Trade Openness and per Capita Income:
The Case of Kuwait

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ملخص :

الدراسات السابقة التي اهتمت بقياس تأثير تحرير التجارة على التنمية وجدت أن هنالك علاقة موجبة وموجهة من تحرير التجارة على التنمية. في هذا البحث يتم دراسة تأثير تحرير التجارة على دخل الفرد، وقد أخذت دولة الكويت كحالة تطبيقية.

تشير نتائج هذا البحث الى أن هنالك تأثيراً سالباً لتحرير التجارة على دخل الفرد وبدرجة معنوية مرتفعة مما يدلل على أن هنالك عوامل أخرى تعمل على التقليل من تأثير تحرير التجارة على دخل الفرد في الكويت. جاءت هذه النتيجة لتشير لوجود العديد من المسائل التي قد تتعلق بتوزيع الدخل، تركيبة الصادرات، والقيود التجارية ، والتي بدورها تستحق مزيداً من البحث في المستقبل.

Abstract:

Early studies that tried to measure the impact of trade openness on development found out the existence of positive relationship between the two.

This paper attempts to investigate the impact of trade openness on per capita income, the case of Kuwait, as an empirical analysis.

The results of this study indicates that there is a negative impact of trade openness on per capita income in Kuwait, and statically significant which indicates the existence of other variables other than the one under consideration that might have impact on per capita income, such as, income distribution,

structure of exports, and trade restrictions, which deserve further studies in the future.

Introduction:

In the 1980s economists dealing with developing countries began to recommend, with increasing insistence, development strategies based on market-oriented reforms that included as a fundamental component the reduction of trade barriers and the opening of international trade to foreign competition. Even the staff of the United Nations Economics Commission for Latin America (ECLA), at one time the most ardent supporter of protectionist policies, began to favor outward orientation.

Moreover, the World Bank, the International Monetary Fund, and other multilateral institutions routinely required the developing countries to embark on trade liberalization and to open up their external sector as a condition for receiving financial assistance.

The collapse of the Communist system in Central and Eastern Europe in the late 1980s and early 1990s added impetus to the analysis of policy reform and structural adjustment. The opening of the external sector and the convertibility of the currency are, in fact, at the center of almost every reform package proposed to former Communist nations.

Jeffrey Sachs (1987), for example, has questioned the premise that trade liberalization is necessary components of successful outward oriented strategies. He has argued that the success of the East Asian countries was, to a large extent, due to an active role of government in promoting exports in an environment where imports had not been fully liberalized, and where macroeconomic (and especially fiscal) equilibrium was fostered.

Lance Tayler (1991), offered a stronger view, arguing that "the trade liberalization strategy is intellectually moribund," and that there are no great benefits (plus some loss) in following open trade and capital market strategies".

Importance of the Research:

In spite of the recent move towards trade reform in scores of developing countries around the world, there still remain some controversies regarding some aspects of trade policies. A particularly important area of disagreement refers to whether "trade openness" packages have played an important role in the performance of the outward oriented economies. This paper will try to fill the gap via empirically investigates the impact of trade openness on per capita income.

To investigate the impact of trade openness on per capita income, this paper will; First, review the modern literature on trade policy in developing countries. Second, conduct an empirical analysis by using Cointegration and Error Correction in time series analysis to investigate the relationship between trade openness and growth in per capita income, the case of Kuwait.

Literature Review:

In the literature, most of the early studies attempted to study and measure, theoretically and empirically, the impact of trade openness on development. Most of these studies found out the existence of positive relationship between trade openness and development.

However, greater openness to world markets can affect income distribution between and within countries. As the growth literature reveals, in general, changes in poverty are mostly associated to changes in average incomes, and hence it is pertinent to evaluate both issues in a comprehensive framework.

Is growth due to trade openness different from growth in general? Or, does trade openness led-growth is anti (pro) poor and thus have negative (positive) distributional impacts? However, if trade openness worsens the distribution of income it would not contribute to poverty reduction, despite the positive overall effect on growth.

The extensive body of evidence surveyed by Goldberg and Pavnick (2007b) reveals a contemporaneous increase in globalization and inequality in most developing countries. The mechanisms through which globalization affects income distribution are country, time, and case specific.

