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Effects of Trade Openness and International Financial Inflows on Africa's Productive Capacity: A Study of the Moderating Role of Governance Institutions

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Abstract

We investigate the effects of trade openness and international financial inflows (including foreign direct investment, remittances and foreign aid inflows) on Africa's productive capacity and how governance institutions are moderating these effects. We adopt the dynamic system GMM modelling framework and the Bun and Carree (2005) bias-corrected least square dummy variable estimator with a panel of 43 African economies. We also use the Driscoll and Kraay (1998) standard error fixed effect estimation, which controls for cross-sectional dependence to provide robustness check. We find that trade openness and the various components of international financial inflows are significant drivers of productive capacity in Africa, and that governance institutions are moderating and enhancing their effects. We also find that renewable energy consumption, human capital development and infrastructure development are promoting Africa's productive capacity. We highlight the policy implications of these findings, which among others, encourage policymakers and leaders in Africa to focus on policies that can enhance cross border trade, attract international financial inflows and entrench high-quality institutions.

Keywords: Trade openness, international financial inflows, governance institutions, productive capacity, system GMM regression

JEL Classification: F40, L83, N20, O14, C23

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1. Introduction

Recent trends in globalization have led to the realization that sustainable growth and development depend on a country's ability to effectively combine productive resources, entrepreneurial competencies and production links (UNCTAD, 2020). Given this realization, enhancing the productive capacities of economies, particularly in developing countries, has become a major focus of recent global development policy debates. Indeed, productive capacities and structural economic transformations are critical to achieving economic growth and development. A review of some recent studies indicates that, when compared to highly sophisticated economies, developing economies generally have lower productive capacities as well as fewer resources and limited capabilities for expanding their production capacities (Xu and Li, 2019; UNCTAD, 2020). Figure 1 shows that unlike leading economies in other regions of the world, African economies on average generally recorded a productive capacities index below 30% over the period 2000–2018, which is quite low. This means that African economies may not have been benefiting much from increased productive capacities, since recent studies have highlighted the benefits of enhancing productive capacities across different economic sectors, such as increased job creation, enhanced levels of investment and increased diversification of the economy, among others (Williams *et al.*, 2016; Osaulenko *et al.*, 2020). Thus, despite Africa's increasing economic growth, which averaged 6.9% in 2021, suggesting a strong recovery following the contraction of 1.6% in 2020 due to the COVID-19 pandemic, the region has only shown limited progress in transforming and diversifying its economies. Furthermore, as rightly observed by UNTAD (2020), structural change in the region is largely characterized by very limited industrialization and a high level of informality. Consequently, there is a need to examine the possible factors that may influence productive capacity in Africa.

The emerging literature has underscored the imperative of integrating national and international development approaches in order to increase the productive capacities of economies around the world (Isaychev *et al.*, 2020; Ramakrishnan *et al.*, 2022). Interestingly, recent studies and several development conferences (*e.g.*, the Istanbul Programme of Action for the LDCs 2011–2020) have identified openness to trade and international financial flows between world economies as some of the upsides of the ongoing globalization process (UNCTAD, 2019; WB, 2020). Firstly, international financial inflows are needed in Africa to bridge the savings-investment gap in order to achieve sustainable investments and increase economic growth (Ikpesu, 2019). Secondly, economic benefits from trade openness and international financial flows are transmitted through enhancement of human capital, creation of jobs, improvement of economic productivity and expansion of capital investment, which are elements that enable the expansion of a country's productive capacity (Fite, 2020). However, when compared to leading economies in other regions