



Trade policy reform

Chapter 5, in reviewing the experience of today's developing countries, concluded that rapid economic growth and efficient industrialization are more likely to be achieved by outward-oriented trade strategies than inward-oriented ones. In the light of that evidence, it is not surprising to find increasing disenchantment with the inward-oriented approach and greater interest in trade policy reforms that increase the degree of neutrality in trade regimes and lead to competitive exchange rates. Yet the number of countries which have experimented seriously with trade reform is limited, and—until recently, at least—relatively little attention has been paid to the lessons to be drawn from their experience (see Box 6.1).

Few of the developing economies which adopted such reforms sustained them for any length of time. Greece, Spain, Israel, and the Republic of Korea were among the first to embark on trade policy reform; today, they all have relatively outward-oriented regimes. Singapore and Hong Kong have, of course, inherited open trading regimes from their status as trading ports. Chile (in the mid-1970s) and Turkey (in 1980) adopted reforms more recently—they were particularly ambitious in Chile's case—but they have not yet stood the test of time.

Elsewhere, trade reform has been spasmodic. For instance, Pakistan undertook halting and limited reforms starting in the early 1960s. Somewhat more ambitious attempts by Yugoslavia (also starting in the early 1960s), Brazil (in the later 1960s), and Argentina (from the mid-1970s) have since been reversed.

This limited progress reflects a number of problems—real or perceived—in the transition

from inward to outward orientation. The transition means that some activities become more profitable and others less so. Often it is protected manufacturing activities whose profitability is most threatened. The more inward-oriented the original policies, the greater these shifts—and the costs associated with them—will be. The pattern of transition may need to be designed to suit specific national situations.

- The more rapid and fundamental the policy changes, the greater the immediate benefits to the economy. But there is also a greater likelihood that more people will face transitional costs as workers are displaced from old jobs and firms abandon old activities.

- As some activities or occupations become less remunerative, resistance to policy change will emerge. Those who are threatened will use political means to obstruct reform.

- Trade policy reform is closely related to reform of other economic policies. In particular, the exchange rate and the way domestic inflation affects it in real terms are crucial to competitiveness in import-replacing and export activities. In turn these are influenced by domestic fiscal, monetary, and credit policies and by policies affecting capital flows.

All these problems of transition make the design of policy reform important. How can policies best be selected, phased, and sequenced to gain the benefits of reform as quickly as possible while minimizing transitional costs and political resistance? The second half of this chapter tries to answer this question. First, to put the issues in perspective, the chapter reviews the experience of trade liberalization around the world.

Box 6.1 Studying the process of trade liberalization

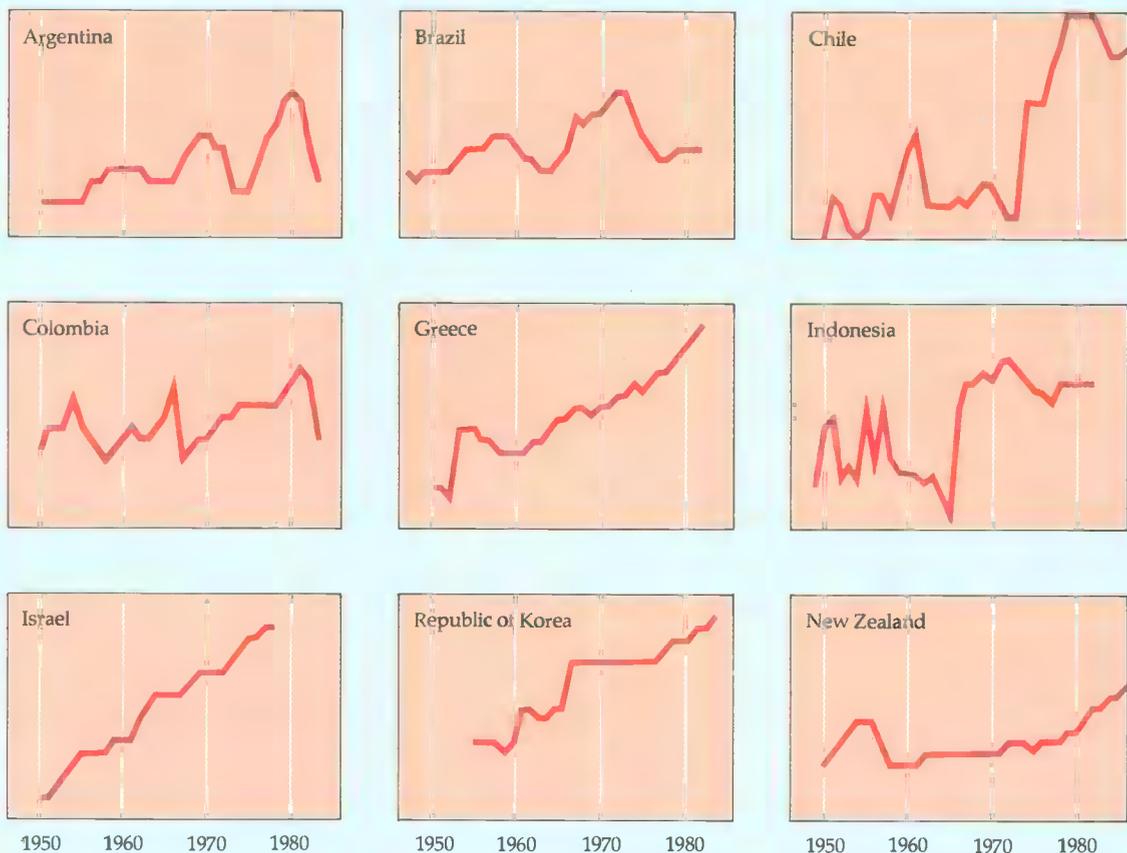
There is an extensive literature comparing policies and performance in outward- and inward-oriented economies, but until recently less attention has been paid to the transition from the one to the other. One multicountry study of foreign trade regimes and economic development looked at the relationship between liberalization and economic stabilization (Krueger 1978). In recent years several multicountry research projects have tried to deal with trade liberalization more directly. One of these is a World Bank project that looks at the experience of liberalization with stabilization in the Southern Cone—Argentina, Chile, and Uruguay (*World Development* 1985).