Importantly, the impacts of trade openness need to be examined in conjunction with other concurrent policy reforms, and the implementation details of particular policies matter. For that reason, relying solely in pooled studies might not conduce to satisfactory policy prescriptions.

Early critics of free trade and the current popular debate suggest that income disparity is brought about by international trade between unequal countries. In the other side of the argument, some authors suggest that movement toward free trade may lead to a reduction in income inequality across countries (Ben-David, 1993).

Generally, there is no systematic relationship between growth and changes in income distribution. Thus the income of the poor tends to grow proportionally with mean per capita income (David and Kraay, 2001). If faster growth were associated with worsening income distribution, then there would be a limit on how much improvement in poverty could be expected from growth alone.

O'Rourke (2001) and Bourguignon and Morrisson (2002), in their studies of historical trends in globalization and inequality, conclude that globalization has been a force for between-country convergence among participating countries since the 1820s. However, Dowrick and Golley (2004) reveal that while trade openness promoted convergence in the 1960s and 1970s, since 1980 the benefits of trade are mostly attributed to the richer economies, with modest benefits to the less developed economies.

Most of the dynamic benefits of trade are obtained through productivity growth, with a small contribution coming through increased investment. Sala-i-Martin (2006) finds that overall

global inequality has been falling since 1980, due to between country convergences. However, other measures of inequality (e.g. the absolute difference of the Gini coefficient to the world's mean, as described by Atkinson and Brandolini, 2010), provide a more pessimistic perspective of the evolution of world income distribution, showing an increasing trend in inequality.

The trends in income distribution also diverge within developing economies. Income inequality has declined through Latin America in the past decade, while it has been growing in countries such as China, India and South Africa (López Calva and Lustig, 2010). The leading factor that explains the decline in inequality, particularly in Latin America, is the narrowing of the earning gaps between skilled and low skilled workers (Arroyo-Abad and Santos-Paulino, 2009).

The studies coordinated by Ian Little, Tibor Scitovesky, and Maurice Scott (1970) and by Bela Balassa (1971) are the pioneer modern multi-country investigations on trade orientation and economic performance in the developing countries.

Perhaps the most important contribution of these studies is that they provided comparative evidence on how the structure of protection to intermediate and final goods affected relative profitability to sectoral value added. Both Little, Scitovesky, and Scott (1970) and Balassa (1971) showed that the degree of protection granted to manufacturing value added was significantly higher than suggested by straightforward data on nominal import tariffs.

According to Little, Scitovsky, and Scott "the policies followed in most of the developing world after World War II had excessively encouraged industrialization at the cost of reducing the incentives for expanding agriculture and export."

They further argued that the most important consequences of this protectionist policy had been a worsening of income distribution, a reduction in savings, an increase in the rate of unemployment and a very low rate of capacity utilization.

The fundamental policy recommendation emerging from these studies was that the developing countries should greatly reduce the degree of protection, opening up to international competition.

One major criticism the previous studied faced was neither Little, Scitovsky, and Scott (1970) nor Balassa (1971) ventured into the analysis of how specific countries evolved from one trade regime to another, nor did they investigate empirically and in detail how alternative policies had affected growth in particular historical settings.

The first systematic attempt at formally classifying trade regimes was introduced by Anne Krueger (1978) and Jagdish Bhagwati (1978). Trade orientation was measured by the degree by which the protective (and incentives) structure in a country was biased against exports.

In the Bhagwati- Krueger project trade liberalization was defined as any policy that reduces the degree of anti-export bias. In the empirical country cases, the authors mostly concentrated on reductions in the import licenses premium (PR) as the fundamental step in liberalization reforms. A particularly important property of this definition of trade liberalization is that it does not require zero, or even very low, import tariffs. In fact, according to this definition it is possible to have a liberalized economy with very high tariffs.

In the 1980s, as a way to provide a solid intellectual basis to its new program lending policies, the World Bank commissioned a monumental 19 country comparative study on trade liberalization led by Michael Michaely. The project not only analyzed the characteristics and consequences of different trade regimes, as its predecessor had done, but went further, investigating the most appropriate ways of actually implementing a liberalization policy.   Issues related to sequencing, speed, and transitional cost were analyzed and compared across countries.

