“The Purpose of trade liberalization should be to enhance the global gains from trade and in particular to empower the developing countries with greater trade opportunities. Yet, aid dependence has increased among many developing countries, raising concerns over the effectiveness of aid. Where are the problems? Discuss the efficacy of trade liberalization and scepticism of aid with empirical evidence.”

Matthew Grimson

Contents

1. Introduction

“One thing that nearly all economists have almost always agreed about is the desirability of free trade.” *(Krugman, 1993)* When viewed from a holistic perspective the liberalisation of trade ‘appears’ to be a good thing, with observably positive results. This coupled with plentiful theoretical understanding and support; the case for liberalising trade is a difficult one to ignore.

Is this an over simplistic view point? Does the basic framework of trade liberalisation always hold

across different types of nation? Or, are there some situations where trade liberalisation is actually damaging?

The other main tactic concerning developed countries is foreign aid. Unlike liberalising trade, the effectiveness of foreign aid polarises the opinions of economists.
In some cases aid is a vital lifeline and may be the difference between an individual living or dying. But how effective is aid? Can aid stimulate real economic growth?
Also, it is apt to assess the donors. Is aid a purely altruistic act of generosity? Or is it a tool for countries to gain influence and support?

Throughout this assignment I will seek critically analyse the effects of aid and trade liberalisation. Using empirical evidence and data I have researched.

2.Trade

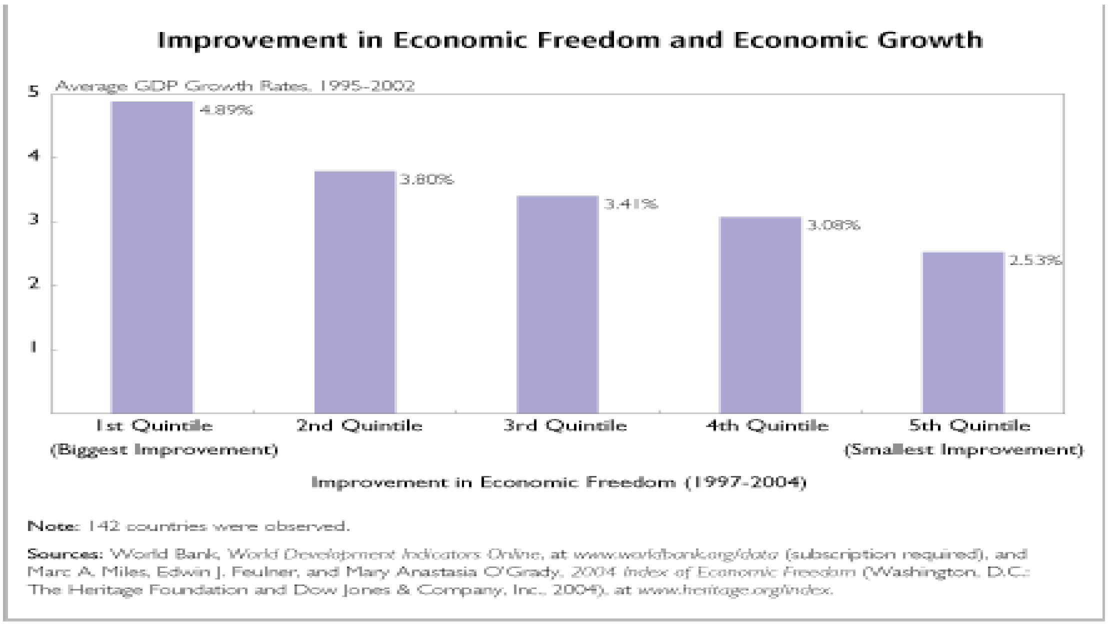
"Trade openness allows economies to better capture the potential benefits from increasing returns to scale and economies of specialisation." (*Kim et al, 2009*) This sentiment is echoed throughout the academic world.
Since the inception of the Adam Smith's (1775) theory of 'absolute advantage' and Ricardo's (1817) supporting paper outlining 'comparative advantage' there has been a solid theoretical framework to explain the gains from trade. Ultimately, when countries 'specialise' in that which they have an advantage to produce, total production capacity and thus the total possible surplus can be realised.
What can trade potentially do for a country? Much thought follows the same basic path. "The case for freer trade is enriched by including the facts that trade liberalization increases the variety of goods, and raises productivity by providing less expensive or higher quality intermediate goods." (*Dornbusch, 1992*)
Ultimately, we as consumers stand to benefit greatly from trade. In an 'ideal world' trade enables us to experience the biggest choice and the highest quality for the lowest cost. When this is the case everyone is able to maximise his or her own utility functions. However, we must be careful not to ignore potential problems that are also present.

