Outward-looking development policies and the prospective for Egypt

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ABSTRACT

This paper visits the relationship between outward looking development policies and economic growth in developing nations, with concentration on the prospective for Egypt after the 25th of January revolution and the rising calls for halting the Egyptian privatization program. The paper presents the arguments whether opening up and integrating with the world economy leads to a higher welfare. It discusses the definition of openness, the historical effects of openness on growth, the measurements of openness and empirical work linking openness to growth. The paper also presents indicators from the Egyptian economy of what openness may have achieved in the last two decades and uses an inductive methodology to make the argument for Egypt to pursue an outward looking development policy with better governance and sound government interventions to alleviate the relatively negative openness effect.

Keywords: Openness and growth, Outward looking development policies

INTRODUCTION

After the 25th of January 2011 revolution in Egypt, calls against openness and the continuation of the privatization process has been on the rise. The newly appointed Egyptian government has expressed several times that privatization efforts are not going to be on their agenda in the near future and the government has rejected an emergency loan from the IMF because of what they referred to as its conditionality. Since the collapse of the Soviet Union and the recipe of development have been focusing on liberalization of the developing economies. The predominant idea is that a faster liberalization of those economies implies faster economic growth. The gate keepers of the world's economic order; The World Bank, the IMF, and the WTO adopt a vision that openness of a developing economy would eventually lead to higher welfare to its people and hence they have encouraged privatization, liberalization of trade in goods and services, free movement of capital, free exchange rates, and faster integration into the world's economy. This paper will discuss the historical effect of openness on growth, the measures of openness, and the empirical work linking openness to growth. The findings will be evaluated against the Egyptian economic performance and will follow an inductive methodology to recommend a path for the Egyptian Economy.

History, Meaning, and Measures of Openness and its Connection to Growth

Economic development books classify the different views to development into two categories; outward looking and inward looking. Todaro & Smith (2011) define an outward looking view as one that encourages free trade, free movement of capital, labor, multinational enterprises, students and the adoption of an open system of communications. In other words, outward looking development policies will focus on export promotion, and integrating with and opening up to the world. Inward looking view to development will on the other hand call for developing nations to determine their own style of development and to adopt learning by doing in manufacturing, depend on indigenous technologies that matches their resources and hence the adoption of import substitution policies and protectionism. Economists have for long taught students the benefits of free trade. Husted and Melvin (2007) widely used International Economics text book and all other similar text books list the theories of comparative advantage, and students are expected to prove that free trade is better than restricted trade and that tariffs are better than quota in terms of welfare to countries participating in trade.

Krugman (1979), and Krugman (1980) noted that the bulk of world trade takes place between developed nations and a large sum of exports and imports within the same country are in similar products. Because of this intra-industry trade, Krugman recognizes two more gains from international trade; trading in similar products adds more varieties to the consumer, and the competition and economies of scale created lowers equilibrium prices which in turn raises real wages.

While in theory, the benefits of openness are obvious, in practice, the results often give mixed indications. The demand for proven correlation between opening and integrating into the world economy and higher welfare has been rising and many attempts were made to validate the relationship or deny it. The concept of openness itself needed to be defined and measured in order to correlate it to better welfare. Even if openness leads to faster growth, the deeper question would arise, how would openness affect unemployment, and how would it affect poverty and inequality. In essence, the source of resistance to integration into the world economy, or globalization forces if we wish to call it so, usually stems from the average labor force, and those who feel worse off due to openness.

Some argue that the globalization phase witnessed nowadays with the resistance to its openness forces have been witnessed before World War I. Williamson (1998) argues that the relative improvement in technology and the advancement in transportation prior to World War I have managed to first create a divergence of real wages and living standards between countries, however, the evolution of well-functioning global markets in goods and labor eventually managed to achieve a convergence between nations. He argues that openness eventually accelerated growth in many western countries especially most of what is referred to now as the OECD countries and managed to improve the real wages of workers because of openness and export oriented strategies. Further, he argues that those countries have grown faster than the rich industrial leaders at the European center, and in some cases even faster than the richer countries overseas in the New World at that time bringing about a factor price convergence that was a major cause for stopping this globalization process since it created rising inequality in labor-scarce economies such as the United States and falling inequality in labor-abundant economies in Europe at that time. Reynolds (1985) provides evidence of fast growth occurring in the developing nations outside of North America and Europe because of openness. Reynolds points out that between 1850 and 1914 the majority of Latin American and Asian economies in addition to some countries in Africa have experienced faster rates of growth due to the expansion of trade and using their trade opportunities.

