Does Aid for Trade Benefit Recipient Countries?

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Abstract

Using bilateral data of aid flows in the gravity model of trade framework, this paper empirically investigate whether Aid for Trade (AfT) increases recipient exports to donors as well as donor exports to recipients. We find that total AfT does not affect recipient exports to donors as well as recipient imports from donors. At disaggregated AfT categories, however, we find that 'aid for economic infrastructure' promotes both recipient and donor exports. Also the effect of "aid for building productive capacity" on recipient exports is insignificant and somewhat surprisingly a negative impact on donor exports.

Keywords: Aid for Trade, Gravity Model, International Trade

Jel Code: F13, F11, F10

1. Introduction

Since 1950s, foreign aid has been directed to least developed and developing countries for various reasons. In 1950s and 1960s, the economic rationale was a growth-led development strategy by fulfilling savings-investment gap and creating a "big- push" (Walt Whitman Rostow, 1960; Arthur W. Lewis, 1954; Ragnar Nurkse, 1966). In the meantime, foreign aid was used by both parties of Cold War as a crucial political tool for persuading non-aligned countries to become a part of their alliance. However, after the economic crisis in 1970s, Keynesian foreign aid policies were criticized in line with the Washington Consensus. World Bank and IMF declared that "efficient" potential private sector investments would be crowded out by expanding activities of public sector with foreign aid flows and correspondingly, public investment must have been cut back and market-based structural adjustment programmes must have been put forward (John Toye,

1993: 191; Hjertholm & White, 2002: 59-60). Nonetheless, in the 1990s, Western donors put foreign aid allocation in their agenda once again. But this time, conditional aid framework began to emerge and donors began to direct foreign aid to the developing countries, those of whom had institutionally strong governments. With the turn of the century, Millennium Development Goals were declared and foreign aid was stated as an instrument in halving absolute poverty until 2015 (IMF & World Bank, 2005: 8).[1]

Looking back to the 60 years of aid effectiveness literature, it can be said that foreign aid policies have been conducted as an extension of the mainstream economic policies of their time. In this regard, it can be argued that last final shift in foreign aid policies of donors has been the so called "Aid for Trade (AfT) Initiative" following the new facets of the globalization process. In the last 20 years, developed and developing countries have gone into a deep integration process. There have been two major developments that have leaded developing countries to rapidly integrate into world economy by enhancing their trade creation capacities: (i) the reduction of trade barriers as a result of trade liberalization policies and (ii) the decline in transportation and communication costs as a result of technological developments. Consequently, industrial production processes increasingly fragmented and developing country producers began to be articulated in global value chains (GVCs). In a world increasingly shaped by these chains, trade costs became more important, as the semi-finished goods cross many borders. At this point, AfT is expected to function as a tool in reducing trade costs and supply chain barriers. More recently, AfT report of OECD-WTO (2013) verifies and underlines the potential role that AfT would play in connecting LDCs & developing countries to value chains.

2. AfT and Its Conceptual Framework

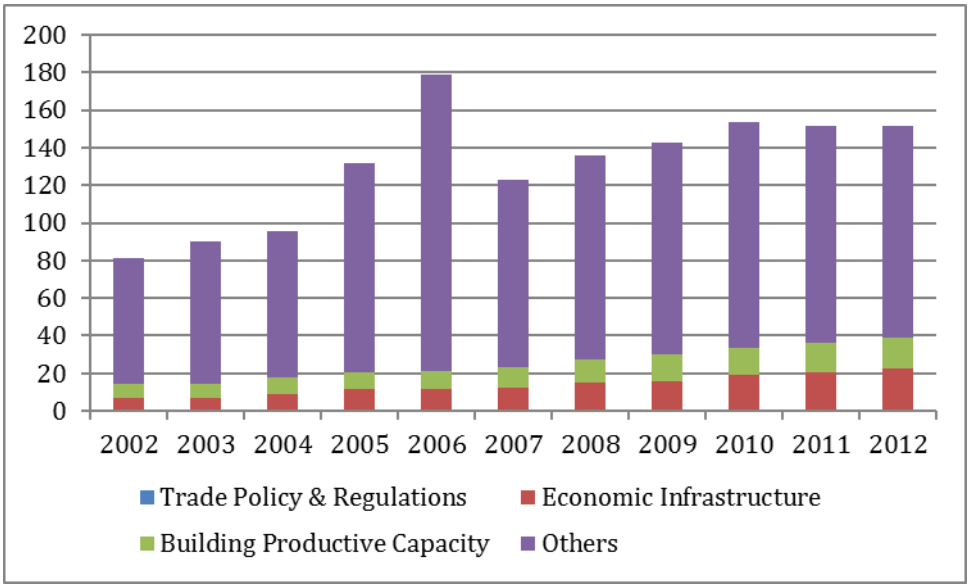
When one considers conceptually, there is nothing new in AfT. It is identified by OECD-WTO initiative as a sub-group/category of Official Development Assistance (ODA)[2] and is composed of five sectoral categories: (i) Technical Assistance for Trade Policies and

