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Trade Liberalization, Domestic competition and Total Factor Productivity: Evidence from manufacturing sector

Aya Elewa¹, Riham A. Ezzat²¹The British University in Egypt, Egypt²Cairo University, Egypt

ABSTRACT

It is widely argued according to heterogeneous firms trade models that trade openness will lead to the exit of the least efficient firms from the market, as they cannot afford the competition by foreign firms. Thus, trade will lead to an increase in the average productivity in the sectors that are exposed to foreign competition. Hence, using the UNIDO sectoral-level data, we use Levinshon and Petrin (2003) methodology to estimate the Total Factor Productivity (TFP) to test how trade liberalization will affect the TFP across countries. The results show that tougher import competition increases the total factor productivity in the manufacturing sector and lower tariffs restrictions leads to higher TFP. Moreover, when we disentangled this trade openness effect by the size of the sector, we found that sector size does not matter. Finally, when we differentiate the results by the development level of the country, we find that developed countries benefit more than developing countries from higher international competition. This reflects that there exist many obstacles in developing countries that prevent gains in productivity increase after trade openness. These results provide us with new evidence regards the hypothesis that international competition positively affects total factor productivity and the extent at which increasing international competition is beneficial for developing countries in the manufacturing sectors.

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A preliminary version