Frankel and Romer (1999) investigated the relationship between trade and growth taking into consideration geographical factors that are country specific such as size and population. Frankel and Romer treated the amount of trade that is caused by geographical factors as an exogenous variable and used it as an instrument for trade to GDP ratios in a regression in which income levels are the dependent variable. Their findings suggest that within-country trade raises income. Further, and controlling for international trade, their findings suggest that countries that are larger and hence have more opportunities for trade within their borders would eventually have higher incomes.

The literature has introduced several measures for the openness of an economy. The simplest measure is the Index of Openness. The Index of Openness sometimes referred to as the International Trade Index is a mathematical expression that relates a country's exports and imports to its Gross Domestic Product. For any given country the index is calculated as follows:

$$Index\ of\ Openness = \frac{Sum\ of\ Exports\ and\ Imports}{GDP}$$

Kotcherlakota and Sack-Rittenhouse (2000) analyzed trade data from 1970 till 2000 for selected countries of the following four regional blocs; the EU, NAFTA, ASEAN, SAARC. They explored the relationship between the Index of Openness of each country and its economic development position. Kotcherlakota and Sack-Rittenhouse point out to strong relationship between the status of growth and development and openness. However, they also point out that the index of openness tends to decline for countries that matured economically and they cite becoming economically strong to the point of being less dependent on the rest of the world as a possible reason for this decline.

Table one indicates the progress of the Index of Openness in several regions in the world between 1960 and 2009. The Arab world has witnessed a rising trend in its openness as indicated by the index, from a value of 59 in 1970 to a value of 92 in 2009. Similarly, the same upward trend is present in other regions; the Euro area, the Middle East and North Africa, and Latin America. In addition, for any given year, the Index of Openness scores a relatively

smaller value for the least developed nations to that of the developing world in general. Table two indicates the Index of Openness for Egypt and other selected countries for the same period. World Bank development indicators show that for Egypt during the majority of the 60's the Index of Openness value did not exceed 40. Starting 1974 the value of the index was on the rise; it reached a value of 82 in 1982 then started to decline. It kept within a fluctuating range between 40 and 50 for the majority of the years till 2004 where it took an increasing trend and fluctuated between 60 and 70. Other developing nation such as Hungary, Tunisia, Turkey, India, and Iran has shown a relatively steady increasing trend in the value of the index.

The index of openness was criticized for many limitations. Alcala and Ciccone (2004) point out that measuring openness as exports plus imports relative to nominal GDP has drawbacks due to the treatment of nontradable goods. They propose, instead, to use a measure which they refer to as real openness. Alcala and Ciccone findings show that international trade has an economically significant and statistically robust positive effect on productivity. Alcala and Ciccone used imports plus exports relative to purchasing power parity GDP (referred to it as real openness) as their openness indicator; they argued that it is preferable on theoretical grounds to the nominal measure conventionally used.

Andersen & Babula (2009) list another criticism to the nominal index of openness in its likeliness to be biased and inconsistent due to endogeneity of the trade volume. Economists want to analyze the relationship between an economy's trade volume and its economic growth. Causality, however, can work the other way round; a higher level of economic activity in a country may lead to an increased volume of trade. In that case, the use of ordinary least squares estimator to investigate the relationship between openness and growth will lead to biased and inconsistent results.

Several attempts to avoid the bias of the index of openness and develop a less biased measure are dominant in the literature. A class of those measures would focus on commercial policies in a nation hence tying the policy to growth becomes easier. Some of those measures would rely on tariffs or average tariff rates and that approach was also criticized. (Pritchett 1996) noted that relying on an average tariff rates might send the wrong signal about the degree of openness since it wouldn't reflect the different weights and importance of given imported commodities. In addition to that criticism, Dollar and Kray (2003) noted that measures of openness relying on tariffs usually don't show a relatively significant correlation with the volume of trade.

