THE ROLE OF TRADE LIBERALIZATION AND FINANCIAL LIBERALIZATION TOWARDS ECONOMIC GROWTH OF BRICS

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THE ROLE OF TRADE LIBERALIZATION AND FINANCIAL LIBERALIZATION TOWARDS ECONOMIC GROWTH OF BRICS

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Statement of Originality

The work described in this Final Year Project, entitled
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is to the best of the author's knowledge that of the author except
where due reference is made.

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ABSTRACT

THE ROLE OF TRADE LIBERALIZATION AND FINANCIAL LIBERALIZATION TOWARDS ECONOMIC GROWTH OF BRICS

By

Joan Wong Mei Tze

Considering the growing emergence of BRICS economy, this study is crucial to policy makers who are interested to know how liberalization had impact on the economies of BRICS. This study examines the role of trade liberalization and financial liberalization towards the economic growth in Brazil, Russia, India, China and South Africa (BRICS) over nine year period starting from year 2003 to 2011. This study employs Levin, Lin and Chu (LLC) Panel unit root tests, Hausman Test, panel data estimation and Pedroni’s cointegration test. Lastly, Granger causality test were conducted. The result shows that broad money supply (M2) has positive effect and significant on economic growth of BRICS. Domestic credit to Gross Domestic Product (GDP) ratio (DC) was found to be adversely affecting economic growth of BRICS.

Keywords: trade liberalization, financial liberalization, economic growth, BRICS
ABSTRAK

PERANAN LIBERALISASI PERDAGANGAN DAN LIBERALISASI KEWANGAN KE ARAH PERTUMBUHAN EKONOMI BRICS

Oleh

Joan Wong Mei Tze

Memandangkan kemunculan yang semakin meningkat oleh ekonomi BRICS, kajian ini adalah penting kepada penggubal dasar yang berminat untuk mengetahui bagaimana liberalisasi memberi kesan ke atas ekonomi BRICS. Kajian ini mengkaji peranan liberalisasi perdagangan dan liberalisasi kewangan ke atas pertumbuhan ekonomi di Brazil, Russia, India, China dan Afrika Selatan untuk tempoh selama sembilan tahun dari 2003 hingga 2011. Ujian kepegunan panel merangkumi tiga jenis, iaitu Levin, Lin dan Chu (LLC), ujian Hausman, penganggar panel dan hubungan penyebab Granger telah digunakan dalam kajian ini. Kajian mendapati hubungan positif dan signifikasi antara wang umum (M2) dengan pertumbuhan ekonomi BRICS. Selain itu, kajian juga mendapati bahawa terdapat hubungan negatif antara kredit domestik (DC) kepada pertumbuhan ekonomi BRICS.

Kata Kunci: liberalisasi perdagangan, liberalisasi kewangan, pertumbuhan ekonomi, BRICS
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CHAPTER ONE

INTRODUCTION

1.0 Introduction

Economic globalization occurred decades ago and it is considered as one of the most influential forces that had shaped the world’s economic situation today. As the scale of trade of commodities and services, international capital flows and technology increases, the global economies become more interdependence as the results of economic globalization. Frankel (2000) highlighted two main factors inducing economic globalization are the lowered cost of transportation and communication in private sector as well as the ease of policy to trade and invest in the public sector. The growing integrity of international market for goods and services acts as the driven factor of globalization therefore trade and financial liberalization are seen as a must for countries that wish to bring their economy to a higher level. According to Awuah (2009), globalization has required liberalization of markets and banishes trade restrictions among the nations who want to take part in economic growth induced by globalization.