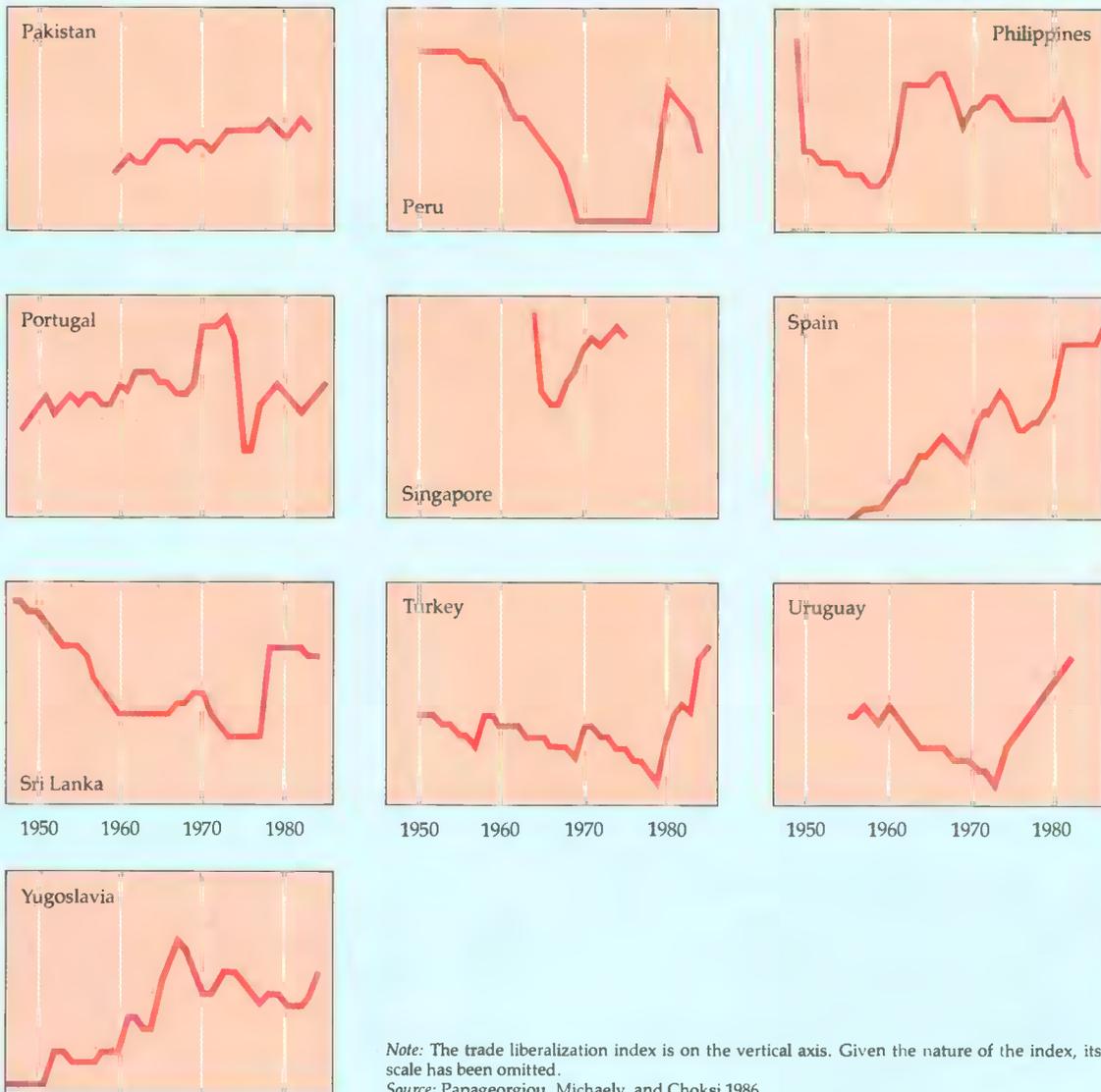
Another project is under way at the World Bank on

the timing and sequencing of trade liberalization policies (Papageorgiou, Michaely, and Choksi 1986). Thirty-seven episodes of liberalization in nineteen countries have been studied. The research is asking such questions as: Should the switch from quantitative restrictions to tariffs, say, or the direct promotion of exports be undertaken as separate stages of trade liberalization? What national and international conditions affect the chances of success? How do other policies affect trade liberalization?

In this study trade liberalization has two meanings: first, a reduction in the levels and dispersion of rates of protection and, second, a change in the *form* of protection from quantitative restrictions to tariffs. In any

Box figure 6.1 Trade liberalization indexes for selected countries, 1946–86





given episode of liberalization, these two elements often appear together; occasionally, they may be in conflict.

As part of the research, a synthetic measure of changes in trade policy over time—the trade liberalization index—was established for each of the countries studied. In the indexes reported in Box figure 6.1 the vertical axis represents a synthetic measure of increasing trade liberalization: the more the curve rises, the

fewer the trade restrictions. The indexes reflect judgments by different authors, based on quantitative indicators, such as the degree of antiexport bias and nontariff protection, and qualitative information about the trade regimes. Thus, the index is strictly ordinal, meaningful only in a comparison within one country over time; it cannot be used to compare the degree of trade liberalization across countries.

The diversity of country experience

The modern trend toward trade liberalization got under way in Western Europe in the late 1940s. It was encouraged by treaty obligations under the General Agreement on Tariffs and Trade (GATT) as well as by such arrangements as the European Payments Union of 1949—underwritten by U.S. aid under the Marshall Plan—and the European Economic Community established in 1958. A series of GATT-sponsored tariff-cutting rounds, as well as the expansion of various preferential trading arrangements within Western Europe, continued the process of trade liberalization. In spite of increasing protection in agriculture and in spite of the new protectionism against exports from developing countries (see Chapter 8), the economies of the industrial countries were probably as open by 1980 as they had been at the height of the free trade era before World War I.

Southern Europe and the Mediterranean

Some of the then-developing countries of Southern Europe and the Mediterranean began to liberalize on the coattails of other European countries—Greece, Israel, and Portugal in the 1950s and Spain in the 1960s. The process is not yet complete. It has

suffered a number of temporary reversals, although the entry of some of these countries into the European Community (EC)—Greece in 1981 and Spain and Portugal in 1986—makes it likely that the liberalization will continue, even if their entry may complicate EC trade policy.

A broad pattern emerges for these liberalizing countries. The reforms started when a macroeconomic crisis led the government to stabilize the economy over a relatively short period; the exchange rate was devalued (and the impact of multiple exchange rates reduced); and nontariff barriers were replaced by substantial tariff protection. (See Box 6.2 for a discussion of the relationship between liberalization and stabilization.) The later moves toward neutrality in trade policy—mainly through tariff reduction, but also through export subsidy in some cases—happened over a far longer period. Within that period, each country sequenced its trade reforms differently. Greece took the boldest initial steps, devaluing and abolishing import controls in one go in 1953. Israel, by contrast, started with a series of devaluations in 1952–55, but did not take the step of replacing quantitative restrictions with tariffs until it had enacted a further series of devaluations in 1962–65.

Trade liberalization in these countries was put under great pressure with the onset of interna-

Box 6.2 Trade liberalization and economic stabilization

Economies often follow a certain pattern when controls are used to try to suppress inflation and trade deficits. This has been particularly true of some economies in Latin America. The cycle may start with inflation, which is provoked, as a rule, by government deficits that are financed by the creation of money. Typically, governments then seek to offset this inflation by maintaining the nominal exchange rate—the price of foreign currency in units of domestic currency. Their aim is to hold down the domestic price of imports to dampen inflation. But, as a result, the exchange rate becomes progressively overvalued. At the same time governments may also use price controls or subsidies to hold down prices.

This approach may work in the short term, but it creates other distortions which then require new controls. For instance, the overvaluation of the exchange rate will reduce the supply of exports, while the aggregate excess demand created by inflation will increase the demand for imports. Together these may result in a balance of payments crisis, followed by the introduc-

tion of tighter direct controls on imports. The external deficit will have to be financed by extra borrowing, and so debt builds up. Price controls, meanwhile, will either increase the budget deficit (if they are sustained through subsidies) or simply reduce the incentive to produce.

In these extreme circumstances governments are faced with the need to act on several fronts. For the short term they need to stabilize the economy, usually through a combination of devaluation and deflation. To improve resource allocation they also need to ease the various controls. The reform of trade policy is, like the liberalization of labor and financial markets, part of this broader economic program.

It is virtually impossible to sustain trade reform in an economy facing a stabilization crisis. On the one hand, inflation leads to a progressive overvaluation of the exchange rate, which increases the bias against exporting; on the other, inflation distorts relative prices and makes them unpredictable. Yet an atmosphere of crisis has sometimes been the political stimulus for reform.

Figure 6.1 Major economic liberalization policies in the Republic of Korea, 1959–83



tional recession in the 1970s. Recession and shocks in the terms of trade led to expanding public sector deficits, inflation, and growing balance of payments problems. At first governments were unwilling to consider devaluation. Trade liberalization may have survived, in some cases, only because of commitments to the European Community. Another Mediterranean country, Turkey, followed a more inward-oriented strategy for a long time even though, like Greece, it had an association agreement with the EC. In recent years Turkey has embarked on ambitious economic reforms, including trade policy reform, with positive results.

East Asia

In the 1960s a few East Asian economies responded to the market opportunities offered by economic growth in the industrial countries (and in some cases to the opportunities for foreign direct investment from these countries) by embarking on an aggressive export-oriented strategy. Hong Kong had been following such a strategy since the 1950s. Singapore—another city-state that had grown up on trading activities—had initially taken a different direction, protecting its domestic market in a short-lived arrangement with Malaysia

Figure 6.2 Evolution of trade incentives in Korea, 1958–84



in 1963–65. But by the early 1970s it had returned to a strategy of low protection.

