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How do trade policies affect economic growth ?

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Abstract

This paper will discuss the impact of trade policies on economic growth and development. By considering discussions of the theory and an up to date review of the empirical literature with evidence from econometric and case studies, it is difficult to deny that trade policies played a significant role and positive influence on worldwide nations in terms of economic growth and development.

Keywords: *free trade, trade policies, trade openness, economic growth.*

1. Introduction

International trade plays an important role in the development of the world's economy and trade policy is the main factor that directly affects millions of people over the world. The appearance of trade liberalization policies thanks to globalization has significantly influenced the issues of international trade and economic growth. The debates of economists and policymakers about the relationship between trade policies and growth have received increasing attention during the last decade. Most economists who support globalization and free trade argue for the positive effects of the international trade and trade policies on economic growth and development. They emphasize that developing countries have exploited all the positive influences of trade policies and globalization when following free trade policies. On the other hand, the other groups argue that international trade has brought negative effects on the development of economies, especially developing nations. They state that free trade only creates benefits for developed countries in most economics fields. This paper will discuss the relationship between trade policies, economic growth and development then argue for the positive effects which free trade has brought to the growth and development of many countries all over the world by providing discussions of the theory and an up to date review of the empirical literature on the relationship between such issues with evidence from econometric and case studies.

2. Review of Literature

2.1. The impact of trade policy from a theoretical view

2.1.2. The impact of trade policy from trade theory

Classical theory of international trade emphasizes on the importance of absolute and comparative advantages. According to Adam Smith, specialization, the division of labour, increases productivity. This concept is extended to trade between nations by David Ricardo. Trade allows each nation to specialize in producing what it does best to maximize their best value of output. The benefits of international trade derived from differences in comparative advantage in each country, and it can be expressed by the different opportunity costs of each one. Hence, benefits of international trade are also derived from the difference in the opportunity cost in producing of each country (Chenery, 1961).

According to classical trade theory, trade liberalization by removing the import and export impediments such as tariffs, import quota and other non-tariff barriers are the best policies from a welfare view (Panagariya, 2000). It also pointed out that trade has brought total welfare improvements to the world. Specialization in producing the more comparative advantage products has increased efficiency in manufacturing activities. In the consumption aspect, trade enables people meet their demand with more choices at lower prices and higher quality (Fajgelbaum, Grossman & Helpman, 2011).

Myrdal (1957) argued that the classical trade theory only applies to the developed countries instead of poor nations. However, evidence about classical trade theory applied to the advantage of a poor country has found. Puerto Rico, a small and poor country, is one of the most popular examples with a strong economic growth when following the classical trade theory. Vigorous growth in many export lines and taking advantages from resources also have found in Israel which follows the classical trade theory (Chenery, 1961).

Generally, the impacts of trade on economic growth and development only occur under some certain assumptions such as perfect competition, constant returns to scale, and fixed technology. Externalities, public goods or uncertainty do not show the benefits of trade liberalization. These static gains from international trade in classical trade theory are not fully absent. However, they only have smaller effects under those assumptions. These assumptions apparently are not always realistic so the classical trade theory does not strongly reflect the impact of trade on economic growth and development, especially in the long run.

The Heckscher-Ohlin theory without the assumption of the existence of perfect competition in both domestic markets is one of the most influential theories in international trade. Comparative advantage is affected by the interaction between nations' resources and the technology of production in this model. Trade profitability benefits from using more of a country's relatively abundant factors in production.

New trade theory considers imperfect competition, increasing returns to scale, and technological innovations instead of the restrictive assumptions of perfect competition and the absence of market failures. According to new trade theory, first of all, welfare can be improved by restrictions to trade (Krugman, 1986). Trade restrictions help nations win market power in the international competitions. More powerful market nations will get national welfare in their economic development. New trade theory also mentioned about externalities as well as the appearance of spillovers in the production process such as physical capital, human capital, knowledge production and technology innovation.

