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ScienceDirect
Journal of African Trade 2 (2015) 71 – 85

Original article

Differential effects of trade on economic growth and investment: A cross-country empirical investigation☆

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Received 21 March 2014; received in revised form 10 August 2015; accepted 10 August 2015
Available online 17 November 2015

Abstract

The paper empirically examines the differential effects of trade on economic growth and investment based on cross-country data. In general, the results are largely consistent with the positive impact of trade on economic growth as found in the literature. However, the empirical results based on different categories of countries show that whereas trade has positively impacted economic growth in developed and developing countries, its effect is insignificant for least developed countries (LDCs), which largely include African countries. Nonetheless, additional results suggest that trade is a key determinant of foreign direct investment (FDI) across all country groups including LDCs, as well as domestic investment in both developing countries and the LDCs. Consequently, first, the structure and pattern of trade in LDCs and African countries in particular should be transformed in order to obtain larger growth benefits as in the case of the other country groups. Second, trade, particularly via the investment channel, is an avenue through which LDCs, including African countries, can adopt new technologies and attract FDI to unlock their potential, e.g., by active integration into regional and global value chains.

JEL classification: F10; F40; F49; F43
Keywords: Trade; Economic growth; LDCs; Developing countries; FDI

☆ This paper was written while on a one-year attachment in the Office of the Director General at the World Trade Organization, under the Mo Ibrahim Leadership Fellowship Programme. I would like to thank Pascal Lamy, the anonymous reviewers and the chief editor of this journal for their helpful comments on earlier versions of the paper. Errors and omissions are the sole responsibility of the author.

The views expressed in this paper are those of the author and should not be attributed to the Central Bank of Kenya.

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Peer review under responsibility of Afreximbank.

http://dx.doi.org/10.1016/j.joat.2015.08.002

1. Introduction

The debate on trade-growth nexus is not new. The view that trade enhances economic growth and welfare has a long history. As far back as the 16th century, Smith (1776) emphasised trade as a vent for surplus production and a means of widening the market. In the same vein, Marshall (1890) acknowledged that causes which determine economic progress of nations belong to the study of international trade. The topic has since remained a key subject of debate in research and policy discourses, leading to ample theoretical and empirical literature on the link between trade and economic growth.

So why revisit the role of trade? The renewed interest in the role of trade is largely underpinned by the latest wave of globalization that has been characterised by not just intensive trade integration and trade openness, but has also been associated with technological revolution. International trade has grown steadily over the last three decades. On average, the value of world merchandise trade increased by more than 7% per year (fourfold increase in volume terms) between 1980 and 2011 (WTO, 2013). Advances in technology, telecommunications and transport have created opportunities for a reorganisation of global production and distribution systems around “value chains”. The other key feature of this evolving global landscape is the increased role of trade in services, which grew even faster than merchandise trade.[1] It is believed that due to the challenges in recording services transactions, the traditional measures of services trade underestimate their importance in global trade (Subramanian and Kessler, 2013; WTO, 2013).

The global trade topography has also been shaped by an increased participation of developing economies in international trade beginning with the industrialising East Asian Tigers who from as early as 1960s pursued an outward-oriented trade policy leading to export-led growth, followed by China and more recently by India. Developing economies’ share of world exports increased from 34% in 1980 to nearly half (47%) of the total in 2011 (WTO, 2013).

The quest for further trade expansion is partly exemplified by the increased proliferation of regional trade agreements and mega trading partnerships across the world. Given the fiscal constraint challenges that many countries are facing around the world, trade is envisaged to be a critical pillar of economic growth and development. A discussion of the global development agenda that fails to take cognizant of the global trade dynamics is, thus, bound to be incomplete. That notwithstanding, the differential trade impacts can easily get masked by the changing global dynamics and the general focus on the global picture. For instance, although in general the share of developing countries in world trade has been increasing, Africa as a continent still accounts for a very low share of world trade—only 2.8% of world’s exports over the decade 2000–2010 (UNCTAD, 2013). The Least Developed Countries (LDCs), most of which are in Africa, remain particularly vulnerable—LDCs’ share of the world exports is only about 1%, and as a group, LDCs have systematically recorded a trade deficit except for 2006–2008 cycle of high commodity prices (Escaith and Tamenu, 2013).

This paper re-examines the role of trade and makes a contribution to the literature by empirically analysing the differential impact of trade on economic growth and investment based on cross-country data. The empirical evidence is based on a sample of 85 countries using data over the last two decades (1991–2011). The differential effects of trade are analysed across three categories of countries, that is, developing, developed, and the LDCs, which largely comprise African countries. Most cross-country studies hardly take into consideration the differing effects of trade on economic growth and, even where

[1] The initiative of measuring trade in value-added as opposed to gross terms has also confirmed the rising role of services in total trade, accounting for about 45% of total trade in 2008 (almost twice the corresponding share measured in gross terms). The World Trade Organization (WTO), which has been part of the driving force behind this initiative observes that the traditional trade statistics misleadingly attribute the full value of traded goods and services to the last economy in the production process when in fact inputs may have come from many different countries (WTO, 2013).