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Changing Trade Costs between People's Republic of China and India

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Douglas H. Brooks is Assistant Chief Economist, and Benno Ferrarini is Economist in the Economics and Research Department, Asian Development Bank (ADB). The views expressed in this paper are those of the authors and do not necessarily reflect the views or policies of the ADB or its Board of Governors or the governments they represent. The authors thank William E. James and an anonymous referee for their valuable comments; and Maria Cynthia Petalcorin for the excellent research assistance.

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Abstract

This paper calculates the decline in costs involving merchandise trade between the People's Republic of China (PRC) and India during the period 1980–2008. Drawing from the recent literature, a comprehensive measure of trade costs is derived from a theory-founded gravity model of international trade, which can be computed on the basis of observed bilateral trade flows and gross domestic product data. The analysis reveals that trade costs have declined sharply since the 1980s, accounting for a large and increasing portion of growth in total trade between the two countries. Whereas the reduction of trade costs accounted for less than one third of the increase in trade between the PRC and India during the 1980s, lower costs seem to explain about three quarters of trade expansion during the 1990s, and up to nearly 85% in 2001–2008.

I. Introduction

Prior to the Industrial Revolution, Asia accounted for the bulk of the world's economic activity. Over the last 200–250 years, the center of economic gravity shifted to Europe and eventually the regions bordering the North Atlantic. International trade played an important role in driving that shift and the rapid economic expansion of Europe and North America, raising unprecedented numbers of people out of poverty in the process. Trade growth, in turn, was driven to a significant extent by falling trade costs. Jacks, Meissner, and Novy (2008, 529) find “that trade cost declines explain roughly 55% of the pre-World War I trade boom and 33% of the post-World War II trade boom, while a precipitous rise in trade costs explains the entire inter-war trade bust.”

The sharp growth of Asia in recent decades suggests that the center of economic gravity is now shifting westward again, across the Pacific Ocean and back to Asia. In particular, the two most populous nations in the world, the People's Republic of China (PRC) and India, are experiencing a resurgence of economic activity. However, until recently there was little trade between Asia's two giants. That is now changing rapidly. In this context, it is useful to examine the dynamics of trade between these two countries and the role that changes in trade costs are playing in the process.

Bilateral and regional cooperation initiatives involving Asian economies have proliferated in the last two decades. Most attention focuses on agreements between governments to reduce policy barriers, but developments in infrastructure, product and transportation technology, support services such as financing, and trade composition have also had significant impacts. And as policy barriers are lowered further and further, the relative contribution of other aspects of trade costs become more important.

In this paper we calculate the decline in costs involving merchandise trade between the PRC and India during the period 1980–2008. The methodology is drawn from Jacks, Meissner, and Novy (2008) who derive a gravity-based measure of bilateral trade costs. We find that declining trade costs account for about three quarters of the increase in PRC–India bilateral trade volume between 1990 and 2008.

II. Measuring Trade Costs

Trade costs matter (Anderson and van Wincoop 2004). Broadly defined, they comprise the whole range of regulatory, transport, and distribution costs involving the transfer of goods from foreign producers to domestic consumers, and from domestic producers to foreign consumers. Essentially, trade costs are the relative costs of international versus domestic trade. Most trade cost components are difficult to quantify, limiting the scope for direct measurement and international comparison. Comprehensive data on trade policy measures, especially nontariff barriers, are unavailable across countries and time, neither are internationally comparable measures for transport and distribution costs.

