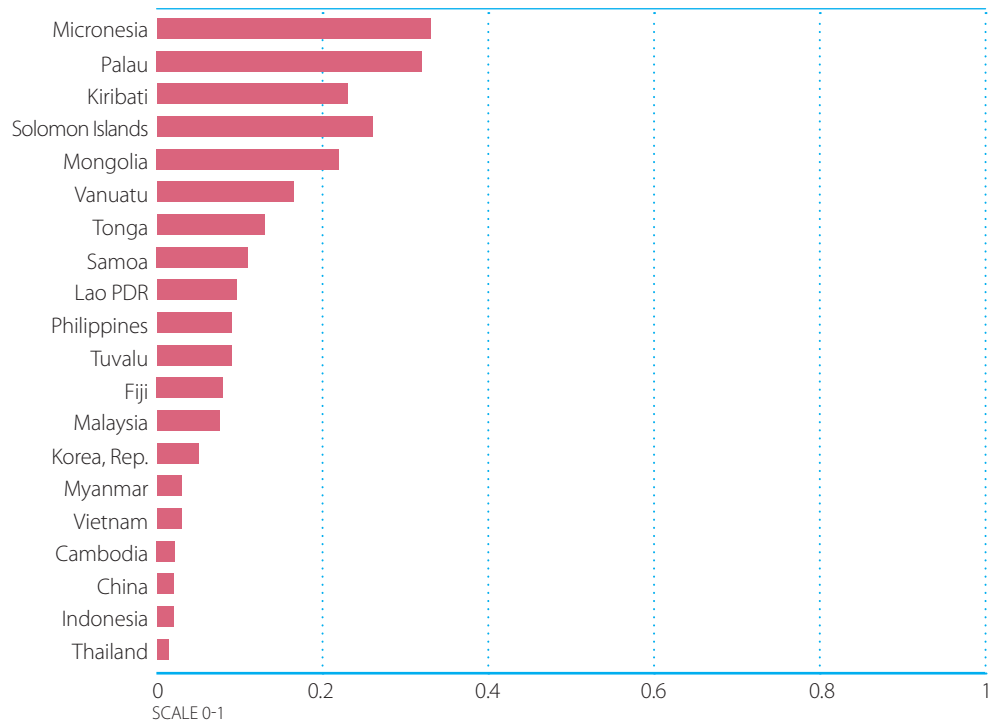


Figure 5.2. Export diversification in selected developing country regions, 2017

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Export diversification (HHI) - East Asia Pacific, 2017



Export diversification (HHI) - Middle East and North Africa, 2017

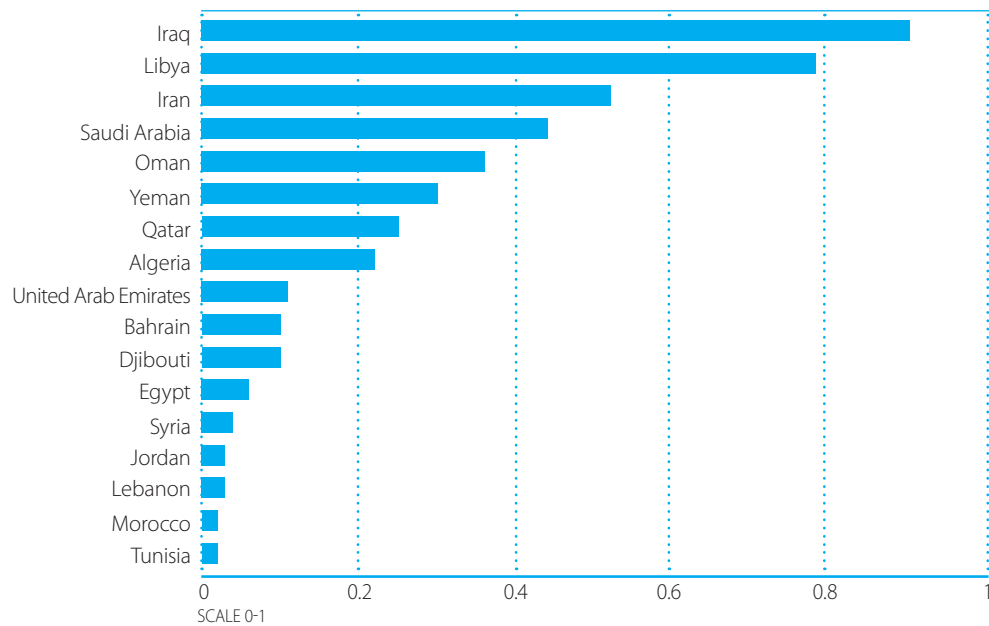
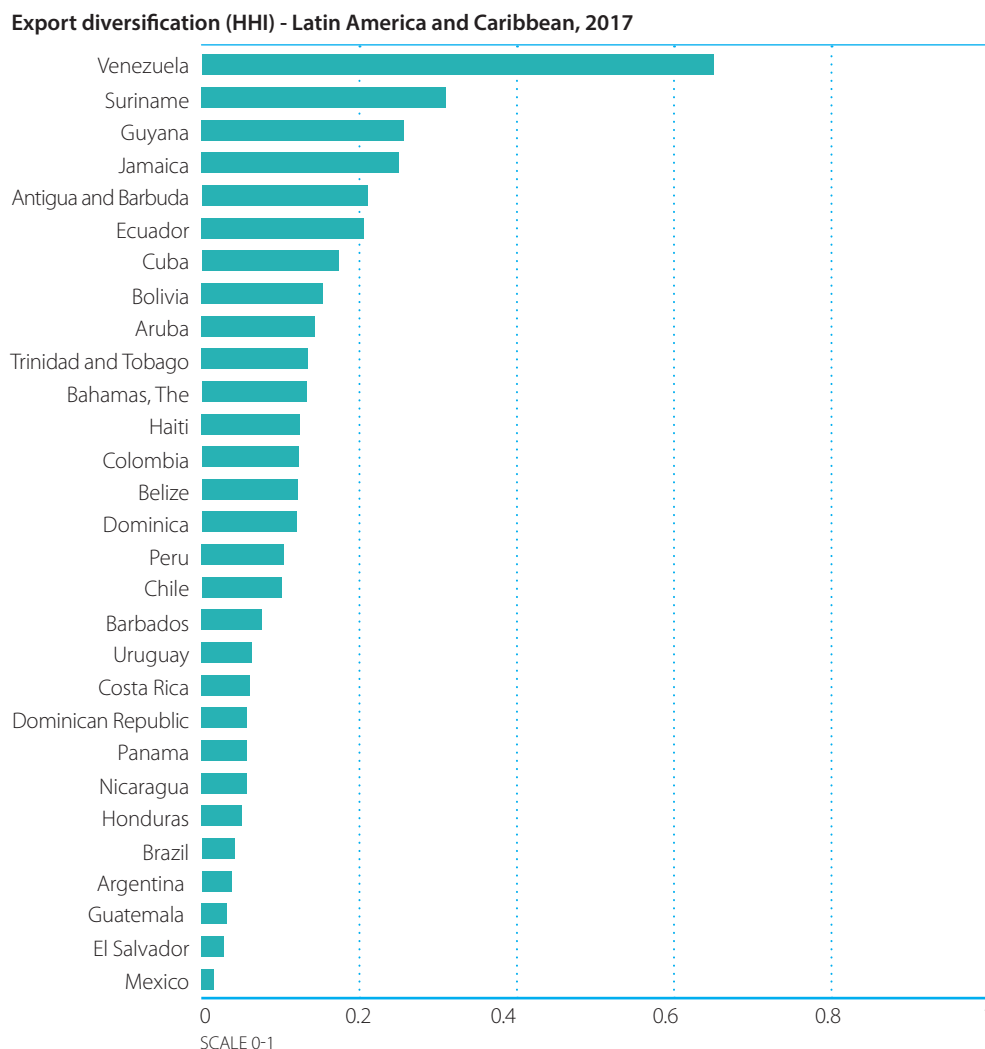


