

trade performance in LDCs.⁸ A number of studies have also shown that appropriate macroeconomic policies are closely linked to East Asia's success at trade development and economic growth.⁹

8. Exchange rate, fiscal and monetary policies, their inter-linkages or linkages to other structural policies, and impact on various macroeconomic indicators has been extensively discussed in the literature (summarized in IMF, 1997b). While bearing in mind the difficulties of establishing causal connections, the following will review the most important indicators of macroeconomic performance and their links to trade development, and also contrast the performance of the LDCs to that of the group of selected developing countries referred to above. The links between macroeconomic indicators and trade development are complex, and thus the discussion aims only at providing examples of economic performance in a key policy area for trade development between two groups of countries with substantially different records.

9. A comparison of the main macroeconomic indicators for the LDCs and the group of selected successful exporters is provided in Table 2. It shows that the group of selected exporters has in general achieved markedly superior macroeconomic performance in terms of higher growth rates, lower fiscal and current account deficits, lower inflation, higher savings rates and more competitive exchange rates in terms of real appreciation compared to the LDCs. These macroeconomic indicators for the LDCs and for the successful exporters and their importance for export development are discussed in more detail below.

⁸For a discussion and overview see IMF (1997b); also Sachs and Warner (1995), World Bank (1993), Thomas (1993), and Harrold (1996).

⁹For a more complete discussion on growth in East Asia, see Sarel (1995).

Table 2. Main Macroeconomic Indicators for LDCs and Selected Exporters,
1980-89 and 1990-96

(percent of GDP unless stated otherwise)

| | Average | | | |
|--|---------|---------------------------------|---------|---------------------------------|
| | 1980-89 | | 1990-96 | |
| | LDCs | Selected Exporters ¹ | LDCs | Selected Exporters ¹ |
| Real GDP (change in percent) | 2.5 | 6.9 | 3.4 | 7.2 |
| General Government Balance | -8.2 | -1.5 | -7.0 | 1.5 |
| Inflation (percent) ² | 19.8 | 13.0 | 23.2 | 7.7 |
| Real Exchange Rate (1980=100) ³ | 84.0 | 74.3 | 173.6 | 88.8 |
| Current Account Balance | -8.5 | 0.2 | -9.0 | 0.0 |
| Gross National Savings | 11.0 | 31.0 | 10.4 | 32.9 |

Source: WEO database; IMF staff calculations

¹These countries are: China, Hong Kong, Indonesia, Republic of Korea, Malaysia, Mexico, Singapore, Taiwan Province of China, and Thailand. These are developing countries that have been marked by successful export development.

²Excludes two hyperinflation countries.

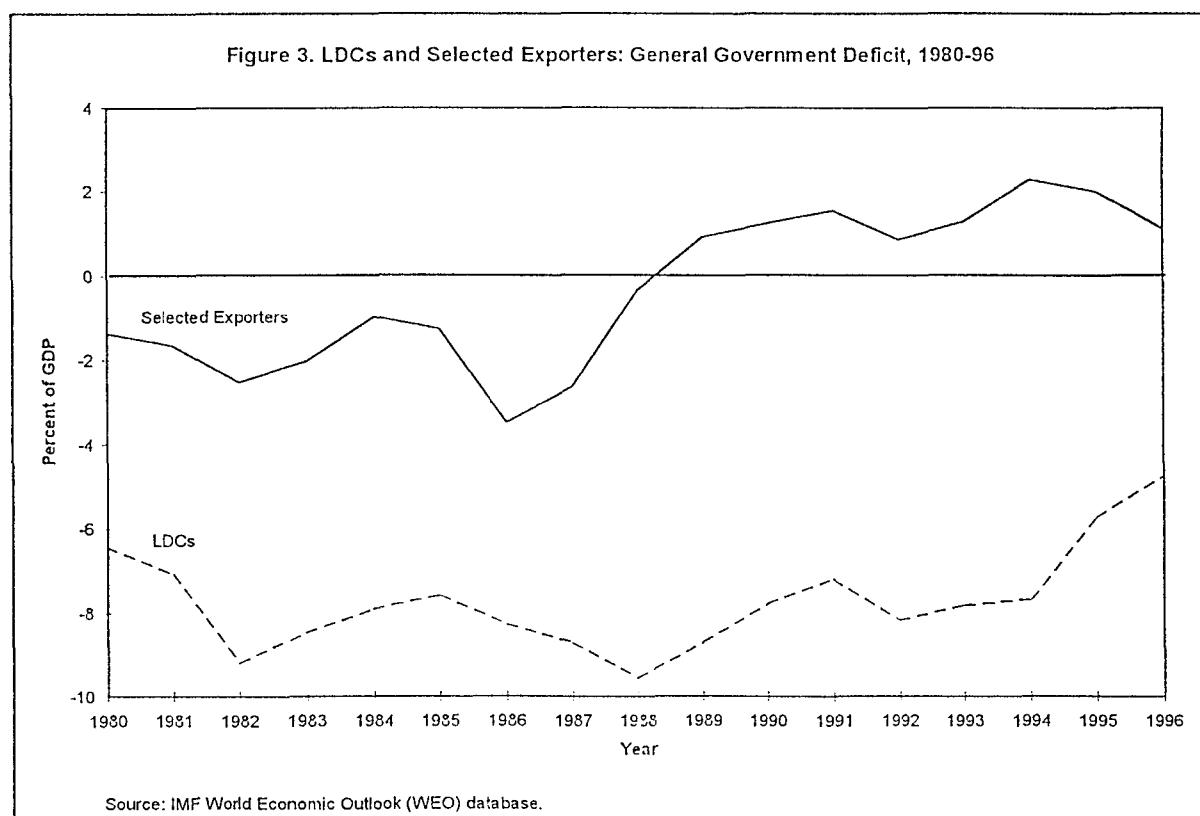
³An increase corresponds to an appreciation of the real exchange rate.

