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STRENGTHENING TRADE POLICY REFORM

Volume II: Full Report

Attached is a report entitled "Strengthening Trade Policy Reform - Volume II: Full Report". This report and "Volume I: Main Findings and Conclusions" (SecM89-1454) will be considered at a Seminar of the Executive Directors to be held on Tuesday, December 5, 1989.

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STRENGTHENING TRADE POLICY REFORM

Volume II: The Full Report

**Trade Policy Division
Country Economics Department
Development Economics
Policy, Planning, and Research**

November 1989

Volume II: The Full Report

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ABBREVIATIONS

ASEAN	-	Association of Southeast Asian Nations
CACM	-	Central American Common Market
CFA	-	Communauté Financière Africaine
cif	-	Cost, insurance, and freight
CMEA	-	Council for Mutual Economic Aid
COMTRADE	-	Commodity trade
EC	-	European Community
ECOWAS	-	Economic Community of West African States
ERP	-	Effective rate of protection
FDI	-	Foreign direct investment
fob	-	Free on board
GATT	-	General Agreement on Tariffs and Trade
GDP	-	Gross domestic product
GNFS	-	Goods and nonfactor services
GNP	-	Gross national product
GSP	-	Generalized System of Preferences
IBRD	-	International Bank for Reconstruction and Development
IDA	-	International Development Association
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
ITC	-	International Trade Centre
MFA	-	Multifibre Arrangement
MUV	-	Manufacturing unit value
NBER	-	National Bureau of Economic Research
NRP	-	Nominal rate of protection
NTB	-	Nontariff barrier
OECD	-	Organization for Economic Cooperation and Development
QRs	-	Quantitative restrictions
RCD	-	Regional Cooperation and Development
RER	-	Real exchange rate
SAL	-	Structural adjustment loan
SDR	-	Special drawing rights
SECAL	-	Sector adjustment loan
SITC	-	Standard international trade classification
TFP	-	Total factor productivity
UDEAC	-	Union Douanière et Economique d'Afrique Centrale
UNCTAD	-	United Nations Conference on Trade and Development
UNDP	-	United Nations Development Program
VAT	-	Value added tax
WPI	-	Wholesale price index

1 FRAMEWORK FOR CURRENT TRADE POLICY ISSUES

Summary and Conclusions

1.01 In responding to the economic difficulties of the 1980s, many developing countries have undertaken trade policy reforms as part of structural adjustment. Trade policy reforms, encompassing exchange rate and commercial policies, were intended to make the economies more open and internationally competitive. A shift in incentives toward tradables was expected from trade reforms, leading to improvements in resource allocation, the generation of foreign exchange, and a rekindling of economic growth. Adjustment lending has supported trade policy reforms in a large number of countries. It has provided balance of payments financing on the grounds that in the short term imports would expand more than exports as a result of trade reforms. This chapter clarifies and assesses the nature of the benefits to be gained from trade policy reforms.

1.02 Strategies for a greater outward orientation usually call for a reduction in economic distortions and the bias against tradables they create. This reduction is achievable by reducing import protection, by raising export incentives, or by doing both. Successful approaches have included reforms involving a somewhat interventionist but relatively neutral policy to reforms entailing substantial liberalization. On one side, priority was given to policies for an "appropriate" real exchange rate and the development of exports (the Republic of Korea; Taiwan, China); on the other, to reducing interventions and lowering import protection (Chile, Mexico). On the whole, successful trade policy reform has comprised elements of a shift to greater neutrality in incentives and of liberalization through a reduction in distortions. Most countries with substantial trade restrictions have achieved gains from trade policy reforms when these reforms have been well-complemented by macroeconomic, sectoral and institutional reforms.

Trade Policy Reforms and Structural Adjustment in the 1980s

1.03 Trade policy reform constitutes a significant part of the structural adjustment efforts of many developing countries in the 1980s. In turn, it is a major component of the policy reforms supported by the World Bank's adjustment lending, as well as by International Monetary Fund (IMF) arrangements.¹ Most countries have a legacy of structural rigidities accompanied by policy interventions, including trade restrictions, that have constrained trade and economic growth. In the wake of the adverse external shocks and balance of payments problems of the early 1980s, trade restrictions were initially tightened further. As external sector problems persisted, however, many countries began to reform their trade policies. A reduction in the restrictiveness of the trade regime (see box 1-1 overleaf on measurement issues) was expected to shift incentives toward exportables and tradables in general. The policy reforms were also expected to improve resource allocation, efficiency and competitiveness. The external financing in support of structural adjustment was intended to facilitate the policy change, especially since the initial increase in imports was expected to exceed the expansion in exports in response to the reform in the short term.

Box 1-1. Measures of Trade Restrictiveness Used by Practitioners

Reductions in the number of commodities subject to quantitative restrictions (QRs) are sometimes measured as the share of the liberated commodities in the value of total imports (or exports). This can be misleading, since the more stringent the QRs, the smaller the shares. Prohibited goods have no weight at all. A more meaningful measure is the share of national production held by goods competing directly with the liberated imports. Estimates of reductions in either quantitative restrictions or tariffs for commodities should be averaged with weights using these production shares. A problem in measuring the economic effects of reductions in quantitative restrictions or tariffs is that only some tariffs and QRs are binding. Some QRs may allow more imports than economic agents wish to import, so their elimination has no economic impact. Some tariffs may be higher than the minimum level that would effectively prohibit imports (the so-called water in the tariff), so the reduction may have no economic impact. Furthermore, changes in QRs and tariffs are often carried out simultaneously, further confusing their net effect.

One effort to resolve these difficulties has been to compare changes in the nominal rates of protection (NRPs), which summarize the net effect of all policy changes on incentives for each product. The NRP of a product is the premium paid domestically because of trade restrictions. This may be calculated as $(P_D/P_W) - 1$, where P_D is the domestic price¹

and P_W is the border price, converted to the domestic equivalent at the appropriate exchange rate and adjusted for quality differences and transportation costs to a common point of sale. On the production side, the NRP is supposed to measure the extent to which protection causes resources to be pulled toward a protected sector, assuming there are no protected imported inputs. For consumers, this measures the degree of distortion affecting demand decisions. Alternatively, the NRP measures the difference between the undistorted value of a good — its border price — and the cost of producing a marginal unit domestically or the value placed on consuming a marginal unit. The presence of protected imported inputs appears to limit the usefulness of NRPs. When there are numerous protected outputs and inputs and the NRPs of several goods change simultaneously, the ranking of products by changes in output will not necessarily be the same as their ranking by changes in NRP.

Protected traded inputs are accounted for by the effective rate of protection (ERP), which measures the protection to net value added in an activity and thus the artificial pull of that activity for nontraded resources in production.² When the ERP of a protected activity decreases, the resources going to that activity should decrease as well, making ERPs a reasonable predictor of the impact of reform.³ Flows of inputs can be netted out at either the industry level (where ERP is an appropriate measure) or at the economywide

1.04 Countries adopting structural adjustment programs have differed in their initial conditions and in the extent of their trade policy changes, on average, from countries not involved in these programs (chapter 2). The severity of external sector problems in the early 1980s and the extent of subsequent trade policy reforms were generally greater for recipients of adjustment loans for trade policy reform than for nonrecipients. Furthermore, the recovery in economic performance (e.g., GDP growth) in recent years has been stronger in the former countries, on average, than in the others (tables A-1 and A-2 in the annex to this chapter). These improvements in relative performance seem to be attributable not only to greater external financing but also to policy reform (see chapter 3). Among the adjusting countries, however, the extent and effectiveness of reform have varied substantially.

1.05 There is a considerable body of literature on the rationale for trade policy reforms (see the following section). Observers have also raised a variety of concerns about trade policy reform, most of them related to trade liberalization (see paras. 1.14-1.16 on the meaning of terms related to trade policy reform).² First, it is said that trade liberalization conflicts with other, more important, policy objectives. In particular, it is argued that liberalization may aggravate the balance of

level to give trade flows (where NRP is the correct measure). (Both approaches are formally equivalent at the economywide level.)⁴

Despite the difficulty of unambiguously predicting resource allocation changes, the general pattern of NRPs and ERPs is a useful indicator of distortions and reforms. For example, movement from high and highly dispersed protection among sectors to low and more uniform protection will increase the efficiency of resource allocation, at least when this is accomplished by lowering the highest rates (see chapter 7 also). Furthermore, when these measures are used as broad indicators, it usually makes little difference whether protection is measured by NRPs or ERPs. At the industry or sectoral level, ERPs can be useful, although different indexes of resource pull may require alternative measures of ERP, and their accuracy depends on a relatively strict set of conditions.⁵ For one reasonable index — value added at world prices — ERP as usually defined is the appropriate measure.

Aggregate protection measures are sometimes summarized as antiexport bias. This approach groups tradable sectors into import-competing products and exportables. The bias is measured as $(1 + RP_E)/(1 + RP_I)$, where RP_E is the average net rate of protection to exports (as a percentage of export value), and RP_I is the average net rate of protection to imports (as a percentage of import value). A ratio less than unity indi-

cates an import-substituting or antiexport regime, a ratio of unity indicates neutrality (or, to some commentators, an export-promoting regime), and a ratio above unity indicates an export-promoting (or ultra-export-promoting) bias.

1. PD may be directly observed in the domestic market, although in practice this may be quite difficult because of the problem of adjusting for quality differences. If the only trade restrictions are tariffs or special exchange rates, the protection rate can be closely approximated by the tariff, adjusted for the exchange rate premium over the market rate.

2. A closely related measure, the domestic resource cost, directly measures the cost of the domestic resources used to earn one dollar of foreign exchange by displacing imports or generating exports, on the margin, with domestic resources valued at shadow prices.

3. However, it cannot be unambiguously proven, that when more than one ERP changes simultaneously, the activity whose ERP has increased relative to the others will necessarily attract the most resources. See J.N. Bhagwati and T.N. Srinivasan, 1973, "The General Equilibrium Theory of Effective Protection and Resource Allocation," *Journal of International Economics* 3:259-81.

4. A. Ray, 1980, "Welfare Significance of Nominal and Effective Rates of Protection," *Australian Economic Papers* (June):182-90.

5. See W. Ethier, 1977, "The Theory of Effective Protection in General Equilibrium: Effective Rate Analogues of Nominal Rates," *Canadian Journal of Economics* (May):233-45.

payments and fiscal problems that have afflicted many countries in the 1980s. Second, the benefits of liberalization and greater openness are disputed. It is contended that there are no firm grounds for believing that trade liberalization increases the growth rate of the economy. To the contrary, some observers argue that protection to infant industries raises economic growth, while some assert that world trade conditions prevent reforming countries from increasing their exports. Other aspects of trade policy have also drawn criticism: for example, export subsidies and other special incentives to promote exports are found to be inefficient. Third, transitional problems associated with liberalization are a source of concern. In particular, it is feared that liberalization produces unemployment and that devaluation increases inflation rates. In addition, the efficacy of adjustment lending as a vehicle for promoting trade reforms is questioned. The report recognizes the possibility of conflicts between trade and other reforms, but suggests sequencing of reforms that can help avoid these conflicts. The findings show that well-implemented trade reforms improve economic performance, and indicate complementary actions that will augment the supply response. While short-term transitional costs are usually expected from resource reallocation, the findings of the Bank's previous research indicate no clear relationship between trade liberalization and unemployment.