[1] Although it is beyond the scope of this paper, it can be argued that such a poverty-focused policy contradicts with conditional aid, which excludes least developed countries whose institutional structures are weak and the number of people living in poverty is high.

[2] Development Assistance Committee defines ODA as a concessional loan with a grant element of at least 25 percent (using a fixed 10 percent rate of discount).

Regulations, (ii) Economic Infrastructure, (iii) Productive Capacity Building, (iv) Trade-related Adjustment, (v) Other Trade-related Needs. Nonetheless, it has gained importance as a result of current economic issues. In Figure 1, following Hühne et. al. (2013), we reduced these sectors into three headings.

Figure 1: The Composition of ODA Gross Disbursements, 2002-2012*



Source: OECD – CRS, http://stats.oecd.org/Index.aspx?datasetcode=CRS1

*constant 2012 dollars in billions

As shown in Figure 1, the share of AfT in total ODA reached 25,5 % in 2012. Even though it does not account for a huge amount of ODA, its share in total ODA has been increasing gradually. Moreover during the years of global financial crisis, it has kept its upward trend where as other ODA flows have declined sharply in 2007 and have continued to be stagnant from then on. This implies the importance developed countries has given to aid-led trade in an interconnected world production and trade system.

Although it is widely accepted that AfT should be increasingly directed to developing world, what should be the aim of aid in relation to trade is a much disputed issue. Before the AfT Initiative, trade was historically viewed as a tool to get rid of foreign aid dependency. Together with the trade liberalization policies and export-led growth strategies implemented by developing countries since 1980s, it has been commonly

assumed that export earnings would induce imports of investment goods and thereby domestic savings constraint would be satisfied and finally, economic growth would reduce the need for aid. But the concept of "gains from trade" has not been a smooth path that all of the developing countries will easily pass through. Besides trade liberalization did not necessarily mean increasing export revenues. As a matter of fact, several developing countries have faced further costs arising from loss of tariff revenues and/or increased import competition. The Uruguay Round had adverse price effects on the products of low-income countries whose exports were mainly tropical agricultural commodities. To put it mildly, the net effect of the benefits and the welfare losses from trade liberalization for many of these countries were not enough to reduce their aid dependency (Oliver Morrissey, 2002: 292-300). Conversely the need for aid has increased and since then, aid has been served and used as a compensation package for social costs of trade liberalization. The well-known examples of adjustment assistance categories can be stated as "coping with adjustment to policy shocks" and "generating supply-side responses to trade liberalization" (Sam Laird, 2007: p. 1).[3] More recently, international organizations have changed their perspective about aid and trade relationship and put forward the idea of Aid for Trade. OECD Development Assistance Committee (DAC) even seems to be more reluctant to support adjustment assistance for the social costs of trade liberalization under the heading of AfT. Instead, DAC focuses mainly on trade facilitation including tariff structures and trade promotion for enterprises in the productive sectors as well as establishing an enabling environment for increasing the volume and value-added of exports, diversifying export products and markets (OECD, 2006: p 12, 27, 32). Moreover AfT is strongly suggested as a tool to connect local producers to GVCs for whom trade costs play a larger role than regular trade. GVCs are expected to offer a path to industrial development by opening up the new sources of capital, permitting the utilisation of network technology and penetration to rich country markets (OECD-WTO, 2013a: p. 89-90). However it is a completely disputed issue