The Republic of Korea has pursued an export-promoting strategy that combines trade liberalization with considerable intervention (see Figures 6.1 and 6.2). Introduced in the late 1950s, export incentives were ineffective at first because of import protection and the overvaluation of the exchange rate. In the early 1960s the government abandoned multiple exchange rates, and in 1964 it devalued the currency substantially. This enabled it to cut its direct export subsidies. The government stabilized the economy and liberalized the domestic financial markets in 1965 and then reduced price controls. The reforms that started in 1964 led to strong growth in exports—but this was also partly due to the fact that import protection was at the outset not as heavy as in many other developing countries. In 1967 the government

switched its import control system from a list of goods that could be imported to the more liberal device of a list of goods that could not be. Starting in 1978 it made further cuts in quantitative restrictions and tariffs.

From early on, incentives were more neutral—between import substitution and exports—in Korea than in most other developing countries. On the import side, Korea’s liberalization has been slow. Another feature was the stability of the real exchange rate. (The real exchange rate is the nominal rate corrected for inflation in domestic prices relative to inflation in world prices; see Box 6.3.) This reflected the government’s emphasis on maintaining export competitiveness in spite of persistent inflation. There has been almost no visible cost of adjustment in this rapidly growing economy. This in turn has helped to make further trade liberalization feasible.

Korea’s trade liberalization remains limited in several respects: selective import controls are still significant (although they are being phased out), controls on the domestic financial market remain, and there has been little liberalization of the capital account.

Several other countries in the region have successfully promoted manufactured exports, but in some cases this success has been limited by incentives that continue to encourage import substitution. In the Philippines, for instance, a substantial volume of nontraditional exports developed in the 1970s. That would have been much harder to achieve if not for a large initial devaluation of the currency and the maintenance of a stable exchange rate thereafter. In addition, bonded warehouses and free trade zones partially offset the continuing high levels of import protection. Nontraditional exporting has remained an enclave activity with little impact on the rest of the economy. Most of this activity involves the assembly of imported pre-cut garments and electronic components. As a result, the net foreign exchange earnings of nontraditional exports are far lower than their gross value.

Latin America

For decades many of the Latin American economies suffered large fiscal deficits, balance of payments problems, runaway inflation, and distorted financial systems. The depression of the 1930s and the enforced self-reliance of World War II gave an impetus to import substitution. This became the region’s dominant industrial strategy in the 1950s.

Several limited experiments in stabilization and

Box 6.3 The real exchange rate

When domestic inflation is higher than world inflation, a country must devalue its currency if it wishes its prices to remain competitive abroad. When the devaluation exactly offsets the inflation differential, the *real exchange rate* is said to remain constant.

The real exchange rate is an index of relative domestic and world prices expressed in terms of a common currency (that is, the index of the number of units of domestic currency per unit of foreign currency multiplied by the ratio of a domestic price index to a foreign price index). Thus, when the real exchange rate is rising over time it is said to *appreciate*, and when it is falling it is said to *depreciate*. (Many analysts calculate the index inversely, with the foreign price series in the numerator and the domestic in the denominator. The coexistence of the two conventions can be confusing. The convention adopted here has the merit of consistency—appreciations go up, and depreciations go down.)

There are two main variants of the real exchange rate. The older variant is the “purchasing power parity” real exchange rate. This compares the domestic price of a representative basket of goods and services with the price of the same basket at world prices converted into local currency. It is, in effect, a measure of overall competitiveness. It can be approximated by comparing changes in consumer prices or changes in labor costs. It does not distinguish between traded and nontraded goods, because it implicitly assumes that their prices move together.

The other variant, which has recently come to be emphasized, compares the price of *nontradables* in the national economy (typically services and labor, whose prices can be proxied by the GDP deflator) with world

prices for *tradables* (foreign wholesale price indexes, for instance, or the import and export price indexes for the national economy). For a small country that cannot affect the world price of traded goods, this variant provides a measure of the changing incentives to move in and out of production and consumption of nontradable and tradable goods. For instance, a depreciating real exchange rate raises the relative price of tradables, encouraging more production and less consumption of import substitutes and exports. This is the interpretation that is most useful to bear in mind when looking at the effect of changing trade and macroeconomic policies on the structure of incentives and on the current account of the balance of payments.

The two variants do not necessarily move together. This may be important, particularly for economies with quantitative restrictions, which break the link between changes in the foreign prices and domestic prices of traded goods. Goods subject to quantitative restrictions become nontraded goods, whose domestic price is set by domestic supply and demand.

In practice, there are problems of measurement. Few published indexes of domestic prices correspond to baskets of either tradable or nontradable goods. There are also weighting problems in constructing an index of foreign prices. So real exchange rates calculated using different statistical series fail to move in tandem.

Excessive variability in the real exchange rate increases risk and therefore discourages investment and production. Frequent adjustments in the nominal exchange rate (if inflation persists), stable macroeconomic policy (implying a stable rate of domestic inflation), and few quantitative restrictions on imports all promote stability in the real exchange rate.

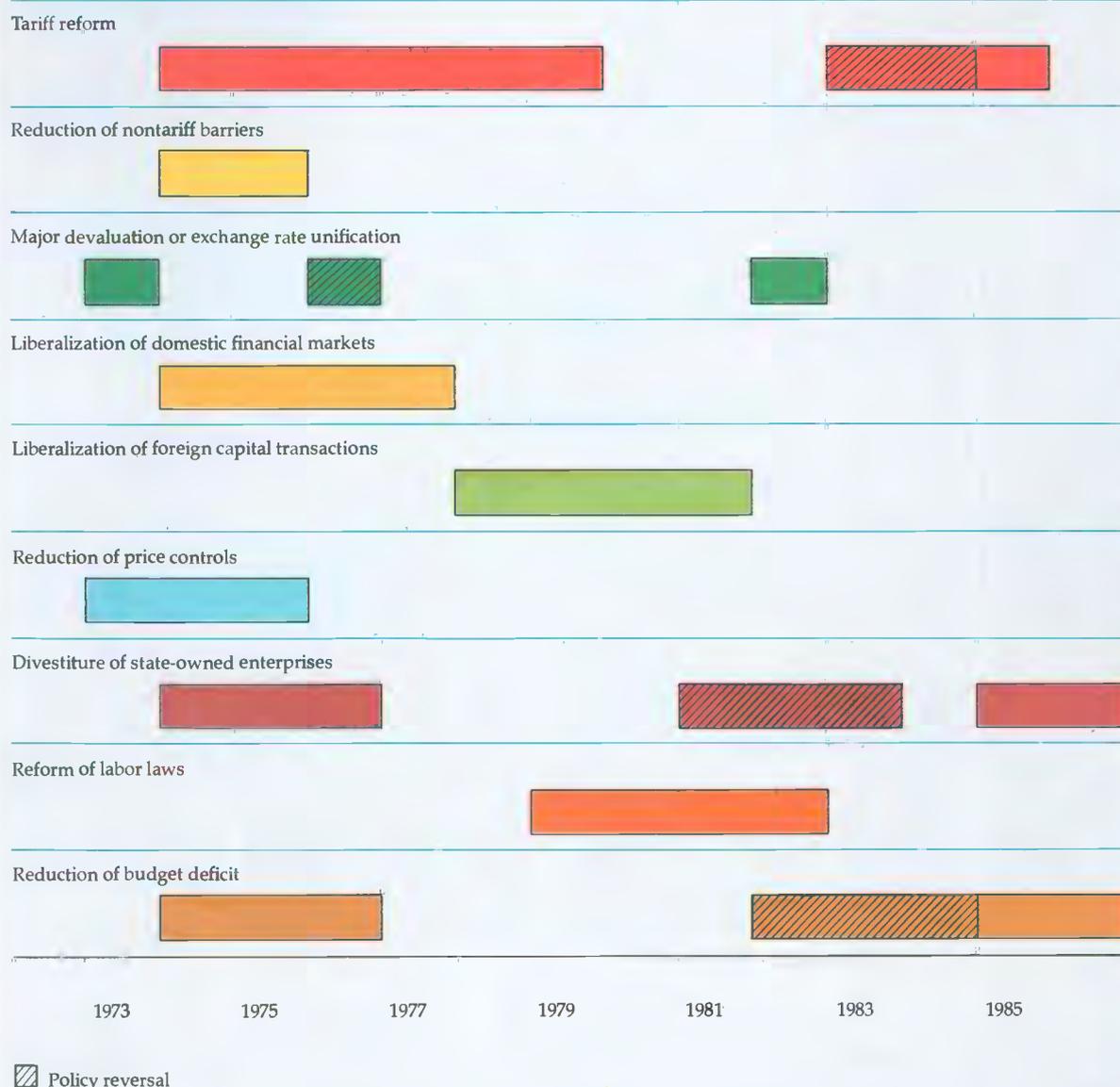
liberalization were carried out in the 1960s, notably in Brazil and Chile from 1964 and in Colombia from 1967. These countries adopted more realistic exchange rate policies—partly through domestic stabilization efforts—and tried to reduce the bias against manufactured exports. They made less progress, however, in reducing import protection. Brazil and Colombia—whose reforms were more extensive than Chile’s—saw much improved export performance.