Gains from Trade Policy Reform

Costs of Protection

1.06 Policy interventions in trade have generally taken the form of restrictions in the import and export regimes that are often associated with exchange rate misalignments. The main objectives have been to protect domestic industry, raise revenue, and improve the balance of payments. The objective of some interventions has been to promote trade, through special incentives and other government assistance. On balance, however, the effect of trade interventions on production incentives has been to protect import-substitutes, to create antiexport bias, and to disperse incentives in the import-substituting and exporting sectors. The resource allocation costs of trade restrictions and the resulting protection are of two types: direct and indirect.

1.07 Direct costs derive from the misallocation of resources in production and the reduction in consumer welfare due to the misalignment of domestic and international prices, assuming that international prices are by and large the proper benchmark. In a static and partial equilibrium framework, these direct costs are generally estimated to be about 1 or 2 percent of gross domestic product (GDP) a year. The costs are larger, however, when the likely effects on market structure are also considered.³ The existence of protection has been empirically linked to excessive market entry in the protected domestic markets in some countries, which means that firms are operating at a suboptimal scale. In other cases, protection has also been linked to noncompetitive pricing.

1.08 Indirect costs derive from the trade regime and the way it is administered. They include the waste of resources in income-generating but unproductive activities associated with protection — such as smuggling, lobbying, evading tariffs, and building plants with excess capacity to get import licenses.⁴ These rent-seeking costs are significant in economies with severe restrictions: they have been estimated at well over 6 percent of GDP in Turkey and India, for example.⁵ The indirect costs of foreign exchange controls and nontariff barriers tend to be large because they involve allocations by the authorities (for example, licensing organizations, state importing monopolies) on the basis of their discretion rather than on efficiency grounds. Import controls also often support undesirable domestic interventions such as price controls and investment licensing. High tariffs — especially when they amount to *de facto* prohibitions — may also induce smuggling and lobbying activities.

1.09 The costs of trade and domestic restrictions usually become most visible when a country faces severe external shocks. Economies that maintained protectionist restrictions were largely divorced from the international price structure and failed to readjust production in response to relative price changes, such as higher oil prices. Protective regimes have also been found to isolate the domestic economy from technological progress abroad, which ultimately hurts competitiveness. When the terms of trade shifted adversely in the past decade, many countries were unable to increase exports rapidly and had little further scope for efficient import substitution. Large trade deficits and macroeconomic imbalances were the result.

1.10 The costs of protection can be reduced by lowering the level of protection, by improving the way it is administered, or by doing both. Gains can also come from indirectly offsetting some of the costs of protection — for example, by encouraging domestic competition behind existing trade barriers. Such once-and-for-all net gains show up in a higher rate of GDP growth as resources previously devoted to relatively inefficient or unproductive uses move to more efficient production. The magnitude of the increase in GDP growth is affected by the way in which the economy adjusts to the price changes.⁶ When the resource reallocation is complete, the economy is expected to be producing at a higher level of GDP, with the size of the increment depending on the initial distortion, the type and extent of reforms, and the resource reallocation. These resource shifts alone do not necessarily increase the rate of growth over time once the adjustment is complete, but the economy will maintain a higher level of GDP than before.

1.11 More difficult to demonstrate, but of great practical importance, are the dynamic effects of reforming the trade regime. There is an empirically established correlation between outward-oriented trade policies and the growth of total factor productivity in industry (see chapter 3).⁷ Traditional growth theories are inadequate for capturing this relation, but other approaches are more successful. If reforms help to improve intertemporal resource allocation — for example, continuously improve investment incentives — they can also boost the long-run growth rate. Some recent growth models have replaced the traditional assumption of constant returns to scale with one of increasing returns to scale and different types of external economies. If the return to capital does not decline, as it does in traditional models, the incentives to accumulate capital do not disappear automatically. So, if trade policy reforms raise the marginal return to capital, they can generate a higher growth rate. Other models have focussed on the role of technological change in generating a higher equilibrium growth rate. The fewer the trade restrictions, the greater an economy's ability to take advantage of a wider range of innovations taking place around the globe, increasing its growth rate. One empirical study that developed a model based on this effect, then tested for its significance in a sample of 90 countries, found that such effects of economic openness were very important in encouraging growth.⁸

1.12 Some recent literature has pointed out a rationale for strategic trade policy⁹ (providing protection rather than reducing it), namely, that it can, in theory, increase economic welfare in some circumstances. However, it is hard to target these interventions successfully in practice. For this and other reasons, the conditions under which strategic trade policy can raise a country's welfare are unlikely to be met in developing countries (box 1-2 overleaf).

What Constitutes Trade Policy Reform?

1.13 Most observers acknowledge the benefits of a greater outward orientation or openness. But these terms say more of the outcomes of policies than of the policies themselves.¹⁰ Differences in the type of policy reform can lead to differences in the degree of outward orientation that results. Some reforms emphasize liberalization,

**Box 1-2. The New
Trade Theory and
Strategic Trade Policy**

Can a government increase national welfare by providing assistance to domestic firms that compete in oligopolistic international markets? Until recently, most economists would have instinctively replied "no," with appropriate caveats added regarding externalities of various sorts. But trade theorists have now identified a number of cases in which protection or subsidization of home-bred "national champions" can be an economically smart thing to do.

The argument for "strategic trade policy" applies to markets in which a handful of firms compete in oligopolistic fashion and receive excess profits or rents (a rate of return on investment that exceeds the normal, competitive return in more heavily contested markets). In such markets, the strategic use of government policy—via import tariffs or export subsidies, for example—can strengthen the home firm vis-a-vis foreign firms and help it acquire a higher share of the industry's excess profits. Provided enough profits are shifted to the home firm, a tariff or subsidy can represent a good bargain overall despite its other costs. This profit-shifting motive provides a rationale, at least in principle, for the use of aggressive trade policies.

In practice, the implementation of strategic trade policies is fraught with difficulties. For one thing, the government has to identify the appropriate industries for targeting. This requires an ability to spot markets in which excess profits (rents) are being made. An important obstacle here is the need to distinguish between *ex post* (realized) and *ex ante* (planned) profits. In risky industries, enterprises that emerge successful will appear to make large excess profits; what is much less observable is the fact that some firms do not succeed and go bankrupt. There is no economic case for targeting industries in which high profits simply serve to compensate firms for the large probability of failure.

In the developing world, the applicability of strategic trade policy is further re-

duced by the fact that very few firms have established themselves in the kinds of industries in which these conditions arise. In the few instances that can be identified, little evidence can be found that targeting has paid off in a profit-shifting sense.¹

Even when appropriate industries can be identified with some acceptable degree of certainty, selecting the correct policy in support of home firms is difficult. For example, trade theorists have identified cases in which national income can be raised only by imposing a tax on domestic firms; subsidies can be inappropriate because in industries in which pricing behavior may have been too aggressive to begin with, they induce firms to reduce their prices. Hence, to ensure that strategic trade policy increases domestic welfare, the government has to be unrealistically knowledgeable about the nature of the strategic interactions between home and foreign firms.

Finally, strategic trade policy is a game that a country's trade partners can also play, to the detriment of all involved. A government's competitive support of national champions is likely to invite retaliation. In the ensuing trade war, all sides can end up as losers.

Due to these and other limitations, the trade theorists who helped develop the literature on strategic trade policy remain extremely skeptical about its policy relevance. Most fear that, rather than being used to enhance national welfare, these new ideas will do damage in the hands of interventionists who take cover behind the intellectual respectability these ideas provide.

1. See the account of the Brazilian firm Embraer's EMB-120 commuter airplane in R. Baldwin, forthcoming, "High Technology Exports and Strategic Trade Policy in Developing Countries: The Case of Brazilian Aircraft," in G.K. Helleiner, ed., *New Trade Theory and Industrialization in Developing Countries*, New York and London: Oxford University Press.

Source: Background note by D. Rodrik.

some a shift to more neutrality. Sometimes the terms are used interchangeably. Most objections to trade policy reform concern measures that are generally encompassed by the term "liberalization." There is also a tendency when discussing issues of trade policy reform to speak of absolute dichotomies instead of gradations of change: outward orientation versus inward orientation, liberal versus interventionist, neutral versus biased. A clarification of these concepts in the light of country experience is provided below.

1.14 A shift toward neutrality implies a move toward equalizing the policy-induced effect on price incentives — broadly speaking, among exportables, importables, and nontradables. Since most countries have a substantial bias against exportables relative to importables and nontradables, more neutrality usually means a reduction in antiexport bias. This reduction can be achieved by reducing import protection, by raising export incentives, or by doing both. Liberalization means a reduction in trade restrictions and an increase in the use of prices instead of discretionary intervention by bureaucrats and politicians. It usually¹¹ implies a reduction in the welfare cost of government interventions — that is, a reduction in the direct costs or at least in some of the indirect costs.

1.15 Two distinctions help in applying the terms “liberalization” and “neutrality” in policy reform. First, trade policy reform, as used in this report, can be a move toward neutrality or a liberalization or both. Sometimes a reform is both a shift toward neutrality — with or without greater intervention — and a liberalization — for example, eliminating an export restriction. A reform can also be a liberalization without being a shift toward neutrality, as, for example, the substitution of approximately equivalent tariffs for quantitative restrictions or a lifting of exchange rate controls combined with a devaluation. Similarly, a reform involving more intervention can increase neutrality: for example, an export incentive to offset some of the adverse effects of high import tariffs.

1.16 The second distinction is that both liberalization and a shift toward neutrality refer to a movement along a spectrum, not necessarily to a sudden shift from total control to free trade.¹² For example, a depreciation of the real exchange rate and the use of tariffs in place of quantitative restrictions reduce the welfare cost of protection and constitute some liberalization. A partially compensated devaluation by combining a reduction in tariffs with devaluation, leads to greater neutrality in the incentive system while increasing welfare. These actions do not necessarily eliminate either the interventions or the protection, but they lead to superior potential outcomes.

1.17 Trade policy reforms include such measures as the removal of export restrictions and export taxes, the introduction or improvement of duty drawback or temporary admission systems for exports, the phasing out of quantitative import restrictions, the reduction and harmonization of import tariffs, or the imposition of taxes on domestic production of protected items at rates equal to their tariffs. With a quantitative restriction-dominated import regime, devaluation is a particularly important reform because it increases the supply of foreign exchange, cuts the excess demand for imports, and hence reduces the pressure on the quantitative restriction system in rationing imports and so the indirect economic costs associated with that process. Devaluation can also reduce antiexport bias, since the local-currency prices of exports rise by the full amount of the devaluation, whereas the prices of import-substitutes (insulated from import competition) may rise only to the extent that devaluation increases their raw material and other costs and that the demand for their products permits.

1.18 Some commentators argue for achieving neutrality (or even a bias toward export incentives) through government intervention or assistance to offset existing biases. Others argue for a decreasingly activist approach to neutrality, signifying liberalization. Success in promoting trade and growth can be found in liberal and liberalizing regimes, as well as in somewhat interventionist but relatively neutral policy regimes. Chile, for example, has recently achieved high rates of export and income growth with minimal policy intervention and a neutral incentive structure established over a decade. Hong Kong has had successful laissez-faire policies for a very long time. But South Korea and Taiwan, China experienced high rates of growth with significant, export-promoting market intervention or assistance during earlier stages of development. The intervention in these two cases was more neutral and less distortionary than in most developing economies (see box 6-1 in chapter 6) and more effective than elsewhere. Moreover, in these cases and in others during the 1980s which were successful in terms of economic performance (such as Ghana, Indonesia, Mexico, Turkey), the direction of reform has been toward liberalization.

