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## The Impacts of Institutions on International Trade in Ghana's Economic Perspective

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### Abstract

The capacity of institutions in promoting the course of international trade and economic growth has been a dilemma and a discourse among trade economist. Since 1957, when Ghana attained her independence, the potential role of institutions in affecting her multilateral trade flows has been remarkably tremendous. This study empirically investigates the impacts of institutions on international trade in Ghana's economic perspective. The econometric tool employed in the study is the Ordinary Least Squares (OLS) technique. The results revealed that business freedom and freedom from corruption has no significant effects on Ghana's trade, however, property rights, monetary freedom, trade freedom and exchange rate exhibit great robust influence on trade in Ghana's economic perspective.

It is recommended that the economic institutions and all the auxiliary sectors in supporting and promoting the course of Ghana's trade should be strengthen and focused so as to enhanced and maximize the potential gains from international trade.

**Keywords:** Institutions, International Trade, Ordinary Least Squares, Ghana.

### Introduction

Most economic growth theories have led emphasis on key economic development indicators that pathed the way to most resilient and strong economics in contemporary times, such as UK, USA, China, Germany, Japan etc, The Solow economic growth model for instance, has outlined that, a well mixer of technology and labor-augmenting technological progress are logic key instruments to not only reaching the steady state of developing economies but also as a means of economic advancement (Robert Solow, 1956). This implies that a well-structured institution leads to economic development, which in turn improves institutional quality. The direction of causation however differs between the developed and developing economies. In developed countries, resilient institutional quality foments economic development, whereas the reverse is rather true in developing countries (Law et al., 2013).

In the last one and half centuries, wages in the less developed countries have fallen far behind those in the developed countries, both in absolute, relative and proportionate terms, between 1870 to 1990, the ratio of per capita incomes between the developed and the developing countries increased by roughly a factor of five and that the disparities in incomes between the richest country and all others has increased by an order of magnitude (Lant Pritchett, 1997). In 1870, these set of countries (developed and developing) Has been different from each other with “high income OECD” countries being identified as the European countries and their offshoots not leaving Japan out. The growth rate of these countries has been remarkably by historical standards and has left a wide gap among the less develop lower income countries to catch up. Apparently, its seems in any case that this growth sample started changing from 1980, after that few of the fastest developing countries on the planet have equally been low-income countries. Consider isolates economies along with wage quintile in the light of 1980 for per head GDP, and setups consequent populace weighted growth rates (Najaf Ali, 2018). This may probably or largely attribute to the different institutional setups in those economists.

Lant Pritchett (1997), further noted that between 1870-1989 the annual GDP per capita average growth rate of most industrialized economists were awkwardly lower than their offshoots countries. As of 1870-1960, USA, Great Britain, Germany and Japan annual GDP per capita were 1.7%, 1.08%, 1.66% and 1.86% per annum respectively. Lant Pritchett strongly believed that convergence will make poorer nations to growth faster and probably overtake richer nations. These predictions are being materialized with the recent economic advancement in the Asian continent, countries such as China, Hongkong, India, Vietnam and others which were considered heavenly poor countries in the 1980s are now growing at galloping pace. These magnificent economic transformations have increased the world economic output considerably, this may be associated with two basic reasons; firstly, international trade has strengthened between and amongst their trading patterners, these economists have realized the vital role of trade and perhaps expanded their economist to the rest of the world. This economic circumvention has led to a considerably rise in their international inflows. Secondly, the role of institutions has also exacted some kind of efficiency in income and assets distributions amongst the business economic agents. A stable, trustworthy and workable institutions significantly affect a country economic progress positively.

