



THE IMPORTANCE OF ECONOMIC DIVERSIFICATION

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ABSTRACT

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.

Keywords: Diversification, Economy, Globalization, Demand, Supply.

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: trade diversification (i.e. exporting new or better products, or to new markets) and 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 Organizations can support through targeted Aid for Trade interventions. These are: the supply of appropriate incentive frameworks; investments and policy reforms targeted at reducing trade costs; effective policies to support adjustment and the reallocation of resources towards new activities; and government interventions directed at specific market, policy and institutional failures.





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. Such a trend is perhaps most visible in global labour markets.

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.

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.

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:

- 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. 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.
- 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.
- 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.

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