1.19 A more outwardly oriented economy can thus be reached by somewhat different routes: through a relatively hands-off approach or through selective and judicious government assistance. Relying on noninterventionist and neutral policies supported by an adequate exchange rate and an overall stable macroeconomic environment has several merits. It avoids the susceptibility to misjudgment and abuse to which targeted investment policies are prone. It also avoids the practical problems that arise because direct export support mechanisms involving subsidies may become subject to countervailing duties under the General Agreement on Tariffs and Trade (GATT). Studies of large samples of countries have indicated that less interventionist regimes have been more effective in promoting exports and growth (para. 3.09).¹³

1.20 At the same time, country studies bring out the positive role of well-designed government policies in supporting trade development (chapters 3, 5, 6, and 7). The most important policies complementary to trade policy reform are a stable macroeconomic environment and a sound legal framework. Without these conditions, the reallocation of resources in response to trade reform is much reduced. Other complements to trade policy reform would include a well-functioning, efficient, and honest trade-related business and administrative environment (ports, customs regulations, customs agents, banks, telecommunications, transport), as well as public and private institutions for developing export market information and links.

The Approach and Contribution of the Report

1.21 The objective of this report is to assist in the design and implementation of trade policy reform. Its approach is to bring together a variety of evidence on the experience with reform and to draw policy implications. The type of data and analysis varies according to the questions addressed. We rely on country studies, cross-section data, and interviews with practitioners.

1.22 The main focus is trade reform during structural adjustment, with emphasis on the experience of the 1980s.¹⁴ Since adjustment lending has supported such

The full country sample of the report comprises eighty-eight developing countries. These are the ninety-five countries under the *World Development Report 1989* definition of low-income and middle-income countries, excluding ten countries because of data unavailability (Afghanistan, Bhutan, Iran, Iraq, Kampuchea, Laos, Lebanon, Libya, Romania, and Vietnam) and including three others because they received adjustment loans and have data (Gambia, Guinea-Bissau, and Guyana).

Among the eighty-eight countries, forty-one received adjustment loans with significant trade components during 1979-87. Excluding Guinea for reasons of data unavailability, forty loan recipients are considered for the analysis. By and large, these countries also correspond to those that have made some efforts in trade reform. However, these also include a few that achieved little policy change (Guyana, Yugoslavia, Zambia, and Zimbabwe), while the forty-seven other countries also include two that carried out substantial reforms, although they did not receive trade adjustment loans (Bolivia and Haiti). In some cases, we examine this group of thirty-six trade reformers. In addition, in some discussions we focus upon ten countries of the forty trade loan recipients that received three or more loans — the intensive-trade adjustment lending countries — and upon twenty-six countries that received a loan before 1986, such that some time had elapsed for assessing implementation. However, precise data on policy implementation were not available for all twenty-six pre-1986 loan countries. Instead, implementation data was available for twenty-four countries —

that is, excluding Brazil, Costa Rica, and Tanzania from the twenty-six and including Bangladesh, which received a first loan in 1987. This group of twenty-four countries was used in many cases rather than the group of twenty-six.

In chapters 2 and 3 we make comparisons of the various adjustment lending country groupings and trade policy reformers with the other developing countries, as well as with twenty-one industrial countries. To assess the policy-performance link in chapters 3 and 5, we subdivided the twenty-four countries into performance categories on the basis of implementation data — low, medium, and high. We also use some other analytical country groupings — low-income versus middle-income countries, Sub-Saharan Africa, highly indebted countries, exporters of manufactures, oil-exporting countries, and nonoil/nonmanufactures exporting countries. Annex table A-3 at the end of this chapter gives the full listing of country groupings.

Changes in performance during the 1980s are the main focus of analysis, although we also look at long-term trends in performance. In some of the comparisons we focus on time periods before and after adjustment lending to a particular country. Most of the trade-adjustment lending was initiated around 1983-84, and so we pay particular attention to the period before and after these years (1980-82 and 1981-83 compared to 1984-86 and 1985-87, respectively). Most of the quantitative discussion ends with 1987, although preliminary data for 1988 are also often presented.

Source: Statistical analysis by F. Ng.

Box 1-3. Country Groupings and Time Periods

reforms, we pay special attention to countries that received such lending (see box 1-3) and draw lessons for the design of adjustment lending. Closely related is the experience with IMF-supported growth oriented adjustment programs. The broader implications of the findings relate more to trade reform than to the World Bank's adjustment lending *per se*.

Chapter Outlines

1.23 The report reviews the rationale for trade policy reform. This chapter began by clarifying what is meant by policy reform and what it is expected to accomplish, emphasizing the alternative mixes and sequencing for different circumstances. A particular focus is the extent and types of policy changes proposed in programs supported by the World Bank and the IMF, the flexibility of program design in adopting to country conditions, and success in implementation (chapter 2). We

then address the effectiveness of trade liberalization in increasing economic efficiency and growth, both through comparisons of large samples of countries that did and did not implement reforms and through country studies (chapter 3).

1.24 Next, the political dynamics of domestic interest groups affected by reforms, which determine the eventual fate of the program are examined (chapter 4). Based on the theory of public choice and examples of successful and failed liberalization attempts, the chapter provides lessons for the timing and pace of a trade reform program, the necessary preparation for its enactment, its design and institutional affiliation, and compensation of losers.

1.25 We emphasize both inconsistencies and complementarities that may exist between trade policy reforms and stabilization measures (chapter 5). Certain types of trade reform may increase the budget deficit if not compensated for by other measures. In very high inflation countries, efforts to reduce inflation that are based on the use of nominal exchange rates as price anchors, rather than on adequate macroeconomic policies, can lead to an appreciation in the real exchange rate. Furthermore, the real interest rate often rises under programs of disinflation. Such circumstances call into question the sustainability and credibility of trade reforms under severe macroeconomic instability — suggesting that priority in sequencing might sometimes be given to effective stabilization. In most circumstances, however, there are strong arguments for trade reforms to accompany stabilization. The new investment that accompanies stabilization may flow to the wrong sectors if incentives are distorted by trade (or other) policies. In addition, a commitment to integrate into the world economy can aid a country in maintaining a sound macroeconomic policy. Furthermore, many types of trade policy reforms may not only improve the incentive structure but may also reduce the fiscal deficit. The appropriate sequence of stabilization and trade reform thus depends on the initial conditions and the type of reforms being considered.

1.26 What is an appropriate and supportive menu of price and nonprice (for example, institutional support) measures for an effective export policy? To answer this, we review the export performance, especially for manufactured exports, of developing countries (chapter 6). We analyze specific policy measures to determine what problems have been encountered and why relatively few countries have sustained their export growth. We find that price measures (especially a realistic exchange rate) and specific institutional and administrative reforms are essential in assisting exporters.

1.27 Aside from the lifting of foreign exchange controls and the unification of exchange rates, the most common first step in import reform (chapter 7) is a reduction in the coverage of quantitative restrictions, often by converting them to tariffs. In a second stage, the level of protective tariffs is sometimes reduced through various methods. We show why the conversion of quotas to tariffs is beneficial in itself and proceed to issues of tariff reduction. Of special relevance are the questions concerning the achievement of greater uniformity of tariffs, which may require increases in some tariff rates on imported inputs; both the merits and the limitations of greater uniformity are set out. Another design issue concerns the ways in which domestic market and public sector characteristics and policies (market concentration, labor market rigidities, institutional features, regulatory policies) interact with trade policy and complement or impede its effectiveness.

1.28 The report also considers the opportunities for multilateral negotiations for developing countries in the Uruguay Round of multilateral trade negotiations (chapter 8). One issue is how countries should evaluate the options of immediate unilateral reform versus eventual multilateral reform under the auspices of the GATT. The importance of an unambiguous commitment by the GATT on the granting of credit for unilateral reform is underscored. The benefits and costs of regional integration are also considered. While pointing out the limited potential for trade policy to aid in regional coordination, the chapter highlights other measures that may be more effective. The chapter also discusses the role of foreign direct investment and the policies that have proven to be most effective in attracting and using it to enhance development.

Common Themes

1.29 In addition to the major themes emphasized in each of the individual chapters, some issues cut across the chapters. One issue relates to the diversity of experience. The report shows that trade policy reform has helped to boost economic performance. But the design and implementation of reform have depended on numerous factors, especially the extent of trade distortions, macroeconomic stability, and required complementary actions. Accordingly, the application of various country taxonomies is useful. First, differences in the initial trade restrictiveness call for different sequences of reforms: exchange rate depreciation and the elimination of key export restrictions first in some cases, reduction of export and import restrictions simultaneously in others, and a lowering of protection in yet others. Second, trade liberalization under macroeconomic instability, debt overhang, and high inflation faces quite distinct constraints. Third, Sub-Saharan countries, and low-income countries in general, have been burdened in addition by underdeveloped institutions and infrastructure that limit the supply response to price changes.

1.30 The key and multiple roles played by macroeconomic and exchange rate policy in trade policy reform are discussed from several perspectives. Chapter 4 discusses the role of devaluation in signaling the credibility of reforms. Chapter 5 discusses the exchange rate as a macroeconomic variable and investigates the conditions under which its role in inflation stabilization programs might conflict with trade policy reform. Chapter 6 stresses the importance for exporters of macroeconomic stability and a devalued and stable exchange rate. Chapter 7, in contrast, shows how the exchange rate can also determine relative prices among tradable goods when quantitative restrictions on imports are binding, giving it a crucial role in programs involving the removal of quantitative restrictions.

1.31 Another common issue relates to the constraints to reform and the constraints to the supply response. Chapter 2 brings out constraints to reform implementation under adjustment lending, while chapter 4 highlights the political economy context of the reform process. Several chapters discuss the constraints to a stronger supply response to reform. The constraints are identified in the final paragraphs of Chapter 3. Other chapters discuss specific constraints in more detail. The role of credibility is highlighted in chapters 4 and 5. Institutional constraints hurt the export response (chapter 6), and domestic market rigidities, inappropriate public sector policies, and infrastructural weaknesses limit the response to import liberalization (chapter 7). Constraints imposed by external protectionism are discussed in chapter 8.

1.3. Finally, the sequencing of trade policy reform is addressed in several chapters. The question of macroeconomic stabilization versus liberalization is dealt with in chapter 5. The issue of trade liberalization versus domestic liberalization is considered in chapter 7, which also addresses the sequencing and pacing of various import measures. The main conclusions of the report are pulled together in Volume I.