Figure 5.2. Export diversification in selected developing country regions, 2017*(Continued from previous page)*

Source: Authors' calculations.

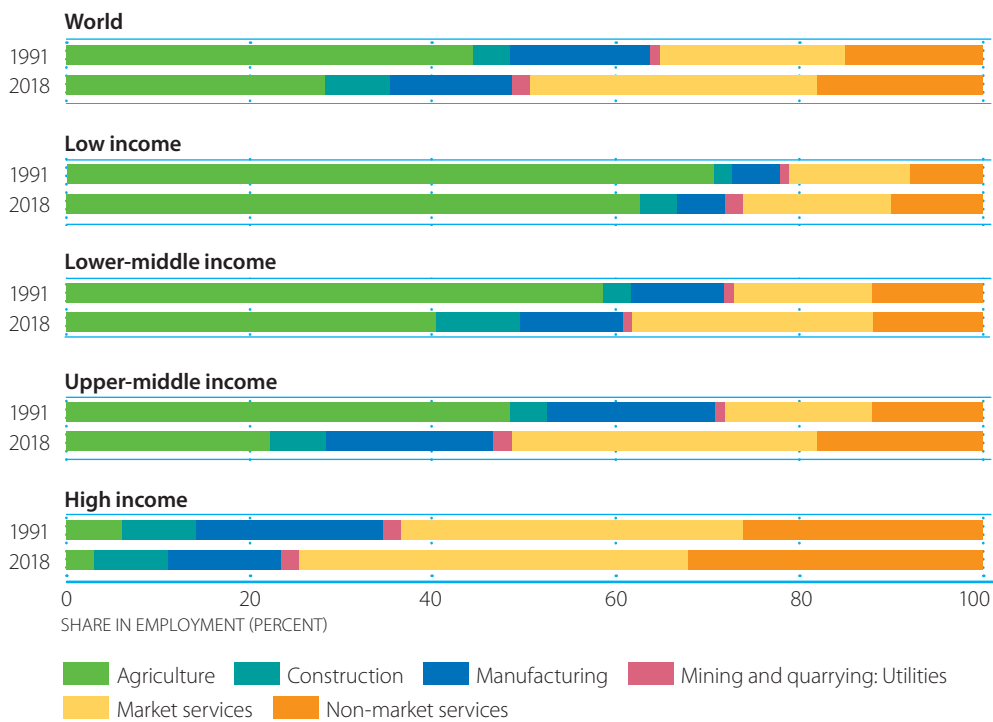
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Diversification helps to manage volatility and provide a more stable path for equitable growth and development. Successful diversification is all the more important now in the wake of slowing global growth and the imperative in many developing countries to increase the number and quality of jobs. Trade expansion is central to creating new, higher productivity jobs that will facilitate growth through structural transformation. Moving labour from low productivity employment, mainly in agriculture, to higher productivity jobs in a range of mostly urban activities characterised by strong agglomeration economies is imperative for sustained growth. Countries in East Asia made such a growth transition in the 1990's through reliance on exports of labour-intensive manufactures. The challenge today for many developing countries is not only to grow labour-intensive manufacturing, but also value-adding agri-business, horticulture, and selected services, activities that are all at once labour-intensive, tradable and value-adding. While rapid increases in working populations offer many developing countries an opportunity for a demographic dividend, reaping it may remain challenging in the absence of economic diversification and job-producing private sector growth. The need for government action through well designed public investments and effective policy reforms that support a more diversified economy remains centrally important.

Economic diversification and structural transformation – the movement of factors of production within and across different sectors towards higher productivity uses - are closely linked phenomena. Structural transformation can refer to the shift from agricultural to non-agricultural sectors, or from manufacturing to services. A broad and well documented trend has been the gradual decline in the importance of agriculture accompanied by an initial increase followed by decline in manufactures and a corresponding increase in services that consistently shows across many countries as a part of the process of economic development (Herrendorf, Rogerson and Valentinyi, 2014). Such a trend is perhaps most visible in global labour markets.