10. A sustainable **fiscal position**, or a public sector deficit that the economy can absorb, is important for trade development because, together with prudent monetary policies, it can have a favorable impact on inflation, savings, external balance, and the resources available for private investment.¹⁰ The macroeconomic consequences of public sector deficits tend to vary depending on how they are financed. Excessive monetary financing of the deficit can lead to inflation, which itself generally discourages output growth. Large domestic public sector borrowing is also likely to lead to higher interest rates and thus crowd out private investment.

¹⁰For a fuller discussion of the consequences of fiscal imbalances and inflation for growth, see IMF (1996).

Heavy national or foreign financing of the deficit may eventually lead to an external debt crisis. Financing aside, a large and burgeoning public sector deficit consumes resources that could otherwise be used by the private sector, *inter alia* for export activities. Furthermore, large public sectors as such tend to crowd out resources from the private sector. In addition failure to reduce excessive fiscal deficits¹¹ can create doubts about the government's ability to sustain an open trade regime, particularly because trade taxes are often invoked as an apparently easy means to raise revenue to reduce the deficit.

11. The average general government budget deficit for the LDCs was significantly higher than that in the selected exporters (Figure 3). On average in the 1980s, the LDCs had government deficits of more than 8 percent of GDP compared to the selected exporting economies' average of about 1–2 percent. The difference increased in the 1990s, when the latter group was in fiscal surplus on average.