2.1 Growth

The net result of trade liberalisation should be to open up the developing world to growth.

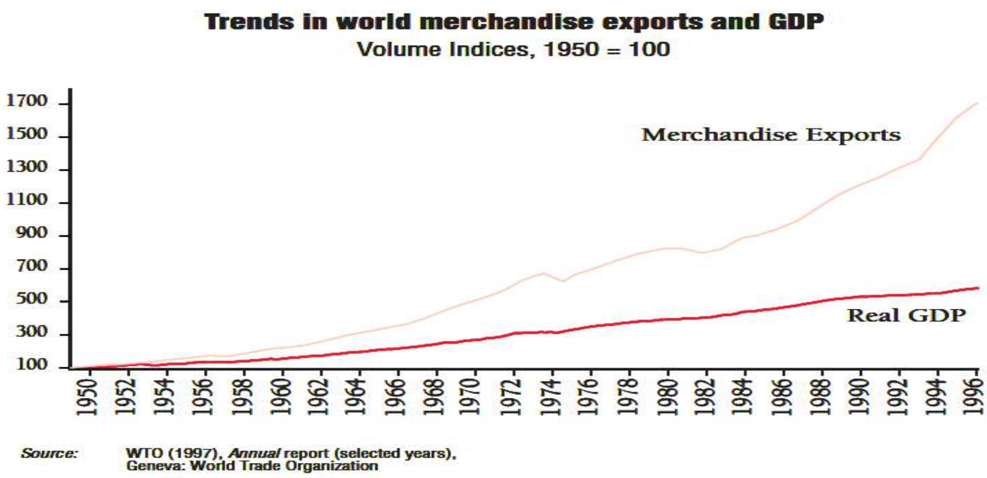
Below is a graphical representation of the effects of 'economic freedom' and GDP growth as presented by the *World Bank*.

Table 1



This displays strong evidence supporting the fact that when economic freedom (i.e. liberalising trade) is applied; the result is a positive effect on that countries growth rate.

Table 2



This second graph supplies further evidence in support, and unlike the previous graph is over a much longer timescale.

This graph is important because it shows the countries are experiencing 'real' growth. There may be case where inflation would cause an illusion of growth when the numbers were looked at in isolation.

The simple truth is there is a consensus that trade liberalisation can induce 'real' growth. Although countries differ in terms of infrastructure and what they export and import, the basic framework of this growth is easy to observe and possible for many countries to achieve in the long-run.

2.1a Growth Case Study: Latin America and East Asia

Table 4

TABLE 1

GROWTH AND EXPORTS IN LATIN AMERICA AND EAST ASIA: 1965–1989

(PERCENTAGE DISTRIBUTION)

