

### **Facts about trade reform**

- 1) Most trade reform packages consist of trade liberalisation.
- 2) Trade liberalisation usually encompasses:
  - a. Removal of quantitative restrictions to trade altogether or their conversion into tariffs;
  - b. Reduction of the level of tariffs;
  - c. Reduction or elimination of tariff dispersion (an indicator of price discrimination);
  - d. Devaluation of the exchange rate;
  - e. Removal of export-taxes.
- 3) Trade liberalisation usually aims at:
  - a. Removal of trade barriers and relative price bias;
  - b. Demand contraction;
  - c. Increasing the supply and diversity of tradables in line with comparative advantages defined by endowed factor-price ratios.
- 4) Most LDCs have liberalised trade significantly, starting in early 1980s, generally as a core component of a market friendly adjustment package applied mostly to curb balance of payment crisis. Most trade liberalisation packages have been applied across all sectors in a blanket fashion. A few LDCs have liberalised more selectively: for example, while imports of intermediate and capital goods have been fairly liberalised – to reduce production costs and ensure product quality and adoption of competitive technology – some items of the “light” industrial sector, often tradables, have remained heavily protected.

### **Trade liberalisation and economic performance**

#### ***Methodology and data***

In order to mapping from trade liberalisation to economic performance, one needs to define and measure liberalisation and indicators of economic performance.

Indices of trade liberalisation usually utilised involve one of, or some combination of the following indices:

$\uparrow \frac{Mp}{GDP} \Rightarrow$  share of imports on GDP increases as import barriers are removed/reduced.

$\downarrow \frac{t_m}{T} \Rightarrow$  share of revenue from import duties on total tax revenue falls as import duties fall.

$\downarrow \frac{e}{e(WPI / p_w)} \cong 1 \Rightarrow$  exchange rate premium falls as the exchange rate is devalued.

Indicators of economic performance usually considered in studies of the impact of trade liberalisation are:

$$\frac{GDP_n - GDP_0}{GDP_0} = GDP \text{ growth rate}$$

$$\frac{Xp^{(n)} - Xp^{(0)}}{Xp^{(0)}} = \text{growth rate of exports}$$

$$\uparrow \frac{MVA}{GDP} = \text{diversification of production away from primary products}$$

$$\downarrow \frac{\sum_{j=1}^3 Xp^{(j)}}{Xp^{(n)}} = \text{export diversification away from 3 main exports}$$

Table 1: Trade liberalisation & economic growth and diversification in SSA 1980-91

Country grouping by degree of liberalisation (a)	Output and export growth rates (%)			Export and output diversification (%)	
	Real GDP	Real MVA	Real exports	Export diversification (b)	Output diversification
High (6)	3.9	1.5	2.9	-2.0	1.5
<b>Medium (4)</b>	<b>5.0</b>	<b>7.1</b>	<b>4.0</b>	<b>-3.4</b>	<b>4.3</b>
Low (16)	1.6	1.4	-0.5	--	-0.2

Note: (a) according to World Bank ranking of countries; (b) a minus sign represents diversification. Bold (dark) figures show the top performing economies.

Table 2: Impact of REER adjustment on exports growth rate in SSA

Countries with a REER that:	1980-1990		1985-1990	
	no. of countries (a)	Average yearly export growth	no. of countries (a)	Average yearly export growth
Appreciated	4 (18)	1.1	3 (14)	<b>6.9</b>
Depreciated				
<10%	1 (4)	-1.1	5 (23)	<b>9.8</b>
10%-30%	9 (41)	<b>4.4</b>	6 (27)	3.0
30%-50%	3 (14)	-1.5	3 (14)	5.4
>50%	5 (23)	-1.8	5 (23)	-2.0
Total countries	22 (100)		22 (100)	

Note: (a) figures within brackets are % of total. Bold (dark) figures show the best performing in each sample period.

Table 3: REER and economic diversification in SSA 1980-90

Countries with a REER that:	no. of countries (a)	Diversification of (in %):	
		Production	Exports (b)
Appreciated	4 (20)	2.2	14.3
Depreciated			
<10%	<b>1 (5)</b>	<b>7.0</b>	<b>-14.8</b>
10%-30%	8 (40)	--	0.2
30%-50%	3 (15)	1.7	0.7
> 50%	4 (20)	-2.5	-2.5
Total countries	20 (100)		

Notes: (a) figures in brackets are % of the total number of countries sampled; (b) a minus sign shows diversification. Figures in bold (dark) show the best performing countries.