Ghana economy has been growing at quite a stable rate since after her independence in 1957. The World Bank forecasts the growth rate of Ghana economy to be 2.4% for 2017-year period up to 3.2% in 2018 and 3.5% in 2019. The region’s growth is expected to be higher at 5% if exclude the big three economies of Nigeria, Angola, and South Africa. According to the World Bank, most of 2018’s top performers are non-commodity intensive economies, and Africa has six of the world’s ten fastest growing economies. The list is led by Ghana (8.3%), which is boosted by oil & gas expansion, Ethiopia (8.2%), Côte d’Ivoire (7.2%), Djibouti (7%), Senegal (6.9%) and Tanzania (6.8%), (World Bank 2018 Africa report)

At the early years of its independence, Ghana GDP growth rate approximately was about 3.5 percent, and over nearly half a century later (2014), the GDP growth rate has only increased by 0.78% bases points to 4.18 percent. Nevertheless, the Per Capita Income, which was \$490 in 1957, was almost less than doubled in 2014 (\$765.49). It’s worth noting that Ghana GDP growth rate encompasses several macroeconomic indicators and the right institutions, economic freedom as well as international trade plays a critical and a contributions role in its GDP progress.

A couple of studies has been carried out on the role of institutions in economic development and integrations, some has found a bi-directional cause and effects relationships between institutions, economic growth and development (see Bates et al., 2013; Chong and Calderon 2000). Most of them however focused on only the role of institutions in productivity growth, investment and economic growth to the neglect of the impact of these institutions on international trade (see Easterly et al., 2004; Bates et al., 2013, Robinson, 2001; Acemoglu et al., 2001;). Ergo, the none effectuating economic growth in most and almost some sub-Sahara African countries, including Ghana, is largely due to or contributing to the weak institutional quality in promoting international trade and economic development

Due to this fallibility and deficiency in the existing literature, this study seeks to fill the research gap and to contribute to the existing literature by proffering an integration and empirical results to elaborate the dynamics and causal relationship of facets that de facto Ghana multilateral trade flows, nevertheless, by estimating and examining how the role of institutions affects the course of Ghana international trade.

### **Economic Freedom, Institutions and Trade**

Douglass Cecil North (1991), an American economist known for his work in economic history defines an institution as "humanly devised constraints that structure political, economic and social interactions"

Economic Freedom can be explained as "An aspect of human liberty that is concerned with the material autonomy of the individual in relation to the state and other organized groups. The highest form of economic freedom provides an absolute right of property ownership, fully realized freedoms of movement for labor, capital, and goods, and an absolute absence of coercion or constraint of economic liberty beyond the extent necessary for citizens to protect and maintain liberty itself" (Najaf Ali, 2018). This can be further strengthened to imply that; a transparent institution promotes a conducive economic freedom. The apex of an economic freedom is associated with a resilient economy, perfect interactions of the market forces of demand and supply, human development, healthy environment, higher per capita income or wealth, eradication of poverty, international trade facilitations etc.

The smattering research interlinking economic freedom, trade and institutions does not displays a clear spectrograph of the underlining phenomena (see Rose 2000; Acemoglu et al., 2001; Anderson & Marcouiller 2002; Depken II & Sonora 2005; Wisdom Akpalu et al, 2017).

### **Review of Literature**

The focused of every government in recent periods is how to increased its economic GDP and perhaps its per capita income of its citizenry. In an itching to accomplished these objectives, several development economists often asked questions such as; why in some societal settings, institutional roles exhibit some positive impacts in technological and innovation advancement, while in some societies they do not? (Parente and Prescott 2005). What institutional measures promotes innovations and human capital development albeit all the economic turmoil's? (P. Aghion and P. Howitt,1992).

Wisdom Akpalu et al, (2017) noted in their studies "Evolution of Institutions in Ghana and Implications for Economic Growth" that, GDP growth rate in Ghana was quite intriguing under quality and better institutions and through out her recent two decades of democracy. The

econometric method employed in the study was the ordinary least square (OLS) estimations procedure. This was used to determine whether democratic regimes deliver better growth outcomes (GDP growth rates) than the military regimes, it was also employed to empirically verify whether the indicators of the two institutions (Political and civil liberties and Property rights) vary significantly across the three regimes/eras (precolonial, military and democratic regimes). The results show a mixer of relationships. Their studies again revealed that, out of the three formal institutions employed in the study, Civil and Political liberties and Property Rights are better indemnified under democratic regimes, compared to the colonial era and the military regimes. However, the reported indicators of Political instability from the empirical results revealed on the average less favorable outcomes under democratic regimes.