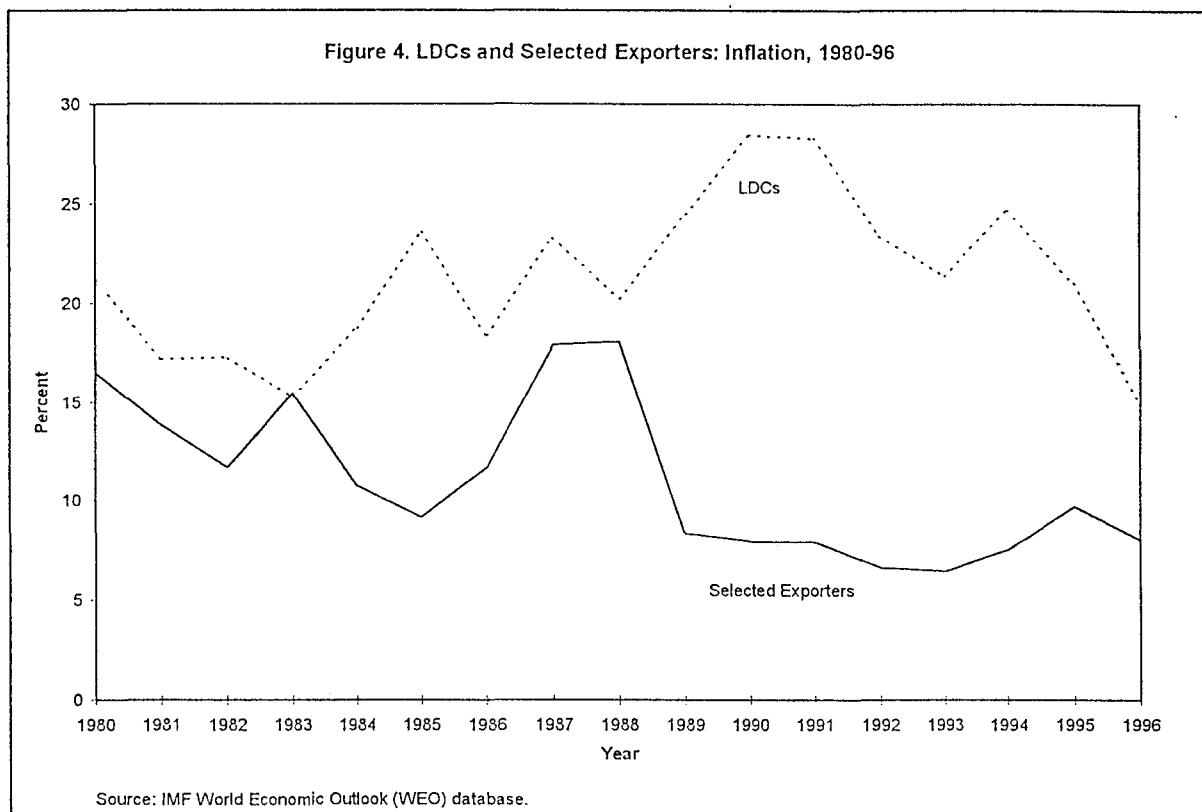


12. Although actual sources of inflation may vary with specific country circumstances, including exogenous factors and shocks, the role of monetary policy is central. High inflation

¹¹The appropriate size of the fiscal deficit depends on individual country circumstances and a number of policy and structural characteristics.

can be bad for trade development as it tends to increase uncertainty and distort price signals, reducing investment incentives.¹²

13. In the LDCs, the average inflation rate¹³ over the past two decades was significantly higher than for the selected exporting countries (Figure 4). LDC inflation in the 1980s was 20 percent compared to 13 percent in the selected exporters. The relative situation deteriorated in the 1990s with average inflation for the LDCs at 23 percent (after excluding two hyperinflation countries) compared with a reduction to 8 percent for the selected exporting countries. The trend for the LDCs seems, however, to have reversed in the mid-1990s.



¹²On inflation and growth see, for example, Sarel (1996).

¹³As measured by the Consumer Price Index (CPI).

14. Fiscal and monetary prudence can also affect exchange rates, which is another component of the macroeconomic environment that can be critical to export growth.¹⁴ A country's competitiveness can be strongly affected by the level and changes in its real exchange rate.¹⁵ A real appreciation,¹⁶ which can result from inappropriate macropolicies, can slow export growth, cause balance of payment difficulties, raise uncertainty and eventually reduce investment. Indeed, there is evidence that periods of high export growth are associated with periods of strong competitiveness as measured by the real exchange rate (Harrold, 1996; and Schadler and others, 1993).

15. Information on real exchange rates for the LDCs indicates that over the past two decades rates have appreciated more than those of the group of selected exporting countries.¹⁷ Figure 5 contrasts movements of real exchange rates of the selected exporting countries and those of the LDCs during 1980 to 1996, and shows that the LDCs have experienced a pronounced real appreciation on average since 1989.¹⁸