Numerous of study investigated the impact of trade liberalization on the economic evolution (Faini, 2004; Kneller et.al., 2008; Harrison, 1995; Heitger,1987).With the push of globalization, the role of trade liberalization becomes noteworthy to foster economic growth. Trade liberalization goes along with giving freedom to the market
and opening up trade to foreign countries in order to boost export from other country to the host country. Removal of trade barriers implies that the country would practice free trade. The pros and cons of free trade were debated vigorously as it results in mixed effects in different countries. It is undeniable that producers from countries that practiced trade freedom will have the access to broader international market, which directly benefits them to international division of labor. Domestic producers will face pressures and innovates thus encourages specialization. In the end, the consumers can be favored with diversity of goods at lower price. On the other hand, Osland (2003) claimed that trade freedom that is derived from globalization does not necessary benefits a country, especially developing countries as compared with developed countries. On this note, the author stated that the gap between the richest and poorest of the world population has become wider than before where the income ratio has change from 30:1 in the 60's to 82:1 in 1995 (United Nations Development, 1996).

United Nation (2013) reports that global inequality has risen over years based on measurement by using Gini coefficient. The number recorded 68.4 percent in 1988, rose to 69.4 per cent 1998 and reached to 70.7 per cent in 2005 with increased of income share of top 10 per cent of world population from 51.5 per cent to 55.5 per cent at the same time. The disposable income inequality also intensified in 65 out of 130 countries for which data trends are available. Dornbush (1992) also agreed that the risk in trade reform such as exchange rate may collapse when import level rise aggressively. Shangquan (2000) highlighted that liberalization of economy of developing countries can cause weakening of the capacity of macroeconomic control and regulations in
developing countries. Thus, it is important to line out the relationship of trade liberalization and economic growth, whether it has urged economic growth or prevailed growth.

In line with market liberalization, financial liberalization is another issue that had been pointed out which also becomes debates of economists. Some economist led by McKinnon and Shaw (1970) agreed that liberalization of financial system contribute to long term economic growth. Levine (2001) claimed that financial integration facilitates the peration of domestic thereby reallocates resource to embrace economic evolution. Meanwhile, Bekaert et al. (2001) found evidence that financial liberalization generates economic growth, specifically by one percent of increase in GDP per capita over a five­year period. Galindo et.al (2003) proved that financial liberalization does enhance efficiency of investment allocation in developing countries.

In another view, Krugman (1993) stated that even there is relationship of financial liberalization and growth; it would be less significant according to empirical results from various researches. Krugman argued that capital is relatively inconsequential to economic growth and large pours of capital had never flowed from rich countries to poor countries. Financial liberalization is tended to encourage excessive risk-taking, escalation of macroeconomic volatility thus proceeding to more regular crises. Broner and Venturay (2010) argued that financial liberalization is not always successful but it depends on the country itself. Different level of country will experience different effects from liberalization of their financial system. Broner and Venturay (2010) remarked that capital flight effect would happen in poor emerging countries as problems arise to
insulate domestic debts form opportunistic defaults on foreign debts, which the conventional view did not explain.

1.1 Research Background

There are extensive of studies on both trade and financial liberalization impacts on the economy growth but most of the studies confine it separately. In this point of view, classical trade and welfare theory explains that under perfect market conditions, there would be an increase of growth led by trade. Researcher such as Rahimi and Shahabadi (2011), Asiedu (2013), Herath (2010), Manni and Afzal (2012) identifies the positive relationship between trade and economic growth. However, the market conditions is always imperfect thus both negative and positive impact shall occur. Rodiguez and Rodrik (2001) claims that the relationship is unnecessary optimistic as the measurement of trade openness is vague and there is no clear and robust relationship between trade openness and growth.

Proponents of trade liberalization view it as an opportunity which would help to boost efficiency and growth especially in developing countries where labor is abundant. Cline (2004) proved that a rise in the share of trade to GDP by 10 percentage point will cause 1.4 to 9.6 percentage of long term increase in labor productivity. Improved productivity in the end will bring positive impact to employment and level of wages. According to Chang, Kaltani and Loayza (2009), openness can increase efficiency of resource allocation through comparative advantage then allows the dissemination of knowledge and technological progress. Competition in domestic and international
markets can be increased long-run growth effect is detected when the areas of specialization promoted by trade enjoy increasing returns to scale. Besides, poverty can slowly be eliminated in these countries and standard of living increased. A country can develop faster with increased labor productivity and reduced poverty.