[3] For example, as tariffs on agricultural products decreases in developed countries, developing country producers cannot response adequately to increased demand by reason of small-scale farming and lack of infrastructure. Foreign aid might eliminate this constraint by improving supply side capacities. Besides trade liberalization bring out undesirable outcomes such as adverse reallocation effects for particular industries or lost tariff revenue. Foreign aid might help developing countries in coping with adjustment to these kinds of policy shocks. For further information, see: Laird (2007).

whether integration into GVCs will sustain a healthy industrialization process, when one considers several studies focusing on the issues such as low value-added content of exports, imported-input dependency, adverse income distribution effects and increasing vulnerability to global economic shocks.[4] Furthermore AfT or "Aid for integration into GVCs" might end up with new dimensions in conditional projects which will probably prevent developing countries from determining their own needs and priorities. This might also hurt the multinational efforts against tied aid and donor countries might reap most of the benefits from AfT.

With these issues in mind, in this study, we investigate whether total AfT given by donor countries increases recipient exports to donors as well as donor exports to recipients. Also, we separately consider the impacts of different types of AfT (Trade Policies and Regulations, Economic Infrastructure and Building Productive Capacity) on recipient and donors exports

3. Literature Review

Looking at the export side, empirical studies concluded with heterogeneous results about the effect of AfT on recipients' exports as well as exports of donors. Using disaggregated trade data of 167 importers (reporters) and 172 exporters (partners) between the years of 1990-2005, Helble et al. (2012) estimated how the sum of AfT received from bilateral donors by both exporter and importer might affect bilateral imports. They found that AfT directed to both exporter and importer has positive and strongly significant effect on the bilateral flows between each trade partner. Using a similar methodology to that of Helble et. al. (2012), Pettersson and Johansson (2013) tested the effectiveness of AfT on bilateral exports by using data for 184 countries and for the period of 1990–2005. However they analyzed the bilateral AfT (and technical assistance) flows instead of aggregating and also AfT, those of which received from and directed to only exporter. The study shows that there is a positive correlation between aid and exports, no matter whether the

[4] For example, Solo Raya region of Indonesia and Lesotho, both of which were promoted with local value-chain projects, have recently experienced a sharp decline in their exports as a result of the collapse of the global economy in 2009 (OECD-WTO, 2013b: p. 21). For a discussion of disintegration of production, GVCs and value-added content of exports, see: Feenstra (1998). For a survey of possible adverse income distribution effects of GVCs, see Feenstra & Hanson (2001).

exporter is aid recipient or aid donor. Cali & Te Velde (2011) was found a similar result by using a sample of 100 developing countries for the period of 2002−2007. Their result suggested that an additional %100 of total AfT (lagged 2 years) is associated on average with a 3,5% increase in merchandise exports by the recipient country, whereas sub-AfT categories suggest that aid to economic infrastructure increases exports while aid to productive capacity appears to have no significant impact on exports.

Although it is important to identify a positive relationship between aid and recipient exports, the benefits of Aft for recipient economy cannot be fully evaluated without looking comparatively the net effect of AfT on recipient's exports in contrast to its imports from donors. A more recent and important study, focusing more specifically on this relative impact of AfT was held by Hühne et al. (2013). By aggregating the bilateral components of the gravity model, they used Total AfT (and particularly of major sub-categories) directed to each recipient from all donor countries for the 1990-2010 period. Bilateral flows between 167 importers and 172 exporters were included in the study where donor-recipient pairs represent just a fraction of all pairs of trading partners. Besides they prefer to estimate the effect of AfT by pooling regressions for the exports and the imports rather than performing separate regressions for them. As a result, they found that total AfT positively affect trade in both directions. Furthermore they suggest that the effect on recipient exports is significantly stronger than the effect on recipient imports, a result which will be further investigated in this study. Similarly, Nowak-Lehmann et al. (2013) focused on the two-sides of the bilateral trade relationship. They analysed the effect bilateral net ODA with data on 21 donor and 123 recipient countries over the period from 1988 to 2007. Their empirical findings, however, contradicts with Hühne et al. (2013) and suggest that bilateral aid seems to have been effective in enhancing donors' bilateral exports, but ineffective as a direct promoter of recipient countries' bilateral exports.