The share of agriculture in total employment has been shrinking across all country income groups. Globally, it has contracted by close to a third, from 44 per cent in 1991 to 28 per cent in 2018, with the largest contribution attributable to middle-income countries (see Figure 5.3).³ The share of employment in manufacturing has also been decreasing globally and is down slightly from 16 percent in 1991 to 14 percent in 2018, a trend driven primarily by high-income countries, where advanced robotics and the adoption of other labour-saving technologies has made the greatest headway (World Bank, 2017). The sectors in which the most significant employment expansion has occurred in recent decades all relate to services, with construction, non-market (public) services and, most importantly, a host of market services leading the way (ILO, 2019).

Figure 5.3. Distribution of employment by aggregate sectors, global and country income groupings, 1991 and 2018 (percentages)



Source: ILO (2019)

Efforts at economic diversification could be made more daunting if new technologies and automation encourage a reshoring of manufacturing production to developed economies. However technological change and globalisation are also 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 (Hallward Driemeir and Nyaar, 2017). The recent years has seen countries at all levels of development witness a significant expansion of the role of services in their economies, with technological change a prime driver of what has come to be called the “servicification” of the world economy (National Board of Trade, 2010).

Technological innovations in services such as mobile communications and associated value-added services (e-commerce, e-payments), access to cloud computing and data storage are rapidly changing the very economics of services delivery and the geography of trade and investment in the sector. In the future, Baldwin (2018) describes ‘virtual presence’ technology and instant machine translation that could enable talented foreigners sitting abroad to provide services in offices and workspaces based in other countries. These developments hold potentially major welfare consequences for households, and for women in particular. They can greatly enhance the ability of small firms to contest markets and supply new products by improving access to information and the potential to deliver goods and services to consumers/buyers on a much greater scale. New technologies allow small firms to sell into global markets as well as to supply services to larger firms that participate in regional and global value chains and to domestic consumers (ITC, 2018). These trends illustrate the relevance of ongoing discussions on e-commerce and micro-, small- and medium-sized enterprises (MSMEs) in the World Trade Organization and their increasing prevalence in latest generation preferential trade agreements (PTAs).

Box 5.1. Chile and Zambia: contrasts in diversification trajectories

Chile and Zambia are both abundant in copper deposits and copper is both countries’ main export product. They also share similar population size but differ significantly in their income levels. Chile’s per capita income (PPP) is over USD 21,000 while Zambia’s is just over USD 3,800. Fifty years ago, both countries produced similar amounts of copper. Both countries have also had similar patterns of copper deposit ownership, with their state-owned companies playing a major role. Yet their longer-term economic performance has been vastly different. Chile has steadily increased copper production while Zambia has remained stagnant, although there has been a recovery since 2000. Whereas Chile progressively lessened its level of resource-dependence, Zambia became more resource-dependent: copper currently represents 50% of Chilean exports while accounting for 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 processed products and complementing this 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 and wine production). In addition, Chile set up mechanisms that allowed it to save the rents from mineral extraction and invest in critical growth expenditures. Specifically: (i) a structural fiscal surplus rule that sterilizes the country’s spending levels against copper fluctuations. This ensures macroeconomic stability and also generates accumulation of wealth when copper prices are high; and (ii) sovereign funds to administer the rents saved. Chile invested a significant amount of savings on training in advanced skills (i.e. 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. Sustained growth and continued political stability have produced only modest improvements in Zambian 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 has done little to create jobs and expand opportunities beyond the relatively small labour force already employed in these industries. 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).

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 or the shackles of geography. In many developing countries, the extractive industries sector is both shaped by and, in turn, influences political dynamics. A focus by policymakers on short-term rents from resources and their allocation to ensure political survival has sometimes distracted from policies and investments necessary to sustain growth in the long-term and has often been associated with increased internal conflict, with adverse effects for diversification. Nevertheless, some resource-rich countries have been able to diversify successfully. Resource rich countries can tax the rents from commodity extraction to fund critical investments in human capital, infrastructure and institutional assets. Box 5.1 showcases the contrasted diversification trajectories of Chile and Zambia.

DEFINING ECONOMIC DIVERSIFICATION

Economic diversification can be defined as the shift toward a more varied structure of domestic production and trade with a view to increasing productivity, creating jobs and providing the base for sustained poverty-reducing growth. *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. For its part, *trade diversification* occurs in three ways: (a) the export (or import) of new products (goods or services); (b) the export (or import) of existing products to new markets, and (c) the qualitative upgrading of exported (or imported) products.

Trade diversification, quality upgrading and the sectoral diversification of domestic production are often closely linked. Trade is often a 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 stabilise 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).

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

Firstly, there has been an increasing focus on *firms* and firm-level characteristics and performance 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 enjoy productivity and wage premia relative to those that do not. Secondly, technological change and the secular decline in 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. Thirdly, pro-competitive regulatory reform and the decline of communication costs has enabled developing countries to greatly expand their participation in trade in services, many of which provide relatively high productivity activities compared to traditional agricultural or manufacturing activity. By supplying three in five jobs held by women worldwide, and four in five jobs within the G20 grouping accounting for 80 percent of global trade, the trend towards increasingly service-centric forms of development also shows important gains in inclusiveness (Lan and Shepherd, 2018; Sauvé, 2019).

The above considerations recall how concentrating on the output of manufacturing sectors may not be sufficient to identify the scope of opportunities for economic diversification. Furthermore, 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. This not only means a much richer menu for discussions on diversification but also the need for a more varied set of diversification metrics.