On the other hand, opponents of trade liberalization claim that gain from trade liberalization has distributed unevenly among developing countries. Trade openness is argued to be negatively affecting economic growth if an economy focuses on the sectors where dynamic comparative disadvantages hold (Redding 1999). Lucas (1998) argues that when a country specializes in sectors which are already largely exhausted, trade will contribute adverse effects on economic growth. Following the studies, it was found that the countries that did not reap benefits had experienced their share of world trade decreases from four per cent in 1980-82 to 3 per cent during 1996-98 as many failed to shift export base away from primary commodity. As primary commodities demand will fall following liberalization of trade, failure to move from depending on primary commodities will surely harm the countries.

Going further into the discussion, financial liberalization as of the country stock markets and other financial instrument was also claimed to generate economic growth (McKinnon and Shaw, 1973). Fry (1997) was in the stand of favoritism of financial liberalization. Fry specified that financial liberalization would not be utilized its benefit if the process does not go along with fiscal reform that focused on make certain that government debt does not explode in the result of the liberalization. Financial liberalization would exhibit positive effect on economic growth by many channels.
When the number of foreign investors is increased, it will then improve local equity price. What follows next is the reduced cost of capital. A careful monitor and regulated country banking system can enhance the effect of financial liberalization on economic growth. Demirguc-Kunt and Detragiache (1998) agrees the occurrence of successful financial liberalization should be conducted in a sound institutional environment.

On the other hand, Chauhan (2012) carried out a study to show the effects of financial liberalization on emerging market economies and found that many countries are considered unsuccessful in liberalizing their financial markets. The main reason of failure could be one country may not have strong regulatory structure, undercapitalized banks, unstable markets and contagion effects. Fratzscher and Bussiere (2004) mentioned that a country which implements financial openness more tends to be harmed by financial crisis in a study of 45 emerging countries. The quality of institution is one crucial factor for countries to benefit from financial openness for open economies. The benefit from financial liberalization was also found to be in diminishing rate (Fratzscher and Bussiere, 2004).

Acceleration of market liberalization can surely reap benefits to the world economy but everything comes with an opportunity cost. If a country develops good policies to cater the problems such as uneven distribution, the benefits of trade liberalization can still outweigh the cost of implementing. Thus, it is concluded that adopting a more opened policy generally helps developing countries to achieve higher rate of growth and to free themselves from the status of developing countries to developed countries.
According to Krueger (2010), most developing countries experienced very high inflation, where it displays more than a single digit number in the earlier period of time. Countries with high inflation rate will cause harm to the low-income groups while the rich can avoid themselves from getting harm or sometimes even benefits from it. Throughout the years, developing countries have been liberalizing their countries in order to sustain growth and making sure that they are not left behind. Taking the example of China, the country started the market reformation in the late 1970s the country has now transformed from a developing to emerging country where by its growth rate has reached almost ten percent of average in the past 36 years which frees millions of people from poverty (Kuijs and Wang, 2010). Following the increase of agricultural output due to market reform, the World Bank poverty line of $1 a day per capita in China falls significantly from 64 per cent to 29 per cent in 1981 to 1987 (Bardhan, 2008). The success of lifting the rural out of poverty can bring much growth to the Chinese economy as productivity of people also increases.

