Impacts of External Shocks on Nations’ Policy Responses and Economic Growth —World Economic Synchronization

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This paper investigates the impact of external shocks on domestic policy responses, and analyzes how measures of policy response differentiated national economic performances, particularly of less-developed countries (LDCs). This study tests the hypothesis that export penetration as the most significant variable producing external shocks while simultaneously stimulating economic growth across the world’s major economies. This analysis also explores the disproportional impact of external shocks on LDCs and economic fluctuations in world business cycle. Assuming that the interactions between external shocks and policy responses took a center role of transmitting shocks and economic stimulus, this paper therefore seeks the empirical evidences that shocks and policies attributable to global economic interactions defines the successfulness of an economy. Based on derived external-accounting data, this study found that the predictors of economic success for LDCs are the measures of export penetration and the extent of adverse shocks facing economies.

INTRODUCTION

Since late 2007, the world has been witnessing major external shocks, originated from imbalanced demand and failed financial markets. Commodity price shocks, companied by the great financial crisis, have been rippling across the international economy. The uncertain impact of such external shocks on the world economy has caused great anxiety to economic policy makers around the world. The concern also causes interests in understanding the relationship of external shocks and policy responses, which is the miss link between trade and economic growth. This paper focuses on the intermingled relationships among external shocks, domestic policy responses and economic developments for less developed countries (LDCs). Empirical analyses are attributed to the role of external shocks and the measures of policies responses that have considerably differentiated economies among LDCs.

The methodology in this paper redefines external shock accounting method, originally developed by Edmar Bacha (1987), using the data extracted from World Development Indicator (The World Bank, 2007). This is a drill-down methodology permitting the disaggregation of current account deficits into external shocks and policy responses, plus error. Given an oversize set of observations for the past 30 years and about 32 variables for each LDC, this paper excludes countries whose economies driven by oil-exports and whose data are incomplete, and
selects only 30 LDCs for this empirical study. However, comparisons of gross domestic product (GDP) growths associating with world economic synchronization were analyzed on the aggregated data for the 123 nations, categorized from high income to low-income.

The original current account dataset (WDI, 2007) was derived to be an external shock accounting dataset using this methodology. Upon the dataset, econometric models were employed to analyze policy sensitivity and stability; to identify which policy response stood out as a key policy rule, whether or not the key policy rule was consistent; and what policy rule differentiates high-growth LDCs from low-growth LDCs. Emphasizing the characteristics of economic synchronization, evidenced with the world business cycle, the paper explores which external shocks and policy responses were playing pivotal roles in transferring economic boom and bust across borders.

This paper unfolds in five sections, introduction, methodology and data, external shocks, policy responses to external shocks and conclusion. Special attention will be given to the relationships among external shocks, export orientated policies and LDC economic growths.

METHODOLOGY AND DATA

Methodology

The methodology employed in this study uses Bacha’s approach to analyze the impact of the 1973-2005 external shocks on LDC and the range of their policy responses. Current account deficits, external shocks and policy responses are the three major components in Bacha’s model. The basic form of model is,

$$
\text{Changes in Ratio of Current Account Deficit to GDP} = \text{Changes in External Shocks} - \text{Changes in Policy Responses} + \text{Error Term}
$$

These three components were not only statistically relevant to economic performance but also theoretically meaningful to be employed to explore transmission mechanisms of world business cycle by using this external shock accounting approach.

Briefly, with the derivation of Bacha’s model, changes in the ratio of current account balance to GDP are divided into two main parts, namely external shocks and policy responses. The external shocks are further drilled down into various individual shocks, which are terms of trade, interest rate, retardation of world trade growth, burden of debt accumulation, direct investment, workers’ remittances, and transfers. The policy responses are disaggregated into four components in our study. They are the export penetration--increasing share in the world export markets; import substitution -- replacing imports with domestic production; and reducing domestic aggregate spending -- “belt-tightening” in consumption and investment. Based on this type of model, policymakers would have information advantages to know if the current external shocks would occur, to what extent affected economies, and how policy rules reacted to adverse external shocks.

In conventional macroeconomics, negative external shocks, such as terms of trade deterioration, reduce demand for exports and international interest-rate increases, directly shrink national income by reducing demand or the purchasing power of existing output (or both). Even if total national output were to be sustained, cuts in income would be possible through a government austerity policy response. Hence, either real national consumption or real national savings (or both) must fall. Other things being equal, a reduction in national savings decreases real investment and thereby cuts future output and real income as well. Real investment could only be sustained if the national saving rate rose or if increased resources could be obtained from
the rest of the world. Similarly, real consumption could only be sustained if the savings rate declined or increased external resources were available. Thus, sufficient external resources make it possible to keep both consumption and investment at pre-shock levels.

External finance can also prove a crucially important determinant of external shocks influencing national macroeconomic performance. The U.S. government loan to Mexico in 1995 and International Monetary Fund (IMF)'s $40 billion program to stabilize some Asian currencies in 1997 were examples where external finance availability dynamically changed the impact of external shocks on domestic economic performance. Without external financial aid, external shocks permanently alter the terms on which individual countries interact with the international economy. An economy facing external shocks requires that "adjustments" be made if previous projections of consumption, investment and income are to be realized in the medium to longer term. Conversely, external finance can represent another source of external shock to a national economy.

External shocks originating from external finance can be favorable or unfavorable to a LDC economy. Economies relying on foreign resources receive more adverse external shocks than those less dependent on foreign resources. Those economies vulnerable to adverse changes in external variables, such as terms of trade, international interest rates, foreign direct investment and supplies of crucial raw materials confront major challenges. Lacking appropriate economic strategy to manage adverse external shocks can worsen the plight of these economies, making them permanently impotent of reacting to external shocks due to their heavy reliance on external finance.

Not only did external shocks engineer the world business cycle transmitting mechanism in the past, but trade and some domestic policy responses influenced it as well. Facing slowing demand for their exports, LDCs might scale back their output level. As a consequence of a scarcity of imported essential inputs, output might fall below or further below the economy's capacity to produce, even with no decline in domestic resources. This situation might be contributed by a decline in the availability of foreign exchange, which determines the economy’s purchasing power for imports. Such a foreign exchange constraint might also impede investment and growth in future capacity if key capital goods, such as machinery and equipment, could not be domestically acquired. Hence, in the medium to long-term, structural adjustments to external shocks were required to offset the short fall in foreign exchange earnings. These adjustments include decreased investment or reduced domestic spending (or both), and further import substitution or enhanced export competitiveness (or both).

Data

The data used in this paper include thirty countries\(^2\), classified as LDCs by the World Bank. The selection was determined by the data availability from the World Development Indicators 2007 (WDI, CD format, previously called World Tables, The World Bank). It was not possible as yet to include all necessary data permitted for an impact analysis of external shocks on policy responses adopted all LDCs for the 1973-2005 time periods. This is because the availability of economic data on many LDCs was very limited.

Using Bacha's methodology proves an appropriate and logical choice to complete the task of "external shock accounting," as well as the analysis of policy responses. One advantage of this type of drill-down methodology is for economists to derive the measures of external shocks immediately upon the availability of current account data. In addition, policy responses, both at the national and at the international level, could be analyzed for both short run and long run
impacts. Therefore, it seemed sensible to conduct empirical analyses related to shorter periods rather than the whole time span permitted by the dataset, specifically for those periods marked by known external shocks. Of particular concern in this study, open economies have experienced some severe dislocations, such as oil-shocks, terms of trade deterioration and export volume decline under the heading of a "world recession effects" and interest rate effects. Taking account of those concerns, a data set of external accounting for a time series (1973-2005) was derived. Thereafter, the data set was grouped into seven time periods, which were the short-term periods of 1973-77, 1978-82, 1982-86, 1987-91, 1992-95, 1996-2000, and 2001-05.