	Annual Rate of Growth of Real GDP		Annual Rate of Growth of Manu-facturing		Annual Rate of Growth of Exports	
	1965–80	1980–89	1965–80	1980–89	1965–80	1980–89
A. *Selected Latin American Countries*						
Argentina	3.5	−0.3	2.7	−0.6	4.7	0.6
Brazil	8.8	3.0	9.8	2.2	9.3	5.6
Chile	1.9	2.7	0.6	2.9	7.9	4.9
Colombia	5.8	3.5	6.4	3.1	1.4	9.8
Mexico	6.5	0.7	7.4	0.7	7.6	3.7
Peru	3.9	0.4	3.8	0.4	1.6	0.4
Venezuela	3.7	1.0	5.8	4.9	−9.5	11.3
Latin America & Caribbean (Average)	6.0	1.6	7.0	1.5	−1.0	3.6
B. *Selected East Asian Countries*						
Hong Kong	8.6	7.1	n.a.	n.a.	9.5	6.2
Indonesia	8.0	5.3	12.0	12.7	9.6	2.4
Korea	9.6	9.7	18.7	13.1	27.2	13.8
Malaysia	7.3	4.9	—	8.0	4.4	9.8
Singapore	10.1	6.1	13.2	5.9	4.7	8.1
Thailand	7.2	7.0	11.2	8.1	8.5	12.8
East Asia (Average)	7.2	7.9	10.6	12.6	10.0	10.0

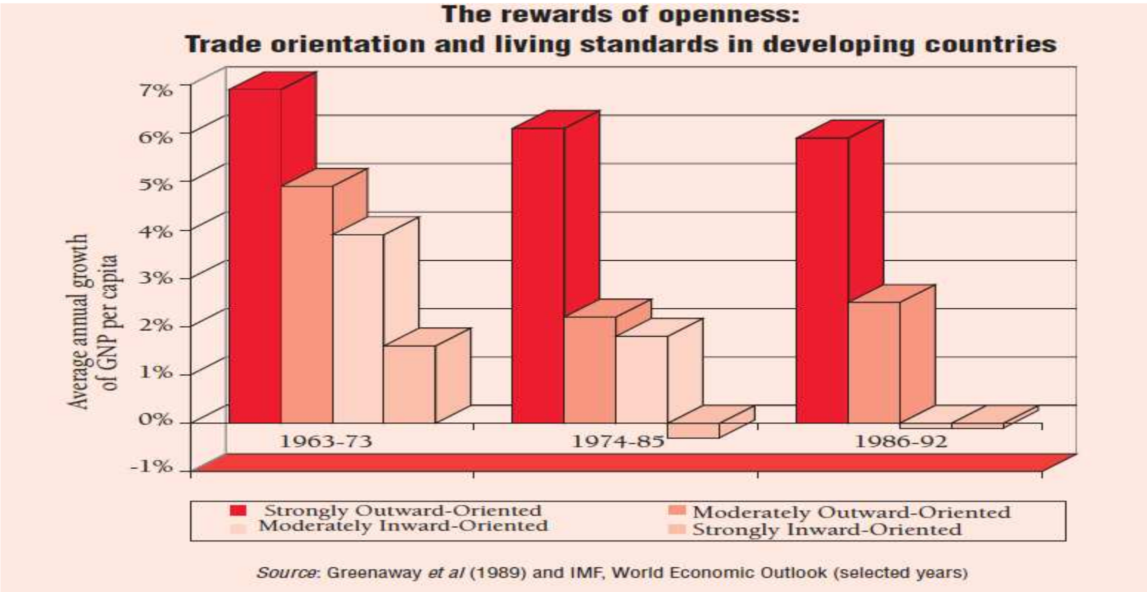
Edwards 1993

I have taken this table to act as a miniature 'case study' regarding the different fortunes of Latin America and East Asia as a direct result of their attitudes to change. To provide some context to this table during this period Latin America were extremely inward looking where as East Asia were taking big steps towards liberalisation.

From 1980-89 East Asia enjoyed an average growth rate of 7.6% where as Latin America was a modest 1.6%. In this brief example it is clear East Asia has comparatively benefited from trade.

2.2 Effects on people

A policy brief by the (*OECD, 1999*) proposes that one of the most effective ways in which to improve the living standards of those in the world is trade liberalisation.