THE POLICY AND INSTITUTIONAL FRAMEWORK FOR DIVERSIFICATION

There is no magic recipe for diversification. There are, however, multiple paths to successful diversification. In countries at very low levels of economic development, the priority is typically to get the fundamentals right. As countries develop, multiple diversification paths may become available. Malaysia, for instance, was previously a primary commodity-based economy. Today it is integrated into global value chains across a wide range of (primarily manufacturing) 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). Long an exporter of a limited mix of agricultural commodities (bananas and unprocessed coffee), Costa Rica has made insertion in regional value chains and the attraction of FDI needed to sustain it a centerpiece of the country's development strategy over the past decades. At latest count, the country's export mix exceeded four thousand products, chief among which medical devices and IT components alongside a host of high value-added services. Much like Costa Rica, the United Arab Emirates are well-endowed with an efficient bureaucracy, stable macro-economic framework, good infrastructure, and a privileged location. It followed a diversification strategy focused on exporting new business services, exploiting agglomeration externalities and building a low-cost business platform (Gelb, 2010).

Everywhere, the trade and investment policy agenda lies 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. Development partners can assist developing countries to put in place the following key basic elements:

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

This approach provides an analytical base upon which a country can define a strategy to address the essential policy requirements for private-sector driven diversification. Each country should of course define its own route to a wider range of trade and production activities that reflects underlying endowments, comparative advantages and national characteristics, including the profile of poverty, availability of skills, institutions and governance conditions and prevailing political economy constraints. This will typically lead to a mix of cross-cutting, sector-focused and geographically targeted measures that will vary across countries, ideally defined in close consultation with the private sector (domestic and foreign) and regularly fine-tuned as the development process unfolds. For example, the route to diversification for a small resource-rich country with relatively high wages will likely be very different to that of a large resource rich country with low-wages.

The approach described above also provides a general step-wise sequencing of priority measures. The initial focus should be on addressing a country's incentive framework. There will be little point in investing heavily in infrastructure to reduce trade costs or in developing measures to support the movement of resources or targeting specific market failures if the incentive framework remains highly distorted and there is a strong bias against exports or if the sectors face significant entry barriers in the form of tariff or non-tariff barriers. In this case, active policies are likely to exacerbate the misallocation of resources. On the other hand, in countries that have been able to put in place an appropriate incentive structure and have efficient backbone services and relatively low trade costs, the policy focus can turn more to facilitating adjustment and targeting more specific market failures.

The sequencing of policies targeted at economic diversification should also take account of the implementation capacity of governments. For example, the implementation of industrial policies has often been undermined by imperfect knowledge of the externalities and spillovers that warrant sector specific interventions and the vulnerability of such interventions to corruption, manipulation, and rent-seeking conduct. Countries with weak institutions and limited capacity to implement complex policies, typically those with lower incomes, will tend to face greater risks when implementing industrial policies as opposed to focusing limited resources on removing disincentives to diversification and delivering essential public goods.

Countries with weak institutions often face significant political economy challenges in implementing a diversification strategy. Countries with a limited economic base, especially when dependent on high-value minerals, will often see political activities focused on rent-seeking behaviour and efforts to capture available economic rents. Despite strong economic arguments for the long-term benefits of diversification, this environment makes it difficult to implement necessary economic reforms. Successful strategies for diversification will therefore be based on a careful understanding of the underlying political environment, the main actors and how they wield power, the institutions that influence how that power is moderated and the potential impact of external factors, including regional institutions and partners such as the World Bank and other development agencies. For many countries, compliance with WTO disciplines, acceding to the world trade body, regional integration schemes and deep preferential agreements entered into with key trading partners can all represent powerful anchoring mechanisms to overcome domestic resistance to change by providing binding commitments that help to lock in reforms necessary for diversification.

Effective collaboration between development partners and international organisations is essential to support the implementation of a diversification strategy. There are a range of issues that require working together in partnership, 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. The 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 issues.

THE INCENTIVE FRAMEWORK FOR DIVERSIFICATION

The World Bank Group's experience in advising governments on economic diversification suggests that there are three key areas of economic incentives that intersect to affect the framework for diversification. These are: i) business regulation and investment policy; ii) trade policy design; and iii) competition policy.

Business regulation and investment policy

Clear, transparent and predictable business regulation that provides a level playing field among investors - small and large, domestic and foreign - are essential for economic diversification. Business regulations such as those governing credit markets, the hiring and firing of workers, quality standards, the procedures and licenses required to start a business, contract enforcement and insolvency – all form an essential part of the incentive framework to encourage investment in new activities. In environments with a poor investment climate, the lack of competitive domestic suppliers, combined with inefficiencies in factor markets and institutional capacity constraints, hinder diversification (Farole and Winkler, 2012). There are three main ways in which business regulation and the investment climate condition the incentives towards diversification:

- *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 market entry. 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 towards more efficient uses. Restrictive entry regulations disproportionately penalise industries characterised by greater experimentation, such as ICT-intensive sectors (Andrews and Cingano, 2014; Aghion et al., 2006).
- *By affecting day-to-day business operations and investment decisions.* These include tax regulation, credit market and labour market regulation. 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 (Bartelsman et al., 2010; Hsieh and Klenow, 2009). Similar outcomes may arise when inefficient firms, including state-owned enterprises are propped up through distortive subsidy practices.
- *By providing a predictable and transparent business environment, reducing the risks associated with testing new products and markets.* Effective enforcement of rules and sound intellectual property rights enable firms to internalise 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 characterised by irreversible investments (Baker et al., 2015; Bartelsman et al., 2010).

Trade policy

The nature and structure of protection in overseas markets shape the opportunities for export diversification in developing countries. This is especially so if overseas protection is biased towards products in which a country enjoys a comparative advantage. For example, tariff escalation (the cascading of import tariffs according to the degree of processing) in developed countries has long constrained opportunities for developing countries to add value to and develop additional activities around agricultural and mineral products.⁴ Similarly, for light manufacturing, import tariffs on products such as clothing and shoes are typically much higher than those on textile fabrics and leather. To some extent, this constraint has been alleviated by multilateral trade liberalisation through the WTO which has reduced tariff peaks in rich countries and through the provision of non-reciprocal tariff preferences for developing countries, although the latter are frequently undermined by unduly restrictive rules of origin. Nevertheless, an important challenge for developing countries, especially the poorest, is to better leverage trade preferences to drive export diversification.