1. Trade policy reform has accounted for about 30 percent of the conditions in adjustment lending. For details, see World Bank, 1988, *Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Series No. 1, Washington, D.C.
2. For an analysis of the rationale for trade policy reforms, see W.M. Corden, 1974, *Trade Policy and Economic Welfare*, Oxford: Clarendon Press. For discussions of issues regarding trade liberalization, see for example, J. Sachs, 1987, "Trade and Exchange Rate Policies in Growth-Oriented Adjustment Programs," Department of Economics, Harvard University, Cambridge, Mass.; L. Taylor, 1988, *Economic Openness: Problems to the Century's End*, Helsinki: World Institute for Development Economics Research; UNCTAD, 1989, *Trade and Development Report 1989*, Geneva.
3. When the initial distortions are very large, conventionally estimated gains in resource allocation from reforms may turn out to be several percentage points of GDP. However, under severe distortions, parallel markets may provide more realistic price signals than official prices, in which case the calculations based on official prices would overstate the gains from reforms. On protection and domestic markets, see T. Condon and J. de Melo, 1986, "Industrial Organization Implications of QR Trade Regimes: Evidence and Welfare Costs," World Bank, Washington, D.C.
4. A former Undersecretary of the Economy in Argentina is quoted in J. Nogues (1989, "Latin America's Experience with Export Subsidies," PPR Working Paper No. 182, Washington, D.C.: World Bank) as noting that "it is more profitable to spend time in these corridors [of the Ministry of the Economy and the Central Bank] than in the manufacturing plant."
5. For some examples, see W. Grais, J. de Melo, and S. Urata, 1986, "A General Equilibrium Estimation of the Effects of Reductions in Tariffs and Quantitative Restrictions in Turkey in 1978," in T.N. Srinivasan and J. Whalley, eds., *General Equilibrium Trade Policy Modeling*, Boston: MIT Press.; A.O. Krueger, 1974, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (June):291-303; S. Mohammad and J. Whalley, 1984, "Rent-Seeking in India: Its Costs and Policy Significance," *Kyklos* 37:387-413.
6. Taking factor market rigidities and underemployment of factors into account can introduce two opposing effects into the analysis. First, if labor or other factors are immobile in the short term, the reform can produce adjustment costs. Second, the growth impact can be stronger if underemployed factors take advantage of improved trading opportunities.
7. For evidence, see H. Chenery, S. Robinson, and M. Syrquin, 1986, *Industrialization and Growth: A Comparative Study*, New York: Oxford University Press. For a review of explanations of the growth effects, see S. Edwards, 1989, "Openness, Outward Orientation, Trade Liberalization and Economic Performance in Developing Countries," Background paper for this report and PPR Working Paper No. 191, Washington, D.C.: World Bank.
8. P. M. Romer, 1989, "What Determines the Rate of Growth and Technological Change?", PPR Working Paper Series 279, Washington, D.C.: World Bank.
9. See for example, P.R. Krugman, ed., 1987, *Strategic Trade Policy and the New International Economics*, Cambridge, Mass.: MIT Press.
10. Policy, of course, is not the only determinant of the degree of openness as measured by the share of trade in GDP. Trade as a share of GDP is also determined by a country's size, proximity to other markets, and the similarity of its factor endowments to those of the rest of the world, among other things. For this reason, although a change in openness in a given country may be a good measure of the effect of a change in policy, openness is a misleading indicator of policy orientation when comparing different countries. For example, the ratio of the sum of exports plus imports to GDP was about 21 percent on average during 1985-88 for the United States, a country with a relatively liberal trade regime, but about 50 percent for Kenya, Malawi, and Yugoslavia, which have restrictive regimes.
11. Any shift to neutrality or any liberalization does not necessarily and always represent a reform. For example, some types of partial liberalization in the face of pervasive distortions might be welfare reducing. Similarly, a poorly designed export subsidy may promote neutrality, but at a higher welfare cost.

12. C. Bradford and . Branson (1987, *Trade and Structural Change in Pacific Asia*, Chicago: University of Chicago Press for National Bureau of Economic Research) have developed a useful scheme for classifying trade regimes along a spectrum.

13. Edwards (op. cit.) and G.W. Scully (1988, "The Political Economy of Free Trade and Protectionism," paper prepared for Conference on the Political Economy of Neo-mercantilism and Free Trade, Big Sky, Montana, June 9-11), for example, studied the effect of intervention on income growth in a worldwide sample. B. Balassa (1988, "Incentive Policies and Agricultural Performance in Sub-Saharan Africa," PPR Working Paper No. 77, Washington, D.C.: World Bank) examined the effect on agricultural and manufactured exports in Sub-Saharan Africa.

14. This focus is intended to complement and extend the World Bank's work on the longer-term trade policy experience of nineteen countries, which is presented in M. Michaely, D. Papageorgiou, and A. Choksi, forthcoming, "Liberalizing Foreign Trade: Lessons of Experience in the Developing World," World Bank, Washington, D.C.; World Bank, 1986 and 1987, *The World Development Reports 1986 and 1987*; as well as the work on adjustment lending in the World Bank report on adjustment lending (1988, op. cit.); and V. Thomas and A. Chhibber, eds., 1989, *Adjustment Lending: How It Has Worked, How It Can Be Improved*, Washington D.C.: World Bank.

ANNEX

Table A-1 Selected Economic Indicators for 40 Recipients of Trade Adjustment Loans, 1965-72 to 1988
(unweighted averages, in percentages)

Indicator	Period averages				Recent experience						
	1965-72	1973-77	1978-81	1982-88 ^a	1982	1983	1984	1985	1986	1987	1988 ^a
<i>Growth rate (constant prices)</i>											
GDP (mp)	5.2	4.1	3.5	2.4	0.3	0.4	2.2	3.5	3.9	3.2	3.6
Exports (gnfs)	7.1	5.2	5.3	4.2	-0.8	1.6	6.5	2.1	7.1	6.3	6.8
Imports (gnfs)	7.8	7.0	4.6	1.1	-6.6	-4.5	1.0	2.9	2.4	5.8	6.8
<i>Shares of GDP (current prices)</i>											
Exports (gnfs)	21.2	24.4	24.2	26.1	23.8	24.5	26.7	26.7	26.2	27.3	27.7
Imports (gnfs)	23.5	29.4	31.9	30.5	31.6	30.3	30.7	30.8	29.0	30.3	30.6
Resource balance ^b	-2.3	-4.9	-7.7	-4.4	-7.8	-5.8	-4.0	-4.1	-2.8	-2.9	-2.9
Current account balance	-3.6	-4.2	-7.4	-5.3	-8.7	-6.6	-4.8	-5.3	-3.9	-4.2	-3.4
Gross domestic investment	18.4	21.8	23.3	19.2	21.1	19.2	18.7	19.2	18.7	18.9	18.6
<i>Debt c-burden ratio</i>											
External debt/GDP	19.8	24.5	37.2	66.9	48.1	55.2	61.1	70.9	74.3	86.0	72.3
External debt/exports(gs)	110.8	115.7	154.6	281.7	215.2	250.7	238.6	288.5	328.6	350.5	299.7
Debt service/exports (gs)	13.6	14.2	19.0	25.2	21.8	23.5	22.3	25.6	28.3	26.4	28.5
Interest/exports (gs)	3.9	4.6	7.6	12.3	11.0	11.9	11.8	12.7	12.9	12.3	13.8
<i>Prices</i>											
Consumer prices (% change)	8.3	30.3	25.2	35.1	23.9	33.9	40.9	40.1	23.3	29.5	54.4
Real exch. rate ^d (1980=100)	na	na	100.6	89.7	108.8	102.9	97.2	94.4	82.2	71.9	70.5
Terms of trade ^e (1980=100)	131.2	117.0	101.9	91.8	91.3	92.9	94.3	91.9	93.2	87.1	92.1

mp = market prices, gnfs = goods and nonfactor services, gs = goods and services, na = not available.

Note: See box 1-2 and table A-3 for country groupings.

a. Preliminary estimates

b. Resource balance = difference between exports and imports of goods and nonfactor services.

c. Debt outstanding and disbursed, public and private, medium and long term; 1965-72 refers to 1970-72.

d. Increase indicates real appreciation.

e. Ratio of export to import price indices of merchandise goods.

Source: Based on World Bank and IMF data.

Table A-2 Selected Economic Indicators for 47 Developing Countries That Did Not Receive Trade Adjustment Loans, 1965-72 to 1988
(unweighted averages, in percentages)

Indicator	Period averages				Recent experience						
	1965-72	1973-77	1978-81	1982-88*	1982	1983	1984	1985	1986	1987	1988*
<i>Growth rates (constant prices)</i>											
GDP (mp)	5.5	6.0	4.2	2.5	3.1	1.9	2.8	2.7	2.6	1.5	3.0
Exports (gnfs)	7.4	4.9	6.5	3.4	-1.9	3.5	5.9	1.5	4.0	5.3	5.5
Imports (gnfs)	5.5	10.2	7.8	0.2	-1.3	-4.7	1.2	4.7	-1.8	2.1	0.9
<i>Shares of GDP (current prices)</i>											
Exports (gnfs)	22.5	25.6	26.8	23.4	24.7	24.7	25.4	24.8	22.7	21.1	20.1
Imports (gnfs)	27.4	33.7	38.4	34.4	39.1	35.8	34.4	33.8	33.1	32.3	32.3
Resource balance b	-4.9	-8.1	-11.6	-11.0	-14.4	-11.1	-9.0	-9.0	-10.2	-11.2	-12.2
Current account balance	-4.4	-2.7	-5.6	-5.4	-8.5	-6.1	-3.9	-4.0	-5.5	-4.0	-6.1
Gross dom. investment	18.6	23.8	25.0	21.6	25.3	21.8	21.4	20.7	20.5	20.5	21.0
<i>Debt^c-burden ratio</i>											
External debt/GDP	19.1	22.9	33.7	55.0	41.8	48.0	51.3	58.0	63.2	66.1	56.4
External debt/exports(gs)	102.3	100.9	133.8	275.1	186.0	212.6	231.0	277.5	337.3	333.8	347.8
Debt service/exports (gs)	9.8	9.2	11.8	18.7	15.4	15.3	16.3	19.0	21.4	19.7	24.0
Interest/export (gs)	2.8	2.8	4.4	7.5	6.5	6.6	6.8	7.4	8.3	7.2	9.5
<i>Prices</i>											
Consumer prices (% change)	3.4	13.4	14.5	22.4	18.1	22.9	18.8	26.3	26.4	23.6	21.0
Real exch. rate ^d (1980=100) na	na	na	99.1	105.6	106.0	109.2	114.2	114.7	100.2	98.5	96.4
Terms of trade ^e (1980=100)	118.3	108.2	99.8	88.6	93.5	94.2	95.8	91.4	84.1	79.8	81.5

mp = market prices, gnfs = goods and nonfactor services, gs = goods and services, na = not available.

Note: See box 1-3 and table A-3 for country groupings.

a. Preliminary estimates

b. Resource balance = difference between exports and imports of goods and nonfactor services.

c. Debt outstanding and disbursed, public and private, medium and long term; 1965-72 refers to 1970-72.

d. Increase indicates real appreciation.

e. Ratio of export to import price indices of merchandise goods.

Source: Based on World Bank and IMF data.