Trade openness allows firms to interact with their global markets all over the world. Thus, the absorption of frontier technologies and global best management practices will be increased by strong interactions amongst nations. Furthermore, innovation, cost cutting and antimonopoly are promoted by trade openness. Most importantly, the increasing of the long run rate of growth is proved by the existence of spillovers in production mentioned in new trade theory. New trade theory does provide a confident evidence to support for a permanent effect on the growth rate.

2.1.2 The impact of trade policy according to growth theories

According to the neoclassical growth model, in open economies, an increasing in the saving rate from trade openness would be invested in the same way as in a closed economy (Schmidt-Hebbel, 1996). This will contribute to the increasing of income level and its growth rate. However, this rise merely temporarily happens until the savings is accumulated enough to cover the depreciation of capital and labour force's increasing. Consequently, in the neoclassical growth model, the growth rate is particularly affected by trade policies in short term.

Regrading to the endogenous growth theory, the output growth rate can be explained without the increases of saving rate when other endogenous factors can influence the output growth rate (Grossman & Helpman, 1991). Technical progress is one of the most important endogenous determinants which could affect this model. Imports, foreign direct investment and technological transfer are positively related to trade policies of countries (Aghion, Howitt, & García-Peñalosa, 1998). So, technical progress can be improved through trade openness and contributes to lifelong growth.

Besides that, in the AK model with the absence of diminishing returns to capital, the economy just keeps growing because innovations are always considered as capital accumulated (Acemoglu, 2009). Accordingly, if savings are accumulated through trade liberalization, trade policy can obviously and definitely promote better economic growth and development (Jones, 1995).

To briefly recap, the classical trade and growth theory indicated that trade policies only influence the per capita income level. More importantly, in the long term, trade liberalization does not increase the growth rate. Alternatively, the long-run rate of growth can be affected by trade policies mentioned in endogenous growth model.

2.2. The impact of trade policy from an empirical view

2.2.1. The impact of trade policy according to cross-country and time series studies

A dataset of 43 developing countries in the 1973–1978 periods was examined by Balassa (1985) had proved that differences of growth rates among countries may be caused by the divergences of trade policies. The results revealed that there is a correlation between trade policies and the economic growth rate in developing nations. Additionally, he stated that there are opportunities for poor countries to promoting their economy by applying modern technology and taking advantages from international trade. Also, Zeren (2013) found a bidirectional causality relationship between openness levels and growth in the G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and United States) from 1970 to 2011. It means that the more openness levels are, the higher growth increases that countries get. In other words, the growth can be greater generated by increasing openness intensity.

Another study of Helpman (1988) also demonstrated the positive influences of international trade which have helped Korea, Hong-Kong, Taiwan and Singapore when taking their advantages to remain and overcome the slowdown at high level of growth rate (8.3%).

The relationships between long-run growth rates and various economic policies, political, and institutional indicators from cross country regressions were analysed by Levine (1992). A data set from 119 countries (major oil exporters excluded) was used to analyze and then a primary finding found that there was a positive robust correlation between growth and the ratio of international trade to GDP.

According to Edwards (1993), the degree of international openness generates the increasing of exports and the positive effect on aggregate growth. He stated that faster growth of exports would result in more significant output growth in more liberalized economies. A positive and statistical significance of openness to economic growth is indicated.

Another study about economic growth by using data from 79 countries in the period 1970-1989 was conducted by other group of authors (Sachs, Warner, Åslund, & Fischer) in 1995 indicated that a higher two percentage points of growth rate was experienced in more open-policy economies compared to the closed ones. Afterwards, an updated research of Wacziarg & Welch (2008) using data in the period 1950-1998 also reconfirmed such conclusion. They found that countries where liberalized their trade regimes would increase their economic growth by approximately 1.5 percentage points higher than them before regardless their initial growth rate differences.