Regional integration and deepened South-South trade also represent effective mechanisms to increase new market opportunities for exporting firms. Diversifying exports to higher income markets is often more difficult than diversifying exports to regional markets. Standards are often higher, requiring larger investments to raise quality and meet higher health and safety requirements (ITC, 2016). Developed country buyers may also demand very large consignments, requiring substantial investments in capacity. For this reason, diversification through exports to nearby countries with similar tastes and regulatory requirements – and hence potentially lower compliance costs – may prove easier. So will South-South trade. Expansion in such markets can then provide the springboard for enlarged access to the 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 to export diversification and to sustained insertion in regional or global production networks. 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 equivalence) between the effects of an import tariff and an export tax on domestic relative prices. 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 non-traded goods and shift production away from exports. Also, tariffs on intermediate inputs used by exporters in the absence of well-functioning duty drawback schemes increase the cost of producing goods for export and therefore, will reduce output of tradable goods. Tariffs on intermediates are of central importance to successful participation in regional and global value chains.

It is also important to address non-tariff measures (NTMs) 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 export-related requirements for exporting can undermine the survival rates of exporting firms. 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. NTMs 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 needed disciplines on discriminatory regulatory measures and a forum for challenging regulations that arbitrarily discriminate against suppliers through the TBT Agreement and non-science-based food safety, animal and plant health measures through the SPS Agreement.

More recently, the WTO Trade Facilitation Agreement provides a mechanism for the global adoption of best practices regarding customs procedures as well as a forum to challenge discriminatory practices. Preferential trade agreements that include provisions for harmonisation or mutual recognition of product standards can also help reduce the costs associated with regulatory diversity and support diversification.

Services trade policies can spur diversification through the expansion of services exports. They can also promote the diversification of goods exports through improved access to a wider range of more efficiently produced services inputs. High costs for energy, telecoms, logistics, and finance, erode firms' competitiveness and deter them from diversifying production and exports. As countries develop, service sector liberalisation can help firms to meet supply requirements, diversify, and integrate into global value chains in goods and services markets alike. Efficient services are also crucial for taking advantage of modern distribution channels. For example, producers are increasingly using e-commerce to sell directly to consumers through web-based outlets. However, diversification toward services exports can be hampered by regulatory diversity. Regulatory heterogeneity affects the fixed cost of entry into a new market as well as the variable costs of servicing that market (Kox and Nordas, 2007). To address this challenge, service sector reforms should go beyond trade openness by focusing on the simplification, harmonisation, approximation or mutual recognition of domestic regulations. (Gari, 2018; Polanco Lazo and Sauvé, 2017).

Rwanda's recent development trajectory illustrates the economy-wide benefits that can derive from a determined focus on diversification and value addition anchored in trade policy (see Box 5.2).

Box 5.2. Rwanda's export diversification path

Rwanda's policy framework has enabled it to successfully diversify exports while simultaneously raising the value of traditional commodity exports. Rwanda succeeded in growing its exports by about 20 percent annually from 2000 to 2016. Over the period, exports have become less dependent on the country's three traditional export products: tea, coffee and minerals. While their export share dropped from 41 percent to 25 percent, their overall export value more than tripled, from USD 415 million to USD 4,125 million. Trade policy focused on value addition has helped to mitigate the impacts of swings in international commodity prices. This is exemplified by the government's coffee strategy, whose focus on improving quality has increased farmgate prices for certain varieties by a factor of 5. Such efforts helped to offset drops in international prices between 2011 and 2015. By continuing to increase value-addition, Rwanda has laid the foundations for resurgent farming earnings once commodity prices rebound.

Rwanda has similarly transformed itself into a services economy, with aspirations to overcome the country's landlocked status by developing it into a regional hub for professional and business services. Half of Rwanda's export earnings already come from services, with mountain gorilla tourism leading the way, followed by transport, ICT, construction and finance. Meanwhile, the improving quality and range of domestic services inputs contributes importantly to the country's rising competitiveness in goods exports.

Rwanda's non-mineral industrial sector has also started exporting, particularly for agro-processing. While light manufacturing has remained broadly constant in export share, the value of exports has witnessed a fourfold increase since 2005, reflecting a rise in exports in a number of new industries, including apparel and leather products, mechanical appliances and beverages.

Regional markets have played an important role in sustaining Rwanda's diversification efforts. The country saw a considerable increase in intra-regional goods trade following its accession to the East African Community (EAC) in 2009, with improved connectivity to the ports of Mombasa (Kenya) and Dar es Salaam (Tanzania) playing a key role. While conflict in the Democratic Republic of Congo (DRC) limited trade prior to 2007, greater regional stability has seen a marked pick-up in commercial ties. By 2016, Rwanda exported more goods and services to the DRC than to the EAC.