To overcome these limitations, Anderson and van Wincoop (2003) derive a theoretically consistent gravity model to infer unobservable trade costs directly from observable trade flows.¹ Under the simplifying assumptions of a one-sector economy with consumers holding constant elasticity of substitution preferences, and common elasticity ε among all homogenous goods, their gravity equation is shown to resolve to:

$$X_{ij} = \frac{Y_i Y_j}{Y_w} \left(\frac{\tau_{ij}}{\pi_i \pi_j} \right)^{1-\varepsilon} \quad (1)$$

where X_{ij} denotes bilateral trade flows by products² from country i to j , and Y_i , Y_j , and Y_w represent the countries' and world total output, respectively. The main insight from Anderson and van Wincoop's gravity specification is that bilateral trade depends on relative trade barriers—that is, bilateral trade costs τ_{ij} in relation to multilateral trade barriers—rather than on some absolute measure of bilateral impediments to trade alone. In terms of equation (1) multilateral resistance to international trade is embodied in π_i and π_j , for countries i and j in relation to their trading partners.³ For example, the relationship postulated in equation (1) implies that an increase in inward multilateral resistance π_i , say a hike in costs by other suppliers to j , is associated with a rise in the trade flows by i to j , assuming that everything else stays the same and that the elasticity of substitution is greater than one, $\varepsilon > 1$. Similarly, an increase in country i 's outward multilateral trade costs π_j is shown to raise its trade with country j .

Anderson and van Wincoop (2003) base their estimation of the elasticity of trade flows to trade barriers on the structural formulation of equation (1). Moreover, they assume that trade costs are a function of bilateral distances and the presence of international borders, in order to circumvent reliance on actual price data quantifying the resistance variables, π_i and π_j . Based on a gravity model calibrated to the year 1993 for a sample

¹ Inference about trade costs is determined in conditional general equilibrium, with product markets for each good clearing in each country, conditional on income and expenditure allocations.

² To simplify notation, product-specific superscripts have been omitted from equation (1).

³ Inward and outward multilateral trade barriers being defined as average price indices weighted by trading countries' income shares (Anderson and van Wincoop 2004).

of 22 industrialized countries, they find that the presence of international borders reduces trade flows between Canada and the United States (US) by 44%. They also find that international trade among the other countries drops by 29% compared to borderless trade.

Other studies have attempted to gauge the strength of resistance factors more directly, for example through the construction of proxies for price indices as the ratio of trading nations' gross domestic product (GDP) deflators (Baier and Bergstrand 2001). Based on a sample of OECD countries over 30-odd years up to the late 1980s, they find tariff rate reductions and falling transportation costs combined to explain about 33% of increases in trade among these countries, with income growth explaining the rest.

In contrast to the estimation approach to the analysis of trade costs, Jacks, Meissner, and Novy (2008) demonstrate that there is a simple analytical solution to the gravity model of Anderson and van Wincoop (2003), which allows for bilateral trade costs to be determined computationally instead of being estimated. The solution to their "gravity redux" rests on the assumption that a country's total exports are inversely related to its trade barriers with other countries, which in turn is reflected in the amount of that country's trade within its own national boundaries, or economic activity. The equilibrium solution of their model yields a remarkably lean specification of the gravity model that can be solved directly for trade costs as a function of observable exports and income variables, suitable for direct calculation. More specifically, Jacks, Meissner, and Novy (2008) show that an "iceberg" measure of bilateral trade costs (τ_{ij}) can be derived as the geometric average of the ratio of bilateral trade flows and the product of the countries' intranational trade, defined as share of tradable goods in national income net of total exports:

$$\tau_{ij} = 1 - \left(\frac{X_{ij} X_{ji}}{\sigma_i (Y_i - X_i) \sigma_j (Y_j - X_j)} \right)^{\frac{1}{2\rho-2}} \quad (2)$$

In applying this formula, we have modified terms in the denominator so that Y_i and Y_j denote total income net of government expenditure of country i and country j respectively, X_i and X_j are the two countries' total merchandise exports, and σ_i and σ_j represent the shares of tradable goods in countries' total income. All the variables are expressed in constant value terms, i.e., deflated by country-specific GDP deflators. Refining the original specification proposed by Jacks, Meissner, and Novy (2008), equation (2) is shown to detract from national incomes, Y_i and Y_j , countries' government expenditure contribution to GDP, since it is assumed to be nontradable. This is to improve the accuracy of the trade cost measure, as Y_i , Y_j in equation (2) is being proxied by GDP, a value added concept from which economic activity in tradables is to be derived.⁴

⁴ The authors thank an anonymous referee for helpful comments about the issue of measuring the tradable share of GDP, including the suggestion to subtract government expenditure from GDP. For a discussion about measurement issues, see Novy (2008).