Using this graph first produced by the IMF, it is highlighted how a countries attitude to trade can effect peoples prosperity (as measured by GNI per capita.)

The message from all three decades is clear. Those countries who were 'strongly outward orientated' enjoyed the most per capita growth. Where as those with strongly inward-orientated policies remained stagnant or even decreased.

These findings should act as a catalyst for many countries to liberalise trade with the rest of the world. Any policy that addresses the trade situation in a country must have its inhabitant's interests at heart. If People can gain from higher wages and increased income then it is within the governments best interests to act.

2.3 Trade Ramifications for the Environment

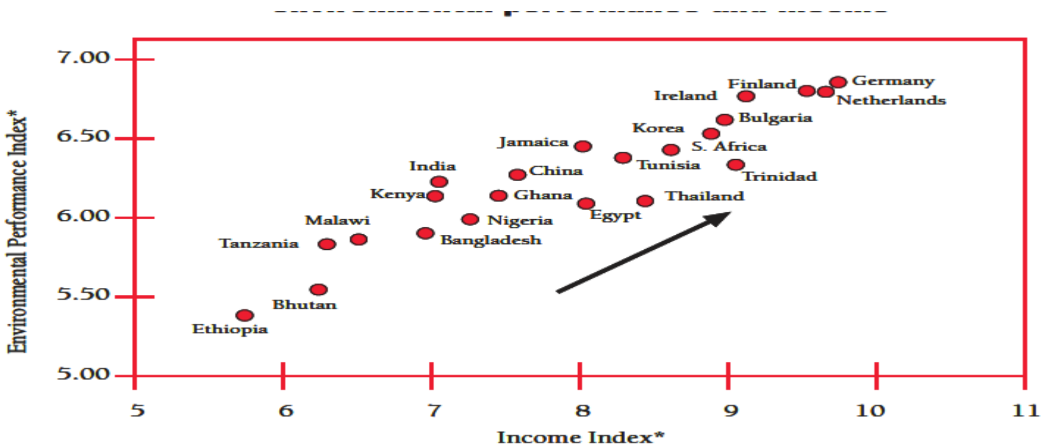
The first potential issue with trade liberalisation is the potential environmental effects. Consider this example: A small developing country grows food that is eaten and consumed locally. The environmental footprint associated is much smaller than if that food is flown all over the world.

Although in a trade relationship two countries may be monetarily better off, there may come a time when the disutility of consuming fossil fuels outweighs the extra utility gained from exporting.

“The European union had been prepared to take a tougher stance by agreeing to a 30% cut in greenhouse emissions by 2020, which would have increased demand for carbon permits.” (*Marketwatch.com*) Policy makers are becoming more sensitive to environmental issues. If trade liberalisation results in increased carbon consumption then as a result of discussions in Copenhagen this will become much more expensive.

However, this remains very much a two-sided debate. A report published by the *(OECD 1999)* claims “by promoting a more efficient use of resources and sustaining growth, can make a vital contribution towards creating the conditions necessary for environmental improvement.” My interpretation of this is liberalisation should make economic relationships their most ‘allocative efficient’, in the process the agents will seek to improve any technologies associated with production which may in turn be the birthplace of environment saving technologies.

<u>Table 3</u>



*Environmental performance and income indices as calculated by the World Bank (1995)

Source: Dasgupta, S. et al. (1995), *"Environmental Regulation and Development: A Cross-Country Empirical Analysis"*, Policy Research working Paper 1448, Washington, D.C.: The World Bank. (April).

This graph seems to go someway to backing up the argument for trade benefiting the environment. There is an obvious correlation between high-income countries and environmental performance.