### *Analysis of the data*

#### A. *What the data show*

*Table 1:* medium liberalisers performed reasonably well, and far better than any of the others, and while high liberaliser economies seem to have stagnated, low liberaliser economies seem to have collapsed even further.

Assuming that definitions and ranking of countries by degree of liberalisation are right: (i) 10 out of 24 sampled countries were defined as high or medium liberalisers, which shows significant commitment to trade reform; (ii) however, since 58% of the countries were defined as low liberalisers, it would be interesting to discuss what prevents them to embark on radical institutional reform.

*Table 2:* there is no systematic link between REER and export performance. Results are extremely period sensitive, which may show problems with the sample and data, or that there is no correlation whatsoever between REER policy and export performance.

On the other hand, the number of countries per group (and so the group composition) varies. Although in both periods half of the countries sampled falls within the groups that depreciated by 30% or less, in the first sample 45% of the countries depreciated between 10% and 30%, whereas in the second only 30% did so. But in both periods the number of countries in the four extreme categories (appreciated, depreciated less than 10%, depreciated between 30%-50% and more than 50%) remained the same. Are the countries in each group the same in both samples? Does the change in the composition of the median groups reflect lagged impact of exchange rate policies followed in a previous period? Does the change in performance reflect a lagged impact of exchange rate policies? Without this information it is difficult, if not merely speculative, to make strong conclusions based on the data.

*Table 3:* there seems to be no systematic relationship between REER policy and output and export diversification, nor between output diversification and export diversification.

In only one case – the only country that devalued less than 10% - there seems to be any significant diversification in both production and exports. However, how relevant can this single case be, since it is a single case? Is it accidental, or can performance be attributed to a specific degree of devaluation? Or are there many other factors influencing economic diversification, which have little to do with REER policy.

Two extreme cases may be more significant. Countries whose REER appreciated diversified production slightly and narrowed the export base very significantly. Countries whose REER depreciated more than 50% narrowed their production base but diversified exports slightly. Countries with moderate REER devaluation did not change – did not narrow or diversify their economies. Are there any conclusions to take from these data?

## B. *Problems with the data*

### *Problems due to definition:*

- is the degree of trade liberalisation well defined?
  - i.  $Mp/GDP$  may reflect availability of forex to import rather than trade liberalisation per se;
  - ii.  $Mp/GDP$  may also reflect specific dynamics of specific adjustment programmes that cannot be fully taken into consideration before the sources of change in imports and in GDP are well understood – example, project tied aid is bound to increase imports irrespectively of trade policy;
  - iii. Since in the ratio  $Mp/GDP$   $p$  stands for price, the ratio may change as a result of changing international price levels and relative prices, irrespectively of trade openness;
  - iv.  $tm/T$  may reflect changes in instruments of protection (from tariffs to other quantitative restrictions); variation in import capability; or changes in the relative role of other sources of fiscal revenue;
  - v. exchange rate devaluation may reflect external shocks and attempts to curb external shocks, without any connection whatsoever to trade policy;
  - vi. since depreciation increases import value in domestic currency, and reduces corporate profits, aggregate demand and wages, at least in the short and medium terms, it is likely that exchange rate depreciation goes together with higher ratios of  $Mp/GDP$  and  $tm/T$  – clearly conflicting trends as far as mainstream assumptions about trade liberalisation are concerned.
  
- are GDP and export diversification well defined?
  - i. Changes in terms of trade (particularly volatile for primary products) may well affect the total value and the composition of

exports irrespectively of policy adjustment in any country. Furthermore, export prices may yet fall or rise as a result of coordinated or uncoordinated action taken by exporting countries, which together may be able to affect the behaviour of the world market;

- ii. MVA/GDP ratios are also bound to be influenced by such changes in terms of trade;
- iii. Economies may be diversifying production into low value added manufacturing, which may not be well captured by the ratio MVA/GDP, although such diversification in productive capacity may be reflected in export diversification. It may be part of the explanation why there seems to be no relationship between export and output diversification in table 3;

*Problems due to aggregation of data:*

- group aggregation
  - i. differentiated performance within groups is hidden;
  - ii. it is not possible to see where a particular country belonging to a particular group with respect to trade liberalisations stands as far as economic performance;
  - iii. one cannot see the policy and economic evolution of different countries: why they have moved from group to group, devalued at different rates in different periods, liberalised differently, and what happened to their economies.
  