Table A-3 Country Groupings for Trade Adjustment Analysis

<i>10 intensive trade adjustment loan countries</i>	<i>26 pre-1986 trade adjustment loan countries</i>	<i>24 trade adjustment loan countries</i>	<i>41 trade adjustment loan recipients^a</i>	<i>47 nonrecipients of adjustment lending countries</i>	<i>88 Developing countries</i>	<i>21 industrial countries</i>
Chile	Brazil	Bangladesh	Argentina	Algeria	Algeria	Australia
Côte d'Ivoire	Chile	Chile	Bangladesh	Benin	Argentina	Austria
Ghana	Colombia	Colombia	Brazil	Bolivia	Bangladesh	Belgium
Jamaica	Costa Rica	Côte d'Ivoire	Burundi	Botswana	Benin	Canada
Malawi	Côte d'Ivoire	Ghana	C African Rep.	Burkina Faso	Bolivia	Denmark
Mauritius	Ghana	Guyana	Chile	Cameroon	Botswana	Finland
Mexico	Guyana	Jamaica	Colombia	Chad	Brazil	France
Philippines	Jamaica	Kenya	Costa Rica	China	Burkina Faso	Germany
Senegal	Kenya	Korea	Côte d'Ivoire	Congo	Burundi	Iceland
Turkey	Korea	Madagascar	Ghana	Dominican Rep.	Cameroon	Ireland
	Madagascar	Malawi	(Guinea) ^a	Ecuador	C African Rep.	Italy
	Malawi	Mauritius	Guinea Bissau	Egypt	Chad	Japan
	Mauritius	Mexico	Guyana	El Salvador	Chile	Luxembourg
	Mexico	Morocco	Hungary	Ethiopia	China	Netherlands
	Morocco	Pakistan	Indonesia	Gabon	Colombia	New Zealand
	Pakistan	Panama	Jamaica	Gambia	Congo	Norway
	Panama	Philippines	Kenya	Greece	Costa Rica	Spain
	Philippines	Senegal	Korea	Guatemala	Côte d'Ivoire	Sweden
	Senegal	Thailand	Madagascar	Haiti	Dominican Rep.	Switzerland
	Tanzania	Togo	Malawi	Honduras	Ecuador	United Kingdom
	Thailand	Turkey	Mauritania	India	Egypt	USA
	Togo	Yugoslavia	Mauritius	Jordan	El Salvador	
	Turkey	Zambia	Mexico	Lesotho	Ethiopia	
	Yugoslavia	Zimbabwe	Morocco	Liberia	Gabon	
	Zambia		Nepal	Malaysia	Gambia	
	Zimbabwe		Niger	Mali	Ghana	
			Nigeria	Mozambique	Greece	
			Pakistan	Myanmar	Guatemala	
			Panama	Nicaragua	(Guinea) ^a	
			Philippines	Oman	Guinea Bissau	
			Senegal	Papua New Guinea	Guyana	
			Tanzania	Paraguay	Haiti	
			Thailand	Peru	Honduras	
			Togo	Poland	Hungary	
			Tunisia	Portugal	India	
			Turkey	Rwanda	Indonesia	
			Uruguay	Sierra Leone	Jamaica	
			Yugoslavia	Somalia	Jordan	
			Zaire	South Africa	Kenya	
			Zambia	Sri Lanka	Korea	
			Zimbabwe	Sudan	Lesotho	
				Syria	Liberia	
				Trinidad & Tobago	Madagascar	
				Uganda		
				Venezuela		
				Yemen Arab Rep.		

Note: None of the groups in this table is based on actual implementation policies; any reference to trade adjustment lending implies only that the countries received a trade adjustment loan.

a. Although it received a trade adjustment loan, Guinea is excluded from the statistical analysis since time series trade data are unavailable.

b. GNP per capita in 1987 of US\$480 or less. Data for Burma and Guinea are incomplete or not available.

c. GNP per capita in 1987 of US\$481-\$5,999.

d. *World Development Report 1989* classification.

e. Manufacturing exports exceed 35 percent of merchandise exports (based on 1987 or the most recent year). As in *World Development Report 1988*, manufacturing export is defined as SITC 5, 6, 7 and 8, excluding 68, 651, 652, 654, 655 and 667 in the COMTRADE database of the United Nations. Data for Botswana, Gambia, Haiti, Lesotho, and Mozambique are incomplete or not available.

Table A-3 Country Groupings for Trade Adjustment Analysis (con't)

<i>39 low-income countries^b</i>	<i>48 middle-income countries^c</i>	<i>36 Sub-Saharan Africa^d</i>	<i>17 highly indebted countries^d</i>	<i>20 manufactures exporting countries^e</i>	<i>13 oil-exporting countries^d</i>	<i>54 Nonoil, nonmanufactures exporting countries</i>
Bangladesh	Algeria	Benin	Argentina	Bangladesh	Algeria	Argentina
Benin	Argentina	Botswana	Bolivia	Brazil	Cameroon	Benin
Burkina Faso	Bolivia	Burkina Faso	Brazil	China	Congo, P.R.	Bolivia
Burundi	Botswana	Burundi	Chile	Greece	Ecuador	Botswana
C African Rep.	Brazil	Cameroon	Colombia	Hungary	Egypt	Burkina Faso
Chad	Cameroon	Central Afr. Rep.	Costa Rica	India	Gabon	Burundi
China	Chile	Chad	Côte d'Ivoire	Jordan	Indonesia	C African Rep.
Ethiopia	Colombia	Congo, P.R.	Ecuador	Korea	Mexico	Chad
Gambia	Congo, P.R.	Côte d'Ivoire	Jamaica	Malaysia	Morocco	Chile
Ghana	Costa Rica	Ethiopia	Mexico	Morocco	Nepal	Colombia
(Guinea)*	Côte d'Ivoire	Gabon	Morocco	Nepal	Pakistan	Costa Rica
Guinea Bissau	Dominican Rep.	Gambia	Nigeria	Poland	Portugal	Côte d'Ivoire
Guyana	Ecuador	Ghana	Peru	Poland	Sri Lanka	Dominican Republic
Haiti	Egypt	(Guinea)*	Philippines	Portugal	Sri Lanka	El Salvador
India	El Salvador	Guinea Bissau	Uruguay	Sri Lanka	Thailand	Ethiopia
Indonesia	Gabon	Kenya	Venezuela	Thailand	Tunisia	Gambia
Kenya	Greece	Lesotho	Yugoslavia	Tunisia	Turkey	Ghana
Lesotho	Guatemala	Liberia		Uruguay	Uruguay	Guatemala
Liberia	Honduras	Madagascar		Yugoslavia		(Guinea)*
Madagascar	Hungary	Malawi				Guinea Bissau
Malawi	Jamaica	Mali				Guyana
Mali	Jordan	Mauritania				Haiti
Mauritania	Korea	Mauritius				Honduras
Mozambique	Malaysia	Mozambique				Kenya
Myanmar	Mauritius	Niger				Jamaica
Nepal	Mexico	Nigeria				Lesotho
Niger	Morocco	Rwanda				Liberia
Nigeria	Nicaragua	Senegal				Madagascar
Pakistan	Oman	Sierra Leone				Malawi
Rwanda	Panama	Somalia				Mali
Sierra Leone	Papua New Guinea	Sudan				Mauritania
Somalia	Paraguay	Tanzania				Mauritius
Sri Lanka	Peru	Togo				Mozambique
Sudan	Philippines	Uganda				Myanmar
Tanzania	Poland	Zaire				Nicaragua
Togo	Portugal	Zambia				Niger
Uganda	Senegal	Zimbabwe				Panama
Yemen, PDR	South Africa					Papua New Guinea
Zaire	Syrian Arab Rep.					Paraguay
Zambia	Thailand					Peru
	Trinidad & Tobago					Philippines
	Tunisia					Rwanda
	Turkey					Senegal
	Uruguay					Sierra Leone
	Venezuela					Somalia
	Yemen Arab Rep.					South Africa
	Yugoslavia					Sudan
	Zimbabwe					Tanzania
						Togo
						Uganda
						Yemen Arab Rep.
						Yemen, PDR
						Zaire
						Zambia
						Zimbabwe

2 IMPLEMENTATION OF TRADE REFORMS

Summary and Conclusions

2.01 Many developing countries have reduced trade restrictions in the 1980s with the support of the World Bank and the IMF. More than half the recipients of adjustment lending from the Bank introduced reform proposals whose intensity matched the initial degree of trade restrictiveness. Reform implementation by loan recipients has varied substantially across countries and by type of reform. Progress has been made in correcting misaligned exchange rates and in reducing impediments to exports, including restrictions on imports needed by exporters. Import/GDP ratios (at current and constant prices) in these countries have increased relative to ratios in nonrecipient countries, reflecting both increased financing and import liberalization. Some countries have begun import reform by substituting tariffs for quantitative restrictions. Reduction of actual protection by lowering both quantitative restrictions and tariff levels has been slow, however, with several exceptions including Chile, Korea, Mexico, and Turkey. In these countries, the bias against tradables and exportables is estimated to have declined as a result of these measures. For most countries, however, data needed to assess changes in the bias are inadequate.

2.02 The World Bank has supported trade policy reforms through ninety-six adjustment loans to forty-three countries during 1979-88. Overall, there has been considerable reform of trade regimes, including some import liberalization. Given the strong emphasis on trade policy in adjustment lending, however, more intensive reforms might have been expected during this period. Four sets of factors, in addition to external conditions, have constrained stronger and more sustained reforms in various countries: (1) macroeconomic performance and conflicts in design, (2) weak supply response in low-income countries, (3) vested interests against reform and inadequate convictions concerning its benefits, and (4) weak implementation capacity. The supply response to reforms depends, in part, on reforms to strengthen institutions and to increase internal competition; reforms in these areas have been inadequate, however.

Background on Trade Reform

2.03 This chapter focuses on the extent of trade policy reform in the 1980s.¹ During this period, many developing countries have received substantial financial and policy support from the World Bank and the IMF to help them institute trade reform measures. We evaluate these policies using cross-country data and country studies prepared or assembled for this report. The detailed empirical findings are based on proposals for changes in commercial policy and exchange rate policy in forty developing countries that received trade adjustment loans during 1980-87 (see box 2-1, overleaf) and on implementation data available for twenty-four of the forty countries (see box 1-3 in chapter 1 for the composition of these groups).²

2.04 Six measures of trade restrictiveness for these developing countries are considered: export impediments,³ import impediments on inputs used in export production, quantitative restrictions⁴ on noncompetitive imports, those on competitive imports, tariff rates,⁵ and tariff rate dispersion. Based on reviews of the

Box 2-1 Adjustment Lending and Trade Policy

During 1979-88, a total of 155 adjustment loans were made to fifty-seven countries. Of these, ninety-six loans to forty-three countries had significant trade components.¹ Among the ninety-six trade loans, fifty-seven were structural adjustment loans (SALs) and thirty-nine were sectoral adjustment loans (SECALs). In addition, there were two program loans (table 1). Over one-third of these operations included technical assistance components or were accompanied by technical assistance loans in support of trade reforms.

For this report we reviewed the loans approved during 1979-87 — seventy-nine trade loans to forty countries (excluding Guinea for lack of data). Forty-two percent of the operations (thirty-three loans) were in eighteen Sub-Saharan countries, 13 per-

cent (ten loans) in six Asian countries, 30 percent (twenty-four loans) in ten Latin American countries, and 15 percent (twelve loans) in six countries in the Europe, Middle East, North Africa region. Together, 63 percent (fifty loans) went to the twenty-three middle-income countries in the sample and 37 percent (twenty-nine loans) to the seventeen low-income countries (GNP per capita below \$480 in 1987). Thirty-one operations were in thirteen highly indebted countries, and twenty-one loans went to twelve exporters of manufactures (manufactured exports over 35 percent of total merchandise exports in 1987).

1. Through June 1989, there were ninety-eight loans with significant trade policy components to forty-five countries.

Table 1 World Bank Loans with Trade Policy Components, by Lending Instrument, 1979-88

Loan	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1979-88
SALs											
number	0	4	6	5	11	2	4	8	8	9	57
\$ millions	0.0	590.0	782.0	801.6	1859.7	431.0	387.8	694.0	539.0	790.0	6875.1
SECALs											
number	1	0	2	0	6 ^a	3	4	7	9	7	39
\$ millions	31.5	0.0	87.0	0.0	1130.9	301.4	560.0	1420.5	2021.0	1607.0	7159.3
Total											
number	1	4	8	5	17	5	8	15	17	16	96
\$ millions	31.5	590	869	801.6	2990.6	732.4	947.8	2114.5	2560.0	2397.0	14034.4
Memorandum item:											
Program loans											
number	0	0	0	1	0	1	0	0	0	0	2
\$ millions	0.0	0.0	0.0	110.0	0.0	140.0	0.0	0.0	0.0	0.0	250.0

a. Includes the Export Development III loan to Jamaica although the program was discontinued.