2.4 Problems with Liberalisation Theory

Not all people are able to unanimously agree upon the positive effects of liberalisation (*Erixon et al, 2006*) highlights "Critics point to tenuous links between liberalisation, openness, growth and poverty reduction." There are arguments that some of the points I have highlighted above are over simplistic. There is also a large anomaly regarding liberalisation and growth in our current society. In an empirical study (*Rodrik, 1999*) noted, "the star performers of the last few decades China and Vietnam have grown fast behind high trade barriers." This is difficult to ignore, despite the links between growth and liberalisation we have established.

However, "it is simply misleading to say that high protection in China and Vietnam has not deterred fast growth, or even contributed to it. The central point is that, starting from near autarky, the have liberalized external trade." (*Erixon, et al 2006*) So perhaps these countries are not as liberal as standards set by other countries but they are certainly moving towards liberalisation.

There is a case to be answered where by liberalisation could harm a country, According to (*Todaro et al, 2009*) "The share of international investment received by the poorest countries is falling rather than rising." There is a rising fear that in a quest for efficiency, some countries will get bypassed and consequently isolated from the rest of the world.

Also in the case of the 'Prebisch-Singer' thesis, countries "find themselves locked in a stagnant situation that perpetuates their comparative advantage." In other words countries will be trapped making a particular good for increasingly poor terms of trade.

2.5 Protecting Infant Industries

Developing countries will look to nurture particular industries to spearhead future growth in the country. However, in the early stages, an industry will not have the same advantages of more established firms elsewhere in the world (e.g. will not be able to realise economies of scale). As a result of this the 'world price' will be lower than the domestic price. Opening these industries up to world markets will force their prices down to a point where operation may not be sustainable.

In this scenario the developing country could benefit from protecting this infant industry (e.g. an import tariff) until such time where they have become more efficient and realised economies of scale through growth.

Using this form of protectionism may assist a country towards future growth

3.Aid

“There has been a growing disenchantment with the potential for development in the poor countries and with the role foreign aid can play in development.” (*Kanbur*, *2003*) There is much ‘economic’ skepticism around aid and the true magnitude of its effects. On the other hand, on a ‘micro’ level aid is saving lives of individuals on a daily basis.

3.1 Allocation and Distribution of Aid

According to (*Todaro et al, 2009*) “Official Development Assistance is allocated in some strange and arbitrary ways.”

Table 5: ODA by region, 2005

Region	ODA Per Capita (U.S $)	GNI Per Capita (U.S $)	GNI Per Capita ($PPP)	ODA as Share of GNI (%)
Middle East and North Africa	88	2198	6084	3.9
Sub-Saharan Africa	44	746	2004	5.5
Latin America and Carribean	11	4045	8116	0.3
East Asia and Pacific	5	1630	5914	0.3
South Asia	6	692	3142	0.9
Europe and Central Asia	11	4143	9152	0.2

Todaro 2009

This table asks some probing questions regarding distribution. The lowest GNI per capita region in this table is South Asia, so it stands to reason that they should receive the most aid. Despite this they actually receive some of the lowest ODA per capita. This becomes even more questionable when we consider the Middle East has nearly double the GNI per capita, but receives 15 times the ODA per capita. Why is it we are helping those who don’t need as much help?

I will now outline the reasons for this, namely; “The pattern of aid giving is dictated by political and strategic considerations.” *(Alesina et al, 2000).*

3.1a Former Colonisation

Table 6

Table 2. Bilateral aid to former colonies, 1970 to 1994.

Donor	*Colony Share (percent)*
Australia	55.5
Belgium	53.7
France	57.0
Germany	2.6
Italy	9.0
Japan	6.3
Netherlands	17.1
New Zealand	22.5
Portugal	99.6
Spain	4.8
United Kingdom	78.0
United States	2.9
AEE	19.6

Alesina suggests that the decision to give aid and how much to actually give is heavily dependant on whether the recipient was a former colony. As you can see from *Table 6* the amount of aid received by former colonies is disproportionately high.

When aid data was subject to an econometric study regarding this topic "the own colony statistic was highly significant in some cases with a t-statistic of 0.10." (*Alesina et al, 2009*) In other words countries are deliberately favouring these countries.