Following China, India had also reformed the economy in 1991, with Brazil, South Africa and Russia also at the same year. Grouping of these five countries forms BRICS and was firstly introduced by Goldman and Sachs (2003). Together they form an economy bloc with high economic development and rapid growth among the other developing countries. According to Rosu-Hamzescu and Rosu-Hamzesu (2011), the West will produce less than half of the world GDP in 20 years more and in another additional 20 years BRICS will lead the world. This five emerging economies are forecasted to be overcoming the Organization for Economic Co-operation and
Development (OECD) with respect to their economy ability. For example, the combined nominal GDP of these emerging countries had exceeded the Group of 7 (G7) nations and in line with that, India and China summation of GDP were forecasted to exceed most of the high-income OECD nations. A report by The Economist (2013) on the BRICS shows that China will surpass U.S as the leading economy in terms of purchasing power parity (PPP) in 2017 and market exchange rate in 2027. The report also viewed that Russia’s economic performance to be overcoming Germany by the terms PPP before 2020 and market exchange rate by 2035. Hence, this study intends to embark upon the effects of trade and financial liberalization in the BRIC economy.

1.2 Background of BRICS Countries

After Goldman Sachs coined the acronym BRIC in 2001, the four emerging economies immediately becomes the concern of economist as the size of economy is predicted to overtake developed countries in few more decades to come. The bloc contributed to 36.3 per cent of world growth in term of PPP during the period 2000-2010 (Marthur and Dasgupta, 2013). It is also predicted Brazil, Russia, India and China will relocate majority of the G-7 countries by 2050. South Africa joined BRIC in 2011 and together these five economies account 26.78 per cent of world GDP in 2011. This shows that how significant is the existence of BRICS economy to the world and the influence of BRICS shall not be overlooked.
Figure 1: GOP Growth of BRICS (%)


Figure 1 above shows the GDP annual growth of BRICS countries based on the annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2005 U.S. dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources (World Bank, 2014.)

Based on Figure 1, GDP growth of BRIC is plotted from year 1990 to 2013. Among the four countries, Russia had shown a rather unstable trend as compared with its counterparts. Russia started off at negative trend but the country performed well in the period after 1998. The drop of GDP growth Russia in 1998 was caused by the
Russia financial crisis. The main reason was related to the transition of its economy from a centrally planned economy to a market economy. During the process, declined output, high fixed exchange rate, fiscal deficit and war in Chechnya has the consequences had hurt the country’s economy and cause a drop to negative percentage of growth. Indirect cause such as Asian financial crisis had influence the demand of the country’s main export which is crude oil and nonferrous metal. This in the end cause declined foreign exchange reserve. However, Russia had shown a very significant improve after the crisis with an upshot of positive growth in 1999 and 2000. The foremost reason that aided Russia is the rise of world oil price during the period and made Russia experience trade surplus. The average price of oil had amplified from $12.8 US dollar in 1998 to $28.4 US dollar in 2000 (de Paula, 2007).

In the beginning of 1990s, Brazil carried out a policy which is based on crawling peg exchange rate regime with nominal diary devaluation which cause in a depreciated real exchange rate and high inflation rate. Brazil had been experiencing high inflation rate since 1960s. High inflation rate and interest rates had refrain investments thus causing low economic growth of Brazil. In order to curb this problem, Brazil had come up with a plan called “The Real Plan” in 1994. A new currency called “real” was introduced. Under the plan, government expenses are controlled, economies is disindexed and interest rates to repress inflation rate. Hence, in the period of 1994 to 1998 shows a rather stable growth compared with previous period. The country now shows a fast trend in its macroeconomic data in the recent years due to its export potential. Rising domestic demand encouraged by public policies results in increasing
spending and credits, especially for investment. There is a slowdown in 2008 to 2009 as the influence of world financial crisis. However, the GDP indicator managed to increase after 2009 as a result of increased household consumption. The common use of credits cards and increasing wages had encouraged Brazilian to spend more thus helping economic growth (Lopez & Cascione, 2011).