The most significant experiments in trade liberalization in the 1970s took place in the countries of the Southern Cone of Latin America: Argentina, Chile, and Uruguay. These countries tried to stabilize and liberalize their highly controlled economies against an international background of recess-

sion, inflation, declining terms of trade, and the volatile capital flows which helped to provoke the international debt crisis of the 1980s. New governments came to power in the mid-1970s in all three countries and designed far-reaching liberalization programs. These radical reforms were undertaken in the face of entrenched political opposition to economic reform, which had grown out of the failure of several earlier attempts.

All three countries carried out an initial stabilization program of reduced public expenditure and devaluation, together with a program of economic liberalization measures which included removing quantitative restrictions, cutting the highest tariffs, reducing price controls, and reforming the financial system. But important differences in the em-

Figure 6.3 Major economic liberalization policies in Chile, 1972–86



Source: Adapted from de la Cuadra and Hachette 1987.

phasis and sequencing of policies in the three countries contributed to different outcomes for the three experiments. Chile attached great importance to a radical reform of trade policy, and this reform was achieved before the liberalization of capital account transactions. Argentina and Uruguay liberalized the capital account comparatively early and made less progress in reducing protec-

tion. In the early 1980s all three countries faced severe economic crises that were the result partly of international conditions but largely of their own mistakes, particularly in pursuing policies that encouraged a real appreciation of the exchange rate. Chile, whose trade reforms survived the crisis, and Argentina, whose reforms did not, provide an instructive contrast.

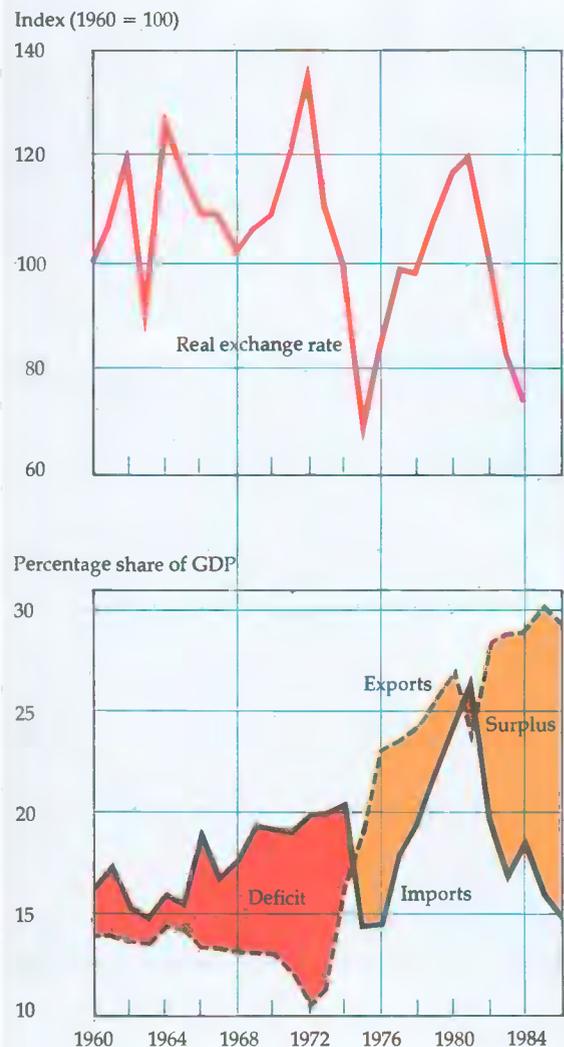
Chile's trade liberalization was unprecedented for its speed and breadth. Trade reforms followed in the immediate wake of other major reforms (see Figure 6.3). These included the virtual elimination of a large budget deficit (starting in 1974); the elimination of multiple exchange rates (between 1973 and 1976); a large real devaluation (in 1973), followed by the adoption of a crawling peg exchange rate; the removal of price controls (from 1973); divestiture of public enterprises (from 1974); and liberalization of domestic financial markets (from 1974). In 1974–75 the government removed quantitative restrictions on imports. It had already started to introduce a series of progressively more liberal tariff reforms, and by 1979 it had achieved a uniform tariff of 10 percent. Exports were neither taxed nor subsidized (although an import duty without a corresponding export subsidy is equivalent to a tax on exports).

Inflation, although much reduced, still persisted after the stabilization, and the government began in 1976 to use the exchange rate in its fight against inflation. Its use of the exchange rate became more systematic from 1978 on when it adopted a crawling peg exchange rate that entailed a series of pre-announced nominal devaluations at less than the differential between domestic and international rates of inflation. This system, intended to fight inflation expectations, in fact contributed, with the continued indexation of wages and the lifting of controls on capital inflows, to a gradual *appreciation* of the real exchange rate. This eroded much of the substantial real depreciation that had occurred since 1973 (see Figure 6.4). Nonetheless, the real exchange rate in the years following 1974 was on average far more favorable to the production of tradables than that for the decade preceding 1973.

After a recession in 1975—the result of stabilization measures adopted since 1973 and an adverse movement in the terms of trade from 1974—the economy responded clearly to liberalization. From 1976 to 1981 GDP grew by 8 percent a year. Trade grew even faster—exports after 1973 and imports after 1976—until the beginning of the 1980s, by which time the effects of the real appreciation of the peso were being felt in earnest (Figure 6.4). In the 1970s Chile began to send new products abroad—for example, fruits, vegetables, and forestry products. Its share in world exports grew, although this was also helped by favorable international markets for its nontraditional products until the beginning of the 1980s.

Chile's unemployment rate increased to 10 percent in 1974. The 1975 recession helped make the

Figure 6.4 Real exchange rate, imports, and exports in Chile, 1960–86



Note: A rise in the index of the real exchange rate indicates an appreciation, and a fall indicates a depreciation.

rate higher, and it remained high (between 13 and 17 percent) for the rest of the decade. Effective import barriers came down significantly only after 1976. According to one estimate, trade liberalization in isolation did not lead to net job displacement: lower import protection cut employment in manufacturing, but this was offset by employment gains caused by trade liberalization elsewhere in the economy, particularly agriculture. Jobs were lost as firms went out of business or were taken

Box 6.4 Sri Lanka: the 1977 trade liberalization

Sri Lanka's United National Party came to power in 1977 with a large majority and a commitment to reintegrate Sri Lanka with the world economy after more than a decade and a half of heavy protectionism. The government saw trade reform as the only way out of the country's economic trouble. It hoped that liberalization would quickly raise employment and improve the supply of goods to meet the widespread shortages. It also hoped that trade reform would help the country attract external assistance.

The government replaced most of the quantitative restrictions with tariffs. The new tariff structure had six bands, with rates varying between zero on essential consumer goods (rice, flour, and drugs) and 500 percent on luxuries. The exchange rate was devalued by 46 percent against the dollar, and the prevailing dual exchange rates were unified at the new rate. The reforms removed a wide range of domestic price controls. Food subsidies were reduced and targeted at the poor. Licensing requirements were relaxed, and repatriation of profits was allowed in order to encourage direct investment from private foreign sources.