The reason for this are two fold. Since aid is used to encourage countries to act in the donors interests (discussed later) there is a higher chance former colonies are more aligned with the donors. This is because the donors have laid much of the political and social infrastructure down in the past. Secondly, donations are often made on "whims and ad hoc judgements of donor decision makers." (Todaro et al, 2009) These decisions are made by individuals and therefore may come laden with political or even emotional ties with the former colony.

3.1b Aid as Payment for Political Support

There is evidence to suggest aid is used as a bargaining tool to gain political support.

The Alesina paper provides a telling example. Within the UN, on average developing countries votes matched those of France 64% of the time. However a regression using data from the last 20 years showed

that when this correlation increased to 73% the amount of aid France gave to these countries increased by 96%.

This is the darker side of aid, and in some respects a violation of public perception regarding the intentions of aid. In situations such as this it is little more than a payment to accrue political power.

3.1c Aid as Incentive for Trade Liberalisation

Relating to the other main theme of this report, a countries openness to trade very much effects how much aid they are likely to receive.

“Open economies get about twice as much as closed ones, ceteris paribus.” (*Alesina et al, 2000*) In a broad sense there appears to be some kind of reward system for operating a liberal trade system.

I believe that it is perfectly viable to use aid to induce political change, if the motivations for said change benefit the recipient country. As we have seen early trade liberalisation can induce growth so donor countries armed with this information should use aid as leverage to bring about reform in trade.

This would appear to be the only viable option in ‘weaning’ countries off aid and hopefully propelling them on a path towards sustainable growth.

3.2 Consumption or Growth Issues

Giving aid is very good and noble. But, how is this aid being consumed? If people are using it in an inefficient way then a percentage of the aid is wasted.

It is touted that growth in developing countries is difficult to achieve, as it requires a large initial amount of investment funded by a large savings surplus, which is often not present. “The model is straightforward. Economic growth depends on investment as a share of GDP.” (*Easterly, 2003*)

If aid is not stimulating investment then ultimately its effect on growth will be limited. Due to the destitute nature of recipients a lot of aid is spent on consumable goods to service the ‘short term’. Easterly reflects this idea and also adds only when “incentives to invest were favourable” is it actually observed.

There may even be situations discouraging investment, as the recipient countries feels they must continue to display poverty to be eligible for more aid.

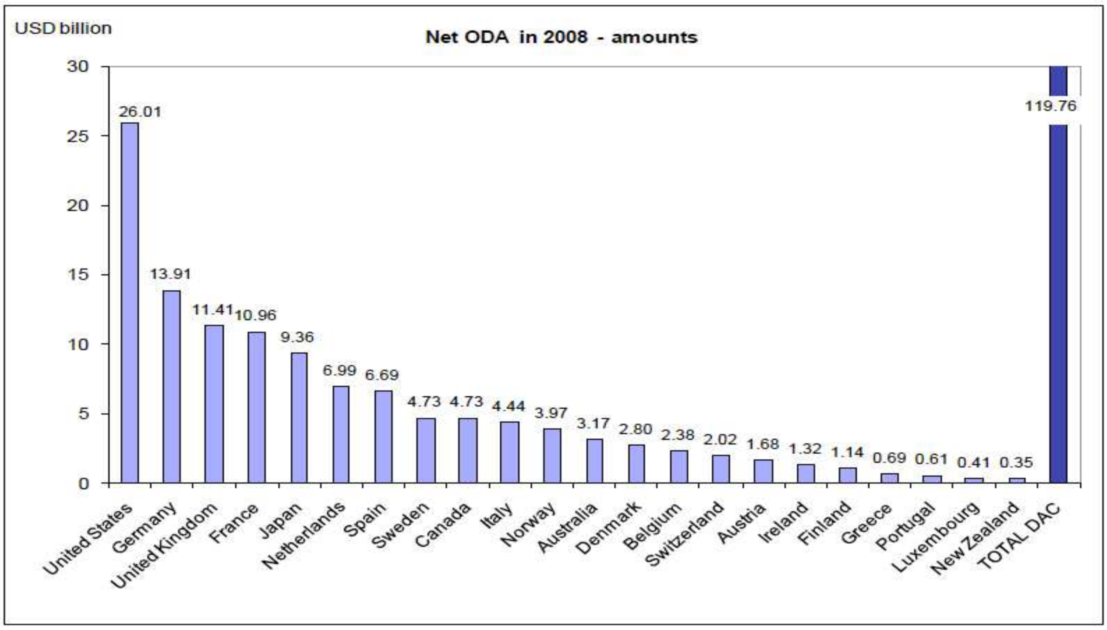
“Aid induced investments expand the role of governments in society and provide incentives to block and slow down market reforms.” (Erixon et al, 2006) As this point highlights if aid does actually add to