Lant Pritchett (1997), in his paper “divergence, big time” portrays how incomes in the less developing countries has fallen behind those in the developed countries. He again shows how the per capita incomes of these two economists (richest and poorest countries) increased by a factor and the difference only changes by an order of magnitude from 1870 to 1990. The study further regressed the relative incomes across the 17 countries or nations considered in the study against their GDP per capita and trend (1 if >1960 and 0 if otherwise). GDP per capita were found to have negative effect on relative incomes of these countries (-0.59), the two-trend considered in his study has coefficients of 0.13 and 0.002. one intriguing fact about this study is that the author was pretty convinced that the developing countries will converged to meet the developed countries. The most tantalizing and intuition question behind this study is how does the various institutions interlined to pushed these economies forward? One could probably give a theoretical answer; perhaps, they had well-established institutions.

A recent study; “role of institutions in affecting the course of international trade in Pakistan” by Najaf Ali (2018), stretched that, institutions like, Trade Freedom, Freedom from Corruption, Property Rights, Monetary Freedom, and Business Freedom, greatly possess some perverse effects on Pakistan trade. The study obtains data from the heritage foundation index for the analysis. The results from the multiple linear regression reveals that exchange rate, monetary freedom and some dummy variable has a negative effect on Pakistan trade while other key institutions such as Trade Freedom, Freedom from Corruption, Property Rights, and Business Freedom had a positive relationship with Pakistan trade flows. The study further carried out some diagnostics test (CUSUM stability test and Breusch-Godfrey Serial Correlation LM Test) to determine the variability and perhaps the stability of the parameters considered. The study recommends that, the property rights enforcement agents in Pakistan should be fused along with the business freedom to magnify the prospects of gains from international trade. Nevertheless, exchange rate oscillations should be controlled in order to have stability and long-term trade patterns.

Ahmet Faruk Aysan et al (2006) elongate in their working paper “Governance and Private Investment in the Middle East and North Africa” that structural reforms such as trade openness and financial development, human capital, economic policies and governance institutions appears to play a significant role in private investment decisions. The study uses the three stages least squares (3SLS) method or procedure to analyzed a panel of 31 countries from 1980- 20002. The study further reveals that low level of corruption, a good quality of bureaucracy, a clear security of property rights, a reasonable risk to operations, a sound taxation and regulation as well as better law and order are of priorities for entrepreneurs’ decisions to invest in these



economies. Their study also confirms some of the theoretical literature on economic growth and investment, more specifically, the study confirms the user cost of capital theory and the natural curse hypothesis. However, the model fails to verify the Solow hypothesis of decreasing return to scale of physical capital accumulation. The study concludes that improved governance institutions and economic reforms will create an inductive environment for private investment decisions.

Daniel Kaufmann et al (2004) have noted that a resilient economic development and higher per capita income really depends on the quality of good governance. They further pinpointed in their 2009 report that, they have been a positive robust improvement on voice and accountability by countries such as Ghana, Indonesia, Kenya, Nigeria, and Peru on their governance (institutions) but also declines in that component in countries such as Belarus, Zimbabwe and Venezuela.

Rohini and Christopher (2005) in their study "Institutions and Development: A View from Below" stressed that institutional development and observed growth in cross-country data possess a robust indications of higher, fast, long-term growth in countries with quality contracting institutions, increased protection of private property rights, improved central government bureaucracy, better law enforcement, increased levels of democracy, higher levels of trust, and smoother operating formal sector financial markets. The study again reveals that index of country openness to trade has apparently reduced poverty to a minimal level in India, Brazil, and Colombia.