Equation (2) thus relates countries' multilateral resistance to their total exports, or their complement, that is the amount of national economic activity in (nontraded) tradables, or $\tau_i (Y_i - X_i)$ for country i . At constant bilateral trade costs, τ_{ij} , a fall in multilateral resistance as signaled by higher total exports, X_i and X_j , causes bilateral exports, X_{ij} X_{ji} , to shrink, and the national level of activity in tradables to rise, as trade is diverted to countries other than i and j . Put differently, as trade between country i and country j becomes relatively more costly, this must be reflected in lower bilateral trade flows, as picked up by the measure defined by equation (2). It should be noted that in the notation of equation (2), τ_{ij} is the iceberg trade cost, so called because it represents the proportion of trade value melted away or lost to the costs of transport. For ease of interpretation and to facilitate comparison with the costs of tariffs, this paper presents tariff equivalent trade costs, which are defined as $\tau_{ij}/(1 - \tau_{ij})$.

To assess the incidence of trade costs in the growth in trade volumes, equation (2) is restated as a function of bilateral trade flows,

$$X_{ij} X_{ji} = \sigma_i (Y_i - X_i) \sigma_j (Y_j - X_j) (1 - \tau_{ij})^{2\rho - 2} \quad (3)$$

Taking natural logarithms and first differences, after some rearrangement, the total difference in bilateral trade flows is broken down to two components, expressed on the right-hand side of equation (4): variations in bilateral trade flows due to trading partners' economic expansion or contraction, and changes in trade costs:

$$\frac{\Delta \ln(X_{ij} X_{ji})}{\Delta \ln(X_{ij} X_{ji})} = \frac{\Delta \ln((Y_i - X_i)(Y_j - X_j))}{\Delta \ln(X_{ij} X_{ji})} + (2\rho - 2) \frac{\Delta \ln(1 - \tau_{ij})}{\Delta \ln(X_{ij} X_{ji})} \quad (4)$$

Jointly, equations (2) and (4) provide the analytical basis for the calculation of trade costs in this paper. The next section implements this method for the case of the PRC and India, in relation to changes in the intensity of trade between these countries, as well as with their main trading partners.

III. The Decline in Trade Costs of the PRC and India

For the first half of the period since the PRC's revolution, its trade was determined more by politics and the needs of central planning than by market-oriented economic forces. In the second half, trade and its associated growth and investment expanded rapidly, with the country's accession to the World Trade Organization in 2001 marking a significant

milestone. Investment in infrastructure, in particular, helped to bring down trade costs (Ma and Zhang 2009).

In the case of India, opening of the economy can be roughly dated to the 1980s (Raghuram and Subramanian 2009). Real GDP growth has continued at about 6% per year since. Licensing regulations were loosened, and the private sector was allowed into previously prohibited activities. Following the 1990 foreign exchange crisis, more significant liberalization began with the reforms of 1991. Barriers to foreign trade were reduced, greater inward foreign direct investment was allowed, and supporting service sectors were liberalized.

The onset of negotiations for a free trade agreement began to increase trade facilitation between the PRC and India in 2005. On 21 November 2006, the PRC and India agreed to double their trade to US\$40 billion by 2010. By 2009, trade between the PRC and India already totaled US\$43.38 billion, an increase of 75% from 2006, according to data released by PRC's General Administration of Customs. Currently the PRC is India's second largest trading partner, while India is the PRC's ninth largest trading partner (Cao 2010).