By most standards the two years following the liberalization were successful. The economy rebounded with GDP growth rates of 5.7 and 6.4 percent in 1978 and 1979, respectively, and continued to grow at 5.8 percent in 1980 (see Box figure 6.4). GDP growth averaged 5.2 percent a year from 1978 to 1985, against 3.8 percent from 1970 to 1977. Growth was spread across nearly all sectors of the economy. By 1983 the unemployment rate had fallen by half, to 12 percent of the labor force.

Merchandise exports (excluding petroleum products)

increased from \$0.7 billion (constant 1960 prices) in 1977 to \$1.1 billion in 1984. Manufacturing output grew quickly (by 7.8 percent in 1978), and capacity utilization in manufacturing increased from 54 percent in 1974 to 74 percent in 1981. During the initial stage of reform, the economy's capital-output ratio declined and its output-labor ratio increased: this points to an improvement in the allocation of resources. Labor also began to replace capital in the medium term.

These early successes stemmed from, first, the shift from quotas to tariffs (which increased the availability of raw material inputs); second, capacity increases that led to higher employment; and third, an expansion in the production of tradable goods (compared with nontradables) brought on by the depreciation of the real exchange rate.

By 1980 the program's initial successes were beginning to wane because of poor macroeconomic management and deteriorating external conditions. Liberalization was partly reversed by a massive increase in domestic aggregate demand, thanks to a rapid expansion of public investment. Financed by foreign borrowing, this increased the demand for domestic goods, which caused the inflation rate to rise and the real exchange rate to appreciate.

Abroad, the hike in oil prices in 1979 triggered a world recession. This reduced the demand for Sri Lanka's exports and worsened the terms of trade. External events and the appreciation of the real exchange rate combined to squeeze the export sector. Only in late 1984 did the government make efforts to get back onto the path of trade policy reform.

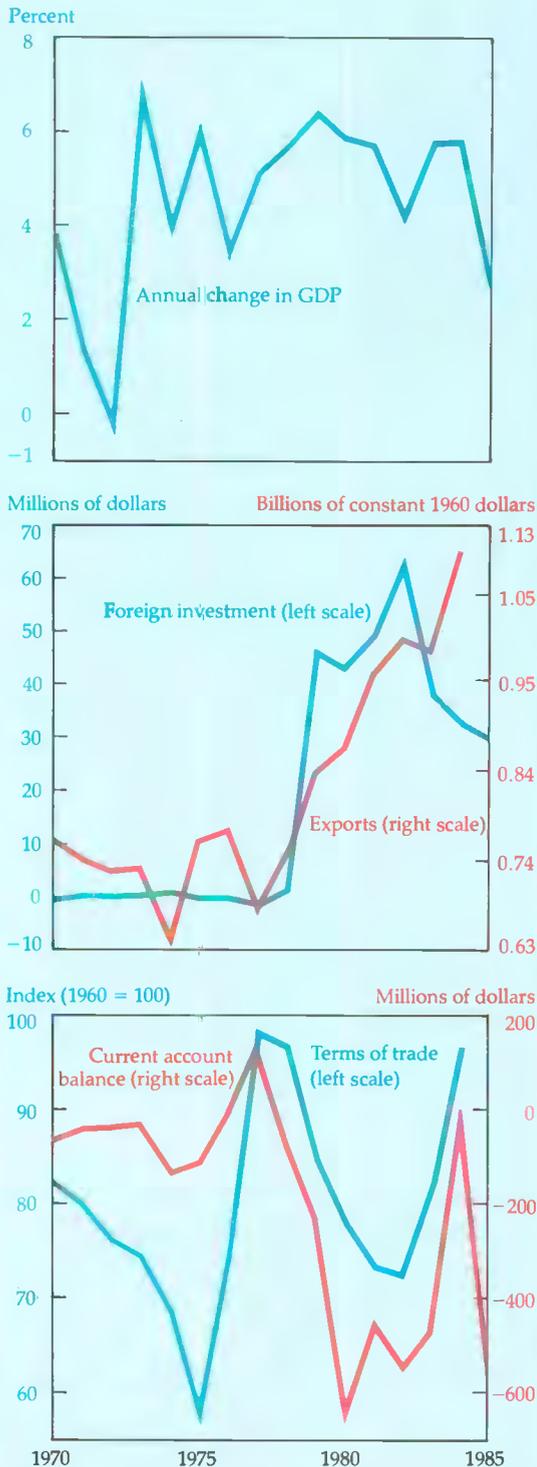
over; other firms survived by achieving large gains in productivity. This rationalization was achieved with little additional investment.

An exchange rate policy that led to real appreciation, post-1977 measures to liberalize exchange controls, and high domestic interest rates all contributed to heavy borrowing from abroad. The peso's appreciation was particularly marked from 1979 to 1981. Exports became uncompetitive, and the trade deficit soared. By late 1981 a domestic recession was setting in, and in 1982 the peso was substantially devalued. The recession was so deep that unemployment reached 25 percent (in June 1982), and the financial sector was virtually bankrupted. The uniform import tariff was raised to 35 percent in 1984, but came down to 20 percent in 1985. Thus trade reform survived the crisis, and

the rationalization it had fostered left Chile's industrial sector in a far stronger position to withstand the shocks of the 1980s. In recent years the economy has grown strongly, and unemployment has come down to under 10 percent. Economic liberalization clearly contributed to this recovery.

Argentina acted with as much speed as Chile in an initial phase of macroeconomic stabilization in 1976. The new government devalued the currency and dismantled its multiple exchange rates. The government also attacked the budget deficit, but was never able to reduce it below 6 percent of GDP. From 1976 the government began to liberalize the capital account, and from 1977 it embarked on a series of domestic financial reforms. Its trade policy reforms were, however, far more limited than Chile's. In 1976-78 export taxes were substan-

Box figure 6.4 Trade liberalization and economic performance in Sri Lanka, 1970–85



tially reduced from their average level of 50 percent. Quantitative restrictions on imports were replaced with tariffs, and some of the highest tariffs were cut. But, on average, tariffs remained high and protective. A program of further reductions was announced in 1978.

Argentina compromised its trade liberalization from the beginning in the way it phased its reforms. The exchange rate was used right from the start as a tool for curbing inflation. By contrast with Chile, the ordering of reforms encouraged an appreciation of the real exchange rate. Traditional exporters responded to the removal of large export taxes, and—since exports were liberalized *before* imports—this helped to fuel expectations of currency appreciation. At the same time, internal financial liberalization resulted in higher interest rates, and external financial liberalization thus attracted foreign capital. The stubbornly high public sector deficit helped push up the interest rate and sucked in more foreign loans.

Around 1979 the situation became critical. The terms of trade deteriorated severely in 1979–80. By 1980 the currency was highly overvalued. This led to an outflow of dollars (in the form of capital and foreign tourist expenditure), which culminated in the inevitable balance of payments crisis, a huge devaluation, an explosion of the budget deficit, raging inflation, and a virtual closing of the economy. Economic liberalization was dead, and trade liberalization was stillborn.

South Asia

South Asian countries have made little attempt to liberalize trade. The region has followed a strategy of import substitution similar to Latin America's. This has created industrial sectors with vested interests in continued protection. The governments of India, Pakistan, and Sri Lanka have also emphasized macroeconomic stability, and the success of their stabilization policies has done much to avoid the economic crises that have been the spur to major trade liberalizations elsewhere. Perhaps the most important attempt at liberalization in South Asia was Sri Lanka's package of reforms in 1977 (see Box 6.4).

Sub-Saharan Africa

It was not until the 1960s that countries in Sub-Saharan Africa began to adopt inward-oriented industrialization strategies. Several countries have recently undertaken adjustment programs which

Box 6.5 Trade policy reform in Sub-Saharan Africa

With independence, many countries in Sub-Saharan Africa saw industrialization as the main route to economic development. Indeed, from 1965 to 1973 the region's industry grew at 14 percent a year and played a leading role in economic progress. But this changed dramatically in the 1970s. Industrial growth slowed to 5 percent a year between 1973 and 1980 and was negative between 1980 and 1985. Industries were plagued by massive excess capacity, and exports remained a small part of output. The sector had consumed a great deal of foreign exchange for little benefit in jobs or output. This rapid decline was part of an overall deterioration of African economies, which included the stagnation of agriculture.