What is the effect of trade orientation on economic performance? This is the fundamental issue which multi-country comparative studies ultimately have to address. Using data from the individual country studies, Krueger (1978) econometrically tested two hypothesis: (1) more liberalization regimes result in higher rates of growth of exports; and (2) a more liberalized trade sector has a positive effect on aggregate growth.

In the latter case she conjectured that there are two channels through which openness positively affected growth. First, there are direct effects that operate via dynamic advantages including higher capacity utilization and more efficient investment projects. Second, there are indirect effects that work through exports: more liberalized economies have faster growth of exports and these, in turn, result in more rapidly growing GNP.

In trying to test the more controversial proposition that trade regimes affect GDP growth independent of exports, Balassa faced the traditional problem of measuring trade orientation. Instead of using dummy variables, as Krueger (1978) had done in the NBER project, Balassa (1982) decided to use the growth rate of exports as a proxy for policy orientation.

Using Spearman rank coefficients on pooled data for eleven countries, he found that exports growth and output growth had been positively correlated and concluded that "the expansion of exports and the consequent growth of GNP have been the result of the incentives applied", Balassa (1982, p. 29).

By and large the results supported the view that countries with more intense and sustained liberalization have outperformed those with failed liberalization attempts.

Measuring the benefits of trade reform has been a frustrating endeavor. Although the discussion of trade policy at times gives the impression that a liberal trade regime can do wonders for a country's economy, and most observers believe firmly that trade reform is beneficial, yet systematic attempts at

quantification fail to single out trade policy as a major factor in economic growth.

But then, of course, growth accounting has not come up with a satisfactory explanation for the residual which may be as much as 30 to 50 percent of growth. The channels through which trade liberalization could bring benefits are broadly these: improved resource allocation in line with social marginal costs and benefits; access to better technologies, inputs and intermediate goods; an economy better able to take advantage of economies of scale and scope; greater domestic competition; availability of favorable growth externalities, like the transfer of know-how.

The static gains from improved resource allocation are classical source of a gain from free trade. Under perfect competition a small, price- taken country will gain by eliminating tariffs. Consumers are better off because their incomes stretch further, and resources are used more efficiently because they are no longer used to produce goods that could be imported at a lower price.

While the traditional discussion often focuses on final, homogeneous goods, the case of freer trade is enriched by including the facts that trade liberalization increases the variety of goods, and rises productivity by providing less expensive or higher quality intermediate goods.

This aspect has been explored in some recent models of growth; for example, Romer (1989) emphasizes both the productivity of specialized resources and the limitations given by the size of the market. In a restricted economy, only a narrow range of specialized intermediate goods or capital goods can be profitably produced and therefore the full range of technological possibilities, which rely on a potentially broader range of inputs, cannot be exploited effectively.

In Romer's model, a greater variety of inputs do more for production than a greater quantity of a narrow range of inputs. Thus, access to a variety of foreign inputs at a lower cost shifts

the economy-wide production function outward, which illustrates a concrete link between productivity and trade regime.

Empirical Analysis:

Introduction:

Early studies that have been conducted on the estimation of trade openness and its impact on growth had found a positive impact directed from trade to growth. The major studies were by Balasa (1977) and (1985), Michaely (1976), Chow (1987), Bahmani and Alse (1993).

This paper, investigates the relationship between trade openness and its impact on per capita income (the case of Kuwait) as a measure of growth. Several initial comments about the paper are worth making.

First, it starts by establishing the time-series properties of the individual variables. The aim here is simply to show that the variables are integrated of the same order. The sampling distribution of the OLS estimator is not well behaved if the disturbance is non-stationary: the distribution of OLS estimator does not have finite moments, and furthermore, OLS is inconsistent in general.

If a unit root is present, it is essential to first difference the variables, thereby eliminating the unit root and achieving stationarity before attempting to estimate the growth model. For this purpose the Augmented Dicky-Fuller (ADF) test as recommended by Engle and Granger (1987) in addition to the Durbin-Watson Statistic suggested by Sargan and Bhargava (1983) to determine whether the time series are stationary in first differences or levels.

Second, Cointegration test is used to establish a long-run equilibrium relationship among Per Capita Income (PI), Trade Openness (OP), and Exchange Rate (R).