A. Data Sources and Calculations

To compute trade costs, bilateral trade data were drawn from the IMF's Direction of Trade Statistics (DOTS) data on bilateral merchandise flows between the PRC and India; and between these countries and their major trading partners, namely, United States; Europe (France, Germany, United Kingdom); Japan; and ASEAN4 (Indonesia, Malaysia, Philippines, Thailand). For the case of trade flows between the PRC and India, we use the data as reported by either country, as well as compute average flows on the basis of the imports and exports figures reported.⁵ For the case of trade of the PRC and India with other trading partners, the analysis relies exclusively on the imports and exports data reported by the latter, assuming that their historical trade statistics offer greater consistency and reliability.⁶ Time series on countries' real GDP and GDP deflators as well as government expenditure data were drawn from the IMF's International Financial Statistics (IFS) and the World Bank's World Development Indicators (WDI). GDP deflators are used to derive trade flows in constant US dollar terms, which enter trade cost calculations jointly with the GDP series, also expressed in constant US dollars.

⁵ An exception to this is the data for the year 1980, for which DOTS does not include data for the PRC and for which only data by India were used.

⁶ All data used in this paper were downloaded during the month November 2009. The United Nations Commodity Trade Statistics Database (UN COMTRADE), accessed through the World Integrated Trade Solution in September 2009, offers longer time coverage of trade data between the two countries than the DOTS database. However, the availability of data for the PRC and India is patchy, particularly for the case of the former. The UN COMTRADE data cover the years from 1962 to 2008, with the exclusion of the years 1963, 1966–1976, and 1982.

We compute trade costs according to equation (2), and contributions to overall growth in trade according to equation (4), setting parameter values equal to $\rho = 11$ (the elasticity of substitution) and $\sigma_i = \sigma_j = 0.8$ (the share of tradable goods out of countries' GDP net of government expenditure and total exports). We thereby follow Jacks, Meissner, and Novy (2008) and Anderson and van Wincoop (2003), who in turn settle for these parameter values comparing a range of estimates available from the extant literature.⁷

The decomposition of the factors accounting for growth in trade among the countries in our data set is calculated according to equation (4), with variables taken at 2-year averages. This is to avoid having year-to-year fluctuations in GDP and trade data that distort the results. Overall growth in bilateral trade flows and the contributions of economic expansion and of shrinking trade costs are then assessed for three distinct time periods: 1980/1981 to 1989/1990, 1990/1991 to 1999/2000, and 2000/2001 to 2007/2008.

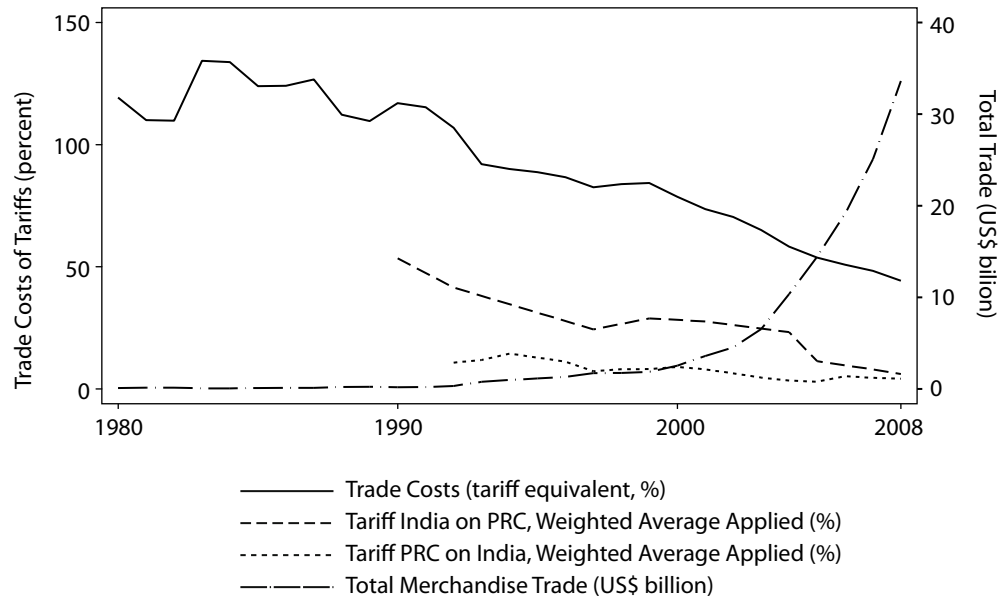
Finally, to gauge the influence of trade policy measures on overall trade costs over time, we compare our trade costs measure with bilateral tariff data, drawn from the UNCTAD Trade Analysis and Information System (UN TRAINS) database. Tariffs are taken at applied level, weighted by trade partners' share of imports by the PRC or India. The tariff series for the aggregate categories, e.g., for ASEAN4, are computed as averages weighted by the countries' share of total aggregate imports or exports to the PRC or India.