The disappointing performance of manufacturing in Sub-Saharan Africa was the result of several complex factors. Formidable resource constraints, which included a critical shortage of local skills and inadequate infrastructure, combined with inappropriate policies to create high-cost and inefficient manufacturing industries. Among the policies that contributed to this were:

- *Exchange rate policies.* Most African countries maintained overvalued exchange rates. The weighted index of the real effective exchange rate for all Sub-Saharan countries appreciated by 75 percent between 1974 and 1984. (In comparison, the index for Asia depreciated by 26 percent over the same period.) This hurt export profitability and discouraged investment in export industries.

- *Tariffs and quantitative restrictions on imports.* Shortages of foreign exchange, caused by the overvaluation of exchange rates, led governments to restrict imports through tariffs and quantitative restrictions. This protected domestic manufacturers from foreign competition and fostered inefficient local production. Smuggling flourished, aided by a booming black market for foreign exchange. For some industries, smuggling and overvalued exchange rates have in fact led to negative or uncertain protection.

- *Price controls.* Governments controlled the prices of products subject to import controls in order to prevent local manufacturers from making excessively high profits. Where they were effective, price controls merely discouraged domestic production; but often they were ineffective, and black markets emerged for several controlled items (see Chapter 7).

- *Nationalization.* Several countries nationalized foreign or joint ventures, discouraged investment from abroad, and became less hospitable to private domestic investors.

The combination of these policies proved extremely damaging to industrial growth and efficiency. High protection and precious little domestic competition often permitted large profits in protected industries. Technological development languished. With time, industries became less competitive internationally. When oil prices rose in 1979 and the international recession followed, Sub-Saharan countries were plunged into a foreign exchange crisis. Policies intended to cope with this only made matters worse. In recent years firms have been starved of inputs, profits have plummeted, and real wages have fallen in the formal manufacturing sector.

Reforming the exchange rate and trade regimes may not produce an immediate increase in export growth, but such measures will at least improve the efficiency of investment and production.

Since the early 1980s there has been a fundamental shift in the policies of some Sub-Saharan countries. The success of these changes is difficult to judge, since most are recent and several are incomplete. Several countries have substantially devalued their currencies (see Box figure 6.5).

Nigeria made radical policy changes in 1986. It abolished the compulsory surrender of export proceeds and the licensing of imports and introduced a more moderate tariff structure. (Further tariff reforms and the removal of some import bans are yet to come.) The

include elements of trade liberalization—for example, the auctions of foreign exchange in Ghana and Nigeria, the elimination of quantitative restrictions in Mauritius, and tariff reforms in Côte d'Ivoire, Senegal, and Zaire. It is too early to judge the success of these experiments (see Box 6.5).

The transition to more outward-oriented policies

Liberalization means abandoning old activities and adopting new ones. Perhaps the most important and politically sensitive cost in this process is un-

employment. Protected sectors may contract as protection is lowered, which can cause temporary unemployment, especially if certain skills are specific to certain sectors. Other sectors will take time to expand, and workers will need to prepare for and seek out the new jobs. Note that trade liberalization cannot cause *permanent* increases in unemployment. In the long run the level of unemployment depends on macroeconomic policies and the efficiency of the labor market. In the short run, however, resistance to trade policy reform is likely to arise, both from displaced workers and from

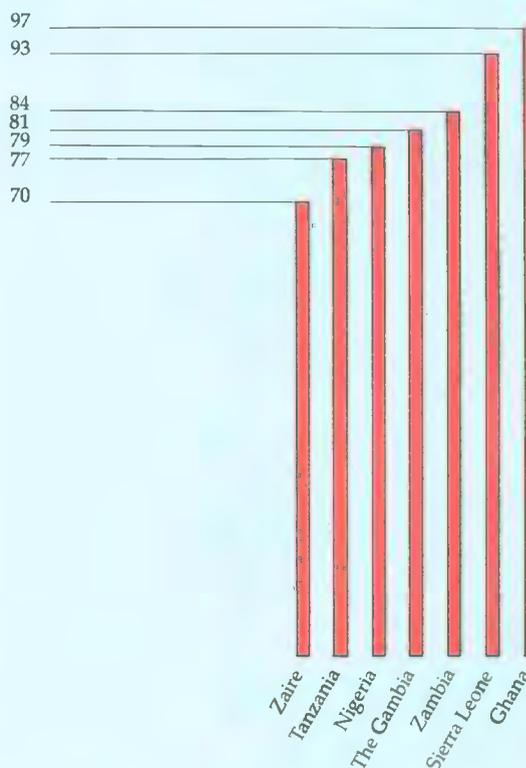
demand for foreign exchange is now largely met by authorized dealers (mainly commercial banks). They purchase the auctioned proceeds of oil exports and foreign loans and buy other foreign exchange earnings directly from their customers. In *Ghana* reform is proceeding almost as rapidly. The government devalued the cedi several times before it began to auction foreign exchange, a practice that is being steadily extended to all merchandise imports. To complement this, the government has taken measures to liberalize imports and promote exports.

Mauritius dismantled its quantitative restrictions on imports within the space of fifteen months. It has since enjoyed an export boom and an economic upsurge. Contributing factors were the recovery in international markets, the promotion of export processing zones, and the country's improved competitiveness after a devaluation and a period of wage restraint. *Zaire's* devaluation in 1983 and its subsequent move to a market-determined exchange rate have already provided a stimulus to exports. These reforms are to be followed by lower import tariffs and the abolition of all export duties and other taxes on manufactured exports. Finally, *Côte d'Ivoire*, *Senegal*, and *Togo* are rationalizing their tariff structures, *Malawi* is promoting exports through better duty rebate systems and improved export credit and insurance facilities, and *Burundi* is eliminating all export taxes on locally manufactured products.

There is ample scope in the rest of Sub-Saharan Africa for trade and exchange rate reform. Such reforms would need to be supported both by other policy changes that allow a greater role for domestic competition and by the provision of adequate infrastructure, skills, and institutional support. With a policy environment conducive to efficient industrial development, there is no reason why the Sub-Saharan countries cannot compete in international markets and benefit from the advantages of international trade.

Box figure 6.5 Currency devaluation in selected Sub-Saharan African countries

(percentage fall against the dollar, September 1983—March 1987)



producers in those sectors which suffer the biggest loss of protection.

Short-term costs

In fact, there is evidence that the unemployment cost of more liberal trade policies may be smaller than commonly supposed. Employment losses are often more concentrated, and hence more visible, than the employment gains which liberalization may spread over the rest of the economy. Gross unemployment—that is, unemployment caused by

discharging labor from the activities which contract because of trade liberalization—has sometimes been substantial. But, as a rule, timely absorption of labor into other activities has helped to prevent large rises in aggregate unemployment. Often there have been relatively few layoffs, even in the sectors which lost their protection. Shifts of labor within sectors—possibly even within individual firms—have been common and have dampened the effect on aggregate unemployment.

After Brazil cut its tariffs in 1967, for instance, there was no apparent increase in unemployment

or business failures. The dramatic dismantling of Indonesia's restrictive import-licensing regime in 1966-67 led to a much improved performance in an economy that had been on the verge of collapse—and there was no rise in unemployment. Sri Lanka's experience in 1977 was similar. A broad dismantling of its highly protective barriers was followed by higher employment, even in the sectors which had seemed to depend most on the trade barriers.

The big exception to this pattern is Chile in the second half of the 1970s. The country's shift from a highly restrictive trade regime to virtually free trade was implemented within five and a half years. One estimate places the manufacturing jobs lost by 1979 owing to trade liberalization at 11-12 percent of the 1974 manufacturing labor force. These losses, however, were offset by liberalization-induced employment gains elsewhere. (The study does not try to account for the rise in unemployment caused by factors other than trade liberalization.)