Mohammad D et al (2009) also studied the long run relationship between private investment and government expenditure in Pakistan. The study employed time series data of the Pakistan economy from 1975-2008 period. The Johansen-Juselius co-integration test used in the study shows the existence of long run relationship among the parameters considered. The results refute the existence of short run causality between the studied variables, however, the long run results show that non-government expenditure such as debt service, defense etc. leads to crowding out in private investment sectors and perhaps possess pervasive effects on social and economic development in Pakistan.

David Dollar & Aart Kraay (2003) in their working paper, "Institutions, Trade, and Growth: Revisiting the Evidence" noted a very crucial interrelationship between Institutions, Trade, and economic Growth. The study employed a mixer of methods (IV regressions, first-stage least square and ordinary least squares) to analyze the interdependence of these economic parameters. The study found out that when institutional quality is used as an exogenous variable, then there is a significant partial association between trade and growth which survives the inclusion of a variety of proxies for institutional quality. Nevertheless, when institutional quality was proxied as an endogenous parameter, they found that the model was relatively weak and unable to estimate the variables in question. Another intriguing findings of the study was that initial income were found to have effects on growth and changes on trade. Conversely, initial institutions once again, predicts the endogenous change in initial income, while initial levels of per capita income that were supposed to be instrumented for the change in initial income were also however, found to explain changes in trade and changes in institutions. The study highlighted in their conclusions that, simple cross-country linear IV regressions, be it or whether at levels or in decadal differences will only result in answering a partial and insignificant portion of the complex interactions roles of institutions and trade on economic growth.

Weingast & Milgrom (1990) examined expansion of international trade in the medieval times as in the case of Champagne fair, and noted that trade was made possible largely by private order courts, whereby the judiciary were private and serves as a documentations ground for the records of traders. This exuberated to the habit that the merchants used to ask the private judges regarding the reputation of the trader to which they are going to trade. Private judges caution the merchants to take precautions when conducting business transactions with traders whose credibility is questionable, the judiciary or judges were also expected to impose fines and penalties to the traders for misconduct, and any breach of business contracts and perhaps if a trader would not pay the fines, he or she were to lose all the future possible contracts or opportunities of trade thereafter. Amongst the absence of enforcement of security or property rights and contracts by the State, private judges combined with the private order institutional arrangements, lead traders and merchants to fulfill the contracts.

Acemoglu et al (2003) shows the effects of institutional quality on economic growth after the world war 2. The results from the two stage least square reveals that institutional mismanagement and oscillations in macroeconomic policies where the major causes of some economic crisis after the war.

### Methodology and Data Source

The study employed annual data (1995-2017) which is sourced from the website of the Index of Economic Freedom -Heritage Foundation and world Bank database. The variables applied in the study includes; exchange rate, which is measured as the official exchange rate of 1Ghana Cedi's per US dollars, total exports of goods and services, freedom from corruption, which is interpreted as the integrity of government institutions in decisions making processes, business freedom, monetary freedom, property rights, which is the extent to which a country's legal framework allows individuals to accumulate private property freely, and trade freedom. The first two variables were obtained from the World Bank development indicators database, while the rest of the variables were extracted from the Index of Economic Freedom -Heritage Foundation.

The study adopted the ordinary least square (OLS) method for the empirical econometrics' analyses. The justification for utilizing this method is that it minimizes the sum of the square's errors of the differences between the observed regressand and the predicted regressors. The OLS estimator is consistent when the regressors are exogenous, and optimal in the class of linear unbiased estimators when the errors are homoscedastic and serially uncorrelated. Under these conditions, the method of OLS provides minimum-variance, mean-unbiased estimation, when the errors have finite variances (Wikipedia, 2018).

The model can empirically be expressed as;

$$Y_i = \beta_1 X_{i1} + \beta_2 X_{i2} + \dots \beta_p X_{ip} + \varepsilon_i \quad (1)$$

Where  $Y_i$  (regressand) is a linear function of the regressors  $X_{i1} \dots X_{ip}$  and  $\beta_1 \dots \beta_p$  are unknown parameters and  $\varepsilon_i$  is the 'noise' or error term.

