Trade openness and economic growth

Trade openness refers to the degrees to which a country or economy permits or have trade with other countries or economies. The trading activities include that of import and export, foreign direct investment (FDI), borrowing and lending, and repatriation of funds abroad.

Economic growth is defined as the increase of per capita gross domestic product (GDP) or other measures of aggregate income. Plainly, it is the annual increases in a country's total output of goods and services.

Open economies generate greater market opportunities for commodities they produce and those they are unable to because of lack of resources or technology associated with its production. At the same time domestic countries are also faced with greater competition from businesses based in other countries.

International trade has been the main driver of growth and development in the last few centuries. It encompasses the exchange between countries of capital and goods and services. Hence, represents a significant share of Gross Domestic Product. Without international trade countries would be limited to the goods and services produced in their own country.

In terms of financial development trade openness enables a way to obtain funds from other countries that, and also invest its surplus funds in other countries. It also leads to greater efficiency as surplus production of one country can be exchanged for surplus production of another country.

OVERVIEW OF ISSUES COVERED IN THE ARTICLE

The article provides an analysis on the link between trade openness and economic growth.

The dynamic effects derived from trade are:

Trade openness has been identified as a promoter of structural change in the economy, enhancing processes already underway due to technological advances and allowing domestic resources to shift from less productive to more productive uses.

The effects from trade are not always favorable to all economies. For the developed countries trade increases the market of resources that they use in the production of other goods, mostly that of natural resources.

Trade has the potential to lift developing countries out of poverty. This can be through the elimination of trade barriers by the developed economies. For example if the developed countries reduce their tariffs and protection on agricultural produce, that are the main source of revenue for developing countries, the developing countries could gain significantly through the boost in exports of their commodities.

Moreover, trade openness can aid strengthen the drivers of productivity through six ways:

By enabling more efficient allocation of resources- by channeling resources of countries into the production of those goods and services that it can produce most efficiently and also through the exchange of surplus production with countries that have a different comparative advantage.

Enable achievement of greater economies of scale- this comes about with the expansion from the domestic market to the world market. Hence removing this constraint would allow industries to produce on a more efficient scale.

Trade also increases the incentives for firms to innovate and with larger markets firms will be driven towards expanding their production leading to an overall productivity in the economy.

It would also trigger greater competition- whereby domestic firms with the exposure to increased competition would innovate. Thus leading to birth of more competitive firms capable of competing in the world markets.

Increased access to new technology- Trade enables reach of products that incorporate new technology. This is because with more open trade structure the different stages of production process can be carried out in other countries which are more technologically advanced.

Trade also creates incentive for investment- Because trade results in a better access to export and import markets, there can be a scope for more productive investments through the creation of new business opportunities. For example an increase in the foreign direct investment into domestic country would enable faster diffusion of foreign developed technology and innovation as it is applied to domestic production processes.

Trade openness and the Developing Countries

Developing countries in order to efficiently and effectively participate in trade would need to overcome significant capacity constraints to enjoy the benefits from a more open trade.

This is because many low income countries face the problems of low levels of human, physical and institutional capital that form a constraint against them to respond to the international market. They also face high transaction costs associated with the production and provision of goods and services such as that of transportation, insurance, customs procedures, communication costs et cetera.

For the Developing countries to overcome these constraints they would require significant resources such as capital and aid flows. However the funds from aid in many of these low income countries may be used to further develop human capital through the provision of education or improve their health services, making it unlikely that private investments will be enough to channel into production. Therefore it is critical that trade reform, that is, amendments in trade barriers, are accompanied by increases in aid flows through mechanisms such as the international financing facility.

Developing countries could also face problems such as decline in the demand for their commodities resulting from multilateral reduction in trade barriers when managing the transition to more open markets in their own economies. This could be the problem for those low income countries which are dependent on preferential access to developed countries markets. Low income countries also tend to be heavily reliant on their tariff as their main source of revenue, hence are vulnerable to balance of payment shortfalls.

For developing countries to overcome these problems there is a need for a designed reform package for separate countries, which can then be integrated into development and production reduction strategies, be further supported by significant additional international aid for use as investment in physical, human and institutional capital that would aid capacity constraints and help with change management.