On the other hand, in various studies, potential negative effect of aid (but not particularly AfT) on trade was analysed. Aid is expected to adversely affect export performance of developing countries, when a large amount of aid flows goes to consumption and

especially those expenditures consisting of non-tradable goods & services. In this case, the price of non-tradables will increase and the real exchange rate will appreciate. Exports will be exposed to a downward pressure as a result of both currency appreciation and transferred resources from tradables to non-tradables.[5] However, Adam and Bevan (2006) states that short run Dutch disease effects of increased aid can be reduced, if aid is directed to public investment and productive uses rather than to consumption.

On the import side of the bilateral trade relationship, AfT is suggested to affect donor's exports (recipient's imports) through various mechanisms. First of all, aid most probably promotes exports of donors to the recipient, if it is conditional to the purchase of goods & services from the donor. This is a well-known example of formal aid-tying.[6] Besides, aid might be tied to donor exports informally as a result of "good will effects" which might cause recipient feel obligated to buy from the donor in order to secure the continuity of the aid flow (McGillivray and Morrissey, 1998; Lloyd et al., 2000; Wagner, 2003).

4.Data and Estimation Methodology

4.1Data

The panel data covers 23 donor and 128 recipient countries with the time period of 2002-2009. Time span is set to the period over which the data for aid disbursement is available. Data on aid for trade are obtained from the the Creditor Reporting System (CRS) which reports the comparable data of aid commitments and disbursements over time and across countries. Since we are principally interested in the ex-post impact of aid on trade, our analysis is merely based on disbursement rather than the commitments data. However, while the aid commitments data have annual coverage of over %90 of the full sample since 1995 , the coverage of the disbursements data are only complete from 2002 onward. From this database we use different types of AfT data which comprises the following categories:

[5] For detailed studies, see Munemo (2007), Rajan & Subramanian (2011), Suwa-Eisenmann & Verdier (2007).

[6] Tied aid is mainly criticized for producing greater dependency by increasing donor influence over policies & projects and thereby undermining the right to self determination. In April 2001, DAC agreed on a recommendation on untying ODA to the least developed countries.

i) Trade policies and regulations (CRS Code 331)

ii) Economic infrastructure which covers data on aid for communication(220) transport and storage (210), and energy supply (230)

iii) Productive capacity building which consists of data on Banking and Financial Services (240), Business and Other Services (250)I Agriculture (311), Forestry (312), Fishing (313), Mineral Resources and Minning (322), Industry (321) and Tourism (332)

The trade data are taken from Barbieri, Katherine and Omar Keshk. 2012. Correlates of War Project Trade Data Set Codebook, Version 3.0. The data for GDP are provided by the World Bank's World Development Indicators (WDI) which are all measured in current U.S. dollars. Because the satisfactory price indices often do not exist for each nation covered in the analysis, we use nominal trade and GDP figures in the regressions and include time dummies to the models as Baldwin and Taglioni (2006) suggests. Lastly, data on the regional trade dummy (RTA) comes from the Head et.al at CEPII database.

4.2Estimation Methodology

In order to explore the impact of AfT on trade , we employ the standart gravity model of trade which describes bilateral trade volumes as a function of economic size of the trade partners and geographical distance between them.

Accordingly , we estimate a specific gravity equation of the following form;

$$\ln X_{ijt} = \alpha + \beta_1 \ln GDP_{it} + \beta_2 \ln GDP_{jt} + \beta_3 AfT_{it-1} + \beta_4 RTA_{ijt} + \beta_5 NA_{ijt} + \boldsymbol{\lambda}_t + \varepsilon_{ijt} \qquad (1)$$

where Xij denotes exports of recipient country i, to all donor countries j. GDPit and GDPjt represent gross domestic products for recipient and all donor countries respectively. AfTit-1 which is the variable of principal interest is the total aid for trade received by country i from all donor countries j. The regression also include the Aft

variable at disaggregated level. More clearly, we also regress exports separately on each aid for trade categories; i.e., aid for trade policies (pol), aid for infrastructure (infra) and aid given for building productive capacity (prod).