These generally low transitional costs support the view that even partial liberalizations can open up enough new opportunities to allow the economy to adjust rapidly. Replacing quotas with tariffs is a case in point. In many developing countries controls on foreign exchange transactions are a particularly important form of quota. When access to foreign exchange is controlled, some firms will find it hard to obtain imported supplies; once these controls are removed, efficient firms will be free to buy the inputs they need and new firms may enter. Such effects help to explain why this form of trade liberalization seems to have been especially fruitful.

Popular perceptions of the unemployment problem can be mistaken. Sometimes trade liberalization really has led to unemployment, but the rise was disguised by other developments, and so the public did not connect the rise in unemployment with trade policy. Occasionally, however, unemployment caused in other ways has been blamed on liberalization (as it was in Chile, for instance). In any case, when trade liberalization has been aborted, the reversal has rarely had anything to do with unemployment.

Political sustainability

Historically, the single most important factor providing the spur to trade liberalization has been crisis—either of the country's own making or imposed from outside. Its most common form has

been an economic stabilization crisis springing from excessive budgetary and balance of payments deficits and rising inflation. But history should not be taken as prescription: countries that do not face such crises should grasp the opportunity for reform that stability offers.

To sustain trade liberalization beyond its initial stage, economic and political stability has proved essential. Few governments have been willing to commit themselves to liberal trade policies. One way to make the commitment and to make it credible is to participate in a treaty. In Greece, Israel, Portugal, and Spain the long-term commitment to an economic alliance with the European Community has helped keep the trade regime relatively open compared with other developing countries.

Another way to boost credibility is to act decisively. Hesitant policy which leads to gradual liberalization is much more likely to run out of steam. This is particularly true of countries with a long history of trade restrictions.

In Chile, for instance, a liberalization in 1956-61 had a weak initial impact. It left high import protection in place, provided little incentive to exports, and failed to prevent a real appreciation of the currency. These reforms were quickly reversed. But a second set of reforms, in 1974-81, is still in place thirteen years after its implementation, in spite of minor reversals in 1983-85. The experience of Indonesia is similar. The initial impact of the first episode (1950-51) was weaker than that of the second (1966-72). The first liberalization was short-lived and largely reversed; the second has, with some reversals in the mid-1970s, remained in effect. So even when a first liberalization attempt collapses, a second has a good chance of success if it is boldly done.

A clear shift in policy is important in two ways. First, without it producers may expect the reform to be quickly reversed. This, in turn, can be a self-fulfilling prophecy because, unless the pattern of production changes to take advantage of the new pattern of incentives, the reform may prove unsustainable. Pressure to reverse it will rise as soon as lower protection allows imports to come in without any offsetting rise in exports. Second, a major reform should spur exports appreciably. It will thus create vested interests in support of the new trade regime.

Macroeconomic policy and trade liberalization

One of the clearest lessons from previous trade reforms is the link between trade liberalization and

macroeconomic policy. Many trade reforms have started with a program of stabilization in which inflation has been reduced through the control of public spending and the application of tighter monetary control and the trade deficit has been reduced both by domestic deflation and a substantial devaluation. The devaluation, improving the incentive for both import substitution and exporting, is a vital step in trade policy reform. Indeed, it is probably more important than the way vested interests or the economic costs of transition are handled.

The more ambitious and long-lasting liberalizations—in Portugal, Greece, Spain, Israel, Chile, and Turkey—all started with macroeconomic stabilization. The countries which have tried to liberalize trade in the midst of macroeconomic crisis have failed. The Philippines, for example, embarked on trade policy reform in the early 1980s as inflation, the trade deficit, and foreign debt were all rising rapidly. Attempts at reform were abandoned after a severe balance of payments crisis in 1983. But there was a subsequent stabilization, and the trade liberalization process has now been resumed.

The evidence also stresses the importance of balance of payments equilibrium once trade liberalization is under way. A large deficit involving a substantial loss of foreign exchange reserves is almost sure to undermine trade reform. This happened in the Philippines after the liberalization of the early 1960s, in Argentina and Uruguay after the liberalizations of the 1970s, and elsewhere. By the same token, Pakistan has been cautious in liberalizing trade for fear of its effect on the balance of payments.

The balance of payments can be affected by changes in capital flows or in foreign remittances of labor income and by other factors over which governments have little control. But what seems to matter most for successful liberalization is export performance. Exports too can change exogenously, because of shifts in the terms of trade or fluctuations in crop output because of the weather. The crucial determinant of export performance, however, has been the real exchange rate for exports. Good performance usually goes hand in hand with a depreciation of the real exchange rate and—possibly even more important—with a real exchange rate which is stable in the long run. The real exchange rate, in turn, depends on changes in the nominal exchange rate and in local prices—and hence on fiscal and monetary policy. The experience of the Southern Cone countries has shown that appreciating the real exchange rate to reduce

inflation expectations is inconsistent with maintaining it at a level appropriate for trade liberalization.

FINANCIAL LIBERALIZATION. Efficient capital markets ought to improve economic flexibility and thus facilitate trade liberalization (see Chapter 7). But, again, the real exchange rate complicates the picture. The trade reforms of Argentina and Uruguay were derailed in the early 1980s after abnormally high capital inflows appreciated the real exchange rate. To guard against excessive appreciation, governments may need to monitor capital flows and, where necessary, influence their timing or sterilize them. (See Box 7.4 for a discussion of the role of financial sector reforms in Chile's macroeconomic problems.)

LIBERALIZATION IN OTHER DOMESTIC MARKETS. Governments often maintain substantial controls on labor markets, industrial prices, and industrial investment (through investment licensing or state-owned enterprises, for instance). Maintaining these controls will, as in the case of financial controls, hamper the effects of trade policy reform on resource reallocation. Fortunately, easing these controls is unlikely to influence the real exchange rate as directly as capital market liberalization (see Chapter 7).

The design of trade policy reform

Reform in the conventional instruments of trade policy can be discussed under three headings: replacing quantitative restrictions with tariffs, reforming tariff protection, and the direct promotion of exports.

Replacing quantitative restrictions with tariffs

It is broadly accepted that moving from nontariff barriers to tariffs is a move toward a more open trade policy. This is so for two reasons. First, tariffs are generally less protective than quantitative restrictions (although it is possible to have tariffs set so high that they prohibit imports). Second, a tariff is a price instrument, not a quantity instrument. As a result, tariffs are more "transparent"—changes in foreign prices feed through more readily to the domestic economy. Quotas, by contrast, uncouple national economies from the world economy. For example, in India cotton is protected by quantitative restrictions, and textile producers are required to use Indian cotton. As a result, move-

ments in the price of this crucial raw material are not always related to those of world cotton prices, which determine the cost of this input to competitors. It is therefore difficult for Indian producers to commit themselves to production for export: the conditions under which they have to compete are unpredictable.

In many cases a shift from quotas to tariffs has been a key element in the early stages of trade policy reform. Sometimes it has been the only element. For example, Israel's first and second phases of reform focused on imports and consisted of the gradual removal of quotas and their replacement with tariffs. Greece's first reforms removed almost all quotas and replaced them with tariffs which were for the most part lower than the tariff equivalent of the quotas.

The evidence of similar episodes strongly suggests that this shift in the form of protection was highly beneficial (Box 6.4). Often, not only did the economy's growth speed up following such shifts, but even in the sectors whose protection had been lowered, production increased as firms began to operate in a less restrictive and more transparent regime. This suggests that in an economy in which trade is regulated largely by quantitative restrictions—and this is true for most economies in which trade is severely restricted—a liberalization policy should start with a shift from the use of quotas to the use of tariffs, even if it means very high tariffs.

What level of tariffs is needed to replace any given quantitative restriction? In practice it is difficult to measure the protection from quantitative restrictions. And, even if this could be done with confidence, the switch to tariffs brings about such large changes in the way protection works that the exercise is likely to be pointless. Some countries have sought to replace quantitative restrictions with more or less equivalent tariffs. For example, Sri Lanka replaced quantitative restrictions with high tariffs in 1977, and the Philippines did this in an ad hoc process from 1957 to the mid-1960s (and ended up unintentionally reducing average protection). In Argentina, however, the tariffs used to replace most of the quantitative restrictions in 1976–78 were on average so high that they shut out imports just as effectively.