B. Empirical Findings

We highlight five main findings at this stage of analysis. First, there has been a substantial reduction in trade costs between the PRC and India, particularly since the early 1990s. In tariff equivalent terms, trade costs fell from 117.0% in 1990 to 44.3% in 2008 (Figure 1 and Table 2, first column.)

Second, falling trade costs were accompanied by a substantial increase in trade volume between the PRC and India. From virtually no trade until the late 1980s, trade between the two countries really took off only in the late 1990s, as the decline in trade costs steepened (Figure 1). Total trade flows accelerated throughout the 2000s, from US\$2,5 billion in 2000 to US\$33,6 billion in 2008 (Table 1).

⁷ Sensitivity tests with alternative parameter values (available upon request) show that the trade costs measure is not overly sensitive and the main conclusions reached are not strongly influenced by the assumptions made about parameter values.

Figure 1: PRC and India—Bilateral Trade, Tariffs, and Costs


Sources: IMF Direction of Trade Statistics, World Bank World Development Indicators, UNCTAD Trade Analysis and Information System.

Table 1: Bilateral and Total Exports (USD million)

Year	PRC to:		India to:	
	IND	WLD	PRC	WLD
1980	72	17,521	24	7,237
1985	88	27,136	29	7,283
1990	121	78,174	68	15,177
1995	811	162,221	354	29,707
2000	1,505	249,223	1,054	42,627
2005	7,733	645,807	6,717	78,155
2008	21,237	859,869	12,390	134,502

IND = India; PRC = People's Republic of China; WLD = World.

Note: Based on averages of exports and imports data reported by the PRC and India.

Source: IMF Direction of Trade Statistics (November 2009).

Table 2: Bilateral Trade Costs (calculated as tariff equivalent, percent)

Year	Between PRC and:					Between India and:			
	IND	JPN	US	EU3	AS4	JPN	US	EU3	AS4
1980	119.3	43.1	65.9	67.3	62.8	67.3	72.0	66.0	78.5
1985	124.0	39.8	64.9	61.5	65.6	66.0	73.9	62.8	80.8
1990	117.0	52.9	58.2	60.9	56.7	74.7	73.5	63.7	69.7
1995	88.7	46.1	49.6	54.5	50.5	78.6	71.2	59.6	64.6
2000	78.7	41.2	46.9	48.8	39.8	79.4	70.5	57.7	52.2
2005	53.8	30.3	37.3	39.3	28.4	75.9	64.2	50.4	47.8
2008	44.3	25.7	33.6	31.3	27.0	64.3	56.9	39.5	42.3

AS4 = ASEAN4 (Indonesia, Malaysia, Philippines, Thailand); EU3 = France, Germany, United Kingdom; IND = India; JPN = Japan; PRC = People's Republic of China; US = United States.

Source: Authors' calculations.

Third, the decomposition of factors accounting for growth in trade points unequivocally to lower costs as a determinant factor. This appears to be the case both for trade flows between the PRC and India and for these countries' trade with United States, Europe, Japan, and ASEAN4 (Tables 3, 4, 5).

Table3: Shares of GDP Growth and Lower Trade Costs in Trade Expansion between PRC and India (percent)

Period	Trade Expansion	Due to GDP Growth	Due to Lower Costs
1981–1990	137.0	71.4	28.6
1991–2000	1,025.7	26.8	73.2
2001–2008	852.0	15.1	84.9

Note: Based on averages of exports and imports data reported by the PRC and India.

Source: Authors' calculations.

