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Trade and economic growth in developing countries: Evidence from sub-Saharan Africa

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Abstract

This study investigates how trade openness affects economic growth in developing countries, with a focus on sub-Saharan Africa (SSA). We use a dynamic growth model with data from 42 SSA countries covering 1980 to 2012. We employ the Pooled Mean Group estimation technique, which is appropriate for drawing conclusions from dynamic heterogeneous panels by considering long-run equilibrium relations. The empirical evidence indicates that a trade threshold exists below which greater trade openness has beneficial effects on economic growth and above which the trade effect on growth declines. The evidence also indicates an inverted U-curve (Laffer Curve of Trade) response, robust to changes in trade openness measures and to alternative model specifications, suggesting the non-fragility of the linkage between economic growth and trade openness for sub-Saharan countries. Our findings are promising and support the view that the relation between trade openness and economic growth is not linear for SSA. Accordingly, SSA countries must have more effective trade openness, particularly by productively controlling import levels, in order to boost their economic growth through international trade.

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1. Introduction

Trade liberalization has become widespread over the past three decades, particularly among developing and transition economies, as a result of the perceived limitation of import substitution-

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based development strategies and the influence of international financial institutions, such as the International Monetary Fund and the World Bank, which have often made their support conditional on trade liberalization. The fundamental rationale for this degree of commitment to a program of trade reform is the obvious belief that liberalization is a prerequisite to a transition from relatively closed to relatively open economies. Economists generally agree that open economies grow faster than their counterparts do (Grossman and Helpman, 1991; Edwards, 1993). If openness is indeed positively related to growth, it then follows that liberalization is a requirement for growth. Despite their early promise, recent experience suggests that not all trade reforms have been as successful as anticipated (Singh, 2010).

The relationship between trade openness and economic growth has been theoretically controversial. While conventional wisdom predicts a growth-enhancing effect of trade, recent developments suggest that trade openness is not always beneficial to economic growth. Increased international trade can generate economic growth by facilitating the diffusion of knowledge and technology from the direct import of high-tech goods (Barro and Sala-i-Martin, 1997; Baldwin et al., 2005; Almeida and Fernades, 2008). Trade facilitates integration with the sources of innovation and enhances gains from foreign direct investment. By increasing the size of the market, trade openness allows economies to better capture the potential benefits of increasing returns to scale and economies of specialization (Alesina et al., 2000; Bond et al., 2005). In their theoretical models, Grossman and Helpman (1991) show that trade openness improves the transfer of new technologies, facilitating technological progress and productivity improvement, and that these benefits depend on the degree of economic openness. This consensus rests on the assumption that trade creates economic incentives that boost productivity through two dynamics: in the short-run, trade reduces resource use misallocation; in the long run, it facilitates the transfer of technological development. Trade liberalization can also force governments to commit to reform programs under the pressure of international competition, thus enhancing economic growth (Sachs and Warner, 1995; Rajan and Zingales, 2003). Trade liberalization in developing countries has therefore often been implemented with the expectation of growth stimulation.

However, endogenous growth models postulate that the contribution of trade to economic growth varies depending on whether the force of comparative advantage orientates the economy's resources toward activities that generate long-run growth or away from such activities. Moreover, theories suggest that, due to technological or financial constraints, less-developed countries may lack the social capability required to adopt technologies developed in more advanced economies. Thus, the growth effect of trade may differ according to the level of economic development. Despite its potential positive effect on growth, some theoretical studies claim that trade openness may hamper growth. For Redding (1999), Young (1991), and Lucas (1988), opening up to trade might actually reduce long-run growth if an economy specializes in sectors with dynamic comparative disadvantage in terms of potential productivity growth or where technological innovations or learning by doing are largely exhausted. For such economies, selective protection may foster faster technological advances.

The empirical analyses are as inconclusive as the theoretical perspectives. Some studies have identified a positive association between trade openness and economic growth (Chang et al., 2009; Kim, 2011; Jouini, 2015), while others have found no association, or even a negative association (Musila and Yiheyis, 2015; Ulaşan, 2015). The literature is inconclusive partly because different analysts use different proxies for liberalization or trade openness and rely on different methodologies. The evidence for growth enhancements through trade liberalization displays mixed effects because of problems with misspecification and the diversity among the liberalization indices used.

Using cross-country data and initial real income per capita as the threshold variable, Kim and Lin (2009) found significant threshold effects in the relationship between trade and growth. Greater openness to international trade has positive impacts on economic growth for high-income economies.

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