Source: World Bank data.

evidence,⁶ the forty countries were grouped into three broad categories according to the average antiexport bias of each group relative to the others at the outset of adjustment lending: low, medium, or high. Although the measurement is somewhat subjective, the differences among the groups were sufficiently large to permit such a broad classification. Only Chile and Korea had a relatively low level of restrictions, 60 percent of the countries had a high level, and 35 percent had a medium level prior to adjustment lending (the early 1980s in most cases) to each country.

2.05 To put the initial restrictions in terms of tariff rates and the coverage of nontariff barriers⁷ in developing countries in broader perspective, these measures

of trade restrictiveness are compared to those for industrial countries. First, the average tariff rate for fifty developing countries, weighted by the imports of each, was 26 percent at the end of 1985.⁸ Adding other import charges raises the figure to 34 percent. For many countries, average rates were much higher (about 90 percent in Bangladesh, Costa Rica, and Pakistan), and within each country rates were very dispersed, with top rates much higher than the average. Most of the World Bank's major borrowers had average tariff rates over 25 percent in 1987-88, with the highest (India's) at 118 percent. Average tariffs on industrial goods in OECD countries were estimated to be about 5 percent in a 1980 GATT report and are roughly of that order today.⁹ Second, the coverage of nontariff barriers — usually a more serious restriction than tariffs — in the fifty developing countries was estimated to be 40 percent (unweighted) of import items corresponding to all tariff positions at the end of 1985. In a World Bank study of eight developing countries for which data were available, six had nontariff barriers covering products representing 35 percent or more of production. Another study gives a similar estimate for thirty-eight developing countries in 1982.¹⁰ It also estimates that in 1984, 15 percent of the industrial product categories of the eleven industrial countries in their sample were subject to nontariff barriers — a stronger trade restriction than from tariffs in the industrial countries as well. Another study provides a similar figure (15.9 percent) for all products in fourteen industrial countries in 1986.¹¹ According to these estimates, developing countries, on the whole, have much more restrictive trade regimes than do developed countries. Exchange rates were also severely misaligned in many developing countries in the early 1980s, as indicated by country studies carried out by the World Bank and IMF. Despite the greater restrictiveness in trade policy in terms of levels, however, developing countries have exhibited a stronger tendency toward more openness than industrial countries in the 1980s.

What Was Proposed?

2.06 In more than half the countries that received trade adjustment loans during 1979-87, the proposed reforms were judged to be adequate — based on a comparative review of evidence and interviews with Bank staff — for addressing their problems. Commercial policy reform proposals were considered strong in twelve of the twenty-four countries with high initial restrictiveness (for example, Ghana, Jamaica, Mexico, and Turkey). In six of these twenty-four cases, however, reform proposals were considered moderate (for example, in Bangladesh and Yugoslavia), and in six others they were mild or nil (for example, in Brazil, Guyana, and Pakistan). Among the fourteen cases with moderate initial restrictiveness, nine had moderate or strong proposals. In general, the strength of export policy proposals corresponded more closely to the degree of initial restrictiveness than did that of import policy proposals. Also, the intensity of the proposals was greater in Latin America than in the other regions.

2.07 Sequencing of actions in the export and import areas is an important dimension of trade reform.¹² By and large, reductions in export impediments have received priority in reform proposals under adjustment lending, together with realignment of the real exchange rate. These reforms have been accompanied or followed by a switch from quantitative restrictions to tariffs. Either in parallel, or subsequently, a reduction in protection levels has been proposed.

2.08 Policy packages are not uniform since initial problems vary significantly across countries. However, a common thread is a reduction in restrictions on exports and imports and a greater reliance on the price mechanism, that is, on exchange rate depreciation and the use of tariffs in place of quantitative restrictions (see table 2-1). Loan proposals usually recognized the need to reduce direct impediments to exports and to imports used in export production. Reform of exchange rate policy was almost always an important goal, whether stated or unwritten, and was often carried out in conjunction with an IMF arrangement. In Colombia, for example, exchange rate reform and fiscal reform were the most notable improvements associated with adjustment lending. Various other price and nonprice export incentives were also proposed. Almost all loans supported greater use of tariffs in place of quantitative restrictions, or reductions in the level and dispersion of tariff rates.¹³ Proposed reductions in the coverage of quantitative restrictions were large in some cases, but modest on average across countries in the case of both items competing with domestic production and noncompetitive items (luxuries, for example). On average, reform proposals matched the degree of restrictiveness well in the area of export restrictions and imports needed for exports, moderately well for quantitative restrictions, and poorly for tariffs.

2.09 Insufficient attention was given to the institutional requirements for export development (see World Bank 1988 op cit., chapter 6 of this report, and para. 2.25). Because most proposals were put together quickly, as is usual in loans for direct balance of payments support, they often included plans for studies to identify needed areas of reform and implementation approaches. Sometimes these plans reflected serious intentions to undertake reform (Indonesia, Morocco), but often they served merely to delay difficult actions. Progress was also slow in the technical assistance component that accompanied most loans.

Table 2-1 Intensity and Distribution of Major Trade Policy Reform Proposals Among 40 Countries Receiving World Bank Trade Adjustment Loans, 1979-87

<i>Area of reform</i>	<i>Present</i>	<i>Not present</i>	<i>Strong</i>	<i>Moderate</i>	<i>Mild or absent</i>
Exchange rate ^a	38	2			
Export promotion ^b	33	7			
Protection studies	28	12			
Overall export policy			15	15	10
Imports for exports			17	15	8
Overall import policy			14	15	11
Nonprotective quantitative restrictions			14	16	10
Protective quantitative restrictions ^c			14	15	11
Tariff level ^c			7	21	12
Tariff dispersion			7	24	9
Schedule of future action			6	29	5
Overall reduction in antiexport bias			17	12	11

a. Often these were not written conditions, but important understandings in the program — usually in conjunction with the IMF.

b. Removal of restrictions, provision of export credits, insurance, guarantees, institutional development, and the like.

c. Where reforms replaced QRs by tariffs, they are counted in both lines. Sometimes the changes reduced protection and sometimes not.

Source: World Bank data.

2.10 A final area that is closely related to trade policy reform and that has received inadequate attention in adjustment lending is policy reform affecting domestic competition (on its importance, see box 2-2 on Poland, overleaf). Price and wage controls, entry and exit barriers, and other regulatory constraints prevent the economy from adapting to the changes in incentives that accompany trade policy reforms (chapter 7). Yet, reform of these policies has seldom been addressed in adjustment lending. One study found that only two percent of adjustment lending conditions were related directly to entry and exit barriers and three percent to other non-price regulatory policies.¹⁴

Implementation Record

2.11 For twenty-four of the forty countries receiving trade adjustment loans, data are available for an assessment of policy reform implementation. Implementation records were judged to be good for the two of the twenty-four countries that had a low level of restrictiveness (Chile) or antiexport bias (Korea) at the beginning of the 1980s. Implementation records for the eight countries judged to have a moderate level of restrictiveness covered the range from low (for example, Malawi), through medium (Panama), to high (Mauritius). Among the remaining fourteen countries that had high initial levels of restrictiveness, six of the nine countries with strong commercial policy reform proposals had relatively good implementation records (Ghana, Madagascar, Mexico, Philippines, Senegal, and Turkey).

2.12 Substantial action has been taken to reduce export restrictions (licensing, prohibitions, and export taxes). Restrictions on imported inputs used in exports have also been significantly reduced. On the import side, several countries have made substantial progress in switching from quantitative restrictions to tariffs. Many countries have adopted tariff reform programs. Progress has been most notable in reducing maximum tariff rates, limiting the number of tariff classes, establishing a (low) minimum tariff, and reducing tariff exemptions. The lowering of protection levels, however, appears modest on average. Most trade regimes continue to maintain escalated tariff systems, with higher tariffs (and quantitative restrictions) on final goods than on capital goods and lower rates (and exemptions) for intermediate and raw materials. Tariff dispersion has usually been reduced, but dispersions in effective protection are still large. This experience supports the conclusion of the study by Michaely et al. (op. cit.) that commercial liberalization is a drawn-out process. For instance, only four countries (Jamaica, Mexico, Senegal, and Turkey) of the fourteen with highly restrictive regimes in the early 1980s had achieved a high degree of commercial liberalization by 1987-88. Guinea, a country not in the sample for want of time-series data, also had a highly restrictive regime that was substantially liberalized in 1986-87.¹⁵

2.13 Reform implementation has been stronger in exchange rate policy than in commercial policy. There was a larger depreciation in the real exchange rate in most of the countries receiving trade adjustment loans compared to others, in part because their somewhat higher debt and significantly greater external shocks made larger depreciations necessary. The larger depreciations were also the result of accompanying exchange rate reform with macroeconomic stabilization and some trade liberalization (see chapter 5 also). Since most countries begin reforms with an overvalued exchange rate, a real depreciation of the currency is an important liberalization measure for several reasons. In the presence of binding quantitative restrictions on some imports, it increases not only the price of tradables relative to

**Box 3-3. Poland:
Policies for Trade
Promotion**

In 1987 Poland began to implement the second stage of the economic reform program initiated in 1981. The thrust of the reform is to continue decentralization, simplify administrative procedures, and permit freer play of market forces. Its spirit is most succinctly captured in the frequently expressed principle: "everything is allowed that is not explicitly forbidden by law." Specific elements include more automaticity of procedures, increased transparency and growing uniformity of trade instruments, gradual lowering of protection to bring prices closer to world levels, demonopolization of trade privileges, and increasing use of the exchange rate as an instrument of trade promotion. Under the auspices of the UNDP/World Bank Trade Expansion Program, a mission visited Poland to evaluate the reforms and recommend steps to enhance Poland's opportunities for greater trade. The mission did not examine issues related to CMEA trade. Some of the mission's conclusions, which may be relevant to other reforming socialist economies, are summarized below.

Three problem areas remain: continuing macroeconomic disequilibrium, central regulation of prices and quantity allocations, and distorted trade incentives. Internal macroeconomic imbalance - - in the form of shortages and excess domestic demand and liquidity fed by budgetary ex-

cesses — is a major factor that inhibits export expansion by absorbing much of production. The planning mechanisms of price control and materials allocation continue to be used to deal with this imbalance, thus inhibiting the flexible price and resource allocation adjustments needed for the transition to efficient trading patterns. Progress has been made on trade policy measures through devaluation, increased foreign exchange retention rights for enterprises, tax relief measures, and substantial demonopolization of trade rights. But two unfavorable characteristics of the trade regime persist: incentives are not uniform but discriminate by sector, and incentives favor the less efficient producers. Foreign exchange allocation is the keystone of export policy, but in the context of goods shortages and excess zloty liquidity, attempts to use foreign exchange allocations to motivate exporters have resulted in a multiplicity of foreign exchange allocation mechanisms and "markets," and high premiums in the markets that are not strictly controlled.

Several recommendations were made to deal with these problems. First, the macroeconomic disequilibrium must be resolved. Successful trade promotion requires solving generalized shortages through the elimination of excess zloty liquidity, the imposition of greater budget discipline, and a reduction in price and wage controls. To the extent that rationing persists because of the macroecon-

nontradables but also of exportables relative to the abovementioned importables, thereby reducing antiexport bias. Moreover, a large depreciation can eventually make some quantitative restrictions redundant, thereby resulting in a de facto liberalization of the import regime (chapter 7).