Through 1973-2005, a half dozens well-documented external shocks clearly marked troughs on the international business cycle. Those major changes were the principal factors in selecting the periods for this empirical analysis. The paper now examines these periods in more detail.

Beginning in the 1970s, the international framework supported an unprecedented growth in trade and global integration for nearly three decades. When the fixed exchange rate became insupportable, the United States suspended the convertibility of the dollar in 1971. In 1973, EEC governments floated major European currencies. The first OPEC oil-price shock (1973) disrupted international trade and capital flow. However, the adverse impacts of oil shocks and rising protectionism left the integration of the world economy intact and even stronger after the1970s. However, as history has shown, LDCs exposed to well-defined external shocks in the early 1970s joined the world economy together to plunge into recession, caused by the collapse of the Bretton Woods system (Bordo, M.D. and Eichengreen, B. eds. 1993), and sharp rising in food and commodity prices, as well as soaring oil prices. During 1978-80, the second oil price shock occurred. In early 1980s, the United States adopted a mix of monetary and fiscal policies pushing up real interest rates worldwide. Consequently, the high interest rates, among other shocks, contributed to the international debt crises and terms of trade shocks. In the second half of the 1980s, economic growth accelerated in the industrial countries. The possible contributing factors were the falling price of oil and the U.S. dollar, expansionary monetary policies and policy cooperation of developed countries (DCs). As a by-product of accelerating DC economies, the world economy became increasingly integrated, allowing trade and financial flows to grow faster than output. In 1988-89, the S&L crises sent the U.S economy along with the world economy into a slump, followed by almost eight years of a technology-driven economic boom. In the early 2000s, the world economy showed signs of fatigue, and 2001 witnessed unprecedented geopolitical shocks triggered on 9-11-2001. Now, we are seeing that history is repeating the external shocks in the forms of soaring food and oil prices in late 2007, then nose-diving commodity and energy prices, in addition to the great credit crunch in early 2009.

**EXTERNAL SHOCKS**

**Counterintuitive Relationship between External Shocks and GDP Growth**

Dividing non-oil exporting LDC into two groups, one with favorable external shocks and the other with unfavorable external shocks, which group of LDCs grew faster? The following Figure 1 illustrates that those LDC economies encountering favorable external shocks generated slow GDP growth. In contrast, those countries that confronted unfavorable shocks were rewarded with higher GDP growth.
Of economic growth relating to external shocks, it was interesting to notice that, as the impact of external shocks shifted from “favorable” to “unfavorable”, the change did not cause LDCs from growing in a “high” rate to a “low” rate. Contrary to common wisdom, the converse occurred during the years from 1973 to 2005, except for the period 1996-2000. Hence, the higher degree of adverse external shocks translated into higher growth rates for LDCs. The conclusion based on the data derived from the external accounting indicated that economies facing unfavorable external shocks would not be a sufficient condition for LDCs to suffer low growth, rather the other way around.

External Shocks and World Economic Synchronization

Phenomena of world economic synchronization (Figure 2) prompted numerous economic studies (e.g. Jesus Cañas and Roberto Coronado, 2004, Kouparitsas, Michael, 2001 and Pradumna B. Rana, 2007).
Correlation coefficients in the table (Table 1) indicate that most LDC economies are correlated with DC economies, as well as present the measures of economic synchronizations between LDC and DC economies. Various degrees of correlation imply that the degrees of economic synchronizations are not universal among various economies.

**TABLE 1**
REAL GDP GROWTH CORRELATION BETWEEN DCs AND LDCs

<table>
<thead>
<tr>
<th></th>
<th>USA</th>
<th>EUROPE</th>
<th>JAPAN</th>
<th>OECD</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EUROPE</td>
<td>0.56*</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>JAPAN</td>
<td>0.32*</td>
<td>0.77*</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>OECD</td>
<td>0.88</td>
<td>0.79</td>
<td>0.68</td>
<td>1.00</td>
</tr>
<tr>
<td>Latin</td>
<td>0.54*</td>
<td>0.60*</td>
<td>0.45*</td>
<td>0.26</td>
</tr>
<tr>
<td>Central America</td>
<td>0.42*</td>
<td>0.45*</td>
<td>0.44*</td>
<td>0.34*</td>
</tr>
<tr>
<td>East Asia,(ex.)</td>
<td>0.36</td>
<td>0.45*</td>
<td>0.40*</td>
<td>0.50*</td>
</tr>
<tr>
<td>South Asia</td>
<td>0.23</td>
<td>0.35*</td>
<td>0.21</td>
<td>0.31*</td>
</tr>
<tr>
<td>ASEAN</td>
<td>0.17</td>
<td>0.46*</td>
<td>0.30</td>
<td>0.28</td>
</tr>
<tr>
<td>Sub-Saharan</td>
<td>0.37</td>
<td>0.53*</td>
<td>0.21</td>
<td>0.17</td>
</tr>
</tbody>
</table>

Despite there is little consensus on the cause of economic synchronization, external accounting results indicate high correlations (Figure 3) between the numbers of LDCs experiencing external shocks and world business cycle.
FIGURE 3
CORRELATION BETWEEN EXTERNAL SHOCKS TO LDCs AND BUSINESS CYCLES OF DCs

Comparison Between Number of LDCs Experiencing Favorable Shocks and the G7 Growth
--Linkages between external shocks and DC economic growth

As the world economic climate became hostile towards LDCs, the magnitude of adverse external shocks rose, so did the current account deficit level. Considering the relationship between external shocks and current account deficits, not surprisingly, the two measures were reinforcing each other. Nevertheless, an exception was found during the period 1982-86 when current account deficits did not increase but decreased thanks to the strong impact of domestic policies reversing the impact of external shocks.

Regarding the relationship between external shocks and domestic policy responses, domestic policies were inversely related to the measure of external shocks. Was this pattern plausible? Theoretically, a nation’s economy with a current account deficit is just like an economic institution, which has to balance their books through either “belt-tightening” or finding new ways to finance their economic needs. Otherwise its economic resources would be exhausted in the long run. On the other hand, in reality, some policy responses, such as increasing export penetration, caused rising adverse external shocks due to widening international exposure. Thus, the inverse relationship between external shocks and policy responses could be seen in this way: the more severe the external shocks to LDCs, the higher the degree of policy responses.

Considering the correlation of each individual economy, some outperforming other economies could be more likely found among those LDCs associated with unfavorable external shocks. This result was not deemed a surprising pattern because of the complexity of the interrelationship between external shocks and GDP growths. First, GDP growth was determined by both short-run and long-run economic factors, while external shocks were a short-run
phenomenon. Second, some ‘adverse’ external shocks might be “good” for a LDC’s growth. For example, foreign direct investments in a LDC would contribute to increasing current account deficits, seen as “adverse” financial measure, but it would feed its long-run growth. Third, adverse shocks might set off ‘wise’ policy responses, which could be favorable to its growth. All such policy rules could be LDC efforts to improve export competitiveness. Although finding correlation between external shocks and economic performance prompted some economists’ interests (e.g. Helleiner, 1987, pp.154; Mitra, and Associates, 1991), the focus was placed on external shocks, accounted for differences in economic performance among individual LDCs. This empirical analysis found that the synthesis of the measure of external shocks and policy responses being responsible for world economic synchronization.

Measured Impact of External Shocks

The applied model captures seven sources of external shocks, which were derived from measures of current account deficits. Figure 4 below illustrates average economic growth rates associated with the distribution of unfavorable external shocks in the period of 1991-2005.