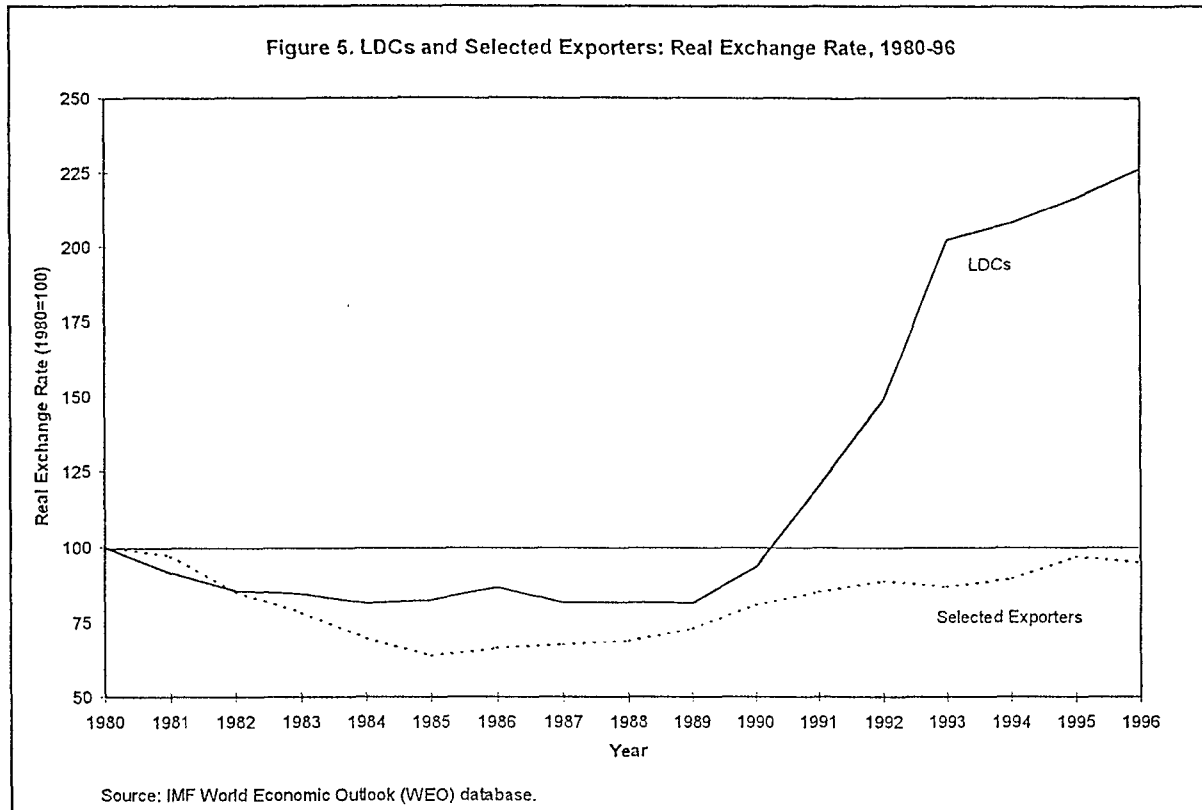
¹⁴Assessing the appropriateness of a country's exchange rate is a complex undertaking that requires taking into account a number of factors. These include the: real effective (trade-weighted) exchange rate (an appreciation indicates a worsening of a country's competitiveness); unit labor costs; foreign exchange reserves (falling reserves may indicate an overvalued exchange rate); the current account (large deficits may be an indication of an uncompetitive exchange rate); and parallel market exchange rates (large differences between the official and parallel market rate can signal that the official rate is under or overvalued). See Dornbusch and Helmers (1991) for a discussion on exchange rate overvaluation and the trade balance.

¹⁵The real exchange rate is usually defined as the nominal exchange rate divided by the price level in the home and trading partner country. Changes in the real exchange rate take account of both changes in the nominal exchange rate and inflation in the home and trading partner country.

¹⁶Here an appreciation of the real exchange rate is defined to mean an increase in the value of the home country's currency relative to other currencies.

¹⁷It would be preferable to use the real effective exchange rate but data constraints prevent these calculations. Instead, the real exchange rate is calculated using the U.S. dollar exchange rate and is based on the CPI.

¹⁸As with other macroeconomic aggregates, the LDC average hides substantial variations among countries including significant real exchange rate appreciation for some countries experiencing civil strife.



16. High savings rates are another important determinant of macroeconomic performance that is linked to trade development.¹⁹ Savings are influenced, inter alia, by the level of real interest rates, in which prudent monetary and fiscal policies can play an important role. High savings rates can be critical to support investment in the economy to meet demands arising from efforts to expand trade, against a backdrop of an increasingly competitive international environment to attract FDI and other forms of foreign capital.

17. The data show that in the last two decades savings rates in the LDCs were relatively low. Gross national savings in the LDCs averaged 10–11 percent of GDP throughout the 1980–96 period, compared with 31–33 percent for the group of selected exporters (Table 2). The level of savings in the two sets of countries reflected, at least to some extent, the respective levels of real interest rates. The average real interest rate on deposits in the LDCs during 1980–1996 was significantly lower—indeed negative—than that for successful

¹⁹For one discussion of the role of saving in trade development, see Harrold (1996).

exporters. Available data shows real interest rates for LDCs averaging -2.9 percent, compared with an average of 2.5 percent for the selected exporters.²⁰

18. In sum, the theoretical discussion and the various indicators of macroeconomic performance suggest that more attention to the pursuit of prudent fiscal, monetary and exchange rate policies to enhance and sustain macroeconomic stability combined with other measures discussed below would substantially benefit the economic performance of the LDCs in terms of export opportunities in international markets and the attraction of increased foreign capital flows.