Reforming tariffs

The movement toward greater neutrality has two dimensions: the lowering of the average level of protection and the reduction in the average disper-

sion, or variance, of protection. If the dispersion of tariffs is not reduced as the tariff average is reduced, the tariff structure may not become more neutral. Indeed, a reform that reduces tariffs on intermediate and capital goods but leaves intact those on final outputs could *increase* effective protection—the level of protection afforded to domestic value added—even though it *reduced* the average level of tariffs.

Of course, it is possible to reduce at the same time both the average level of tariffs and their dispersion. Governments have approached the task in several ways: an equiproportional cut in all tariffs, an equiproportional reduction of the excess of each tariff over some target level, higher proportional reductions of higher tariffs, or some combination of these and other methods. As a rule, simple schemes widely applied work better than case-by-case and fine-tuning methods. Some tariff reforms have attempted to target the effective, rather than the nominal, rate of protection (the Philippine reforms of 1981–85 are one example). This is unnecessarily complicated and may misfire anyway because of measurement problems.

Many economists favor the so-called concertina approach to tariff cutting. First, all tariffs above a certain ceiling are lowered to that ceiling; next, all tariffs above a new, lower ceiling are lowered to that ceiling; and so on. This should yield the lowest adjustment costs without leading to inadvertent increases in effective protection. Chile's tariff reductions in the 1970s more or less followed this scheme.

Lessons about the amount of time necessary to eliminate quantitative restrictions and tariffs are difficult to draw. Some reforms have taken a long time—Korea and the countries of southern Europe, for instance, have still not completed their reforms after at least two decades. Fewer have been completed within the medium term—the process lasted five years in Chile, for example. But none have been fully implemented over the short term. There is no obvious relationship between the length of the period of policy reform and its chances of success. But the apparently low adjustment costs in most trade reforms, together with the danger that lengthier reforms will be less credible, are arguments for faster reform.

Some tariff reforms have used institutions, typically tariff commissions, either to set tariffs on a case-by-case basis or to hear appeals for exceptions to the reforms that have been scheduled. Tariff commissions such as those in Australia, New Zealand, the Philippines, and Sri Lanka have often

approached their task with too many objectives. Their work has probably not contributed to increasing neutrality (see Box 6.6).

Direct promotion of exports

The logic of trade liberalization is that the tariffs should be as low as possible. As long as the aver-

age tariff is not zero, an element of discrimination against exports remains (unless they are equivalently subsidized). Chile's reforms achieved a uniform tariff of 10 percent with no exceptions. Later, this was revised, and Chile ended up with a uniform tariff of 20 percent, which left a mild discrimination against exports, but not enough to prevent export growth. The experience of Brazil and the

Box 6.6 Can governments ease the trade reform process?

Governments are seldom able to bring about economic reform at the stroke of a pen. They first have to overcome the opposition of groups which fear they may be adversely affected.

Transparency and persuasion

There is sometimes a bias in government decisionmaking: pressure groups can noisily voice their narrow interests, but when benefits are spread widely across the community no single group sees that it has much to gain. For example, it is easier to grasp the costs of closing down an inefficient car manufacturing plant than to see the benefits of cheaper cars and employment opportunities spread across the rest of the economy.

Another bias can arise when governments, to accommodate tensions between a sectional interest and the public interest, pass laws so vague that they appear to satisfy both. The law must then be implemented by administrative decision, and the special interest groups will attempt to influence the relevant administrators.

One way to promote public understanding of the public interest is to set up a "transparency" agency whose job would be to provide an overview of government intervention. The aim would be to help the government and the public see sectoral proposals in an economywide framework. Tariff commissions, established in such countries as Australia, Canada, New Zealand, the Philippines, Sri Lanka, and the United States, are intended to carry out this role, but the results have been mixed. The commissions have often spent much of their time working on highly technical questions such as whether an industry has suffered "damage" or "injury," whether it can be attributed to imports, and whether these imports are unfair in some sense.

Transparency agencies can, in fact, claim some real successes, but the problems they face should not be underestimated. On top of the sheer difficulty of predicting the future, governments are always under pressure to mute their role by diluting their terms of reference.

A possible defense against this kind of pressure would be to make full review a legislative requirement.

With sufficient independence and investigative powers a transparency agency could influence other branches of the bureaucracy. A bipartisan agreement that such review would be mandatory could serve as a kind of legislative constraint on government.

Safeguards and compensation

A government trying to convince the public that a certain reform will proceed smoothly might tip the scales by offering guarantees against disruption. These might include strengthened antidumping provisions (a safeguard measure) or additional income support for those who stand to lose (a compensation measure).

Unfortunately, the experience with safeguard measures is not encouraging. In practice, the search for safeguards has become a complicated process which is carried along by its own momentum and has precious little to do with economic efficiency. For example, a recent antidumping case in Australia dealt with cherries in brine from Italy. It turned on the appropriate valuation to be attached to the drums in which these cherries were packed for shipment. It seems that "dumping" could be "proved" if the drums were valued at their price when new—but if, as turned out to be the case, some drums were secondhand, then dumping could be not proved.

Compensation measures are an alternative approach, but they too have had many defects. The costs of identifying winners and losers are very large. This is because of the practical difficulties of sorting out policy changes and their impacts—people win and lose for all sorts of economic reasons, and it is seldom possible to be sure of the cost inflicted on a particular group by any given policy. Compensation measures also create "moral hazard," in which people are given incentives to behave inefficiently to qualify for compensation.

Buying off pressure groups differs from straightforward compensation—at least in principle. It is a way of overcoming obstacles to change in an overtly political way. Even with this more limited objective, however, the record is discouraging. Far from softening resistance to change, this approach merely channels protest into pressure on governments about who should get the most compensation.

Philippines shows that export growth can be achieved in the presence of significant import protection, as long as governments can prevent the real exchange rate from appreciating.

Where significant import protection remains, governments might consider offsetting the discrimination against exports with administrative measures to provide imported inputs at world prices or with subsidies. Directly promoting exports in this way may also help to form a constituency for continued protection. But it may come to be seen as a long-term alternative to further import liberalization. This appears to have been the case in Pakistan and, in the 1970s at least, in the Philippines.

Direct export promotion is a difficult alternative to cuts in import protection. It raises administrative problems and often requires significant budgetary resources. Like any other selective intervention, it will also encourage rent seeking. Above all, the risk of GATT disputes and of countervailing duties in importing countries has made direct export promotion increasingly unattractive.

The lessons of trade liberalization

Trade policy reform is complicated. It is closely linked to liberalization in capital, labor, and domestic product markets and to macroeconomic policy. It is partly a political process, in which credibility and expectations play an important role. Feasible policy choices may differ from country to country, and reform may be vulnerable to changes

in the international environment. Because of this complexity, there is no single optimal path to reform. But there are, nonetheless, lessons to be drawn from previous attempts.

- Trade liberalization must involve large shifts of resources, but it has not always raised unemployment by as much as is commonly supposed.

- Strong and decisive reforms have carried greater credibility and have been better sustained than more timid reforms.

- Replacing quantitative restrictions with tariffs is a useful first stage of trade liberalization.

- Providing a realistic real exchange rate is vital to the successful introduction of trade reform. Keeping it stable is essential if the reform is to be sustained. All this requires a macroeconomic policy that manages inflation and the nominal exchange rate so as to keep domestic costs in line with world prices.

- The scope for successful trade liberalization depends on complementary reforms in the domestic economy—especially in financial and labor markets. (These issues are explored further in Chapter 7.)

Trade liberalization—like any major economic reform—is not easy. Above all, it requires a strong political commitment, most likely in the face of resistance from those who, in the short term at least, stand to lose. It is to be hoped that this commitment will come more easily as the evidence mounts that trade policy reform will quickly bring benefits at a lower cost than policymakers have sometimes feared.