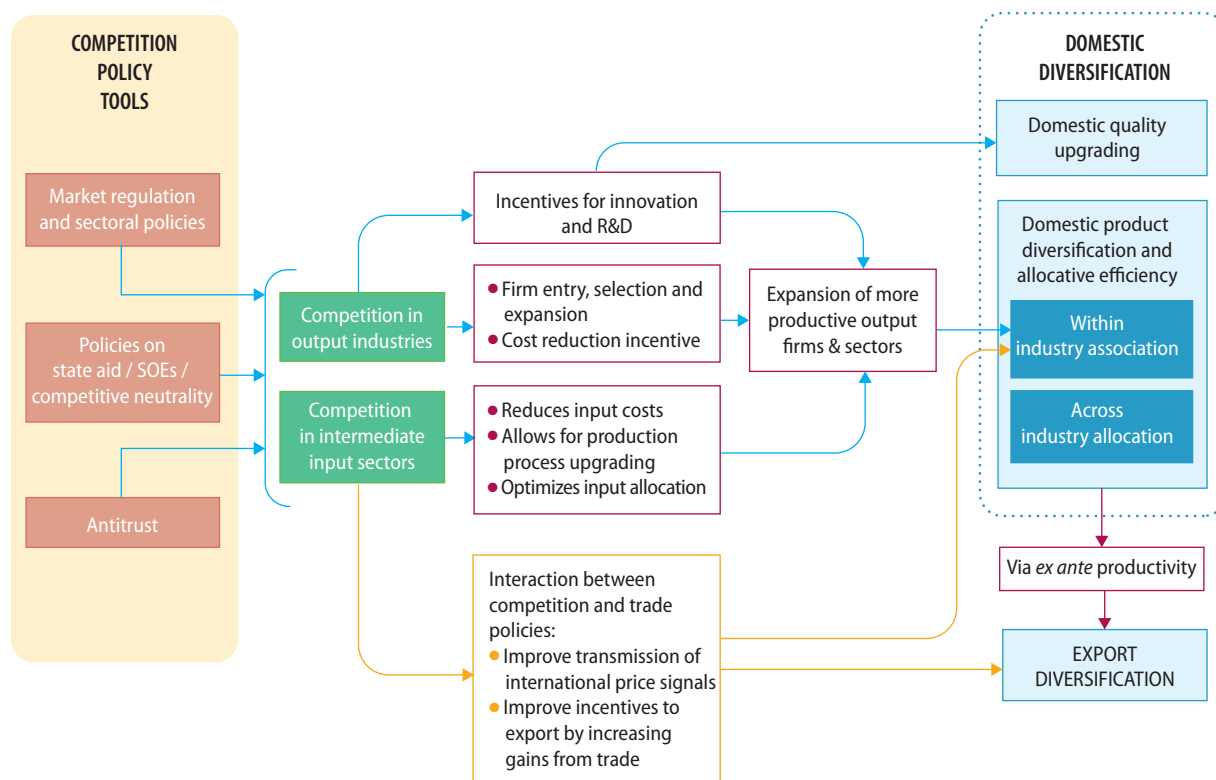
Source: World Bank (2019).

Competition policy

Competition policy plays an important role in the expansion of an efficient and diverse private sector and 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 behaviour can seriously inhibit the scope and incentives to innovate and diversify (see Figure 5.4). 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 dominant market positions 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 also encourages “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 5.4. Competition policy and economic diversification



Source: World Bank and OECD (2017).

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 fertiliser, cement, energy, finance and telecommunication markets), are often saddled with entry barriers and anticompetitive behaviour, due to economies of scale, network effects and the presence of state-owned enterprises.

Fostering greater competition among service suppliers can prove especially important to lowering prices for consumers and producers alike. While a host of other factors – small scale, weaker collateralisation of intangible assets, inadequate access to finance, regulatory deficiencies – contribute to service sector inefficiencies, studies show that the pay-off from increased competition and efficiency could be large. Scaling up services trade provides double benefits: services exports represent a potentially important source of foreign exchange earnings that underpin diversification efforts. Meanwhile, services imports can lead to greater competition, lower prices and increase quality, enhancing efficiency gains and competitiveness in the process (Roy, 2019). Hoekman and Shepherd (2015) argue that the greater contestability of services markets improves overall allocative efficiency by producing significant benefits for downstream users, particularly in manufacturing. Using cross-country data for the world and East Africa, they find that a 10 percent reduction in a country's services policy stance (as measured by the World Bank's Services Trade Restrictive Index (STRI)) is associated with a 4.4 percent increase in manufactured exports from a country such as Rwanda.

Competition policy reforms can have tangible impacts on diversification, as the following examples show:

- In India, downstream manufacturing firms diversified production following far-reaching services reforms enacted in the 1990s that promoted competition in key input markets (in particular, the liberalisation of telecommunications, 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, promoted the entry of new small businesses and resulted in significant gains in financial inclusion.
- In Honduras, competition policy reform promoted the entry of new firms in agricultural input markets (fertilisers and pesticides). The reform eliminated discretionary procedures and reduced the registration time from three years to ninety days. Since the reforms were enacted, three hundred new products were registered, and the price of some pesticides fell by 9 percent.
- In the 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 significant 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 IMPERATIVE OF REDUCED TRADE COSTS

The single most important determinant of long-run trade growth is reducing the cost of getting goods to market – and securing inputs for local producers at lowest cost. For landlocked and small island economies, transportation costs inflate the costs of exporting and of sourcing inputs by up to 50 percent. While distance remains the most important source of trade costs, the lack of facilitation at borders, the fragmentation of supply chains and limited access to affordable air cargo opportunities or land transport corridors all contribute to the high cost of trading across borders (Rastogi *et al.*, 2014). Investing in trade-related infrastructure, coordinated with relevant policy reforms and better governance, is key to help reduce trade costs and support more diversified trade. 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). In LDCs, the focus should be on ensuring that basic port, border and connecting transport infrastructure is in place. Best practices from trade and development projects implemented by the World Bank and other development partners show the importance of coordinating such infrastructure interventions with aid-for-trade support targeted at: (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 all 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 an area where performance improvement can support the diversification priorities of developing countries. Available empirical evidence suggests that export concentration is often associated with poor logistics (World Bank, 2017). A range of studies have indeed 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 (Huria and Brenton, 2016).

The trade logistics sector is often characterised by regulatory and institutional fragmentation and a lack of coordination that 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. It also aggravates the competitive disadvantage faced by some countries by virtue of their geographical position.

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 remain in a number of countries, there has been a degree of liberalisation 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. Full implementation of the WTO's Trade Facilitation Agreement and deepened liberalisation commitments in the cluster of transport and logistics-related services noted above assume particular importance as policy complements in this regard.