- the dynamics of reform and its impact is not captured and explored:
  - i. example 1: countries that have devalued significantly because of a negative external shock (ex, a sudden large fall in the TT of a major export crop), are unlikely to increase M and X until the next TT boom – this may be captured as GDP and export diversification; the way M/GDP ratio changes depends on whether M or GDP adjust faster to the shock;
  - ii. example 2: the relationship between other aggregates of the economy (ex, between devaluation and I, and/or I and output and export diversification) are not explored, despite the fact that I is likely to have a more crucial impact on the behaviour and potential of the economy to promote change;
  - iii. example 3: the difference between the short and long term impact of measures cannot be examined – a country may have diversified exports because of some international trading agreement specific to that country, or contraction of aggregate demand at home. In any case, export diversification may be short-lived;
  - iv. example 4: lagged impact of measures is not explored;
  - v. example 5: an attempt to link trade policy, alone, with crucial dynamic economic factors is bound to fail;
  - vi. example 6: causation is an unsolved problem – ex., has liberalisation caused, or been caused by crisis or success?

## **Factors behind success**

Countries that have achieved GDP growth rates above average, particularly those that have improved overall economic performance (including diversification) show:

- Investment/GDP ratio high and increasing;
- Continuous growth of imports;
- With the exception of Bangladesh, all fast growing economies start from very low levels of GDP and very narrow output and export structures;
- Hence, it might be that given the state of the economy, relatively small amounts of I result in high rates of growth and diversification in the short and medium terms, either because of the very low starting point or because of idle productive capacity.

Most countries that performed well in the 1970s also liberalised earlier (particularly in the early 1980s), but have not performed as well in the 1980s. Particularly significant is the fall of the rate of growth of imports.

- have they liberalised because they performed well?
- Is their current relatively slower growth associated with liberalisation? Import capacity contraction? Or simply a natural process of stabilising around a steady rate of growth?
- As liberalisation reduced their import capacity? If so, why and how? If not, have they liberalised because of increasing pressures on import demands of economic strategy?
- Their rates of investment are the highest (and increasing), although not as high as in the 1970s. Is the rate of investment starting to put pressure on their import capacity, or is it being reflected on their ability to substitute imports?

As far as I is concerned, the second half of the 1980s is marked by a sharp decline in the ratio I/GDP. Additionally, the rate of growth of I has been negative for half of the sampled countries in the 1980s.

Exports of manufactures have accelerated in all sampled countries. However, there are five important points to note to qualify this trend:

- the level of manufacturing exports is very low. In only two countries in the sample exports of manufactures exceed 220 million USD/year;
- the acceleration of exports of manufactures does not seem to have accelerated overall export. Does this result from declining or volatile terms of trade for traditional exports? A move away from traditional exports (with and absolute fall in traditional exports)?
- The ratio MVA/GDP is very low; only in one third of the countries sampled it exceeds 10%;

- Most of the activities registered as manufacturing actually consist of first stage semi-processing of primary products, particularly minerals;
- With no exception, the countries with higher rates of exports of manufactures have low MVA/GDP ratios and specialised as exporters of 2-3 minerals (manufacturing being the first stage of semi-processing, hence the low MVA/GDP). Can this also explain slow growth of overall exports? Interestingly, these countries also have fallen ratios I/GDP and many have negative rates of growth of I.

### **Factors behind failure**

There is no data to discuss “failure” in the same detail as “success”.

Nonetheless, it is possible to mention that trade liberalisation does not address the problem of increasing productivity and quality and lowering costs. In fact, elements of trade liberalisation, and the context of trade liberalisation, may well lead to declining productivity:

- devaluation increases costs of manufacturing production, reduces investment and harms technical change (both because profit expectations are lower and because rents are harder to capture);
- current account liberalisation reduces market opportunities for new firms/industries, in particular for those with higher externalities;
- forex scarcity, due to shortages and liberalisation of access to forex, increase costs of capital and expansion and prevent firms from acquiring, utilising and maintaining productive capacity;
- trade liberalisation and devaluation do not work well as mechanisms of re-allocation of resources;
- simultaneous trade liberalisation and devaluation in several countries may result in the fallacy of composition because of the narrow patterns of specialisation, thus exacerbating forex and market losses;
- trade liberalisation in LDCs has been happening in parallel with increasing protection in DCs against exports from LDCs.

### **Alternative trade reform**

ISI should be linked to EOI, based on selectivity (of both ISI and liberalisation) and contingent to performance (example, export performance).

Trade reform must be linked with development strategy and creation of production capacity. Namely, trade policy should help productivity to increase, learning to take place and cost to be lowered.