FIGURE 4
AVERAGE GDP GROWTHS AND THE DISTRIBUTION OF UNFAVORABLE EXTERNAL SHOCKS

The Figure 4 clearly shows that the terms-of-trade is the prominent shock factor that was responsible for about 50% of all shocks and was an important indicator for economic openness. Any highly open economy would be easily affected by this type of shocks. Based on the data produced from the model, the following discussion is designated to answer how and to what extent an individual shock variable transmits the world economic influence to domestic economic fluctuations, and thus contributes to the synchronizing mechanisms of world business cycles.

As the single most significant factor of all adverse external shocks (Figure 4 and 5), terms-of-trade played a major role influencing LDC export earnings, contributing to LDC current account deficits through the time periods. The adverse impact on LDC current account deficits as a percentage of GDP was greater than that of all other external shocks (Figure 5).
The external shock accounting results indicated a clear pattern that terms-of-trade inversely correlate with efforts of LDC export penetration. This kind of correlation suggests that, the greater efforts of export penetration made by LDCs, the higher degree of external shock exposures, and the higher adverse impacts of terms-of-trade. Those findings were consistent with the observations reported by some literature (Schiff, 1995; Trade and Development Report, United Nations, 1986,).

**FIGURE 5**
**ECONOMIC GROWTHS ATTRIBUTABLE TO EXTERNAL SHOCKS (1987-2005)**

The contributing factors to the deteriorating terms-of-trade were debated in the past. First, the slowing-down in DC economies reduced aggregate demand, and spread a strong deflationary impact on money wages and commodity prices (United Nations, 1986, Trade and Development Report). According to the United Nations, much price deceleration during the early 1980s recession occurred in the seven largest OECD countries. Second, the export competition from LDCs, mostly concentrated in a few agricultural commodities, contributed to declining in terms-of-trade in the 1980s (Schiff, 1995). Those arguments suggested the terms-of-trade was exogenously determined. However, Khorshed Chowdhury (1994) argued that the terms-of-trade could be endogenously determined. He pointed out that structural adjustment in LDCs, responding to negative external shocks and trade liberalizations, could result in real exchange rate depreciation and thus a fall in their terms-of-trade. The observations in this paper do not conflict with either Schiff’s (1995) or Chowdhury’s (1994) propositions, which suggested the measure of LDC policy responses were inversely related to the terms-of-trade, and thus to the external shocks.

The external shock accounting results strongly suggested that the terms-of-trade was associated with DC economic performances and LDC trade strategies among other policy
responses. This relationship showed how the terms-of-trade contributed to world economy synchronization, indirectly linking DC economic fluctuations to LDC economic growths.

**Other External Shocks**

The second most significant factor adversely affecting the current account balance was the burden of debt accumulation (indebtedness). Based on the derived external accounting results, the measures of indebtedness correlated to GDP growths across LDCs. When LDCs were relieved from reducing their burden of debt accumulation, their economies grew fast. When LDCs suffered from increasing indebtedness, their GDP growths deteriorated significantly. The inverse correlation between LDC indebtedness and their GDP growths was noted in some literature. For example, in Chowdhury’s (1994) research, he rejected both Bulow and Rogoff’s (1990) proposition that the external debts of LDCs constituted a symptom rather than a cause of economic slowdown; as well as Dornbush (1988) and Krugman’s (1989) proposition that external debt contributed to economic slowdown.

Compared with the adverse impacts of other external shocks, the adverse impacts resulted from indebtedness in LDCs on GDP growths prove moderate. Table 2 compares the adverse impacts on GDP growths between indebtedness shocks and terms-of-trade, during the four different periods, between 1973 and 2005.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Indebtedness</td>
<td>0.20%</td>
<td>0.31%</td>
<td>0.41%</td>
<td>0.20%</td>
<td>2.60%</td>
<td>4.40%</td>
<td>1.10%</td>
</tr>
<tr>
<td>Terms of trade</td>
<td>1.73%</td>
<td>1.56%</td>
<td>1.52%</td>
<td>0.78%</td>
<td>1.30%</td>
<td>0.30%</td>
<td>14.50%</td>
</tr>
</tbody>
</table>

Among mechanisms that caused economic synchronization, interest rates played a crucial role affecting trade, indebtedness of LDCs, and ultimately LDC economic growths. In addition, the results showed that changes in interest rate shocks directly related to changes in burden of indebtedness. Favorable changes in interest rates resulted in favorable changes in indebtedness, and vice versa.

Regarding real GDP growth, LDCs facing favorable changes in interest rate shocks grew faster than LDCs confronting unfavorable changes in the same period, ranging from 5 per cent to 12 per cent.

The following chart (Figure 6) shows a close relationship between changes in the U.S. prime rates and interest rate shocks to LDCs, expressed as a percentage of GDP.
Severe external interest rate shocks coincided with the occurrence of tight financial markets in major DCs, reflecting some aspects of the transmission mechanism. Of the economic synchronization from 1973 to 2005, the high interest rate in major DCs caused LDC debt-servicing difficulties, ultimately, contributing to the economic fluctuations of LDCs.

There were some evidences that foreign direct investment (FDI), as one shock component, correlated with interest-rate shocks. For example, the US prime rate, according to the Economic Report of President (1995), rose from 5.72% in the early 1970s to 12.67% at the end of 1970s, and peaked at higher levels between 14% and 18.87% in the early 2000s. The outward flows of FDI from the United States fell from an average of 16.9 billion dollars (Eric D. Ramstetter, 1993, pp. 156) during 1976-80 to 4.8 billion dollars during 1981-85. The outward flows in FDI trended in the opposite direction to levels of in the U.S. interest rates.

As shown in Table 3, the number of FDI recipients decreased from 24 LDC (1973-77) to 16 LDC (1978-82), and further declined to 12 LDC (1982-86), while the mean LDC growth across countries dropped accordingly. After 1986, FDI rose in 17 LDCs when the mean GDP growth improved for those that had inward flows of FDI. The measure of FDI inflow remained quite stable between 1% to less than 2%. There was a clear pattern indicating the correlation between GDP growth rate of FDI recipients and the measure of FDI inflow/outflow, expressed in percentage of growth.
The results suggested that world economic synchronization was attributable to FDI, which had impacts on cycles in LDC recipients. The external accounting results indicated that changes in FDI made to LDCs directly correlated to changes in their GDP growth. There was little doubt that FDI did have an important role in the transmission mechanism for economic synchronization.

POLICY RESPONSE TO EXTERNAL SHOCKS

The Roles of Policy Responses

Roles of policy responses became undisputable considering the phenomenon of economic synchronization, on which policy responses evidently had more impacts on economies than external shocks did. Without the positive impacts of policy responses, the negative measure of external shocks might chip away some GDP growth, given the fact that external shocks adversely affected current account deficits. The results of this empirical study indicate that external shocks set off policy responses from all LDCs, regardless of favorable or unfavorable impacts of the shocks. Of 30 LDCs, almost 75 percent of those experiencing current account shocks responded by means of an improved “trade-ratio,” and more than 58% by means of decreasing their aggregate spending during the overall period of 1973-2005. Hence, the transmission mechanism of economic synchronization was also attributed to policy responses, which played various important roles in the process of the transmission. As suggested in the previous section, appropriate policies could transform the disadvantages of external shocks into economic strength.

