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The effect of World Bank trade adjustment assistance on trade and growth, 1987–2004: Is the glass half full or half empty?

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ABSTRACT

This paper studies the association between trade reform, growth, and trade adjustment assistance in a sample of developing countries that underwent trade reforms during 1987–2004. Our analysis explicitly differentiates between a group of countries that received trade adjustment loans from the World Bank and a non-recipient group. The results suggest that trade adjustment assistance is positively associated with economic growth after trade reform in the medium to long run. In comparison to a pre-reform period and to the non-recipient group, the recipient countries registered 0.2 percent higher growth of real GDP per capita, 5.0 percent higher import growth, and 2.5 percent higher export growth over a period of three to five years after trade reform.

1. Introduction

The late 1980s to early 2000s constituted a period of significant trade reform initiatives across the developing world. During these years, protectionist policies and import substitution-led strategies were abandoned as the developing countries sought to achieve more sustainable paths to development and greater economic integration into the global trading system. For some countries,

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the process of trade reforms was undertaken without trade adjustment assistance and external assistance. For many, however, trade reforms were aided by international organizations, both technically and financially. This paper studies economic performance after trade reforms and the role of trade adjustment lending extended by the World Bank to a large number of developing countries from 1987 to 2004.

By focusing on this episode of trade reforms and trade adjustment loans, our work provides a historical account and contributes to a strand of the literature that studies the effect of trade adjustment assistance on economic reform. Recent works, notably Cadot et al. (2011), point out that the challenges facing any evaluation framework on the effectiveness of trade adjustment assistance are due to the lack of consensus on suitable criteria for distributing the aid for trade effectively. Any evaluation study is further complicated by the wide variation in the quality of data and cross-country empirical specifications.[1] Against these backdrops, a recurring theme in the literature is to search for answers to the following two empirical questions: first, were economic reforms beneficial to the countries that undertook them, i.e. in terms of macroeconomic outcomes, productivity, and GDP growth; and, second, did the trade adjustment assistance have favorable value-added impacts that helped improve the economic outcomes significantly in the aid-recipient countries?

Trade has traditionally been viewed as a driving factor of external balance and an engine of growth through improved resource allocation, stronger incentives for adaptation and innovation, cheaper capital goods, and higher foreign direct investment flows associated with new trade opportunities. While it is believed that countries grow more rapidly by abandoning a long-term autarkic approach, existing evidence on the association between trade reforms and economic performance have been inconclusive. As trade remains important to the overall development strategy in the developing countries, this empirical uncertainty has generated a long-standing debate on whether there is any link between trade reform and economic growth, as well as any potential role of trade adjustment assistance and external intervention.

In the past, well-known studies such as those by Sachs and Warner (1995), Krueger (1998), Edwards (1998), Frankel and Romer (1999), Dollar and Kraay (2004) and Berg et al. (2012) suggest that more open countries tend to grow faster. In the literature, openness to trade, or trade intensity, is typically defined as the ratio of gross trade (imports plus exports) relative to GDP. However, as Looi Kee et al. (2009) and Collier et al. (1999) argue, the trade intensity index may not be entirely appropriate as an indicator of the trade policy stance. The index may instead reflect an increase in aid flows or an improvement in terms of trade rather than the extent of trade reforms. Further, Rodriguez and Rodrik (2000) point out methodological problems with the empirical strategies thus far undertaken to establish the relation between trade reform and economic growth, particularly the use of the openness dummy variable proposed by Sachs and Warner (1995) and later by Wacziarg and Welch (2008). This is because in practice the openness dummy variable that aims to characterize the restrictiveness of a trade policy regime is often correlated with other measures of poor economic performance. To improve upon the restrictiveness measure of a trade regime, Wacziarg and Welch (2008) attempt to identify years when non-reversed trade liberalization programs were launched. Applying this new indicator together, they find that output, investment, and openness increase significantly after trade liberalization.

Clearly, a proper identification of the years in which trade reforms have taken place allows for a more assertive conclusion about the impact of trade reforms on output growth and other variables of general interests, including both export and import growth. For example, using twenty-two episodes of trade liberalization, Santos-Paulino and Thirlwall (2004) find that after controlling for several variables such as changes in world demand and the real effective exchange rate, trade liberalization still has a large positive impact on both import and export growth. In addition, an empirical framework also needs to take into account contemporaneous events and lagged effects in assessing the economic response to trade reforms; for instance, Greenaway et al. (2002) show in a dynamic model of growth that trade liberalization impacts the growth rates of real GDP per capita favorably, with the effect appearing to be modest, lagged and relatively persistent.

[1] Also see the useful discussions in Wei and Zhang (2010), Deaton (2010), and Rajan and Subramanian (2008).