Symetrically, we also separately regress import volumes of recipient countries from donor countries on the regressors defined above to compare the effects of AfT on trade in both directions. Hence, comparing the regression coefficients on the Aft variables in both export and import equations enable us to decide whether Aft primarily increases recipient exports to donors or vice versa.

Equation 1 also includes the regional trade agreement dummy (RTA) which equals 1 if both countries share the same trade agreement. NAij denotes the dummy for AfT which equals 1 when there exists missing values. Finally, λt is common time-specific effects which capture the impact of common economic shocks and/or global trends and, εijt is the stochastic error term.

We estimate our baseline gravity model using country- pair specific fixed effects to control for unobserved heterogeneity in the bilateral trade relationship.Also, to tackle the potential reverse causation problem and to account for the lagged effect of AfT on trade, we use one-period lagged values of aid flows. Using the lagged values of aid flows seems particularly reasonable since the realization of the impact of AfT on trade volumes probably take some time.

5.Empirical Results

5.1Exports

Table 1. reports the estimation results for the baseline gravity model for exports. First of all, the results present that in all specifications, the estimated coefficient on the GDP_recipient are positive and significant at %1 level indicating that economic size of

the recipient countries matter for their exports. This finding is not surprising since the recipient countries in our sample consist of relatively low and middle income countries: as they get richer, their export potential increases at a moderate rate.

The findings also show that the coefficient estimates for the GDP_donor are always positive, but insignificant at conventional significance levels. This result might stem from the fact that the foreign income elasticity of import demand for recipient country' products is low. This might not be surprising once we realize that the exports structure of the recipient countries in our sample heavily consist of primary products.

Moreover, while the RTA variable which is a dummy variable for regional trade aggremeents, enters into the regressions with positive sign, its coefficient is always insignificant at conventional levels implying that trade aggreements between donor and recipient countries have not statistically any impact on recipient country' exports.

Colum 1 of Table 1 documents the estimation results for total Aft which is the variable of our primary interest. As is apparent from the Table, although the coefficient on the Aft is found to be positive, it is not significant at the conventional levels. In other words, the data do not show that aid given to the recipient countries has any statistically impact for recipient exports to donors. Given the mixed results reported in the related literature, this finding coincides with the results of Nowak-Lehmann et al. (2013) who also find that net effect of aid on recipient countries' exports is insignificant.

Table 1. REGRESSION RESULTS FOR AID AND EXPORTS

	Ln(Exports)			
Variables	(1)	(2)	(3)	(4)
ln(GDP_{donor})	.0222	.0471	.0241	.0651
	[.2721]	[.2700]	[.2726]	[.2723]
ln($GDP_{recipient}$)	.8325***	.8516***	.8365***	.8799***
	[.1493]	[.1507]	[.1492]	[.1518]
RTA	.1392	.1395	.1394	.1461
	[.1655]	[.1651]	[.1655]	[.1683]
ln(AfT)	.0045	-	-	-
	[.0139]			
NAaft	.0930	-	-	-
	[.1750]			
ln(Infra)	-	.0219*	-	-
		[.0125]		
NAinfra	-	.2459*	-	-
		[.1499]		
ln(Prod)	-	-	-.0105	-
			[.0141]	
NAprod	-	-		-
ln(Pol)	-	-	-	-.0121
				[.0211]
NApol	-	-	-	-.1907
				[.2478]
Within R^2	0.8567	0.8565	0.8567	0.8561
No. of Observations	19608	19623	19609	19429

Not: 1.Robust Standard errors are in parentheses.
2.***, ** and * indicate the significance level at 1%, 5% and 10% respectively.