How did LDC domestic policies come to play the role of transmission? Not surprisingly as indicated by the external shock accounting results, a list of countries characterized by external shocks, from strongly favorable to strongly unfavorable, experienced the process of economic adjustments inversely relating to the measure of external shocks. In another words, the higher the measures of adverse external shocks, the more favorable impacts of policy responses to current

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**TABLE 3**

<table>
<thead>
<tr>
<th>Periods</th>
<th>LDC classified By direct investment Income</th>
<th>Change in* Direct Investment Income</th>
<th>Number of Countries</th>
<th>Percentage of total LDC %</th>
<th>Average Growth Rate Of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973-77</td>
<td>Favorable changes</td>
<td>-1.67</td>
<td>24</td>
<td>80</td>
<td>6.31</td>
</tr>
<tr>
<td></td>
<td>Unfavorable changes</td>
<td>1.17</td>
<td>6</td>
<td>20</td>
<td>5.82</td>
</tr>
<tr>
<td>1978-82</td>
<td>Favorable changes</td>
<td>-1.32</td>
<td>16</td>
<td>53</td>
<td>4.43</td>
</tr>
<tr>
<td></td>
<td>Unfavorable changes</td>
<td>2.11</td>
<td>14</td>
<td>47</td>
<td>1.50</td>
</tr>
<tr>
<td>1982-86</td>
<td>Favorable changes</td>
<td>-1.67</td>
<td>12</td>
<td>40</td>
<td>3.45</td>
</tr>
<tr>
<td></td>
<td>Unfavorable changes</td>
<td>2.48</td>
<td>18</td>
<td>60</td>
<td>2.53</td>
</tr>
<tr>
<td>1987-91</td>
<td>Favorable changes</td>
<td>-1.83</td>
<td>17</td>
<td>57</td>
<td>4.42</td>
</tr>
<tr>
<td></td>
<td>Unfavorable changes</td>
<td>0.95</td>
<td>13</td>
<td>43</td>
<td>3.79</td>
</tr>
</tbody>
</table>

Note: *: Negative sign indicates increasing FDI; Positive sign indicates decreasing FDI, as percentage of GDP.
account deficits. Hence, the higher measure of favorable external shocks, the more unfavorable impacts of policy responses to current account deficits.

Did policy responses correlate with the cycles in LDC economic growth? External shocks followed an alienation process, through the reaction of policy responses, transforming changes into economic cycles. The results indicated that LDC policy responses directly correlated with their economic growth and inversely correlate with external shocks (Table 4).

Linking external shocks, policy responses and economic performance into a comprehensive view, the derived measures (Table 4) indicated that individual “policy-efforts” responding to external shocks differentiated LDC economic performances because policy responses were processes of economic adjustments, as reactions to external shocks.

### TABLE 4
POLICY RESPONSES AS LINKAGES BETWEEN EXTERNAL SHOCKS AND GDP GROWTH, 1973-2005

<table>
<thead>
<tr>
<th>Period</th>
<th>Current account deficits</th>
<th>Average GDP Growth</th>
<th>External Shocks</th>
<th>Total Policy Responses</th>
<th>Consumption Contract</th>
<th>Investment Reduction</th>
<th>Import Replacement</th>
<th>Export Penetration</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973-77</td>
<td>Favorable</td>
<td>5.9%</td>
<td>-2.8%</td>
<td>2.2%</td>
<td>0.1%</td>
<td>0.3%</td>
<td>0.6%</td>
<td>1.1%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>6.3%</td>
<td>2.4%</td>
<td>-1.3%</td>
<td>-0.4%</td>
<td>-0.4%</td>
<td>0.1%</td>
<td>-0.6%</td>
</tr>
<tr>
<td>1978-82</td>
<td>Favorable</td>
<td>1.2%</td>
<td>-2.4%</td>
<td>1.9%</td>
<td>0.3%</td>
<td>0.0%</td>
<td>0.3%</td>
<td>1.2%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>4.2%</td>
<td>2.5%</td>
<td>-1.4%</td>
<td>0.0%</td>
<td>-0.2%</td>
<td>-0.9%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>1982-86</td>
<td>Favorable</td>
<td>1.8%</td>
<td>-2.2%</td>
<td>0.8%</td>
<td>0.2%</td>
<td>0.1%</td>
<td>0.6%</td>
<td>-0.1%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>3.8%</td>
<td>2.5%</td>
<td>-4.1%</td>
<td>-0.6%</td>
<td>-0.5%</td>
<td>-0.4%</td>
<td>-2.6%</td>
</tr>
<tr>
<td>1987-91</td>
<td>Favorable</td>
<td>3.0%</td>
<td>-1.9%</td>
<td>1.3%</td>
<td>-0.1%</td>
<td>0.0%</td>
<td>0.6%</td>
<td>0.7%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>6.1%</td>
<td>1.2%</td>
<td>0.6%</td>
<td>-0.2%</td>
<td>0.5%</td>
<td>1.6%</td>
<td>-1.3%</td>
</tr>
<tr>
<td>1992-95</td>
<td>Favorable</td>
<td>3.9%</td>
<td>-6.8%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>-0.1%</td>
<td>1.0%</td>
<td>-0.9%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>5.5%</td>
<td>1.5%</td>
<td>0.8%</td>
<td>0.7%</td>
<td>0.2%</td>
<td>0.3%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>1996-00</td>
<td>Favorable</td>
<td>3.5%</td>
<td>-9.0%</td>
<td>1.2%</td>
<td>-0.9%</td>
<td>-0.1%</td>
<td>0.3%</td>
<td>1.9%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>2.1%</td>
<td>4.3%</td>
<td>1.5%</td>
<td>0.0%</td>
<td>0.1%</td>
<td>0.8%</td>
<td>0.5%</td>
</tr>
<tr>
<td>2001-05</td>
<td>Favorable</td>
<td>3.7%</td>
<td>20.0%</td>
<td>-2.1%</td>
<td>0.0%</td>
<td>0.1%</td>
<td>0.8%</td>
<td>-3.0%</td>
</tr>
<tr>
<td></td>
<td>Unfavorable</td>
<td>4.9%</td>
<td>10.9%</td>
<td>-3.1%</td>
<td>-0.2%</td>
<td>0.1%</td>
<td>1.2%</td>
<td>-4.1%</td>
</tr>
</tbody>
</table>

Policy responses to the shocks took various forms, which might cause future structural adjustments, restoring external balances and rates of economic growth to normal levels. The future structural adjustment involved export promotion or import substitution, and short-term reduction in domestic spending.

**Policy Sensitivity to External Shocks**

Policy responses varied across LDCs, as shown with empirical results of external shock accounting. Facing various degrees of external shocks, some LDCs preferred “belt-tightening” to the improvement of ‘trade ratio’ and vice-versa. The measured impact of trade policy responses was much greater than the impact of the “belt-tightening” on reducing current account deficits because consumption contraction and investment reduction were passive economic adjustments, compared to improving “trade ratio” widely adopted by LDCs.

Which policy response was more sensitive to external shocks? Multiple cross-sectional regressions contribute to the analysis, with policy response are expressed as a function of
external shocks, assuming that external shocks prompted policy responses. The independent variables are all individual external shocks. The dependent variables are “policy-efforts,” separately, which are export-penetration, import-replacement, consumption-contraction and investment-reduction. They could be to some extent correlated, because changes in LDC policy responses might reflect their practical and ideological preference with respect to the degree of external dependence, the role of market, and the future expectations. All those variables are from cross-country data. They are pooled for the period 1973-2005, and derived from our empirical external-accounting results. Four separate equations, the regressions of export penetration, import replacement, consumption contraction and investment reduction on external shocks are expressed in the following model:

$$PR_i = \beta_0 + \beta_1 ES + \mu$$

where

- $PR_i$ = policy responses ($i = 1, 2, 3, 4$), which are export-penetration ($PR_1$), import-replacement ($PR_2$), consumption-contraction ($PR_3$) and investment reduction ($PR_4$), and
- $ES$ = External shocks.