Equation (1) can also be written in matrix notation as;

$$Y = X\beta + \varepsilon \quad (2)$$

Where  $Y$  and  $\varepsilon$  are  $N \times 1$  vectors of the values of the response variable (the regressand) and unobserved scalar random variables (the errors) for the various observations.  $\beta$  is a  $p \times 1$  vector of unknown parameters; regressors.

Equation (1) is further extended to include the study variables as follows;

$$\ln EXP = \beta_0 + \beta_1 EXR + \beta_2 FRC + \beta_3 BSF + \beta_4 MOF + \beta_5 PRR + \beta_6 TRF + \varepsilon \quad (3)$$

Where,  $\beta_0 \dots \beta_6$  are unknown parameters to be estimated. EXP represent exports of goods and services, EXR is exchange rate, FRC is freedom from corruption, BSF is business freedom, MOF is monetary freedom, PRR is property rights and TRF is trade freedom. Ln and  $\varepsilon$  represent natural log and the unobserved error term respectively.

## Results and Discussion

**Table 1.0 Descriptive statistics**

Variables	mean	Std.Dev.	Minimum	Maximum
EXP	22.543	0.864	21.1830	23.662
BSF	58.943	5.652	50.000	70.000
EXR	1.372	1.225	0.119	4.350
FRC	42.100	10.523	32.900	70.000
MOF	63.822	5.508	51.200	71.000
PRR	49.952	0.229	48.900	50.000
TRF	60.226	9.838	31.200	67.800

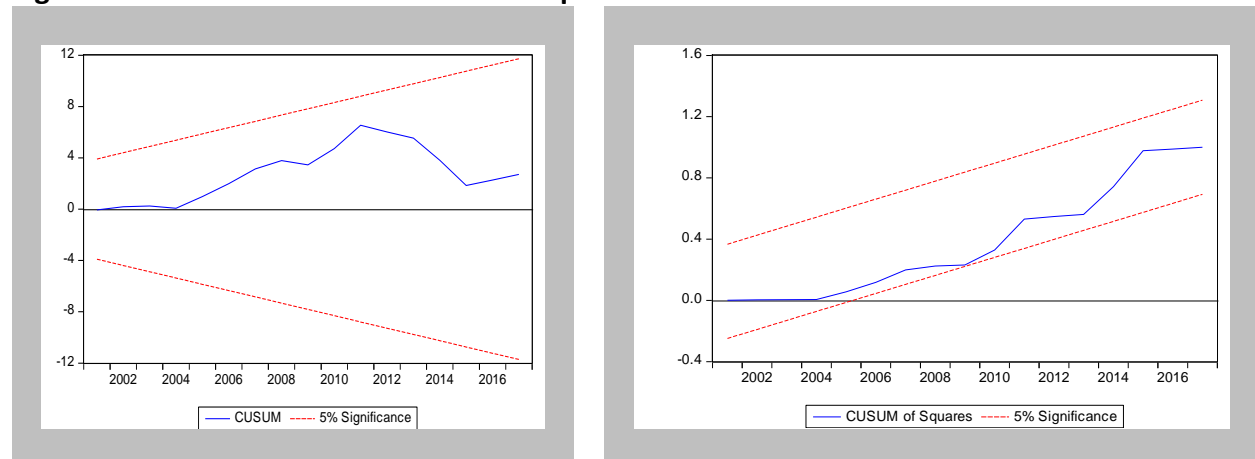
From table 1.0 above, its clear that the highest mean is 60.226 and the lowest is 1.372 which corresponds to trade freedom and exchange rate respectively. We are motivated that, this two variables will have a great impact on trade.

## Configuration and determination Model Test

### *Stability diagnostic test*

Figure 4.1 shows the CUSUM tests and CUSUM of squares test of stability for the variables employed in the study. The figure reveals no structural breaks in the study parameters since they do not exceed the 5% significance line. Hence, it's worth noting that all the variables are stable in the model. In other to check for outliers and whether the model is possibly mis-specified (for example, to check for linearity) the dependent variable was set us a leverage against the regressors (independent variables) using leverage plots, from figure 4.2 most of the residuals apparently moves along the regression line as expected. We are therefore confident that the model is not entirely mis-specified hence stable.