INTERVENTIONS THAT TARGET SPECIFIC MARKET, POLICY AND INSTITUTIONAL FAILURES

Effective government interventions to support economic diversification require a fluid dialogue and close coordination with the private sector – both domestic and foreign. 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 best able to 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 often inherent in public-private interaction. As institutional capabilities vary greatly across countries, policymakers must be mindful of policies that match their existing capabilities. Types of government interventions that can support diversification include the following elements:

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 such as difficulty in gaining information on product standards in 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 products. When such information is not readily available, export promotion agencies can usefully fill the gap. These institutions can notably 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. While some agencies have made strong contributions to the export performance of their sponsoring countries, such models are not always easily replicable. 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 may need to incorporate sunset clauses and reward rather than pick winners (Lederman *et al.*, 2010). Second, export promotion agencies work best when they function autonomously, flexibly, and maintain open communication channels with private actors to support a demand-driven strategy. Third, export promotion activities are best financed through general revenues rather than through taxes on exports.

Investment promotion agencies

Investment policy and promotion efforts can support diversification by attracting greater volumes of foreign direct investment (FDI). Good practice is to refrain from using *mandatory* local content requirements (Sauvé, 2016); to promote policy coherence between FDI linkages to local firms and investment incentives, notably through well designed supplier development programs (see Box 5.3); and to provide a host of investor “after-care” services, including those targeted at anticipating possible sources of tension between host countries and foreign firms (World Bank Group 2018). 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 stocks (Qiang *et al.*, 2015). International investment disciplines, particularly those embedded in PTAs, have been shown to increase FDI in participating countries. But restrictions on foreign acquisitions, discrimination in licensing, restrictions on the repatriation of earnings, and inadequate legal frameworks to appeal regulatory decisions can easily deter foreign investment.

Box 5.3. Stimulating product upgrading through supplier development programs

An increasingly effective means to increase exports is to deepen the domestic supply chain of value added. To the extent that domestic suppliers can substitute for imports now going into exports, increasing value added contributes to embodied exports. Doing so typically requires quality upgrading to improve linkages between domestic suppliers and large international ‘anchor’ firms. This is particularly important because anchor firms often have detailed technical and quality requirements for their supplies which may differ from generic quality certification. Globally recognisable producers with brand names to uphold often require suppliers to comply with additional private standards linked to social, environmental, labour, gender or safety norms which may exceed national legal requirements (UNIDO, 2013; Steenbergen and Sutton, 2017).

A supplier development program can help develop domestic supply chains and promote important host country FDI spillovers. This is done by bringing large anchor firms and potential local suppliers together, a task which investment promotion agencies are well placed to perform, and then providing additional support and incentives to ensure that suppliers get the appropriate training and upgrading assistance to ensure that their products meet the quality standards of the anchor firm. Chile’s Supplier development program offers a model of ways to foster domestic supply chains in a market supportive way. The program eschews mandated (and WTO non-compliant) rules for value-addition but focuses instead on improving commercial linkages between SMEs and large foreign customers through various ‘marriage counselling/matchmaking’ services, subsidised credit and other fiscal incentives to promote linkages. Arraiz *et al.* (2013) found that this program was significantly effective in increasing sales, employment and the survival rates of SME suppliers. Similar programs have been launched in El Salvador, Colombia and Malaysia.

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 linkages 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 neighbouring countries, who generally know the receiving country better. 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 (focusing on export-oriented production).

As noted above, 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, enhances access to distribution networks and sources of finance. Low and middle-income countries that succeed in attracting “efficiency-seeking” FDI have greater success in diversifying their export structure.

For example, in Honduras, FDI played a role in jumpstarting the country's light manufacturing sector 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, taking advantage of closer regional ties (within the NAFTA) to insert local producers into the continental production networks operating in the sector.

The impact of FDI on diversification also depends importantly on *host* country conduct. Countries with less education or larger technological gaps generally find it more difficult to extract spillovers from inward foreign investment. The impact that foreign investment exerts on the overall economy ultimately depends on the quality of the business environment. All things equal, countries with better 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 IT sectors have helped raise diversification of production and improve the productivity of workers and firms, including those that operate outside the FDI attracting sectors.

Spatial Policies

Spatial Policies (SPs) can play an important role when growth is not regionally balanced and certain areas within countries lag behind (Moreira *et al.*, 2013). SPs involve policy interventions which aim to stimulate the economic development of specific locations within a country by attracting the emergence of productive and innovative firms. The key characteristics of SPs are that they: (i) target a specific area; (ii) are tailored to the specific context and history of a locality; (iii) aim to overcome coordination failures between different actors; and (iv) frequently involve stakeholders at the national and local levels in the assessment, design and implementation stages. These activities can be organised around four types of interventions: (i) growth poles; (ii) special economic zones; (iii) economic corridors; and (iv) clusters.

Growth Poles emanate 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 labour and infrastructure, all the while minimising the costs of providing public goods and services. In growth poles, strategic public investments in infrastructure 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 neighbouring areas through the diffusion of these activities.

Special Economic Zones (SEZs) have been used to support diversification. SEZs are typically established to achieve one or more of the following aims: (i) attracting FDI; (ii) serving as "pressure valves" to alleviate large-scale unemployment; (iii) supporting a wider economic reform strategy; and, (iv) acting as experimental areas for the application of new policies and approaches (Farole, 2011). SEZs, such as export processing zones or industrial parks, 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 attract investment that exploits a key source of comparative advantage—typically low-cost labour in developing countries. For example, in addition to successful examples from China and Malaysia, economies such as the Dominican Republic, Honduras, Republic of Korea, Madagascar, Mauritius, Chinese Taipei and Vietnam have all 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 (Lederman and Maloney, 2012). The success of SEZs requires a flexible approach that is not based solely on fiscal incentives, limited labor regulations and wage restraint but encompasses a broader approach to providing an effective business environment and building firm-level competitiveness, linkages with the domestic economy, innovation and social and environmental sustainability.

Economic Corridors are characterised by the 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.

Clusters are geographic concentrations of interconnected companies and institutions in a particular sector. 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 specialised 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. Collaboration mechanisms can include 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. Pooling resources to enhance the quality of the cluster products and improve their commercialisation and marketing offers another example. Local research centers, universities or consultancies also often provide industry-specific training programs and basic and applied research relevant to the cluster. Government agencies can provide support to 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, too great 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 specialisation of existing ones. Facilitating networking platforms in order to improve coordination and generate knowledge spillovers, 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.