The regression outputs suggested that export-penetration policy was the most sensitive domestic policy among other policies used in response to external shocks. This is because $R^2$ and the t-ratios in the model ($PR_1$) was sensitive to external shocks at a statistically significant level, as other models ($PR_2, PR_3$ and $PR_4$) were either statistically insignificant or have a very small coefficient.

Export penetration stood out as the primary policy response, among the other three policy reactions, assuming domestic policies were policy makers’ choices to reverse the adverse impacts of external shocks on current account balances. The relative importance of each policy reactions was measured in means of the reduction of external deficits presented as percentages of GDP.

The average impacts of export penetration were higher, ranging from 4.1% to 6.4%, than the impacts of all other policy responses during the four selected time periods. Ranked by the impact of policy-efforts as a percentage of GDP, the secondary policy response was import substitution, averaging from 2% to 3.9%. The investment reduction was the third and the consumption contraction the fourth. Both investment reduction and consumption contraction, so called “belt-tightening,” would sacrifice economic growth in both the long-run and short-term. Apparently, most LDCs did not use investment reduction and consumption as important means of adjustment. However, “belt-tightening” resulted from rising in the current account deficit was necessary in some LDCs to restore external balance by the reductions in aggregate demand, such as by reducing rates of investment or consumption (or both), thus affecting both current and future GDP.

However, the above statements are not conclusive if export penetration responses to external shocks were only events but economic trends, which should be observed as consistent and continuous over the time period. Thus, the motivation to test the sufficient conditions led to the regressions of export penetration on external shocks separately for seven different periods. The model was expressed as follows:

$$EP_i = \alpha + \beta_i ES_i + \mu$$

where

- $EP_i$ = export penetration;
- $ES_i$ = external shocks, as ‘$i$’ = 1, 2, 3 and 4, for the periods of 1987-91, 1992-95, 1996-00 and 2001-05 respectively.
The regression output indicates that the coefficients ($\beta$) were getting more negative from -0.32 to -0.91 through the periods. That is, in an alternative presentation, the impact of export penetration policy on current account balances was seen in a rising trend.

Although the rising trend of export penetration response to external shocks was apparent, without evidences of consistency and continuity, the assessment still invites questions. To find evidences of the consistency and the continuity of export orientated policy being more significant than those of other policy responses, a multi-linear model was designed to test the hypothesis whether the coefficients ($\beta_i$) of external shocks were similar over the four different time periods.

Testing the similarity of the rate of change (i.e., slope) and the average level (i.e., intercept) of export penetration response to external shocks, dummy variables were practically required for the model. Dummy variables were used to represent external shocks during four different periods, as suggested by Gujarati (1992). Two models were run separately to avoid spurious model specification.

Model 1

$$PR_i = \alpha_1 + \alpha_2 \Delta_2 + \alpha_3 \Delta_3 + \alpha_4 \Delta_4 + \alpha_5 ES_i + \alpha_6 \Delta_2 ES_i + \alpha_7 \Delta_3 ES_i + \alpha_8 \Delta_4 ES_i + \mu$$

where,

- $ES_i$ = External Shocks, as `$i$' = 1, 2, 3 and 4, for the period 1987-91, 1992-95, 1996-00 and 2001-05, respectively;
- $\Delta_i$ = 1, as `$i$' = 2, 3, and 4, for the period 1992-95, 1996-00 and 2001-05, respectively, otherwise $\Delta_i$ = 0;
- $\alpha_1$, $\alpha_2$, $\alpha_3$ and $\alpha_4$ were intercepts; and $\alpha_5$, $\alpha_6$, $\alpha_7$ and $\alpha_8$ were slopes for the period 1987-91, 1992-95, 1996-00 and 2001-05, respectively; and $\mu$ = Error term.

The hypotheses to be tested in this section were:

- $H_0$: $\alpha_6 = 0$, $H_1$: $\alpha_6 \neq 0$
- $H_0$: $\alpha_7 = 0$, $H_1$: $\alpha_7 \neq 0$
- $H_0$: $\alpha_8 = 0$, $H_1$: $\alpha_8 \neq 0$

**TABLE 5**

<table>
<thead>
<tr>
<th>Coefficient</th>
<th>$\alpha_1$</th>
<th>$\alpha_2$</th>
<th>$\alpha_3$</th>
<th>$\alpha_4$</th>
<th>$\alpha_5$</th>
<th>$\alpha_6$</th>
<th>$\alpha_7$</th>
<th>$\alpha_8$</th>
</tr>
</thead>
<tbody>
<tr>
<td>(t ratio)</td>
<td>1.337</td>
<td>-0.433</td>
<td>-6.178</td>
<td>-2.521</td>
<td>-0.324</td>
<td>-0.045</td>
<td>-0.155</td>
<td>-0.590</td>
</tr>
<tr>
<td></td>
<td>(-4.72)*</td>
<td>(-0.294)*</td>
<td>(-4.324)*</td>
<td>(-1.680)*</td>
<td>(-3.029)*</td>
<td>(-0.267)</td>
<td>(-0.951)</td>
<td>(-2.506)*</td>
</tr>
</tbody>
</table>

Notes: $R^2 = 0.364$ and numbers in parentheses are t-ratio; N = 139
* denotes statistically significant at the 1% level (one tail)

As indicated by the above results, the different individual slope dummies were statistically insignificant for the period 1992-95 and 1996-00. An increasing negative slope indicated the rising measure of export-penetration policy responses to external shocks. However, as the dummy slopes for the two periods tended to be zero statistically, the impacts of policy response ($\beta_2$ and $\beta_3$) presented a similar pattern to that ($\beta_1$) for the base period 1987-91. In contrast, the different slope dummy for the period 2001-2005 was statistically significant at the 1% confidence level. This result indicated that the pattern changed, with increasing export penetration responses as the coefficient ($\beta_i$) getting more negative. The derived coefficients from
dummy variables for four different periods indicated the rising trend of export-penetration responses, are shown in Table 6.

### TABLE 6
**COEFFICIENTS FROM DUMMY VARIABLES FOR THE REGRESSION OF EXPORT PENETRATION ON EXTERNAL SHOCKS**

<table>
<thead>
<tr>
<th>Period</th>
<th>constant *</th>
<th>coefficient *</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987-91</td>
<td>$\alpha_1 = 1.34$</td>
<td>$\alpha_5 = -0.32$</td>
</tr>
<tr>
<td>1992-95</td>
<td>$\alpha_1 + \alpha_2 \Delta_2 = 0.90$</td>
<td>$\alpha_5 + \alpha_6 \Delta_2 = -0.37$</td>
</tr>
<tr>
<td>1996-00</td>
<td>$\alpha_1 + \alpha_3 \Delta_3 = -4.84$</td>
<td>$\alpha_5 + \alpha_7 \Delta_3 = -0.48$</td>
</tr>
<tr>
<td>2001-05</td>
<td>$\alpha_1 + \alpha_4 \Delta_4 = -1.18$</td>
<td>$\alpha_5 + \alpha_8 \Delta_4 = -0.91$</td>
</tr>
</tbody>
</table>

* Negative sign indicates that export penetration policy response Reduced current account deficits, expressed as a percentage of GDP.