investment this increases the role of a government who are potentially ill informed and can potentially make bad decisions particularly in relation to trade.

3.3 Aid today

"Development aid is at its highest level ever in 2008" (OECD). In 2008 the amount of aid from other nations had increased 10.2% in real terms to 119.76billion dollars.

Table 7



These figures are difficult to interpret, as it is hard to disentangle how much aid is through a sense of altruism and how much is necessary due to dependence on aid.

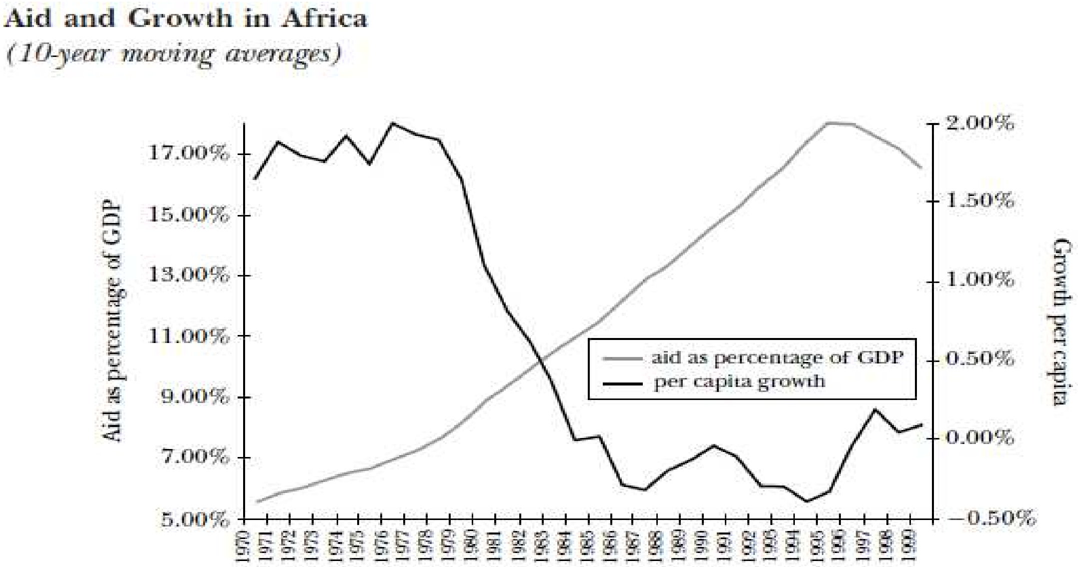
I believe the more aid we give, the more dependant developing nations become on this aid. The more we increase aid the less incentive we are giving countries to seek genuine alternatives to achieve growth. These larges increases in aid will ultimately damage the world economy due to the opportunity cost of not investing them in more lucrative opportunities.