**Figure 4.1 CUSUM Tests and CUSUM of Squares Test**





**Figure 4.1 Leverage plots**

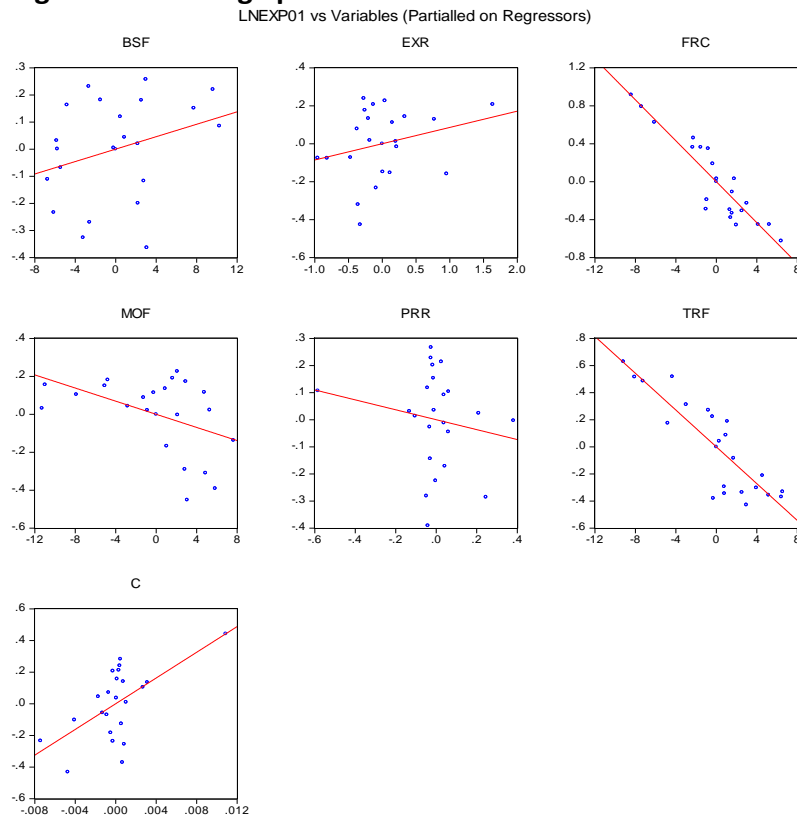


Table 4.1 and table 4.2 shows the results for the Breusch-Godfrey test for serial correlation and Heteroskedasticity Test: Breusch-Pagan-Godfrey. Since the p-values are greater than 5% significance level (0.1035, 0.5900>5%), we fail to reject the null hypothesis of no serial correlation and Heteroskedasticity and conclude that, the data is free from serial correlation and Heteroskedasticity.

**Table 4.1 Breusch-Godfrey Serial Correlation LM Test**

F-statistic	1.702135
Obs*R-squared	4.536982
Prob.F(2,14)	0.2148
Prob.Chi-Square(2)	0.1035

**Table 4.2 Heteroskedasticity Test: Breusch-Pagan-Godfrey**

F-statistic	0.674991
Obs*R-squared	4.645834
Prob.F(6,16)	0.6718
Prob.Chi-Square(6)	0.5900
Prob.Chi-Square(6)	0.9382
Scaled Explained SS	1.787190

### OLS Estimates

Dependent Variable: LNEXP01

Method: Least Squares

Sample: 1995 2017

Included observations: 23

**Table 4.3 OLS estimates**

Variables	Coefficients	Standard Error	t-statistics	P-value
BSF	0.011466	0.008932	1.283726	0.2175
EXR	-0.994059	0.526836	-1.886847	0.0775*
FRC	-0.107914	0.011963	-9.020938	0.3415
MOF	0.017303	0.008571	2.018714	0.0606*
PRR	0.796735	0.337660	2.359579	0.0504**
TRF	0.067866	0.009999	6.787121	0.0000***
C	40.62902	13.29111	3.056856	0.0075***