Model 2

$$PR_i = \alpha_1 + \alpha_2 \Delta_2 + \alpha_3 \Delta_3 + \alpha_4 \Delta_4 + \alpha_5 ES_i + \mu$$

was used to test the similarity of differential intercept dummies. The null hypotheses were:

- $H_0: \alpha_2 = 0$, $H_1: \alpha_2 \neq 0$
- $H_0: \alpha_3 = 0$, $H_1: \alpha_3 \neq 0$
- $H_0: \alpha_4 = 0$, $H_1: \alpha_4 \neq 0$

### TABLE 7
**REGRESSION RESULTS BASED ON MODEL 2—EXPORT POLICY RESPONDING TO EXTERNAL SHOCKS**

<table>
<thead>
<tr>
<th>Explanatory Variable</th>
<th>Constant</th>
<th>$\alpha_2$</th>
<th>$\alpha_3$</th>
<th>$\alpha_4$</th>
<th>$\alpha_5$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coefficient (t ratio)</td>
<td>1.273</td>
<td>-0.182</td>
<td>-6.128</td>
<td>-1.781</td>
<td>-0.437</td>
</tr>
<tr>
<td></td>
<td>(-4.82)*</td>
<td>(-0.124)</td>
<td>(-4.233)*</td>
<td>(-1.194)</td>
<td>(-6.587)*</td>
</tr>
</tbody>
</table>

$R^2 = 0.332$; N= 139

Notes: * denotes statistically significant at the 1% level (one tail)

The results of two models for differential intercept dummies were similar. The hypothesis could not be rejected, except for the period 1987-91. Hence, the average levels of export penetration responses to external shocks among the period 1992-95, 1996-00 and 2001-05 were similar, but not for the period 1987-91.

To test equality of coefficients from the above models with and without dummy variables, Chow test was applied. Chow statistic is expressed as follows:

$$F = \frac{(SSR_2/df_2)/(SSR_1/df_1)}{SSR_2/df_2}$$

where

- $SSR_2$ and $SSR_1$ = the sum of the squared residuals from the model without and with dummy variables, respectively;
- $df_2$ and $df_1$ = the degree of freedom, accordingly.

The results ($F_{137,131,1} = 1.81$, and $F_{137,134,1} = 1.15$, for model 1 and 2 respectively) could not reject the hypothesis that the coefficients from the models either with or without dummies were similar.
The conclusion is that external shocks were similar over the four different time periods and the measure of the export policy response was rising continuously in reducing current account deficits. That export policy response ($\beta_i$) tripled to 91% from 32% through the period of 1992-2005, almost doubled from the period of 1996-00.

Why was there such a trend? As noted above, policy responses had long-term impacts. Hence, the positive impact of export penetration could be delayed but shown in a rising trend over time. As noted by Syrquin (1988), some LDCs, such as, Chile, Israel, S. Korea and Turkey, had devoted much time to building the export bases before the emergence of their export expansion. Therefore, it was possible for some countries including China, Indonesia, Philippines, Thailand and other LDCs with export strategies, to take many years to fully achieve their export oriented policies. Another possibility was that, seeing the association between the income of export and the demand for exports, the level of LDC exports was to a great extent determined by income level of DCs. Rising demand for LDC exports worldwide over time could contribute to the trend. Hence, the trends of export-penetration policy responses were rising over time.

As a brief note made to the linkage between LDC economies and world business cycles, trade policies, served as a “gear” of economic synchronization, were the most sensitive to external shocks, among other policy responses. The global economy, largely influenced by business cycles in DCs, caused external shocks, which called for economic adjustments in LDCs. The most important economic adjustment was trade-policy efforts set in motion by business cycles in DC growths, due to the influences of DC income level on the demand for LDC exports.

**FIGURE 7**

**AVERAGE GDP GROWTHS OF LDCs ASSOCIATED WITH EXPORT PENETRATION SHOCKS**

Based on the external accounting outputs, Figure 7 represents an average GDP growth rate of LDCs associated with unfavorable versus favorable export-penetration shocks. It is not difficult to see the linkage between the adoption of export-oriented policies by LDCs and relatively high economic growths.
**High-Growth LDC versus Low-Growth LDC**

One remaining question is whether or not export-penetration policy efforts resulted in the differences of economic growths of LDCs. As an alternative question, did a high-growth LDC (HLDC) respond to external shocks with more measures of export-penetration policies than a low-growth LDC (LLDC) did in terms of policy responses?

A Chow Test is used to answer the above question. First, two subsets of data are generated, based on GDP growth rates. The data pool contains a cross-section panel data through 1987-2005. One subset represents HLDCs with GDP growth rates of more than 3%. The other subset represents LLDCs with GDP growth rates less than or equal to 3%. Second, export-penetration policy responses are regressed on external shocks, using the whole cross-section panel dataset. Third, two regressions are separately run for HLDC and LLDC, allowing the parameters for both HLDC and LLDC to be tested for differences in policy responses. Thus, there are three equations expressed as follows:

\[ EP_i = \beta_0 + \beta_1 ES_i + \mu \]

where

- \( EP_i \) = Export policy responses, \((i = 1, 2, \text{ and } 3)\);
- \( ES_i \) = External shocks, \((i = 1, 2, \text{ and } 3)\); and
- \( i = 1 \) for equation 1, which employs whole cross-section pool data;
- \( i = 2 \) for equation 2, which employs the HLDC subset data;
- \( i = 3 \) for equation 3, which employs the LLDC subset data.

This type of Chow test is used to confront the null hypothesis that actions of a HLDC was not different from that of a LLDC, in terms of export policy responses. The hypothesis is expressed as follows:

- \( H_0 : \beta_{11} = \beta_{12} \)
- \( H_1 : \beta_{11} \neq \beta_{12} \)

**TABLE 8**

RESULTS REFLECTING DIFFERENTIATION OF HLDC FROM LLDC

<table>
<thead>
<tr>
<th>Regression of Export-penetration on External shocks, 1987-2005</th>
<th>( R ) squared</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equation 1, using whole cross-section panel data,</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>Coefficient</td>
</tr>
<tr>
<td>-0.740</td>
<td>-0.411</td>
</tr>
<tr>
<td>Equation 2, HLDC subset, with Growth of GDP greater than 3%</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>Coefficient</td>
</tr>
<tr>
<td>-1.964</td>
<td>-0.546</td>
</tr>
<tr>
<td>Equation 3, LLDC subset, with Growth of GDP less than 3%</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>Coefficient</td>
</tr>
<tr>
<td>0.941</td>
<td>-0.251</td>
</tr>
</tbody>
</table>

Chow Test Statistic: 6.746 which is greater than critical value of \( F(\alpha=1\%,DF_1=82,DF_2=53) = 1.73 \)

‘*’ Notes: \( F = (ssr1-ssr2-ssr3)*DF/(2*(ssr2+ssr3)) \)

Table 8 shows the results of the test. Based on the Chow statistic values, the null hypothesis is rejected at a one percent significance level. Therefore, the conclusion strongly suggests that a HLDC differs from a LLDC in choosing policy responses to external shocks.
How much difference was there? The above regression results show that HLDC export-oriented policy accounted for 55 percent of the offsetting response, for every dollar loss caused by external shocks to the current account balance. Compared to LLDC, export oriented policy accounted for only 25 percent of the response to external shocks. That was equivalent to 120 percent greater measured response by HLDC than that by LLDC using export oriented policy. Comparing the intercepts, which represent the mean external shocks, HLDC experienced three times as much external shock as LLDC did in the period 1987-2005. The statistic parameters produced from the previous regressions also suggest what external shocks to LDC economies might not be a necessary factor unfavorable to economic growths. Nevertheless, the conventional wisdom believed that it would be in the disadvantage to LDCs if they were exposed to a great degree of external shocks. The above finding will certainly be a contribution to the debate whether adverse external shocks accounted for differences in performance among individual LDC economies, despite the denials made by Mitra (1991) and Helleiner (1987).

Why did some LDCs perform better when they were facing more substantial external shocks? The greater measures of external shocks that LDCs experienced, the more open their economies would be. To a greater extent, rising measures of external shocks would likely force those LDCs to make some necessary economic adjustments, especially, adopting export oriented policies to offset the adverse impact of external shocks.