One of the most cited work that redefined openness and linked it to growth is that of Sachs and Warner (1995). Sacks and Warner defined openness based on five criteria to cover what they note as all major types of trade restrictions; tariffs and quotas, the black market premium which serves a proxy for import controls, whether the country was socialist or not, and government monopolies on exports. According to their model, a country is considered open if average tariff rates are less than 40%, non tariff barriers (mainly quotas) covers less than 40% of trade, any black market premium is less than 20% and government has no monopoly of major exports. Analyzing data gathered from over 93 countries from all around the world for the period between 1970 and 1989, Sachs and Warner conclude that open economies are converging in their welfare in the 20th century just as it did at the end of the 19th century and that this convergence can occur to those who join the new round of globalization taking place. According to their criteria, Sachs and Warner classified the Egyptian economy as one that was never open between the 1960's and the early 1990's. Given the openness criteria, the Egyptian economy

between 1960 and 1980 had a currency black market premium with a mean of 83%, and in the mid 80's had an average effective import tariff of 49%.

Rodriguez and Rodrik (2000) point out that the Sachs and Warner measure of openness has a statistically sensitive setup. In particular, the focus on protectionist policies while disregarding other bad policies in addition to the econometric difficulties in obtaining and analyzing reliable data. Wacziarg and Horn (2008) used the Sachs and Warner index and worked out some data problems and were able to expand the data set to cover 141 countries and expand the time series into 1998. Their work suggests that liberalization dates that describe periods of discrete shifts in trade policy, can be useful to estimate the within-country response of growth.

Wacziarg and Horn (2008) list Egypt as one of the countries classified as open since 1995 according to their analysis. Their findings indicate that Egypt had an average tariff rate of 30.1% between 1990 and 1999, and a currency black market premium of 12.45%. They indicate that that black market premium has fallen from 70% to 10% between 1990 and 1991. In addition, they note that non tariff barriers averaged 57.3% between 1989 and 1994 whereas the unweighted tariff rates averaged 42.2% in 1991 before decreasing to 28.3% in 1994. They also note that Egypt's average tariff rate between 1995 and 1999 was 26.1% whereas its non-tariff measures covered 28.8% of trade. Wacziarg and Horn classification of Egypt as an open economy since the mid 1990's coincides with the liberalization of the Egyptian Economy and the launching of the economic stabilization program in the early 90's with the privatization efforts that started with the supervision of the IMF, thought they admit to the fact that 1995 was chosen as a mid point to describe the timing of openness.

Despite the fact that the majority of analytical research indicates a positive linkage between openness and growth, anti-globalization movements across the globe are getting their voices louder by the day. Bhagwaty (2004) lists three forms of opposition to globalization; anti-capitalist, anti-globalist, and anti-corporation. Bhagwaty reviews the effect of liberalization of trade on growth, the effects of foreign direct investment, hot funds movements, technology spill over, and cross-border migration. In addition, he notes that globalization did improve wages and labor standards, improved gender inequality and fostered democracies. Bhagwaty argues that contrary to what some might think, globalization forces did have achieved some success reducing poverty and child labor. On the other hand, Bhagwaty acknowledges some shortcomings of globalization, and attributes most to unsystematic approach in dealing with openness from the developing nations arguing for the need of better governance, and better management of the speed of reform.

Panagariya (2004) argues that sustained growth cannot be achieved without rapid growth in trade which in turn requires low or declining barriers to trade. Panagariya argues that the experience since the 1960's shows that the claims of some that openness to trade leads to sustained income losses are unfounded even in developing nations that faced stagnation and declining per-capita income. His findings indicate no strong ties between import surges in those nations and falling per-capita income.