B. Openness and Trade Development in LDCs

19. While a stable macroeconomic environment is the first pillar of trade development, an open and outward-oriented trade regime is second. An open trade regime helps allocate resources into trade-related activities according to a country's comparative advantage. A trade regime that facilitates externally-oriented growth is one with reasonably low levels of tariff protection and limited restrictions on trade (except for health and security reasons), including nontariff barriers (NTBs) in the form of quantitative restrictions (QRs) and licensing requirements, foreign currency restrictions, state control of trading, and export taxes and controls. The regime should also be nondiscriminatory, relatively simple, and easy to administer, which implies transparent regulations, few discretionary exemptions, and reasonably uniform tariffs. The importance of open trade policies to successful export development has been highlighted in a large number of studies, including notably Bhagwati (1988), Krueger (1994), and Sachs and Warner (1995).

20. In addition to improving prospects for trade development, open trade policies enable countries to be more effective in attracting investment. Among other factors, a liberal and stable trade environment reduces the cost of imported inputs and provides easy and reliable access to the international market. This can facilitate transfer of technologies to LDCs embodied in capital or intermediate goods that can lead to substantial improvements in productivity, and thereby in export and growth performance.²¹

21. Available data show that the LDCs retain relatively high levels of protection²² in comparison with the fast-growing developing country exporters. Tariffs in the mid-1990s averaged about 21 percent in LDCs, or almost twice the average level of the fast growing developing country exporters (Table 3). The available data on NTB coverage, while limited,

²⁰Data available from IMF's *International Financial Statistics*.

²¹See Coe, Helpman, and Hoffmaister (1994).

²²Experience in Fund programs shows that in recent years there has been some trend toward increased trade liberalization in the LDCs.

indicates that NTBs in many LDCs covered 25–40 percent of imports, while in the group of selected exporters the coverage ratios were below 5 percent. This suggests that there is considerable scope for comprehensive trade reform in many LDCs, including the reduction/elimination of nontransparent NTBs as well as the lowering of tariff levels. Moreover while no comparative data is available on the prevalence of discretionary and statutory exemptions from restrictive trade practices, the incentives for and distortionary impact of such exemptions will be higher in LDCs because of the higher level of trade restrictiveness.

Table 3. Average Tariffs for LDCs and Selected Exporters

(Percent)

| Unweighted Averages for Tariffs 1/ | |
|------------------------------------|------|
| <hr/> | |
| Average for LDCs 2/ | 21.0 |
| Average for selected exporters | 11.0 |

Sources: WTO and Fund documents.

1/ Unweighted average equal to the sum of the number of tariff lines at each tariff rate divided by the number of tariff lines.

2/ Data on LDCs for which recent (1995 or later) tariff information is available.

22. In sum, given the relatively high protection levels and often nontransparent nature of trade regimes in LDCs, the literature suggests that trade development in LDCs will be difficult unless their trade regimes are substantially liberalized and made more transparent.

C. Trade Policy in Fund-Supported Programs

23. Trade reform is an important element in Fund-supported programs complementing appropriate macroeconomic policies. A recent study by Fund staff of trade liberalization in Fund-supported programs²³ found, for example, that nearly all of the programs reviewed contained elements of trade policy reform. This section will discuss selected aspects of guidelines developed by staff for trade reform in Fund-supported programs, and key findings of the recent Fund study.

24. The need for further trade liberalization in many developing countries (including many LDCs) was confirmed by the above study. It covered medium-term Fund-supported programs in the 1990s, and looked at the extent of trade liberalization targeted and achieved and economic factors influencing trade liberalization. It found that the majority of the countries reviewed started their program periods with trade systems that were restrictive. LDCs accounted for about half the sample, and most had restrictive trade regimes at the start of the

²³IMF (1997a). The review examined 30 multiyear Fund arrangements for 27 countries (13 of which are LDCs) in the 1990s and trade policy during the 1990s in detail in 6 countries (2 of which were LDCs).