Policy responses to external shocks might be involuntary reactions from those LDCs. However, the reactions made those LDCs winners in the long-run. In the medium term to the long-term, export orientated policies presumably raised total factor productivities through favorable effects on the efficiency of resource allocations, capacity utilizations, economic scales, technological changes, and ultimately stimulating economic growths.

To the contrary, LLDCs were among those countries minimizing their exposures to external shocks. However, minimizing exposures to external shocks indicated a lack of export orientated policy efforts. For instance, countries like Argentina, Bolivia, Costa Rica, El Salvador, Madagascar, Malawi, Sudan and Venezuela all had negative growth rates, but they had positive changes in their current account balances in the 1978-82 period. These outcomes were also essentially true in the 1982-86 and 1987-91 periods. Of those countries with low growth rates or negative GDP growths, most of them did not improve their export competitiveness in the highly integrated world economy. Consequently, these LDCs could minimize their exposures to external shocks and suffer little adverse impacts of external shocks on their external balances, but they could not achieve decent economic growths.

CONCLUSION

Performance of an economy in this integrated world very much depends on the well-being of the rest of the world. The world economy from integration to globalization, through trade in particular, produced so many shocks to LDCs, such as the 1973 and 1979 oil price crises, high commodity price cycles, the early 1980s’ debt crises, geopolitical shock in 2001, and soaring commodity prices and the world financial crisis started from late 2007. Facing the impact of external shocks on their external balances, LDC had to find appropriate policies to offset those adverse effects. Through juggling different policy responses to external shocks, some LDCs found themselves evolving and coming out as HLDCs, and some found their economies lagging behind others as LLDCs.
The transmission mechanisms did not merge as a simple form of linkages. With abundant evidences presented in this paper, the transmission mechanism can be illustrated as follows. Cycles in the world economy, in which DCs often acted as an originator played a crucial role, generated substantial external shocks directly affecting LDC current account deficits. Adverse impacts on current account deficits resulted in policy responses, which directly differentiated economic performances. Policy responses, especially open-economy policies, gave LDCs extensive external exposures, and caused them to face major external shocks. This situation resulted in strong linkages connecting great measures of adverse external shocks to significantly positive policy reactions, potentially delivering high economic growths.

HLDCs were in an economic environment forcing them to adjust their economic structures to survive through the turbulent shocks contributed by the global economy. Those of capable to outperform economies in average often turned risks of external shocks into economic advantages by promoting export penetration. To the contrary, some LLDCs did not have good policies to cope with external shocks. Certain LLDCs virtually isolated their economies from the rest of the world. Without exposing themselves to the “hostile” world, most of them had limited the impact of external shocks on their current account balances. However, as economic data reiterated, LLDCs with limited accessibilities to the world economic resources were not able to recover from their prolonged recessions. At the end, overwhelming evidences lead us to believe that trade oriented policy is the essential factor to explain differences of LDC growths and that adverse external shock can be a disguised blessing to LDCs in the long-rum.

APPENDICES

1). The Derivation and Description of Bacha's Model

First, variables and their explanations are used in this paper.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Explanations of variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>$M$</td>
<td>Imports of goods and Non-Factor Services (NFS) at current domestic currency prices (DCP).</td>
</tr>
<tr>
<td>$V$</td>
<td>Factor payments to abroad (net) at DCP.</td>
</tr>
<tr>
<td>$E$</td>
<td>Exports of goods and NFS at DCP.</td>
</tr>
<tr>
<td>$T$</td>
<td>Net current transfers from abroad at DCP.</td>
</tr>
<tr>
<td>$D$</td>
<td>Current account deficit including transfers at DCP.</td>
</tr>
<tr>
<td>$X$</td>
<td>Exports of goods and NFS at 2000 DCP.</td>
</tr>
<tr>
<td>$p_m$</td>
<td>Domestic current price index of imports, with 2000 = 1.0.</td>
</tr>
<tr>
<td>$p_x$</td>
<td>Domestic currency price index of exports, with 2000 = 1.0.</td>
</tr>
<tr>
<td>$j$</td>
<td>Import content of domestic absorption at 80 DCP. or $j = J/(A_o)$</td>
</tr>
<tr>
<td>$C$</td>
<td>Sum of government and private consumption at 2000 DCP.</td>
</tr>
<tr>
<td>$I$</td>
<td>Gross capital formation at 2000 DCP.</td>
</tr>
<tr>
<td>$A$</td>
<td>Gross domestic absorption at 2000 DCP.</td>
</tr>
<tr>
<td>$W$</td>
<td>General Agreement on Thrifts and Trade (GATT) volume index of world exports, expressed in 2000 dollars, and converted to 2000</td>
</tr>
</tbody>
</table>
domestic currency prices by using of the average domestic currency/dollar exchange rate for 2000.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>$x$</td>
<td>Market share in world exports at 2000 DCP. Calculated according to equation, $x = X/W$</td>
</tr>
<tr>
<td>$V_i$</td>
<td>Net interest payments to abroad in DCP. This is calculated multiplying the item ‘others’ of ‘net factor service income from abroad’ in current dollars by the average domestic currency/dollar exchange rate.</td>
</tr>
<tr>
<td>$R$</td>
<td>Net workers’ remittances from abroad at DCP.</td>
</tr>
<tr>
<td>$V_d$</td>
<td>Net direct investment income to abroad at DCP. This is calculated by the equation, $V_d = V - V_i + R$</td>
</tr>
<tr>
<td>$r$</td>
<td>Dollar rate of interest. This is calculated by the equation, $r = V/F$</td>
</tr>
<tr>
<td>$F$</td>
<td>Net foreign debt at end of year $t-1$, expressed in domestic currency by use of average domestic currency/dollar exchange rate in year $t$.</td>
</tr>
<tr>
<td>$Y$</td>
<td>GNP at DCP.</td>
</tr>
<tr>
<td>$Z$</td>
<td>GNP at 2000 DCP.</td>
</tr>
<tr>
<td>$P_y$</td>
<td>Implicit GDP deflator.</td>
</tr>
</tbody>
</table>

Second, this type of Bacha's model may be set out as follows.

That is, the current account deficit including transfers at current domestic currency prices, $D_t$, is originally set by an identity to net imports--imports minus exports ($M_T - E_t$), plus net transfers--net factor services to abroad minus net transfers from abroad ($V_t - T_t$) at time ‘$t$’.

When all the following symbols are denoted as above, imports are expressed as the product of the domestic current price index of exports, with 2000 =1.0 and volume of imports at 2000 domestic currency prices (2000 DCP):

$M_T = P_t^{m}J_t$

Exports are expressed in the same fashion as imports.

$E_t = P_t^{x}X_t$

Exports at 2000 DCP are expressed as the product of the export coefficient, ($x_t = X_t/W_t$) and the real value of world trade ($W_t$).

$X_t = x_tW_t$

Similarly, imports at 2000 DCP are expressed as the product of the import coefficient, ($j_t = J_t/A_t$) and real domestic absorption, $A_t$, which is the sum of real consumption ($C_t$) and real gross domestic capital formation, ($I_t$).

$J_t = j_tA_t$, and $A_t = C_t + I_t$

Net factor services to abroad are the sum of net interest to abroad ($V_i'$) and other net investment income to abroad ($V_d'$), and net workers’ remittances from abroad ($R_t$).

$V_t = V_i' + V_d' - R_t$

Net interest, in domestic currency, is then expressed as the product of the current dollar interest rate (per cent per year) ($r_t$) multiplied by the net stock of foreign debt at the end of the previous year ($F_{t-1}$).

