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Growth by Destination: The Role of Trade in Africa's Recent Growth Episode

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SUMMARY

Over the period 1990–2009, Africa has experienced a distinct and favorable reversal in its growth fortunes in stark contrast to its performance in the preceding decades, leading to a variety of hypotheses seeking to explain the phenomenon. This paper presents both cross-country and panel-data evidence on the causal factors driving the recent turnaround in Africa's growth and takes the unique approach of disaggregating the separate growth impacts of Africa's bilateral trade with: China, Europe, and America. The empirical analysis presented in this paper suggests that the primary and most robust causal factors driving Africa's recent growth turnaround are private sector and foreign direct investment. Although empirical evidence of the role of bilateral trade openness in Africa's recent growth emerges within a fixed effect estimation setting, these results are not as robust when endogeneity and other issues are fully accounted for. Among the three major bilateral partners, Africa's bilateral trade with China has been a relatively important factor spurring growth on the continent and especially so in resource-rich, oil-producing, and non-landlocked countries. The econometric results are not as supportive of growth-inducing effects of foreign aid. These findings emerge after applying a variety of panel data specifications to the data, including the recent fixed effects filtered (FEF) estimator introduced by Pesaran and Zhou (2014) and the dynamic panel generalized method of moments (GMM) estimator, which allows for endogeneity between trade and growth.

1. Introduction

The idea that trade openness is an important, causal, contributing factor toward the promotion of economic development and growth has for long been debated by economists and policy makers. Since Ricardo's critique of the Corn Laws in the early 1800s, the debate has not waned. The key argument for free trade, as proposed by Ricardo, and dating at least as far back as Adam Smith, is that nations could improve their incomes and long-run growth rates by specializing in the export of goods and services in which they have a comparative advantage. With trade occurring between nations, resources are more efficiently allocated, output is increased, and feasible sets of consumption possibilities are expanded, leading to static gains from trade. Modern trade theories, such as those propounded by Helpman and Krugman (1985) and Romer (1986), emphasize the dynamic gains from trade that constantly shift countries' production possibility frontiers outward. Greater trade openness also encourages private entrepreneurship, attracts foreign investment, fosters learning-by-doing, and encourages acquisition of knowledge and new technologies thus leading to increased productivity and economic growth.[1]

Pro-growth trade arguments, however, can be rebutted if it can be established that market and institutional imperfections prevail, which may cause openness to induce: (i) the underutilization of human and physical capital and natural resources, (ii) the concentration of economic production in extractive economic activities, or (iii) the specialization away from technologically advanced, increasing return sectors. Endogenous growth models presented

[1] The growth-enhancing effect of trade openness is supported by a large body of literature (e.g., Ben-David, 1993; Bhagwati & Srinivasan, 2002; Dollar, 1992; Dollar & Kraay, 2001; Edwards, 1998; Frankel & Romer, 1999; Sachs & Warner, 1995a; Wacziarg, 2001).

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by Eicher (1999), Grossman and Helpman (1991), Lee (1993), and Young (1991) emphasize these more pessimistic possibilities.[2]

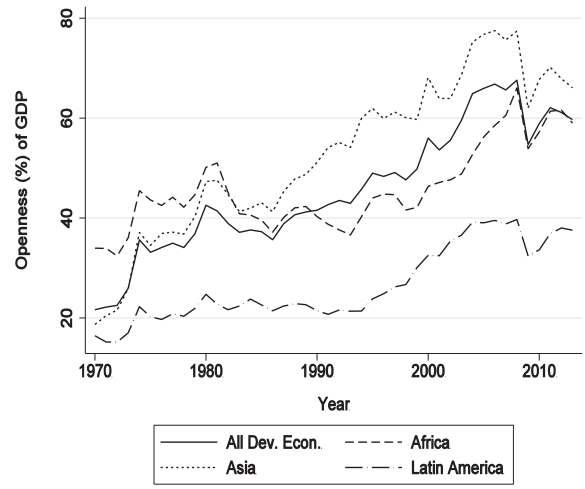
East Asia arguably provides an example of how trade can positively affect growth. Outward-oriented and export-led growth policies implemented in the 1960s and 1970s have hailed success in many East Asian countries and contributed to their significant progress and development over the past three decades. Figure 1 confirms the increased level of Asia's openness since 1970, where openness is measured as the total value of trade (imports + exports) normalized by the value of GDP. Through greater exposure to international markets, Asian countries became increasingly competitive and more integrated within the global economy, making a swift move from exports of raw materials to exports involving more dynamic, higher value added, and technologically advanced products (Hammouda, 2004).

