National Center for Policy Analysis

BRIEF ANALYSIS
No. 553
For immediate release:
Thursday, May 25, 2006

Trade and Economic Growth, Part II

by Arnold C. Harberger

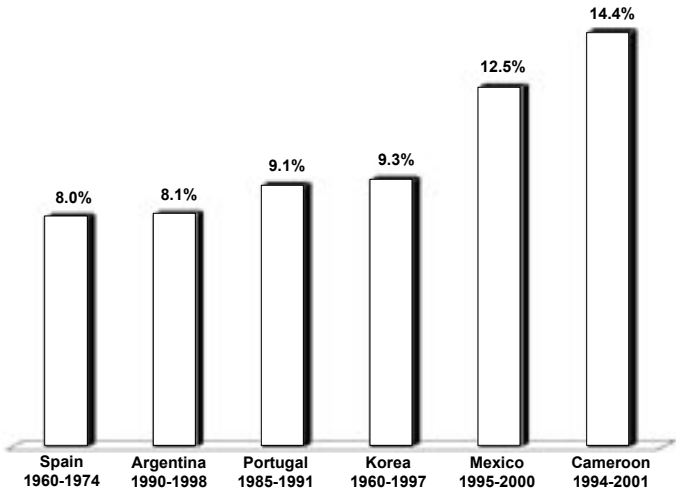
The period between 1950 and 2000 was the greatest half-century in human history in terms of the improvement of economic conditions and the betterment of life for the great majority of people. The last quarter of the 20th century was probably the best 25 years of all time from a strictly economic point of view.

According to the *Human Development Report* of 2003, both developing countries and high-income Organization for Economic Co-operation and Development (OECD) countries experienced significant economic growth. The study shows that from 1975 to 2001:

- Per capita income in developing countries grew an average of 2.3 percent annually compared to 2.1 percent for OECD countries.
- In the 1990s, developing-country per capita income growth rose to 2.9 percent and high-income OECD growth fell slightly, to 1.7 percent.

This unprecedented world economic growth has been accompanied by an equally impressive growth of world trade. In fact, it is the exception, not the rule, to find a country or area where international trade has *not* grown faster than its gross domestic product (GDP) at one point or another during the last 50 years. Most of the "growth miracle" cases — Japan, Taiwan, Korea, Brazil, Spain, Portugal, Greece, Singapore, Hong Kong, Thailand, Malaysia, Indonesia, China and now India — have experienced such episodes of export-led growth. The opening of these economies to freer international trade was an important factor in generating and supporting these growth miracles, as well as most successful growth episodes in other countries. For just about every class of country — whether classified by state of development, form of government, cultural or religious traits, economic structure or geographical region — the relative importance of international trade has been growing over the last five decades.

Selected High-Growth Episodes*



* Percentage by which exports grew faster than gross domestic product.

Source: Arnold C. Harberger, *On the Process of Growth and Economic Policy in Developing Countries*, U.S. Agency for International Development, PPC Issue Paper No. 13, December 2005.

Therefore, it appears that market-friendly, liberalizing policies help facilitate growth. And, as the following will show, if any single measure signals that policies are moving in the right direction, it is the growth rate of a country's exports.

Economic Growth. Successful growth episodes can be defined as periods of five or more years during which a country enjoys average economic growth of 4 percent or more, after adjusting for inflation. The observed average growth rate is composed of incremental increases in capital and labor, and real cost reduction — an increase in the productivity of the labor and capital used to produce goods. Any additional explanatory factor works through one or more of these components. Such is the case for any stimulus coming from a country's export performance.

Export Growth. Successful growth episodes are closely linked to the speed of export growth. Export growth is not a component of the GDP growth rate in

the same sense as the other three factors. But there are circumstances that produce export-led growth. These include trade-liberalizing policies, cost-reducing innovations by exporters and simply the good luck of real increases in world prices of those exports.

For example, consider a shift of a certain amount — say $10 million — of resources from the production of home goods (nontradables) to exports. This means people would have $10 million less of nontradable items, but could buy $10 million more of imports. At this point, there is no contribution to growth, just a shift in the pattern of production.

The situation changes a bit if one posits real cost reduction as the stimulus to the resource shift. Real cost reduction occurs when the productivity of labor and capital increases. If production of the exports in question benefited from a 20 percent real cost reduction, the $10 million of shifted resources could produce as much as $12 million of the export item.

"Trade liberalization spurs economic growth."

The connection between exports and growth comes from real cost reduction in export activities and is no different in kind from real cost reduction in other activities, such as residential construction or domestic transport, which are clearly nontradable goods and services.

Economic growth is also linked to export expansion due to trade liberalization. But even a huge liberalization will have only a transitory effect on the growth rate (see "Trade and Growth, Part I"). Thus, we would expect a modest connection between export expansion and the economic growth. But we see something quite different. In almost every successful growth episode, exports grow faster than GDP, and usually much faster, even after adjusting for price inflation. The figure shows some of the 59 high-growth episodes that occurred in 41 countries from 1960 to 2001. Overall:

- Exports grew over 2 percentage points faster in 37 cases and faster by over 4 percentage points in 21 of the 59 cases.
- Exports grew faster by 5 percentage points or more in 18 of the 59 cases.

This is a much stronger link than we would expect from trade liberalization and/or real cost reductions in the countries' export industries. Mexico, for example, had a very high rate of export growth compared to GDP, with exports growing 12.5 percentage points faster from 1995 to 2000. Cameroon had the highest rate, with exports outpacing GDP by 14.4 percentage points between 1994 and 2001. [See the figure.]

A Gold Rush Economy? There is the possibility that an increase in exports mobilizes new resources. This is something like a "gold rush" economy. The gold rushes of the past brought a flood of miners to California, Alaska and other areas enjoying mineral booms. But they also brought storekeepers, construction workers, entertainers and so forth. If these people were simply shifted from another part of the same national economy, producing less there and more here, it would make little economic difference. But if they come from abroad, as many did in California and Alaska, and bring capital along with them, there is an incremental increase in labor and capital due to the expansion of an export industry.

The gold rush example shows how export expansion is often supported by capital investments from abroad. Such an expansion can also stimulate a derivative growth in demand for nontradable goods and services, which can be met in part by increases in the labor force and capital stock. Thus, export booms are linked to international capital movements, immigration and increases in labor force participation.

Conclusion. There is a strong correlation between successful growth episodes and the rate of export growth. The necessary circumstances for growth can be achieved by liberalizing trade and mobilizing resources through free markets. Government policies support various components of growth — by fostering the growth of human capital, facilitating the process by which firms make productive investments and, above all, creating a favorable environment for seeking and implementing real cost reductions. Government policies cannot create these forces, but government can and should open the door.

Arnold C. Harberger is a professor of economics at the University of California, Los Angeles.