Third, modeling the dynamic adjustment of the model, I use the Error-Correction procedure. The error-correction methodology follows that in Engle and Granger (1987).

Data Sources

Throughout the International Financial Statistics (IFS) CD released by IMF, a time series annually data about Kuwait were obtained, and covering the period (1990-2014).

Methodology

The empirical analysis will be carried in the following steps:-

I.   Model Specification.
II.   Testing for Statioary Series.
III.   Cointegration Equations.
IV.   Error-Correction Model.

I. Model Specification

This paper applies the Unit Root test, Cointegration and Error-Correction Modeling method to the initial model of trade and growth.

The Initial Model

$$LnPI_t = a_0 + \beta_1 LnOP_t + \beta_2 LnR_t + \varepsilon_t \quad \dots\dots\dots (1)$$

Where PI is per capita income (GDP/Population), OP is a measure for trade openness, nominal {(Export + Import)/GDP}, R is the official exchange rate, and ε is the error term, Ln is the natural logarithm, and t is the time period.

Table 1: Estimation of the initial model (Equation 1)

Dependent Variable: LOG(PI)
Method: Least Squares
Sample: 1990 2014
Included observations: 25

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	4.378511	2.381790	1.838328	0.0796
LOG(OP)	-0.690305	0.188754	-3.657159	0.0014
LOG(ER)	-6.162543	2.112288	-2.917473	0.0080
R-squared	0.627083	Mean dependent var		16.88055
Adjusted R-squared	0.593181	S.D. dependent var		0.518234
S.E. of regression	0.330542	Akaike info criterion		0.736001

Sum squared resid	2.403677	Schwarz criterion	0.882266
Log likelihood	-6.200012	F-statistic	18.49715
Durbin-Watson stat	0.465345	Prob(F-statistic)	0.000019

Table (1) reports a significant t-statistic for the exchange rate (-6.162543) and a significant coefficient for the trade openness (-0.690305) , with R-squared coefficient (0.627083) greater than the Durbin-Watson coefficient (0.465345), and Prop (F-statistic)= 0.000019 (less than **0.05**), which indicate that there is a spurious regression , which gives a lead to investigate whether this spuriousity was caused by nonstationary time series, trends, or due to model misspecification.

II. Testing for Stationary Series

Unit Root Tests should be performed before applying cointegration tests, because statistical inference from time series is usually based upon the assumption of stationarity.

This study employs the Augmented Dicky-Fuller (ADF) test. The null hypothesis of nonstationarity is tested against the alternative of stationarity and is investigated for all variables (PI, OP, and R). Table 2 reports the Unit Root Tests using the ADF test.

Table 2: Stationary test of each variable

Variable	With no Trend	With Trend
LnPI	-1.280056 *	-3.673154 *
LnOP	-0.780002	-1.910978
LnR	-1.617457	-2.451246
Δ LnPI	-5.071937 **	-5.019760 **
Δ LnPO	-6.036895	-5.949002
Δ LnR	-5.008906	-5.177036

Notes: * The Mackinnon (1996) critical values for the ADF test that Includes a trend is -3.644963 at the usual 5% level. The comparable figure with no trend in the test is - 3.029970.

** The Mackinnon (1996) critical values for the ADF test that includes a trend is -3.658446 at the usual 5% first difference. The comparable figure with no trend in the test is -3.020686.

Taking the first differencing for all series induce stationarity, which implied that all the series are integrated of order one ...I~(1).

III.   Testing for Counteraction

Applying Johansen and Juselius (1988) test, the results are reported in table 3.

Table 3: The Cointegration Test
Unrestricted Cointegration Rank Test

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	5 Percent Critical Value	1 Percent Critical Value
None **	0.773356	37.45175	29.68	35.65
At most 1	0.105715	3.311143	15.41	20.04
At most 2	0.031718	0.741332	3.76	6.65

*(**) denotes rejection of the hypothesis at the 5%(1%) level.
Trace test indicates 1 cointegrating equation(s) at both 5% and 1% levels

To determine the number of cointegrating relations r, subject to the assumptions made about the trends in the series, we can proceed sequentially from r = 0 to r = k-1 until we fail to reject.

The first row in table (3) tests the hypothesis of no Cointegration, the second row tests the hypothesis of one cointegrating relation, the third row tests the hypothesis of two cointegrating relations, and so on, all against the alternative hypothesis of full rank, i.e. all series in the VAR are stationary.