China had emerged as a powerful economy and was forecasted to overtake U.S in five years' time. China had introduced a few economic reform since 1979 thus showing the upward trend of the GDP growth. In 1990, the country had only 4.06 percent of growth. However, the GDP growth increased in 1994 to 14.24 percent. Since then, China had a rather stable growth rate. According to Morisson (2014), there are two main reasons of the growth of China’s GDP which is large-scale capital investment and rapid productivity growth. The global economic crisis in 2008 had also affected China when the exports, imports and foreign direct investment of China decreased then distressing the growth of GDP. In order to cushion the effect, China provides numerous of incentives to boost domestic consumption, giving a more loose monetary policies to encourage bank lending and a $586 billion was used to realize an economic stimulus package (Morisson, 2014). In 2008, China GDP growth dropped to 9.63 percent compared with 14.16 percent in the previous year.

The GDP growth of India decreases in 1991 as balance of payment of India was pressured following the drop in oil price as the effect of Gulf war. After that, a reform was introduced by their Finance Minister, Manmohan Singh. Industrial licensing regime was eliminated and firms were privatized (Cagliarini & Baker, 2010). Apart from that,
anti-competitive restrictions on entering the market were also eliminated gradually throughout the time period. As the result, the reform had helped India to improve the of balance of payments and growth rate of GDP of the country averaged 5.63 percent between 1992 and 1994. India was also affected by Asian financial crisis in 1997 but recovered fast after the crisis. The economic crisis in 2008 does harm India GDP growth where growth recorded a total of 5.91 percent of drop in that period. The indicator then bounces back to 10.26 percent in 2010. There is a slowdown of growth in recent year as it recorded only 5.02 percent of growth in 2013.

South Africa is greatly known for its abundance of natural resources for centuries. Mineral resources are especially the key of the country’s economy growth and mining is the main driving force. The performance of South Africa’s GDP growth started to turn better after 1994, when the apartheid issue ended in the respective year (Arora, 2006). The GDP growth of South Africa increased steadily during the period to 4.3 percent in 1996. However, the country can avoid from the Asian financial crisis and the growth drop to 0.52 percent in 1998. After financial crisis, South Africa performed well thanks to the greater openness to trade and investment (Arora, 2006). There is also more contribution of private sector to the economy. Both of the factor raised technological innovation hence positive growth of GDP. Du Plessis, & Smit (2006) mentioned that the growth of South Africa’s after 1994 is related to improvement in overall domestic expenditure of South Africa. GDP growth of the country reaches its peak during 2006 recording 5.6 percent. During 2009, their economy is also impacted by the global economy crisis thus a record of -1.5 percent.
Table 1: Comparison of GDP per capita of BRICS 1990 and 2013

<table>
<thead>
<tr>
<th>Year</th>
<th>1990</th>
<th>2013</th>
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<tr>
<td>Brazil</td>
<td>3086.92</td>
<td>11208.08</td>
</tr>
<tr>
<td>Russia</td>
<td>3485.11</td>
<td>14611.7</td>
</tr>
<tr>
<td>India</td>
<td>375.89</td>
<td>1498.87</td>
</tr>
<tr>
<td>China</td>
<td>314.43</td>
<td>6807.43</td>
</tr>
<tr>
<td>South Africa</td>
<td>3182.21</td>
<td>6617.91</td>
</tr>
</tbody>
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Table 1.1 shows the comparison of GDP per capita of BRICS countries taking comparison between 1990 and 2013. As all of the countries reformed at average during 1990s, the data can show the comparison of income of people in BRICS before economy reform and after economy reform. All the countries show increasing trend in the GDP per capita after economy reform. The most significant change occurs in China where there is almost 2000 percent of increase in GDP per capita before and after reform. The economy boom of China has increased the GDP per capita significantly. The GDP per capita of China is relatively smaller than other except South African mainly because of the large population size which makes the number seems smaller. Russia shows second largest difference where there is 419.26 per cent of difference in year 1990 and 2013. Brazilian and Indian economy exhibit average growth of 363.08 and 398.75 per cent during the comparison year. The lowest change is in South Africa where there is 207.97 per cent of increase in GDP per capita of the country.