In contrast, the African experience has been bleak. Following the failure of inward-looking trade policies implemented in the 1960s and early 1970s, many African nations turned to greater external openness (Hammouda, 2004). Unlike their East Asian counterparts however, African countries continued to experience sluggish growth and became increasingly marginalized in the 1980s. Africa, then tagged the "hopeless continent",[3] registered negative real GDP per-capita growth rates, averaging 0.8% per annum over the decade beginning in 1980. Figure 2 shows regional trends in real GDP growth per capita during 1971–2010. The figure highlights the relatively sub-par real per capita GDP growth performance of Africa until the 1990s. By this time, as displayed in Figure 3, the region was surpassed by Asia in terms of real GDP per capita—a rough but useful proxy of average living standards.

The fact that Africa continued to lag behind other regions despite comprehensive trade reforms and other efforts to emulate export-led growth models prompted some researchers to reconsider the trade-growth relationship. Many studies subsequently highlighted the contingent aspect of the trade-growth link, implying that trade openness would lead to growth only if appropriate economic, social, institutional, and political conditions are in place (Dufrénot, Mignon, & Tsangarides, 2010). These include factors like governance, economic policies, and the extent of bureaucracy and competition (Dollar & Kraay, 2003; North, 1990) and the growth of inputs such as capital, labor, education, and infrastructure (Krugman, 1990).

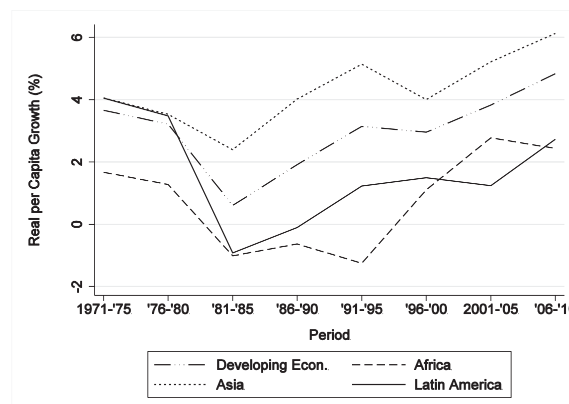
The mid-1990s marked the beginning of a positive reversal in Africa's growth fortunes. In real GDP per capita growth terms, Africa made a noticeable leap from the negative real (per capita) growth in GDP to a more reassuring 2% average rate per annum (see Figure 2). In the first decade of the 21st century, real GDP growth jumped to 5% per annum on average, proving resilient throughout the turbulent mid-2000s—despite the global financial crisis—outstripping GDP growth in the EU and the US.

The literature on African growth identifies a boom in commodity prices as a key driver spurring the region's recent economic success. This explanation, however, loses its appeal in the face of evidence that many non-resource-dependent countries have also



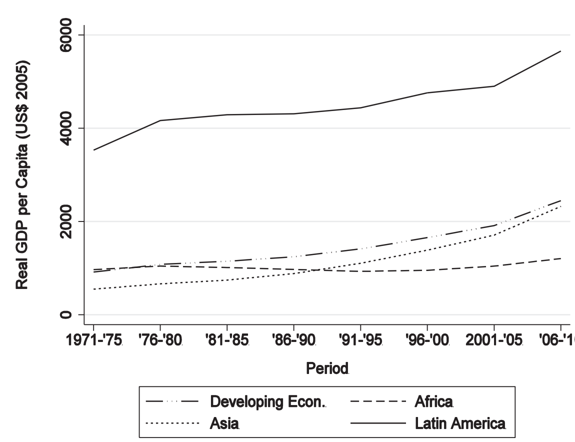
Source:UNCTAD

Figure 1. Regional openness 1970–2010.



Source:UNCTAD

Figure 2. Trends in real growth per capita by region (5 year averages).



Source:UNCTAD

Figure 3. Trends in real GDP per capita by region.

[2] In Grossman and Helpman (1991) and Matsuyama (1992) a country may specialize in a non-dynamic sector as a result of openness, thus losing out on the long-run benefits of increasing returns. These models generally include imperfections in financial markets or imperfections in contracts which induce individuals to follow a limited notion of static comparative advantage. Sachs and Warner (1995b, 1999) introduce a model where specialization and trade are extractive. Natural resource sectors divert the economy's resources from achieving technological progress—the key to growth in the long run. In this case, the underlying imperfection is an institutional weakness that encourages natural resource depletion for quick gains, which are subsequently appropriated away by certain groups in society. Rodriguez and Rodrik (2001) review the theoretical arguments which could lead trade openness to have a detrimental effect on the economies of developing countries.

[3] "The Hopeless Continent" was the title of the published version of The Economist, 13 May 2000.