Moreover, Column 2 - Column 4 report the estimation results which contain the Aft variables at disaggregated level. The results show that only the INFRA variable which denote the aid for communication, transport, storage and energy supply, has statistically significant coefficient at conventional levels. However, the size of the coefficient is not large (.02) implying that aid given by donors for the infrastructure investments has only moderate effect on recipient exports to donor countries. On the other hand, the estimated coefficient on the PROD variable is found to be negative and insignificant which is consistent with the findings of the some other studies (for example,Cali and Velde,2010). Similarly, aid given for trade policy and regulations does not affect the recipient exports to donor countries. This result is consistent with the expectations, since this type of aid constitutes only the marginal share of the total aid given by donor countries.

5.2 Imports

The estimation results for the baseline gravity model of imports are reported in Table 2. First of all, as is apparent from the Table 2., the results show that economic size of the recipient countries increases their import flows from donor countries as expected. Furthermore, in all models, the coefficient on the GDP_donor is positive and significant at %1 level implying that size of the donor countries is also matter for their exports to recipient countries. However, somewhat surprisingly, the estimated coefficient on the RTA is always negative and statistically significant.

Table 2. REGRESSION RESULTS FOR AID AND IMPORTS

	Ln(Imports)			
Variables	(1)	(2)	(3)	(4)
ln(GDP_{donor})	1.7231***	1.7350***	1.672***	1.5716***
	[.2323]	[.2323]	[.2316]	[.2344]
ln($GDP_{recipient}$)	.4915***	.4896***	.4996***	.5004***
	[.1341]	[.1339]	[.1338]	[.1347]
RTA	-.4149**	-.4421***	-.4191**	-.4536***
	[.1670]	[.1668]	[.1671]	[.1701]
ln(AfT)	-.0020	-	-	-
	[.0191]			
NAaft	-.2389	-	-	-
	[.2252]			
ln(Infra)	-	.0569*	-	-
		[.0306]		
NAinfra	-	.5365	-	-
		[.3699]		
ln(Prod)	-	-	-.0566***	-
			[.0212]	
NAprod	-	-	-.8008***	-
			[.2446]	
ln(Pol)	-	-	-	-.0499
				[.0457]
NApol	-	-	-	-.3507
				[.5084]
Within R^2	0.7227	0.7230	0.7227	0.7219
No. of Observations	20226	20241	20227	20046

Not: 1.Robust Standard errors are in parentheses.
2.***, ** and * indicate the significance level at 1%, 5% and 10% respectively.

Similar to the findings of our export regression, the Aft variable enters into the regression with insignificant coefficient. However, the sign of the coefficient turns now negative. The reason for this becomes clear when the results for the disaggregated aid variables are considered. Colum 2-4 of Table 2 report that the estimated coefficient on the PROD variable is negative and significant while the INFRA variable has statistically significant positive coefficient. There exists the possibility that aid given for building productive capacity might be used by the recipients to promote their import substituting sectors. However, once we consider the moderate coefficient on the related variable (.05) and the relatively short-time span of our sample, this possibility seems not so strong. Similarly, there is indication that aid for infrastructure investments promotes recipient imports from donors. This results is expected since the increasing communication and transportation possibilities of the recipient countries' decrease the cost of trade between trade partners.

Conclusion

This study try to answer a specifically -defined question: Does aid for trade increases the recipient exports to donor countries? Or does it promote the donor countries' own export interests? To explore this issue, contrary to the earlier studies, we run separate regressions for exports and imports of recipient countries to minimize the problem of systematically zero aid values. Our findings suggest that overall AfT does not have statistically significant impact on recipient exports to donors as well as recipient imports from donors. At disaggregated AfT categories, there is a little positive relationship between aid given for infrastructure invesments and recipient exports. From the imports side, we find that aid given for building productive capacity is negatively correlated with recipient imports while aid given for infrastructure investments slightly promotes imports. However, the sizes of the coefficients of those variables are quite small indicating that the relationship between aid and recipients imports is not so strong.

On the other hand, we argue that our results should be evaluated cautiously especially in terms of political relevance. We only propose that the data, on average, do not suggest the statistically significant relationship between AfT and recipient exports to donors as well as donor exports to recipients.

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