Developed countries can also play an important role in providing the resources needed for the investment that can cushion out the difficulties that developing countries face in their transition to a more open economy. They could do this by firstly providing direct assistance to those countries affected by the loss of preferential margins secondly, by providing substantial additional resources allowing these countries to build a pro-trade infrastructure so that they are prepared to handle trade shortfalls beforehand. This would lead to a boost in their social spending in education and health.

THEORETICAL UNDERPINNINGS

There has been a lot of literature done on openness and economic growth.

Rodriguez and Rodrik, 2001, 261-324 pointed out that there is no strong conditional correlation between economic growth and a number of direct measures of trade policy, such as weighted and unweighted tariffs, import quotas, or other non tariff barriers.

Dollar and Kraay, 2002, 195-225 claimed that there was a reasonably strong correlation between growth or productivity and the ratio of trade in GDP, especially when the later is measured in prices of a constant base year

Frankel and Romer, 2000, 379- 99 explained the use of instrumental variable estimates to compute the effect of trade volumes on growth where the later is instrumented with its geographic determinants as derived from the estimation of gravity equations

Bhagwati and Srinivasan, 1999 discounted the aggregate growth evidence altogether, and called for concentrating exclusively on the evidence from case studies

FINDINGS

The article elaborates on the growth of economies in the year 2007.

Country

Growth Rate

Africa

6%

Latin America and west Asia

5%

Overall world output Growth

3. 4%

Over the past five years the GDP per capita has increased for the above mentioned countries by more than 15%.

However, this does not apply to all developing countries, as not all have experienced improvements in their terms of trade, that is, the relative ratio of prices of exports over imports. This is because they have to contend with higher oil imports bills, while the prices of their commodities have not increased proportionately.

The fastest growing regions of the world have been identified as East and south Asia mainly due to the strong performance of China and India. There has also been signs of a shift in the sources of world economic growth with the US economy slowing down and domestic demand of Europe and Japan recovering.

Even though enormous difference persist between the developing economies and the G-7 countries, encompassing France, Germany, Italy, Japan, UK, US and Canada, there was a significant shift in the per capita GDP of developing countries compared to the later country.

Country classification

Change in GDP per capita between 2003 and 2007

Developing

30%

G-7 countries

10%

The dynamics of overall growth in developing countries have been stimulated by a strong growth in export revenues.

Country classification

Change in real exports

Developing Economies

More than doubled (200%)

G-7 Countries

Rose by less than 50%

Despite the deterioration in the terms of trade of some developing countries, other developing regions export grew at a slow pace, close to those of developed countries, however the gains from terms of trade boosted the purchasing power of their exports. On the whole the share of developing countries in global trade rose by 8%.

Year

Developing countries Share of Global trade

1996

29%

2006

37%

A study carried out by Weisbrot M, Baker D, and Rosnik D 2005 of the last 25 years data on economic growth and various others social indicators revealed that there was slower rates of economic growth and reduced progress on social indicators for many of the low and middle income countries.

Social indicators including areas such as:

Education

Health

Housing

Income and Economic activity

Population

Unemployment

Literacy

Water supply and sanitation

DISCUSSION

What about Fiji islands?

Ever since independence, Fiji opened its doors to establishing relationship with other countries through their engagement in trade and diplomatic relationship with them. However since then, with increasing globalization and trade liberalization, Fiji has been too slow to adapt to change which lead to lost opportunities in furthering of our trade and benefits forgone.

Ever since Fiji signed agreement to the World Trade Organization in 1996, the government has adopted an export oriented and outward-looking trade policy. Fiji since then has gradually liberalized its trade and reduced its import restrictions in favor of export promotion. This has resulted in increased volumes of exports and imports together with increased prosperity and opportunities within the economy such as creation of more jobs in industries such as tourism.

Apart from the WTO, Fiji is also a member to a number of regional trade agreements. Fiji sees integration as a key towards fuller participation in the increasingly liberalized global economy because this would result in larger trade and investment market for Fiji.

Some other agreements that Fiji is a member to include:

The Melanesian Spearhead Group (MSG) Trade Agreement, 1993- Allows trade to take place freely between Fiji, Papua New Guinea, Vanuatu and Solomon Islands

The Pacific Island Countries Trade Agreement (PICTA), 2001 – seeks to establish a free trade area among the fourteen Forum Island Countries (FICs)

The Interim Economic Partnership Agreement (IEPA)- an agreement between Fiji, Papua New Guinea and the European community, which provides duty free market access on all products from Fiji except for sugar and rice, which are subjected to longer transitional periods.