Fourth, the bulk of trade cost reduction appears to be on the account of the PRC. Indeed, besides reducing its trade costs with India, the PRC managed to do so with most of the other trade partners or regions considered in this study (Table 2).

Fifth, India's bilateral trade costs with its partner countries appear to have fallen by proportionally less than the PRC's. Even after accounting for the PRC's generally lower trade costs than India's since the outset, the fall in trade costs involving the PRC as a trading partner is consistently more pronounced than that of India, in relation to all the trading partners (Table 2; compare also Table 4 with Table 5).

Table 4: Shares of GDP Growth and Lower Trade Costs in Trade Expansion between PRC and Its Trade Partners (percent)

Partner	Period	Trade Expansion	Due to GDP Growth	Due to Lower Costs
US	1981–1990	165.6	57.1	42.9
	1991–2000	290.2	49.8	50.2
	2001–2008	177.7	13.4	86.6
Japan	1981–1990	0.5
	1991–2000	191.3	39.4	60.6
	2001–2008	202.1	11.7	88.3
EU3	1981–1990	139.3	53.0	47.0
	1991–2000	206.6	44.4	55.6
	2001–2008	160.9	–7.4	107.4
ASEAN4	1981–1990	155.0	60.4	39.6
	1991–2000	248.5	26.1	73.9
	2001–2008	243.1	19.5	80.5

ASEAN4 = Indonesia, Malaysia, Philippines, Thailand; EU3 = France, Germany, United Kingdom; US = United States.

Note: Data are taken at 2-year averages (e.g., 1980/1981–1989/1990).

Source: Authors' calculations.

Table 5: Shares of GDP Growth and Lower Trade Costs in Trade Expansion between India and Its Trade Partners (percent)

Partner	Period	Trade Expansion	Due to GDP Growth	Due to Lower Costs
US	1981–1990	40.9	102.6	–2.6
	1991–2000	106.6	60.8	39.2
	2001–2008	156.7	19.0	81.0
Japan	1981–1990	–2.2
	1991–2000	2.3
	2001–2008	164.4	20.0	80.0
EU3	1981–1990	48.6	63.4	36.6
	1991–2000	93.4	48.4	51.6
	2001–2008	183.3	–1.4	101.4
ASEAN4	1981–1990	127.5	51.9	48.1
	1991–2000	208.4	12.3	87.7
	2001–2008	165.2	31.4	68.6

ASEAN4 = Indonesia, Malaysia, Philippines, Thailand; EU3 = France, Germany, United Kingdom; US = United States.

Note: Calculations are based on data taken at 2-year averages (e.g., 1980/1981–1989/1990).

Source: Authors' calculations.

IV. Conclusion

In this paper, trade costs for merchandise trade between the PRC and India were derived based on bilateral trade flows and GDP data. Trade costs were found to be declining, with the decline accounting for a large and increasing portion of bilateral trade growth over the 1980–2008 period, and about three fourths of the trade expansion since the early 1990s when bilateral trade flows were liberalized. While the PRC tariffs on imports from India have fallen, and Indian tariffs on imports from the PRC have dropped sharply, overall trade costs for the two countries have declined and bilateral trade has increased almost exponentially.

So far, the PRC has accounted for the bulk of the trade cost reduction. Considerable room remains for lowering trade costs further, particularly in India, where infrastructure investment appears to have tremendous potential. As Asia's two giants continue to increase their importance in the global economy and expand their trade, benefits are likely to spread throughout Asia and the world.

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About the Paper

Douglas H. Brooks and Benno Ferrarini find that merchandise trade costs between the People's Republic of China and India have declined during the period 1980–2008. Using a comprehensive measure of trade costs as derived from a theory-founded gravity model of international trade, and computed on the basis of observed bilateral trade flows and gross domestic product data, the paper reveals that trade costs have declined sharply since the 1980s, accounting for a large and increasing portion of growth in total trade between the two countries.

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ADB's vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region's many successes, it remains home to two-thirds of the world's poor: 1.8 billion people who live on less than \$2 a day, with 903 million struggling on less than \$1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.