**Note:** \*\*\*, \*\*and \* donates 1%, 5% and 10% significance levels respectively.

### Model Statistics

R-squared	0.958791	Mean dependent var	22.54326
Adjusted R-squared	0.943337	S.D. dependent var	0.863692
S.E. of regression	0.205592	Akaike info criterion	-0.080054
Sum squared resid	0.676291	Schwarz criterion	0.265531
Log likelihood	7.920618	Hannan-Quinn criter.	0.006860
F-statistic	62.04395	Durbin-Watson stat	1.263380
Prob (F-statistic)	0.000000		

Table 4.3 above displays the results of the OLS estimates. Out of the six regressors considered in the model, four of them are statistically different from zero, the R-squared and Adjusted R-squared are also in a good standing, depicting the goodness of fit of the model. The results show that a “significant” (not total depreciation) percentage increase in the exchange rate depreciation of the Ghanaian cedi (GHC) to the US dollar will lead to an increased in trade (as measured by the export of goods and services) by 0.99%. Depreciation of the “Cedi” makes the export of goods and services cheaper to the rest of the world. Another significant variable with a great impact on trade is monetary freedom. The study statistics reveals that, it has 0.02% effect on trade for every percentage increased in monetary freedom in the country. Monetary freedom implies monetary policies that endeavors to fight inflation, maintain price stability, and preserve the nation’s wealth, with monetary freedom, people can rely on market prices for the foreseeable future, investments, savings, and other longer-term plans can be made more confidently and efficiently. Trade freedom also possesses a positive and a significant relationship with trade. It has a coefficient of 0.07, which implies that a significant percentage increased in trade freedom will increase the volume of trade by 0.07%. when property rights are well defined and respected, trade facilitations will be smooth. Property rights has a positive and significant effect on Ghana

trade, its increases trade by 0.79% for every percentage increased or improvement in property rights.

The findings of this study are in line with previous studies on institutions and trade (see Najaf Ali, 2018, Wisdom Akpalu et al, 2017, Rohini and Christopher, 2005, David Dollar & Aart Kraay, 2003, Ahmet Faruk Aysan et al, 2006). Najaf Ali (2018), for instance, confirms that institutions like, Trade Freedom, Freedom from Corruption, Property Rights, Monetary Freedom, and Business Freedom, greatly possess some perverse and positive effects on Pakistan trade. Ahmet Faruk Aysan et al (2006), concludes that structural reforms such as trade openness, a clear security of property rights, financial development, human capital, economic policies and governance institutions exhibits significant role in private investment decisions.

## Conclusion

Institutions plays a crucial role in sustaining and promoting the course of international trade in every economy. This studies empirically looks at the impact of institutions on international trade in Ghana's economic perspective, the output from the econometric analysis reveals quite a robust and significant relationship of parameters such as exchange rate, monetary freedom, property rights and trade freedom on Ghana's trade. Some interesting revelations of the study is the fact that, all the significant variables which affects the course of Ghana trade are largely associated to the economic institutions (monetary freedom and trade freedom) in the country. Therefore, its recommended that government should conceive and hatch apropos and relevant policies to strengthen the economic institutions and all the auxiliary sectors in supporting and promoting the course of Ghana's trade. Again, the ministry in charge of trade should be fortified and focused so as to enhanced and maximize the potentials gains from international trade. This will attract and motivate investors who want and have the passion to engage in international transections to do so with little frustrations. When government impose and implement the appropriate policies, it will move along way to boost, intensify and magnify its economic salvation in the long run.

This study makes a profound contribution to the theoretical and empirical literature in the following direction; from the word go, it's the first study that incorporated and investigated the impacts of institutions in promoting the course of trade in Ghana. Contextually, the study offers an integration and theoretical characteristics that intricated the dynamics and causal relationship of facets that de facto Ghana multilateral trade flows. Again, the study empirically refute corruption as an obstinate and a canker that retire international trade.

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