# How Much Do Trading Partners Matter for Economic Growth? by Vivek Arora and Athanasios Vamvakidis ++ - A Review

*Dinci J. Yilkudi* *

## I. Introduction

The paper empirically examined the extent to which a country's long-term economic growth was influenced by the economic fortune of its trading partners. The study used panel data for over 100 countries to see if trading partners' growth had a strong effect on domestic growth. A strong relationship was found between the economic growth of a country and the economic conditions of its trading partners.

## II. Summary of the paper:

The authors observed that though literature says that trade openness has a positive impact on growth, the relationship between foreign economic conditions and domestic economic growth has been relatively neglected in the literature. Hence, they undertook an analysis using panel data for the period 1960–1999 for 101 industrial and developing economies. The analysis suggested that a 1 percent increase in economic growth among a country's

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* *Dinci J. Yilkudi is a Senior Economist in the Research Department of the Central Bank of Nigeria.*

trading partners (all things being equal) was correlated with an increase in domestic growth of 0.8 percent. In addition, the authors also believed that the level of foreign income relative to domestic income matters for growth because the ratio of the average per capita GDP of trading partners relative to a country's own per capita GDP was positively correlated with growth. This result was found to be stronger for more open economies and for more recent decades (1980–1999).

There have been debates as to whether trading with less developed countries was beneficial. The authors stated that it was important to note that the net impact on any country's growth as a result of trading with relatively less developed countries was an empirical question, as the impact is negative if the relative income effect dominates and positive if the relative growth effect dominates. Empirical literature on the growth-openness connection was reviewed and most studies documented a positive relationship between openness and growth. The studies showed that openness increases growth rates, unconditional convergence and income. However, a few studies insisted that this was not so as some of these studies did not control for other important growth determinants and that shortcomings existed in the openness measures that were used. Economic conditions abroad, including both growth rates and income levels, were seen to have impacts on growth through channels such as aggregate demand effects and technological spillovers.

The authors started their analysis by constructing trade weights that could be used to calculate weighted average growth rates and income levels of each country's trading partners. They used exports weights and constructed a time series for the period 1960–1999. The data revealed that the relative importance of a country's trading partners did not change much, as reflected in the high correlation of trade weights across time. Specifically, from 1960–1999, the correlation between trade weights in successive 5-year periods was 0.93 and for successive 10 year periods, it was 0.88. Second, for most countries, the set of most important trading partners remained relatively stable over time. Third, countries that trade with relatively rich countries (in terms of per capita GDP) in one decade trade with relatively rich countries in the next decade too; so also relatively poor countries. Fourth, the data indicated that the most important trading partners had been United States, followed by United Kingdom, Germany, the Netherlands, France, Italy and Japan. The impact of trading partners' growth on domestic growth was quantified by estimating a fixed-effects panel regression which allowed an analysis of a cross-section of countries over time. They estimated the model as follows:

$$(\textit{Real per capita}\ \text{GDP}\ \textit{growth})_i = c_i + \beta X_i + u, \quad \textit{for country}\ i = 1, \ldots, n.$$

Where $c_i$ is the matrix of constant terms for each country i; $X_i$ is the matrix of independent variables; β is the matrix of parameters to be estimated; and u is the error term.

The results of the estimates showed that even after controlling for other growth determinants, a 1 percent increase in growth among a country's trading partners was correlated with as much as 0.8 per cent increase in domestic growth (it pays to trade with fast growing countries). Second, trading partners' growth with domestic GDP and domestic per capita GDP was not statistically significant, meaning that both rich and poor countries benefit from trading with fast-growing trading partners. Third, a rise in trading partners' GDP that lowers the ratio of domestic to foreign GDP by 10 percent was correlated with an increase in domestic growth of 0.13 per cent (meaning that what matters for a country's growth is not how rich its trading partners were but rather how rich they were relative to the country itself. The authors, therefore, came to the conclusion that a country's growth was positively associated with both the growth rates and relative incomes of its trading partners, and countries benefit from trading with fast-growing and relatively richer countries.

## III. Comments

The paper is an important contribution to the literature on economic growth. Specifically, the authors were able to address a question which has been relatively unexplored in the growth-openness literature, that is, how much the economic condition of trading partners' matter for growth rather than on whether and how much openness in general matters. In doing this, they mentioned specifically that the growth of trading partners is very important for economic growth in the domestic economy and that trading with relatively better economies would increase economic growth. The authors were also able to use appropriate trade weights in their analyses by ensuring that the weights used were not based on a fixed point in time, therefore, capturing the changes accurately. They achieved this by estimating a time series of trade weights for each country.

Notwithstanding the contribution of the paper to the body of literature, it is important to note key areas which it failed to address. These are:

1. Though the authors mentioned that the economic conditions of trading partners mattered for economic growth, they failed to mention those necessary economic conditions. An analysis of the economic conditions would have helped in achieving the objectives of the paper. A clearer picture would have been given by stating the channel of this effect.

2. The absorptive capacity of an economy matters a lot if the benefits of trading are to be reaped. Not all countries would be expected to benefit equally from trading with relatively more developed economies. Whether a country benefits depends on its relative backwardness and its absorptive capacity. New products and new production methods could be transferred to domestic economies only if these countries are able to imitate and acquire new skills, and if people are willing to learn. This increases competition and improves exports, leading to economic growth.

3. Next to the absorptive capacity of the domestic economy, are structural rigidities and production bottlenecks that are inherent in most developing

economies. These include corruption and lack of adequate infrastructure. Even when there is absorptive capacity, infrastructural facilities may not be available, or are inefficient. Also, the issue of corruption which is common to many developing countries, particularly in Sub-Saharan Africa, could cripple the rewards of trade. In the recent past, however, many governments have made a lot of effort at addressing this. For example, in Nigeria, concrete steps have been taken, especially, with the setting up of the Economic and Financial Crimes Commission (EFCC), and the Independent and other related Corrupt Practices Commission (ICPC).

4. The thrust of the paper was in contrast to the dictates of economic integration and trade liberalization. Economic integration entails the elimination of trade barriers between economies. This would not allow for countries to individually dictate the countries they want to trade with. This has important implications for economies that are seriously involved in the creation of single economic zones with other countries. The introduction of a common external tariff (CET) would significantly simplify and rationalize tariff structures, and eliminate import prohibitions, thereby improving market access opportunities for third world countries.

This paper is very relevant to Nigeria, especially as the country has a strong desire for economic growth and development. However, for Nigeria to benefit from trading with its partners, it is pertinent to note that spillover effects to an economy are not only gotten through foreign direct investment (FDI), but also through trade, thus, emphasis should not only be placed on FDI. Nigeria should also open up and sustain new markets in other parts of the world such as South Africa which seem to be very promising.

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