The South pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), 1981 – is a non reciprocal agreement that allows Fiji and other Fourteen Forum Island Countries (FIC) to export almost all of their products to Australia and New Zealand duty free.

The Pacific Agreement on Closer Economic Relations (PACER), 2001- agreement for cooperation on trade and economic integration between Fourteen FICs and Australia and New Zealand, with a view towards the development of a single regional market.

With the agreement on the above regional trade agreements Fiji has committed to trade liberalization.

The relation between openness and Economic Growth in Fiji

YEAR

EXPORTS

IMPORTS

GDP AT CONSTANT PRICES

TRADE OPENNESS INDEX

PERCENTAGE CHANGE IN GDP AT CONSTANT PRICES

1990

900726000

1112901000

1611500000

1. 249535836

3. 6

1992

664571000

950672000

1568100000

1. 030063771

-2. 7

1992

650900000

958436000

1664200000

0. 967032809

6. 1

1993

697513000

1165911000

1707500000

1. 09131713

2. 6

1994

83360000

1229100000

1794400000

0. 731419973

5. 1

1995

875900000

1253900000

2373000000

0. 897513696

1996

1052100000

1384500000

2486500000

0. 979931631

4. 8

1997

896530000

1392700000

2427400000

0. 943079015

-2. 4

1998

1016200000

1434100000

2458800000

0. 996543029

1. 3

1999

1215661000

1838251000

2673000000

1. 142503554

8. 7

2000

1154800000

1822222000

2626800000

1. 133326481

-1. 7

2001

1221329000

2017051000

2675900000

1. 210202175

1. 9

2002

1132188000

1970000000

2761200000

1. 123492684

3. 2

2003

1269223000

2284730000

2784400000

1. 27638019

0. 8

2004

1205519000

2501639000

2935400000

1. 262914083

5. 4

2005

1192578000

2722787000

2897600000

1. 351244133

-1. 3

2006

1201573000

3124342000

4407500000

0. 981489507

1. 9

2007

1209813000

2890072000

4369900000

0. 938210257

-0. 9

2008

1471028000

3601404000

4379200000

1. 15830106

0. 2

2009

1230341000

2807950000

4248800000

0. 950454481

-3

To find if there is a relation between the trade and economic growth within Fijis Economy I have graphed the trade openness index, calculated as (Export+ Import)/Gross Domestic product at constant prices and the percentage change in GDP to see the degree of their association.

Graph showing the relative correlation between the openness index and percentage GDP Growth For Fiji

The correlation coefficient for the above data set is:

PERCENTAGE CHANGE IN GDP AT CONSTANT PRICES

TRADE OPENNESS INDEX

PERCENTAGE CHANGE IN GDP AT CONSTANT PRICES

1

TRADE OPENNESS INDEX

0. 003120368

1

0. 003 a correlation of this amount shows that for Fiji there is a weak or almost no relationship between the extent of trade openness and economic growth.

Therefore, not all growth in GDP is explained by the extent of trade.

Other factors influencing the growth of GDP could be:

Physical capital

Human capital

Technological change

CONCLUSION

To conclude it is recognized that increase in income growth of a Country is achievable if the country strengthens its capacity and hence becomes more productive. Trade openness can play an important role in increasing long term productivity growth in the economy by enabling a more efficient allocation of resources, by providing greater opportunities to make use of economies of scale, through the exposure of the domestic country to greater competitive pressures, by rewarding innovation and providing access to new technology and by increasing incentives for investment.

RECOMMENDATION

In my recommendation I believe that Fiji as a developing country is not being able to fully take advantage of trade because of capacity constraints which is highly due to its smallness, isolation from major trading partners, and the lack of advanced technology for production. For a country like Fiji, open trade provides markets for its commodities.

To capture the greater benefits of trade Fiji needs to:

Strengthen local capacity including private sector participation, to engage in global trade

Improve on the existing trade agreements Fiji is part of, bilateral and multilateral and regional

Improve on investments

Advocating Fiji's interest to be a part of Pacific Islands Forum, the commonwealth and the United Nations

Strengthen its institutions such as those market and political institutions.

Develop its infrastructure to further facilitate trade

Using aid received from the developed countries fully and in most productive investments

These factors would lead to more foreign investors in to the economy and lead to the extraction of a substantial amount of gain from trade.