"Aid can be effective in any country where it is accompanied by sensible economic policies." (Easterly, 2003) Some of the selectivity highlighted in the 'distribution' section can be a 'good' thing. Governments must target their aid in places in which it will make the most difference. But more importantly the fact is aid cannot be given alone. In many cases the western world is donating to extremely corrupt and

kakistocratical nations where aid without considerable assistance is an utterly futile pursuit.

<u>3.3a Aid and Growth: A Mixed Relationship</u>

<u>Table 8</u>



This graph displays evidence to suggest aid has no effect (or even a negative effect). It is obvious from the table that as when aid increases growth in GDP gradually declines.

This graph may well be hiding an important factor such as rapidly growing population that is distorting the figures. However, if we take this graph at face value it is not a reason to abandon aid altogether. Instead we should concentrate our efforts into understanding how we can adapt the aid to become more effective and realise its aims. This graph does highlight the fact that at its worst aid is very inefficient over time.

Aid may be very ineffective if it's indiscriminately given. It should instead be cleverly masqueraded as a stimulant for investment and growth.

<u>4. Conclusion: Aid and Trade Liberalisation United</u>

Globalisation is defined as; "a trend away from distinct national economic units toward one huge global market." (Hill, 2007) Globalisation is **inevitable** and is now difficult to reverse. So in many respects markets have decided that trade liberalisation is the way forward for future growth. As I have discussed trade liberalisation at its strongest can cause abundant growth but perhaps more important, through this,

improve the lives of those living in developing countries. This is not to say that this method is flawless, there are situations in which countries could suffer damage. Extremely poor countries cannot compete and will thus be condemned to a difficult and stagnant existence.
Taking this into account a developing country should adopt a ‘flexible’ approach in the face of trade liberalisation and exploit the opportunities when they come. Protectionism can be an ugly process at times but it may be necessary in some cases to protect some countries from becoming the ‘losers’ in trade liberalisation.

But how can we push countries towards this?

Perhaps the easiest way to push these countries towards this is **Aid**. As I have discussed aid is a difficult concept. Although it has the power to do good the fact is it is very inefficient, all the way through the cycle of giving it. Quite often aid is given to the wrong people, or to the right people who use it in the wrong way. Also, aid dependency is increasing showing no signs of slowing down.
I believe aid needs to first, become united, as it is more effective when it is coordinated from one hub. Secondly, aid needs to become the incentive for liberalising trade as that is a way in which we can seriously increase a countries chance of achieving growth.
At the very soul of aid is altruism. It is easy to become disillusioned with the figures and its obvious inefficient nature. But, the fact is aid helps people. I for one am willing to accept aids inefficiencies if I believe it is making a difference to individuals lives; which I truly hope that it is.

In many situations a developing country cannot achieve it with one of these factors alone. Only when ‘receiving aid’ and trade liberalisation is successfully juxtaposed at both ends of the relationship, will this become a possibility.

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Tables and Graphs

Table 1.*http://www.heritage.org/research/tradeandforeignaid/bg1761.cfm (Visited 22/12/2009)*

Table 2. OECD online Report. “Open markets matter: The benefits of trade and investment liberalisation.” 1999.

Table 3. OECD online Report. “Open markets matter: The benefits of trade and investment liberalisation.” 1999.

Table 4. Edwards, Sebastien. “Openess, Trade Liberalization, and Growth in Developing Countries.” Journal of Economic Literature, Vol.31 No, 3. pp 1358-1393. 1993

Table 5. *Todaro, Michael P. and Smith, Stephen C. Economic Development, Tenth Edition. Addison Wesley. 2009*

Table 6. *Alesina, Alberto and Dollar, David. “Who gives foreign aid to whom and why.” Journal of Economic Growth, Vol. 5. pp 33-63. 2000*

Table 7. *http://www.oecd.org/document/2/0,3343,en_2649_37431_41049090_1_1_1_1,00.html (18/12/2009)*

Table 8. *Easterly, William. “Can foreign aid buy growth?” Journal of Economic Perspectives. Vol. 17, No. 3. pp 23-48. 2003*