2.14 Table 2-2 presents a matrix showing the extent of exchange rate depreciation and the intensity of commercial policy reforms among the twenty-four countries as indicators of trade regime changes during the 1980s. The table focuses on changes in the post-trade-loan period. But by comparing these changes with the situation prior to the loan, it also gives a rough idea of how much of the problem was being addressed. The table does not fully capture the extent of the initial problem, however. For example, both Korea and the Philippines depreciated their real exchange rate "moderately" compared to their long-term levels, but the "adequacy" (see box 5-1) of the long-term levels may have been different in each case. Subject to this caveat, the table distinguishes the degree of reform in the twenty-four countries in the 1980s. Korea, Mexico, and Turkey are three of the most substantial commercial policy reformers. Chile, Colombia, Ghana, Pakistan, and Zambia sustained the largest depreciation in real exchange rate in the postloan period compared to a previous long-term trend rate.

omic disequilibrium, it should be implemented in ways that ensure that exports receive comparable incentives through access to foreign exchange and materials and through the flexible application of wage and price adjustments.

Second, the reduction in the coverage of central planning and allocation mechanisms needs to proceed more rapidly to prevent the planning mechanisms (which remain administratively strong) from being applied in favor of domestic market needs at the expense of exports. Two shortcomings of price reform merit remediation. First, price liberalization has been limited largely to internationally traded goods, particularly exports, and should be extended. Second, and more fundamental, price reform has not led to the dissolution of traditional price-setting mechanisms and a new reliance on market forces but rather to the use of the price-setting mechanism to more closely simulate market-clearing prices. Retention of this administrative mechanism makes it very easy to reverse the progress of the reform. While wages and profits are not directly controlled, the application of various taxation mechanisms, including the "excess wage bill" tax, limits enterprise flexibility in setting wages. Until deeper fiscal reform brings increased reliance on taxation of personal and enterprise incomes, the restrictive effect on wage flexibility of the excess wage bill tax should be reduced or eliminated. The

very high tax rates on profits also impede efficient resource reallocation, particularly the comparatively higher rate for export enterprises. Also needed is a rapid move to positive interest rates to improve incentives for efficient investment. This increase in rates would reduce demand for credit and help the move to tighter monetary policies.

Third, export incentives should be simplified and made more uniform and transparent. The price equalization account, which subsidizes inefficient exporters at the expense of efficient ones, should be reduced in scope. Any subsidy should be received by all exporters of a given product, regardless of their level of profitability; ceiling rate should be established; and rates should be reduced as the zloty is devalued. Foreign exchange retention accounts represent the strongest direct incentive for exporters. The system should be simplified and move toward greater uniformity as soon as possible. The role of fiscal incentives should decline as real devaluation, greater retention rights, and less administrative intervention stimulate exports.

Source: UNDP/World Bank Trade Expansion Program, O. Havrylyshyn, 1989, Poland: Policies for Trade Promotion, Washington D.C.

Quantitative Measures of Changes in Incentives

Real Exchange Rate

2.15 The real exchange rate is an indicator of the relative incentives for the production of tradables versus nontradables (see box 1-1 on measurement issues regarding these incentives). Adjustments in real exchange rates were substantial in a large number of trade adjustment loan countries (see box 5-1 on the real exchange rate). The adjustments involved a series of devaluations or the institution of a crawling peg, supported by macroeconomic adjustments. Figure 2-1 compares changes in a trade-weighted multilateral real exchange rate vis- a-vis major trading partners for twenty-one industrial countries, forty recipients of trade adjustment loans, and forty-seven nonrecipients. The domestic currency depreciated in real terms by more than 22 percent between the period 1981-83 and the period 1985-87 among the forty trade loan recipients, in contrast to 2 percent in the nonrecipient countries, and appreciated slightly in the industrial countries (table 2-3, overleaf). This implies that the price of traded goods relative to the price of nontraded goods increased in the trade adjustment loan countries.

Table 2-2 Intensity of Reforms in Trade Regimes in 24 Sample Countries During 1980-87

Exchange rate depreciation ^a	Reduction in antiexport bias through commercial policy reform (export and import)		
	Mild	Moderate	Substantial
Mild (no depreciation or some appreciation)	Guyana ^a	Côte d'Ivoire, Senegal	
Moderate (less than 20%)	Kenya, Malawi, Togo, Yugoslavia ^a , Zimbabwe ^a	Bangladesh, Madagascar, Morocco, Panama, Philippines, Thailand	Jamaica, Korea, ^b Mauritius
Substantial: (20% or more)	Pakistan, Zambia ^a	Colombia, Ghana	Chile, ^b Mexico, Turkey

Note: The table indicates changes after reform compared to the prereform situation. In the case of commercial policy, the judgment of the prereform situation is derived from accounts in World Bank reports. In the case of the exchange rate, it is based on trends in purchasing power parity over the long term. In some countries, there have been important changes since 1987 that are not captured in this table: improvements in Morocco and reversals in Turkey are cases in point. In some instances major improvements occurred in 1986-87, which are emphasized in the table (for example, Mexico and Jamaica in commercial policy). There are also important reformers which are not included in this sample because adjustment lending for trade policy was too recent (Indonesia and Uruguay) or because the reform was not related to adjustment lending (Bolivia, Haiti).

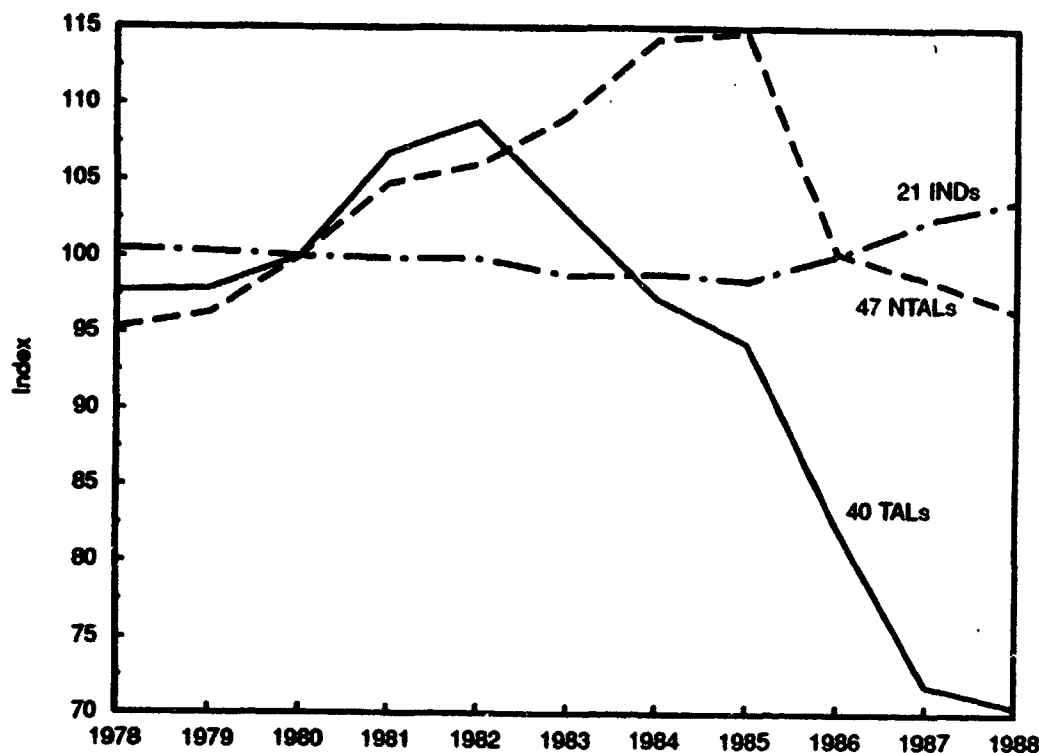
^a Aborted, reversed, or no commercial policy reform.

a. Based on a measure of the average change in real exchange rate during the post-first-loan period compared to the period 1965 to the year before the first loan.

b. Chile and Korea had already achieved substantial reforms by the early 1980s.

Source: World Bank and IMF data.

Figure 2-1: Real Exchange Rate Indices, for Selected Country Groupings, 1978-88
(unweighted averages; 1980= 100)



21 INDs = twenty-one industrial countries.

40 TALs = forty trade adjustment loan recipient countries.

47 NTALs = forty-seven nonrecipients of trade adjustment loans.

Note: Multilateral index of the real exchange rate measured against a basket of currencies of trading partners.

Increase in index indicates a real appreciation.

Source: Based on IMF data.

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Table 2-3 Real Exchange Rate Indices for Selected Country Groupings, 1980-88
(unweighted averages)

Sample group	1980	1981	1982	1983	1984	1985	1986	1987	1988 ^a	Percentage change	
										1984-86/ 1980-82	1985-87/ 1981-83
10 Intensive trade loan recipients	100.0	114.0	113.2	98.6	84.0	81.2	73.2	69.4	69.8	-27.1 ^{**}	-31.3 [*]
26 Trade loan recipients	100.0	107.7	110.4	103.5	96.2	93.4	81.9	72.1	71.5	-14.6 ^{**}	-23.1 [*]
40 Trade loan recipients	100.0	106.8	108.8	102.9	97.2	94.4	82.2	71.9	70.5	-13.3 ^{**}	-22.0 [*]
47 nonrecipients	100.0	104.7	106.0	109.2	114.2	114.7	100.2	98.5	96.4	5.9	-2.0
Developing countries	100.0	105.8	107.4	106.1	105.7	104.5	91.2	85.2	83.4	-3.8 [*]	-12.0
Industrial countries	100.0	99.9	99.8	98.7	98.8	98.4	100.1	102.7	103.7	0.8	-0.5

Note: See box 1-3 and table A-3 in chapter 1 for a discussion of the sample groupings. Increase in index indicates a real appreciation.

^{*} The difference in means of depreciation between the trade adjustment loan recipients and nonrecipients is significant at the 5-percent level.

^{**} The difference in means of depreciation between the adjustment loan recipients and nonrecipients is significant at the 1-percent level.

a. Preliminary estimates.

Source: Based on IMF data.

2.16 While economy-wide measures of the real exchange rate can indicate a change in bias against tradable goods, these measures can rarely show the changes that may occur in relative prices between exportable commodities and import-substitutes.¹⁶ A partial distinction can be made by using separate export and import weights to calculate the real exchange rate. However, to fully make this distinction, measures of changes in effective protection for the different sectors, or measures of real effective exchange rates for exporting activities versus import-substituting activities, would be needed. While individual country studies of import protection and some of its effects exist for Chile, Colombia, Kenya, Korea, Mexico, Morocco, Pakistan, Philippines, Thailand, and Turkey as well as for Argentina (not in the group of twenty-four countries), the results are not comparable across countries and are rarely based on time-series data. Comparisons of even nominal protection rates or the coverage of quantitative restrictions are difficult. The World Bank should assist in building up a database to enable comparisons of nominal and effective protection rates over time and across developing countries.

Import Liberalization and Protection

2.17 One measure of the extent of import liberalization for an import category is the change in its import/production ratio. Overall, however, import/GDP ratios can reflect the availability of financing as well as import liberalization. During the 1980s, import levels in developing countries declined (in current and constant prices) on average because of balance of payments problems, as did import/GDP ratios. The ratio of nonfuel imports to GDP declined as well, although the extent of the fall was less than for total imports. The reduction in the import/GDP ratio was significantly less for countries associated with trade reforms and adjustment lending. The declines in the ratio were systematically less among countries that received trade adjustment loans than in the other countries (table 2-4, overleaf).

2.18 Examination of the conditions in trade adjustment loans and their implementation records indicate that import protection on average has fallen modestly (rather than dramatically) in most of these countries (para. 2.12). By and large, tariff structures remain escalated, with the highest protection afforded to final goods. This seems consistent with the evidence on changes in the composition of nonfuel imports since 1980. If protection of the most protected goods (consumer goods) had been reduced substantially, they would have increased as a fraction of imports, and intermediates used in their domestic production would have decreased their share in the total. Instead, intermediate goods, and capital goods to a lesser extent, have increased relative to consumer goods in the total (table 2-5).