$V_i' = r_tF_{t-1}$

It is then possible to rewrite imports, factor payments to abroad and exports as follows,
\[ M_{t} = P_{t}^{m}J_{t} = P_{t}^{m}j_{t}A_{t} = P_{t}^{m}j_{t}C_{t} + P_{t}^{m}j_{t}I_{t} \]  
\[ V_{t} = V_{t}^{d} + V_{t}^{d} - R_{t} = r_{t}F_{t-1} + V_{t}^{d} - R_{t} \]  
\[ E_{t} = P_{t}^{x}X_{t} = P_{t}^{x}x_{t}W_{t} \]  
(2)

Substituting (2), (3) and (4) into equation (1) and dividing both sides by \( Y_{t} \), equation (1) becomes:

\[ D_{t}/Y_{t} = P_{t}^{m}j_{t}C_{t}/Y_{t} + P_{t}^{m}j_{t}I_{t}/Y_{t} + r_{t}F_{t-1}/Y_{t} + V_{t}/Y_{t} - R_{t}/Y_{t} - P_{t}^{x}x_{t}W_{t}/Y_{t} - T_{t}/Y_{t} \]  
(5)

National income in current prices is equal to the product of real national income and the implicit deflator of GDP:

\[ Y_{t} = P_{t}^{y}Z_{t} \]  
(6)

Substituting (6) into (5), we have:

\[ D_{t}/Y_{t} = P_{t}^{m}j_{t}C_{t}/P_{t}^{y}Z_{t} + P_{t}^{m}j_{t}I_{t}/P_{t}^{y}Z_{t} + r_{t}F_{t-1}/Y_{t} - R_{t}/Y_{t} - P_{t}^{x}x_{t}W_{t}/P_{t}^{y}Z_{t} - T_{t}/Y_{t} \]  
(7)

Let

\[ \rho_{t}^{m} = P_{t}^{m}/P_{t}^{y} \] or \( P_{t}^{m} = \rho_{t}^{m}P_{t}^{y} \)  
(8)

\[ \rho_{t}^{x} = P_{t}^{x}/P_{t}^{y} \] or \( P_{t}^{x} = \rho_{t}^{x}P_{t}^{y} \)  
(9)

Substituting (8) and (9) into (7), we have:

\[ D_{t}/Y_{t} = \rho_{t}^{m}j_{t}C_{t}/Z_{t} + \rho_{t}^{m}j_{t}I_{t}/Z_{t} + r_{t}F_{t-1}/Y_{t} - R_{t}/Y_{t} - \rho_{t}^{x}x_{t}W_{t}/Z_{t} - T_{t}/Y_{t} \]  
(10)

Taking first differences of equation (10) and rearranging produces the type of Bacha’s equation:

\[ d(D_{t}/Y_{t}) = j_{t}A_{t}/Z_{t}d(\rho_{t}^{m}) - x_{t}(W_{t}/Z_{t})d(\rho_{t}^{x}) + F_{t-1}/Y_{t}d(r_{t}) - X_{t}\rho_{t}^{x}d(W_{t}/Z_{t}) + r_{t}d(F_{t-1}/Y_{t}) + V_{t}/Y_{t} - R_{t}/Y_{t} - \rho_{t}^{x}x_{t}W_{t}/Z_{t} - T_{t}/Y_{t} \]  
(11)

Model (11) is the type of Bacha’s model, where the symbol \( d(\ ) \) is the difference operator. Empirically, subscript ‘\( s \)’ is used as a simple average of the current year and base year, rather than ‘\( t \)’, being either the current year or the base year, for the weights for the above model. The following interprets equation (11) in economic terms:

\[ [d(D_{t}/Y_{t})] \] \( \ldots \) Changes in the ratio of current account deficit to GDP between final year and base-year

\[ [j_{t}(A_{t}/Z_{t})]d(\rho_{t}^{m}) - x_{t}(W_{t}/Z_{t})d(\rho_{t}^{x}) \] \( \ldots \) Terms of trade deterioration

\[ [- F_{t-1}/Y_{t}]d(r_{t}) \] \( \ldots \) interest rate shock

\[ [- x_{t}(W_{t}/Z_{t})]d(\rho_{t}^{x}) \] \( \ldots \) retardation of world trade growth.

\[ [r_{t}d(F_{t-1}/Y_{t})] \] \( \ldots \) burden of debt accumulation

\[ [d(V_{t}/Y_{t})] \] \( \ldots \) change in net direct investment income to abroad

\[ [- d(R_{t}/Y_{t})] \] \( \ldots \) change in workers' remittances

\[ [- d(T_{t}/Y_{t})] \] \( \ldots \) change in unrequited transfers

\[ [j_{t}p_{t}^{m}d(C_{t}/Z_{t})] \] \( \ldots \) consumption contraction

\[ [j_{t}p_{t}^{m}d(I_{t}/Z_{t})] \] \( \ldots \) investment reduction

\[ [p_{t}^{m}(A_{t}/Z_{t})]d(j_{t}) \] \( \ldots \) import replacement

\[ [- p_{t}^{x}(W_{t}/Z_{t})]dx_{t} \] \( \ldots \) export penetration

\[ [+ \varepsilon] \] \( \ldots \) interaction effects and adding-up errors.

2). Lists of countries whose real GDP growth calculated for economic growth

30 selected LDCs: Argentina, Bangladesh, Benin, Bolivia, Botswana, Brazil, Chile, China, Colombia, Dominica, Ecuador, Egypt, Arab Rep.El, Salvador, Honduras, India, Indonesia, Israel, Korea, Rep., Madagascar, Malawi, Malaysia, Mexico, Morocco, Pakistan, Paraguay, Peru, Philippines, Senegal, Sri Lanka, Sudan, Tanzania, Thailand, Turkey, Uruguay, Venezuela, RB, and Zambia.

Sub-Saharan Africa: Angola, Benin, Botswana, Burundi, Cameroon, Cape Verde Is., Central Africa., Chad, Congo, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-

**Central America and Caribbean:** Barbados, Costa Rica, Dominican Rep., El Salvador, Guatemala, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Trinidad and Tobago.

**East Asia without Japan:** Hong Kong, Korea, South(R), Malaysia, Philippines, Singapore, Taiwan, Thailand, Fiji and Papua N. Guinea.

**South Asia:** Afghanistan, Bangladesh, Burma(Myanmar), India, Nepal, Pakistan and Sri Lanka.

**Western Europe:** Austria, Belgium, Cyprus, Denmark, Finland, France, West Germany, Greece, Iceland, Ireland, Italy, Netherlands, Norway, Luxembourg, Portugal, Spain, Sweden, Switzerland and UK.

**Latin America:** Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Paraguay, Peru, Surinam, Uruguay and Venezuela

**ASEAN:** Malaysia, Philippines, Singapore and Thailand.

**ENDNOTES**

1. See Appendix 1, The Derivation and description of Bach’s Model.
2. See appendix 2.
3. Note: GDP growth rate in average 1961-91; number of observations: 31; ‘*’ denotes significant real GDP growth correlation.
5. All expressed as percentage of GDP;
   • Negative sign denotes favorable shocks--reduced current account deficits;
   • Positive sign denotes unfavorable shocks-- increased current account deficits.
6. LDCs were sorted by reduced current-accout deficits followed by ranking the mean for each measure of policy responses.
7. The criterion of 3% used for classifications are arbitrary to have sufficient number of countries in each subset.
8. The first two components of the Bacha's equation (equation 11) reported in Avila and Bacha's paper (1987, PP 179,) were
   • \( d(D/Y_i) = j_i*C_i/Z_i*d(r_i^w) - x_i*Z_i*d(r_i^f) \)

**REFERENCES**


Heston and Summers, 1993, *Penn-World Table (Mark 5.5)*, University of Pennsylvania.