The international pillars that push for the liberalization of the developing economies are with no doubt, The IMF, the World Bank, and the WTO. The IMF has for long been giving loans on conditionality terms based on a country's reform progress. Stiglitz (2003) criticizes the IMF role that has changed from its original purpose; giving short loans to governments that suffer temporary deficit in its balance of payments due to external shocks. Instead, the IMF got involved in long term loans and writing recipes for the developing world to reform their

economies often by enforcing a one size that fits all type of liberalization policies. Stiglitz notes that while most of the reforms in theory might hold, many of the over 100 nations that benefited from IMF loans and followed the prescribed policies have ended up in a worse situation. Stiglitz argues that Even if the right transformation conditions were imposed to ensure that IMF loans are used well, the loans may free up resources elsewhere, with no guarantees that the freed resources will be used well. In addition, stiglitz points out that in some cases wrong conditions were imposed and cite the financial market liberalization in Kenya and fiscal strictness in East Asia that plunged many countries into deeper trouble. Moreover, Stiglitz notes that fiscally strict policies dictated by the IMF have induced recessions in many cases when applied under the wrong circumstances. In addition, he notes that capital markets controls were relaxed in Western Europe in the 70's when countries in that region has reached a mature state of development criticizing the push to free capital markets in developing nations by the IMF. Stiglitz also criticized the IMF position backing up rapid privatization citing that such actions in the presence of largely corrupt government bodies often lead to monopolies. The later criticism resonates with the causes of the 25th of January Egyptian revolution, where demonstrators were motivated by the rejection of entrepreneurial figures that monopolized strategic industries privatized during the late 1990's and early 2000's and were heavily involved in the political life.

THE PERFORMANCE OF THE EGYPTIAN ECONOMY

Table three indicates that Egyptian exports have been on the rise since 1995. Exports of goods and services have increased from $13.3 billion in 1995 to $44.6 billion in 2009 where exports of goods have increased from $4.7 billion to $23.1 billion. Similarly, foreign direct investment has increased from a little less than $600 million to $6.7 billion during the same period. Imports on the other hand, have also witnessed a sharp increase; from 17.1 billion in 1995 to 53.8 billion in 2009. Table four indicates that Egyptian GDP per capita (measured in PPP, 2008 US$) has been steadily on the rise; from $3448 in 1990 to $5634 in 2009. In addition, that table indicates that Egypt's ranking on the Human Development Index continuously increased; from 0.484 in 1990 to 0.614 in 2009. Table five indicates that the percentage of Egypt's population that falls below the two dollars a day poverty line and the one and a quarter dollar a day poverty line (measured in PPP) has steadily been on the decline between 1991 and 2009; the former decreased from 27.64% to 18.46% while the later has declined from 4.46% to 1.91% . In addition, the figures show that the income distribution as measured by the GINI coefficient has held steady around a value of 32 indicating no serious changes in the distribution. The figures show that unemployment has increased from 8.95% to 11.24% in 2005, but decreased to 9.38% in 2009. All previous indicators point to an economy that to a large extent has been improving during the last fifteen years.

CONCLUSION

The literature indicates that the forces of globalization witnessed nowadays is another version of forces that played the same role between 1850 and world war one and resulted in a rise in welfare for many countries participating in trade and opening up their economies. While there may not be consensus on one measurement of openness, the majority of measures constructed in the literature have been positively correlated to growth. In particular, countries classified as open has performed better than those classified as closed. Empirical work has

classified Egypt as closed from the 1960s till 1995 and open afterwards. The Egyptian economy since the late 1990's has been performing relatively well, with continuous increase in real GDP per capita and an increase in exports of goods. Moreover, it has managed to reduce poverty and continuously achieve higher scores on the Human Development Index. A call for halting reforms at this turning point in Egypt's history does not seem to be the right path for development. While the globalization forces may have some negative effects, many argue that governments may be able to counteract them. The literature indicates that many negative effects can be halted by increased governance and transparency, by selective reforms at a reasonable phase, by reforming the financial sectors in relationship to the state of development, and by a government involvement in the economy to reduce the negative effect of the sectors harmed by globalization. This path seems to be the reasonable one for the Egyptian economy to retain and increase the gains obtained from openness through the last two decades.