POLICIES TO SUPPORT ADJUSTMENT

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 – telling examples include the growth of India’s software industry, the increased sophistication of China’s exports as well as rising exports of business services from the Philippines (Agosin *et al.*, 2012). However, high enrolment rates in secondary and tertiary education do not automatically translate into high-quality learning. Skills development depends on the quality of educational inputs and a focus on learning outcomes. Secondary schools and universities may produce graduates with narrow skills or with specialisations in fields that are no longer in high demand. Alignment with labour market demand is critical to address skill mismatches and support economic diversification. Addressing such mismatches is proving particularly important as a determinant of digital uptake.

Improving public-private coordination is required to better identify the skills needed for current and future labour 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 skill-sets. 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 globalised markets in which they operate. Therefore, longer-term education and labour reform needs to be accompanied by improved systems for skills development, particularly vocational training. These systems need to be informed by the private sector so that they can deliver the range of skills that are relevant to evolving market demands 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 (Kazandjian *et al.*, 2016). Inequalities of opportunity, for example in education, constrain the pool of human capital upon which diversification can be driven. Discrimination that limits the volume and nature of labour force participation by women narrows the pool of talent from which employers can hire. It also limits the number of female entrepreneurs. Hence, identifying and addressing gender disparities and constraints in education, training, access to finance and information networks and in the labour market represent important elements of inclusive diversification strategies.

A well-functioning financial sector is a further key element 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. Deeper financial markets and the diversity of funding sources they offer support diversification into more complex goods and greater varieties. They do so by allowing firms to access long-term capital financing and by funding riskier investments. In Africa, for example, shallow financial sectors have been a major obstacle in efforts to diversify economies, as firms become unduly reliant on a narrow range of risk-averse lenders, typically banks. Obstacles in the financial sphere include complex credit application procedures, lack of collateral, high lending costs, inadequate venture capital and non-bank sources of funding, and short maturities against the backdrop of low financial capability which prevent firms from accessing finance.

Policies that support innovation and entrepreneurship and the reallocation of resources to innovating firms can be important in supporting the move to a wider range of higher quality of goods and services. Investing in innovation increases firm capabilities, facilitating the adoption of new technologies that improve productivity and product quality. Both product and process innovation can help firms to diversify by reducing production costs and freeing up resources that could be redeployed into innovative activities.

FINAL THOUGHTS

This chapter's discussion of the diversification challenges and paths taken by a range of developing countries suggests that no single formula exists that can promote an orderly process of structural change able to enhance the resilience of economies to external shocks and provide citizens with the more productive employment opportunities they crave. Policy must always and everywhere adapt to the specific circumstances, differing geographies and endowments, and contrasted institutional, governance and implementation capacities of countries at differing levels of development. The success of diversification efforts ultimately depends 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 any given country. Investments in skills, infrastructure, institutions and governance quality (i.e. 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.

While every country follows a different path to diversification, a number of common features are apparent from successful cases of sustained trade-led structural change. The experience of several countries suggests the following are important drivers of successful diversification efforts:

- (i) a broad level of political commitment within government and societal support towards the goals of economic development, poverty reduction and social stability;
- (ii) a focus on export growth, FDI attraction and on increasing the range of goods and services exported;
- (iii) the importance of a strong, technically capable administration to manage the diversification process;
- (iv) the presence of influential stakeholders with interests in non-mineral exportable sectors, to offset in part the political influence of the dominant sector(s);
- (v) the importance of building both human capital and institutional capacity (Gelb, 2010).

In many instances, sustaining a diversification drive will require a multi-pronged approach targeted at stimulating exports of agricultural and manufacturing products and services. In most country settings, no single sector can (nor should) provide the necessary export growth on its own. Similarly, there are important and growing interdependencies between sectors, notably between services and manufacturing, that prevent any sector from growing too large without sufficiently competitive inputs from other sectors.

While the current global environment creates daunting challenges for poor, small, landlocked and/or resource-dependent countries, this chapter has shown that a range of diversification routes can be followed. For such routes to prove successful, however, policy attention needs to be paid to four key determinants of diversification strategies which development partners and International Organisations can support through targeted aid-for-trade interventions. These are:

- (i) the supply of appropriate incentive frameworks;
- (ii) investments and policy reforms targeted at reducing trade costs;
- (iii) effective policies to support adjustment and the reallocation of resources towards new activities; and
- (iv) government interventions directed at specific market, policy and institutional failures

NOTES

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2. The Herfindahl index (also known as Herfindahl–Hirschman Index or HHI) is a measure of the size of firms in relation to the industry and an indicator of the amount of competition among them. Named after economists Orris C. Herfindahl and Albert O. Hirschman, it is an economic concept widely applied in competition law analysis. The HHI is defined as the sum of the squares of the market shares of the firms within the industry where the market shares are expressed as fractions. The result is proportional to the average market share, weighted by market share. As such, it can range from 0 to 1.0, moving from a huge number of very small firms to a single monopolistic producer. Increases in the Herfindahl index generally indicate a decrease in competition and an increase of market power, whereas decreases indicate the opposite.
3. In low-income countries, 63 per cent of workers were still employed in the agricultural sector in 2018, down by just 8 percentage points since 1991 (see Figure 1).
4. The growing vibrancy of South-South trade has drawn increasing attention to the fact that the tariff structure of large emerging countries also features punitive elements of tariff escalation.
5. One probing example is the Southern Agricultural Growth Corridor of Tanzania ("SAGCOT"), a public-private partnership initiated at the World Economic Forum (WEF) Africa (WEFA) Summit in Dar es Salaam in 2010 and whose implementation period runs for 20 years up to 2030. Its ultimate objective is to boost agricultural productivity, improve food security, reduce poverty and ensure environmental sustainability through the commercialisation of smallholder agriculture. See <http://sagcot.co.tz/>

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