A research of Harrison (1996) also focused on the correlation between openness and economic growth. Although that relationship is not always strong, a positive correlation of openness and growth is still found according to various measures in this research. The model used either price-based or administrative measures similarly revealed a positive relationship between trade and growth in many studies of Barro (1991), Dollar (1992), Bhalla and Lau (1992) and Thomas and Nash (1992). With micro studies, a positive relationship between export growth and output growth was found in the studies of Nishimizu and Robinson (1984) and Sryquin and Chenery (1989). Additionally, the relationship between growth rate and trade policy is parallel which means that trade policies improve the growth rate, and higher growth rates also motivate more open trade regimes.

Frankel and Romer (1999) used data for 1985 from the bilateral trade amongst 63 nations to examine an empirical research of the effect of trade policies and international trade on living standards. The findings found that international trade would increase income.

A research study of Buch and Toubal (2009) focused on the convergence of per capita incomes between East and West Germany and the lower international openness of East Germany after the fall of the Berlin Wall in 1989. They used the methodology introduced by Frankel and Romer (1999) to consider the endogeneity of openness. They found that "the degree of openness for trade has a positive impact regional income per capita".

All above mentioned models indicate that trade policies do affect economic growth and development. However, Yanikkaya (2003) concluded that trade openness does not have a relationship with growth. The author continued that there was a strong relationship between trade barriers and growth, especially for developing countries. There is also no difference from trade in term of growth effects between developed and developing countries. Jalles (2012) analyzed the effects of regional trade agreements and trade integration on economic growth from 21 nations in South and South-East Asian from 1980 to 2004. The findings indicated that the impacts of openness of either a single country or of its neighbors on economic growth are not very clear.

Although the openness is not the only door and free trade policies also do not create significant influences on output and national income, the trade policies plays an essentially important role to the economic growth and development of most nations. Closed economies may suffer lower welfare from international trade compared to open economies. Briefly concluded, trade liberalization, by itself, cannot be an almighty power for economic growth and development however less open to trade and capital countries discouraged them from improving global living standards (Wolf, 2004).

2.2.2. The impact of trade policy according to evidence from specific countries

There are countries that benefit from trade liberalization which will be evidently given in following part. From 1970 to 1980, trade liberalization was considered as an essential determinant which significantly promoted to the economic growth of Chile (Monfort, 2008). Also, a systematic process of trade liberalization was reformed in 1964 which created significant changes in the development of Korea's economy. Consequently, such liberalization offered positively economic growth effects and development of Korea (Jin, 2000).

By the early of 1990s, Vietnam started to open economy, promote international trade and gradually integrate into the development of free trade. Vietnam suffered the dependence on import commodities from China (Eichengreen, Rhee, & Tong 2004) and the negative consequences of new and small industries and farmers (Gates 1996). However, Vietnam was not able to get such economic growth and development without that those trade policies (Truong and Gates 1996). The research of Chang (2007) indicated that by the more open trade policies, Taiwan's economy experienced optimistic growth. From 1990 to 1997, its GDP growth rate increased at

6.5 percent. Taiwan's economy did not suffer negative consequences from Asian financial crisis in 1998 and presented an amazing growth rate of 4.7 percent.

The other findings of Tsai and Huang (2007) found that openness positively contributed to the economic growth and was a significant tool to poverty reduction of Taiwan in via both income and distribution effects temporarily and permanently. Further consideration on Khan and Qayyum's study (2007) which indicated that a positive relationship between trade policies and long-term economic growth in Pakistan was demonstrated. Furthermore, there were short-run and long-run causality relationships among trade openness policies, human capital and sustainable economic growth in Pakistan (Chaudhary et al., 2010)

Although trade openness might create some challenges and pressure for economic growth, its offered benefits by trade liberalization cannot be denied. All above mentioned evidence across countries and time series research studies and case studies of Chile, Vietnam, Korea, Taiwan and Pakistan have strongly advocated for the positive effects of trade openness policies on economic growth and development.

3. Conclusion

Trade openness enables countries to focus on their competitive advantages to maximize the output and thus promote economic growth as well as increase income level. Trade polices also widen opportunities for countries to catch up-to-date global trend and development in production and commercialization. All things considered, it can be stated that international trade and trade policies play a significant role and positive influence on worldwide nations in terms of economic growth and development.

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