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APPENDIX

Table I-Index of Openness for World Regions 1960-2009

Region	60	65	70	75	80	85	90	95	00	05	09
Arab World	-	-	59	84	87	68	75	74	73	92	-
East Asia & Pacific (developing only)	-	-	16	21	34	32	43	55	67	86	65
Euro area	37	38	40	45	53	58	55	57	73	74	71
Europe & Central Asia (developing only)	-	-	-	-	-	-	42	60	68	65	60
European Union	39	39	42	47	53	59	54	58	71	73	70
High income: nonOECD	-	-	97	107	121	115	124	134	137	196	
High income: OECD	22	23	26	32	37	36	35	37	45	47	45
Latin America & Caribbean (all income levels)	24	22	23	27	31	31	32	41	44	46	42
Latin America & Caribbean (developing only)	22	19	21	25	28	28	32	37	41	46	42
Least developed countries: UN classification	30	32	30	28	38	32	33	43	47	59	57
Middle East & North Africa (all income levels)	-	-	60	86	84	68	72	69	70	88	-
Middle East & North Africa (developing only)	-	37	40	68	60	45	57	55	52	71	-

Source: Compiled from World Bank Development Indicators 2010

Table II-Index of Openness for Selected Countries between 1960 and 2009

Country	60	65	70	75	80	85	90	95	00	05	09
Algeria	106	48	51	77	65	50	48	55	63	72	77
Bahrain	-	-	-	-	239	192	210	152	154	176	-
Egypt	40	39	33	61	73	52	53	50	39	63	57
Hungary	44	59	63	90	80	82	60	92	148	134	-
India	12	9	8	12	16	13	16	23	27	41	44
Iran	-	31	39	77	41	23	38	35	40	58	-
Israel	23	51	79	100	103	103	80	65	74	85	67
Jordan	-	-	-	-	124	113	155	125	110	147	108
Kuwait	-	91	84	106	113	96	103	94	87	92	-
Tunisia	-	33	47	64	86	70	94	94	93	100	107
Turkey	6	10	11	16	17	35	31	44	43	47	48

Source: Compiled from World Bank Development Indicators 2010

Table III – BOP Indicators for Egypt between 1980 and 2009

Indicator Name	1980	1990	1995	2000	2005	2009
Imports of goods and services (BoP, current US$) Billions	9.1	14	17.2	22.8	34.3	53.8
Exports of goods and services (BoP, current US$) Billions	6.3	9.8	13.3	16.9	30.7	44.6
Goods exports (BoP, current US$) Billions	3.8	3.9	4.7	7	16	23.1
Foreign direct investment, net inflows (BoP, current US$) Millions	54.8	734	598	1235	5375.6	6711.6
Foreign direct investment, net inflows (% of GDP)	2.4	1.7	0.9	1.2	5.9	3.6

Source: Compiled from World Bank Development Indicators 2010

Table IV – Selective Human Development Indicators for Egypt between 1970 and 2009

Indicator	1970	1980	1990	2000	2005	2006	2007	2008	2009
GDP per capita (2008 PPP US$)	NA	2,633	3,448	4,322	4,676	4,904	5,156	5,425	5,634
HDI Index	NA	0.393	0.484	0.566	0.587	0.594	0.601	0.608	0.614
Internet users (per100 people)	NA	NA	0	0.6	11.7	12.6	14.8	16.6	NA

Source: Compiled from UNDP Human Development Indicators 2010

Table V – Selective Human Development Indicators for Egypt between 1991 and 2009

Indicator Name	1991	1996	2000	2005	2009
Poverty headcount ratio at $2 a day (PPP) (% of population)	27.64	26.31	19.37	18.46	NA
Poverty headcount ratio at $1.25 a day (PPP) (% of population)	4.46	2.46	1.81	1.99	NA
Poverty gap at $2 a day (PPP) (%)	5.98	4.96	3.5	3.45	NA
Poverty gap at $1.25 a day (PPP) (%)	0.6	0.34	0.32	0.39	NA
GINI index	32	30.13	32.76	32.14	NA
Unemployment, (% of total labor force)	NA	8.95	9	11.24	9.38

Source: Compiled from UNDP Human Development Indicators 2010