As can be seen, the null of no Cointegration is rejected because the values of the trace statistics are greater than the critical value. However, the null of at most one co-integrating vector cannot be rejected in favor of r =2. Also, the null of at most two co-integrating vector cannot be rejected in favor of r =3. Thus, there is one vector among the variables of the initial model (equation #1).

Furthermore, the trace test indicates that the variables have long run association (in the long run they move together). In addition, when the variables are cointegrated, then we can use the Error Correction Model (ECM).

IV.   Error-Correction Models

Having detecting the number of cointegrated equations (Johansen's procedure), moving on to use the error correction model (ECM) becomes a necessity.

The estimated ECM takes the following form in correcting the initial model:-

$$\Delta LnPI_t = a_0 + \delta_1 \Delta LnOP_{t-1} + \delta_2 \Delta LnR_{t-1} + \varphi EC_{t-1} + \varepsilon_t \dots\dots(2)$$

Where:-

Δ is the difference operator, (PI) Per capita Income, (OP) Trade Openness,(R) Official Exchange Rate, (EC_{t-1}) The error correction term, (Ln) The natural logarithm, ε : The error term, t: The time period.

In an error-correction model, the short-term dynamics of the variables in the system are influenced by the deviation from equilibrium.

Table 4: The Error Correction Model (ECM) Estimation

Dependent Variable: D(LPI)
Method: Least Squares
Sample(adjusted): 1991 2014
Included observations: 24 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.049458	0.033483	1.477123	0.1552
D(LOP)	-0.361048	0.141309	-2.555030	0.0189
D(LER)	-3.427350	1.485119	-2.307794	0.0318
EC(-1)	-0.256704	0.111725	-2.297636	0.0325
R-squared	0.413369	Mean dependent var		0.067738
Adjusted R-squared	0.325374	S.D. dependent var		0.195865
S.E. of regression	0.160875	Akaike info criterion		-0.665363
Sum squared resid	0.517617	Schwarz criterion		-0.469021
Log likelihood	11.98436	F-statistic		4.697660
Durbin-Watson stat	1.993482	Prob(F-statistic)		0.012185

From table (4) we can notice that the impact of trade openness is negative (-0.361048) and statically significant (t-statistic=-2.555030), and the R-square is (0.413369) which indicate that the impact of trade liberalization on per capita income in the case of Kuwait is insignificant.

Furthermore, the coefficient and the magnitudes of the EC term (φ) indicates the speed of adjustment to the long-run equilibrium relationship in the ECM.

In our analysis, we found that φ (the coefficient of the EC term) in equation #2 is negative (-0.256704) and statistically significant (t-statistic=-2.297636), which indicates that that Trade Openness(OP) Granger causes Per capita Income (PI), and it also indicates that OP and PI are adjusting to their long-run equilibrium relationships with a speed of adjustment =25.67%.

In addition, the results revealed a negative impact of trade openness on per capita income, the coefficient of OP=-0.361048, and statically significant (t-stat. = -2.555030). This finding raises many issues need to be investigated in future research, such as, income distribution, structure of exports, and trade restrictions.

Conclusion:

One problem for trade openness is political. Too long a phase-in period and too many safeguards for those who might be adversely affected in an invitation to disruption and reversal. The other problem comes from the exchange rate.

The elimination of obstacles to trade creates an immediate increase in imports. But although inputs become more readily available and technology improves, the beneficial rise in exports does not happen immediately, even if a real depreciation is undertaken.

These findings give a clear message that in the case of most of the developing countries there are other factors contribute to the low per capita income, which decrease the impact of trade openness on per capita income.

As we know, developing countries have to establish efficient institutions to carry out the objectives of the society as well as to secure the continuum progress of the development process in the country.

In addition, the lack of freedom and human rights contributed to push down those societies toward wars and more social and economic crises, which at the en Free trade Leeds to a more economically rational market structure. Gains from liberalization also result from scale economies and economies of scope that arise in wider markets.

Moreover, markets in protected economies are narrow and lack of competitors from the rest of the world fosters oligopoly and inefficiency. Protectionism can create market power for domestic firms, where under free trade there would be none.

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