2.19 For most countries, detailed quantitative measures of the direct effects of the reforms are not available. The limited information that is available on individual countries shows considerable variation in changes in import impediments (see annex table A-1). Chile, Korea, Mexico, the Philippines, and Turkey are among countries that undertook broad import reform. Chile's import liberalization has been one of the most extensive in recent time. Quantitative restrictions were rapidly replaced by virtually uniform tariff rates of 10 percent by mid-1979. The uniform rate has been changed several times but has been stable at 15 percent for the last several years. Commercial policy reversals were corrected and coupled with a substantial devaluation during 1983-85; since 1983 the export/GDP ratio has nearly doubled. Mexico implemented a major reduction in import restrictions in the mid-1980s, substantially reducing antiexport bias and achieving a large increase in nonoil exports. Korea has sustained liberalization and export development over a long period of time. Turkey carried out a major trade reform and provided substantial export incentives in the first half of the 1980s, transforming the economy from its inward orientation to a more outward-looking one and nearly tripling its export/GDP ratio during 1980-87. The Philippines began with tariff

Table 2-4 Imports of Goods and Nonfactor Services in Constant Prices as a Percentage of GDP for Selected Country Groupings, 1980-88 (unweighted averages)

Sample group	1980	1981	1982	1983	1984	1985	1986	1987	1988 ^a	Percentage change	
										1984-86/ 1980-82	1985-87/ 1981-83
10 Intensive trade loan recipients	32.7	31.9	27.9	27.8	28.6	29.0	28.4	31.6	28.0	-7.2 ^{**}	1.5 ^{**}
26 Trade loan recipients	34.3	32.5	29.1	28.1	27.9	28.5	28.5	29.6	26.1	-11.4 ^{**}	-3.5 ^{**}
40 Trade loan recipients	33.4	32.3	30.5	29.4	29.1	29.3	28.7	29.1	26.2	-9.5 ^{**}	-5.6 ^{**}
47 Nonrecipients	39.9	40.9	39.7	37.1	32.9	32.9	30.9	30.1	31.2	19.8	-20.2
Developing countries	36.9	36.9	35.4	33.5	31.1	31.1	29.8	29.6	28.4	-15.7	-14.3
Industrial countries	35.5	34.9	34.7	34.5	36.4	37.1	38.0	37.7	40.1	6.0	8.2

Note: Very similar results are obtained using current prices.

a. Preliminary estimates.

* The difference in means between the trade adjustment loan recipients and nonrecipients is significant at the 10-percent level.

** The difference in means between the trade adjustment loan recipients and nonrecipients is significant at the 5-percent level.

Source: World Bank estimates based on national account statistics.

Table 2-5 Composition of Nonfuel Imports at Current Prices in the Trade Adjustment Countries, 1980-87 (percentages)

<i>Component</i>	<i>1980</i>	<i>1982</i>	<i>1983</i>	<i>1984</i>	<i>1985</i>	<i>1986</i>	<i>1987</i>
Consumer goods	22.4	20.4	20.2	19.7	18.0	17.9	16.5
Capital goods	31.0	32.6	33.7	32.7	33.1	32.2	32.2
Intermediate goods	46.6	47.0	46.1	47.6	48.9	49.9	51.3
Total nonfuel imports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Average value (US\$ million)	4,260	3,871	3,492	3,568	3,517	3,818	4,379

Note: Data are averages for the thirty-seven countries for which data were available.

Source: World Bank estimates based on balance of payments data.

reform in the early 1980s and, after some delays, followed up with substantial reductions in quantitative restrictions in the mid-1980s. Its export/GDP ratio increased modestly, from about 19 percent in 1978-81 to 23 percent in 1987.

2.20 Milder reform and reform reversals occurred in many other cases. Colombia, whose trade regime has been characterized by remarkable stability over the past thirty years, undertook some export promotion along with modest import reform in the 1980s. Kenya and Pakistan, among many others, undertook only mild reforms although their trade regimes are quite restrictive. Yugoslavia and Zambia implemented reforms, only to abandon or reverse them later. Overall, the effect of import reform on antiexport bias has varied, ranging from very significant reduction in Mexico to little change in Pakistan. For most countries, there is insufficient information to measure any change in bias. An effort should be made in the future to assemble the needed data.

Progress and Constraints in Reform

2.21 Reforms have been relatively substantial in removing export taxes, establishing duty-exemption schemes for exporters, and making tariffs more uniform. But there has been less success in institutionalizing and sustaining some of the price changes. By and large, institutional reform of trade policy has been limited. There are many instances of abandonment, reversals, and flip-flops in price policies. Despite modest goals, Yugoslavia abandoned its reforms; Kenya and Côte d'Ivoire made slow progress; Morocco and Thailand partially reversed their tariff reform; Argentina reversed its reform of quantitative restrictions; and Sierra Leone, Somalia, Uganda, and Zambia abandoned their use of exchange rate auctions. If policy changes are not sustainable and credible, the supply response is also likely to be limited.¹⁷

Constraints to Policy Reform

2.22 Based on the sample of twenty-four countries, background studies, and interviews with World Bank economists, as well as previous studies,¹⁸ four factors can be identified as constraints to more thorough implementation of reforms. Poor

macroeconomic performance and conflicts between trade policy reform and stabilization goals are one impediment to reform implementation. Recession, continuing high inflation rates, and real appreciation of the currency inhibited earlier reforms in Costa Rica, Jamaica, and the Philippines. Balance of payments problems resulting from a fall in copper prices and faulty exchange rate management contributed to Zambia's policy reversal. In a few cases, trade reforms have been curtailed because of the adverse effects on the fiscal deficit of a fall in trade tax revenue and the failure to compensate for the loss by reducing spending or raising revenue in other ways. For fiscal reasons, Morocco partially reimposed the import surcharges it had reduced in an earlier phase of reform. In the Philippines, the imposition of customs duties and tariff surtaxes to increase revenues for stabilization purposes has conflicted with attempts to liberalize imports. While these conflicts may sometimes be unavoidable, less distorting, alternative means of generating revenue (or reducing expenditure) are preferable to trade taxes, which create distortions. When a country has a weak tax system, however, some trade taxes may remain necessary in the short term to generate revenue (see chapter 5).

2.23 Second, a weak short-term supply response has been an impediment to reform by limiting its effectiveness. If export and efficient import-substitution industries increase output strongly and rapidly, this helps the sustainability of reforms by quickly absorbing the resources released from the previously highly protected sectors. Rapid export response also helps avert a balance of payments crisis. Slow export expansion contributed to Kenya's failure to liberalize. Costa Rica and Côte d'Ivoire, which made more rapid progress in commercial policy reform, were vulnerable to declining terms of trade, and their export diversification is just beginning. Even Chile, with its unusually high commitment to reform, has been helped by a strong export response, which has increased the availability of foreign exchange and so has helped prevent a balance of payments crisis and consequent policy reversals. In Jamaica, the availability of financing has been crucial for maintaining the liberalization effort in the face of a worsening current account balance.

2.24 A third constraint is inadequate government commitment to the reform program. Inadequate commitment has limited the sustainability of reforms, particularly in the highly indebted countries and in Sub-Saharan Africa. In a number of cases in which the government has not "owned" the program (Kenya, Malawi, and Zambia), implementation has been weak. The slow pace of reform has in turn sometimes hurt the credibility of the program for the private sector, further diminishing its sustainability. Changes in political regime and leadership often compound these problems and have led to policy reversals. A related constraint is internal opposition to reform (see chapter 4). Resistance from those who stand to lose from policy changes, as in Zimbabwe, has often delayed or reversed reductions in protection. In Yugoslavia, despite modest goals related to trade and the foreign exchange regime, political opposition (in addition to macroeconomic instability) led to dilution or reversal of reforms.

2.25 A fourth constraint relates to administrative or institutional weaknesses that result in inadequate implementation capacity. Progress in institutional reform has been particularly limited. Sometimes a country's limited administrative capacity has been a critical constraint: Bangladesh and Côte d'Ivoire made slow progress in part because of administrative difficulties. The introduction of tariff

reforms, export tax rebates, duty drawback systems, and bonded warehouses has been subject to administrative delays in many cases. Often, changes in policy require changes in administrative arrangements and capabilities if they are to be successfully implemented (for example, import administration may need to be reorganized to implement tariff reforms). Sometimes, policy changes have been predicated on the completion of studies, which were delayed for various reasons (for example, in Colombia and Kenya). In many cases, a general problem is the lack of a medium-term economic policy planning framework within which trade reforms can be discussed, coordinated, and implemented. Planning ministries or departments in many countries (Colombia, India, and Pakistan, for example) are well organized to conduct medium-term physical and financial planning, while many finance ministries and monetary authorities are well-equipped to deal with short-term macroeconomic policies. Institutional capacity for formulating trade policies for the medium term, however, is often weak. Furthermore, an intellectual lobby for the promotion of medium-term reforms in this area is also lacking.

New Sector Reform Programs

2.26 Almost all of the seventeen adjustment loans introduced during calendar year 1988 and the first half of 1989 with significant trade policy reform components were follow-up loans to others that had also addressed trade policy issues. Ten were in Sub-Saharan Africa, four in the Latin America and Caribbean region, one in Asia, and two in the Europe, Middle East, North Africa region. The great variance across programs in the actions to be taken emphasizes both how far some countries have progressed and how little reform has been undertaken by others. It also emphasizes the multiplicity and multiple layers of trade and domestic regulations that have insulated economies and that must be removed to open them to international competition and encourage exports.

2.27 Of the countries that still have far to go, many have import licensing requirements and high and widely dispersed tariff rates. For many, the real binding constraint to imports, at least in some sectors, appears to be foreign exchange rationing. This is especially true in Sub-Saharan Africa. Thus, many of these programs must begin by reforming the system of foreign exchange allocation. It is not clear, however, to what extent protection will actually be reduced by such measures alone. To reduce the divergence between domestic and world price structures, not only must foreign exchange rationing be relaxed, but nontariff barriers, sometimes of several different types, must be relaxed and tariffs lowered. Some of the reform programs in Sub-Saharan African countries that have already received multiple trade policy loans are still at a very early stage, at least on the import side, and are a long way from significantly reducing protection. A number of programs call for a reduction in the coverage of nontariff barriers, but little reduction in tariffs (Honduras, Nigeria, Togo, Tunisia.) Few of the programs were analyzed in terms of their prospective effects on actual effective protection in different sectors, so even where some progress is made in reducing nontariff barriers and tariffs, it is not always clear that the progress is coming in the most protected sectors.

2.28 Other countries in 1988-89 are continuing to implement long- running trade policy reforms and are getting into relatively advanced issues. Mexico, for example, has already eliminated almost all nontariff barriers to manufactured imports and

has one of the lowest and most uniform tariffs in the developing world. However, it is now improving its antidumping system because of some concern that it was providing unjustified protection. In addition, bottlenecks created by regulations in the transport sector and inefficiencies in the customs service have impeded efficient adjustment to the policy reform, and these are now being addressed in several sector adjustment loans. In Argentina, some goods liberated from protective barriers in the first phase of reform were being reprotected by the use of official reference prices, ostensibly to guard against unfair trade practices. The current program therefore calls for the use of GATT-consistent customs valuation and substitution of an antidumping system for the reference prices. Other programs, including those of Indonesia and Kenya, also include establishment or improvement of such systems.

2.29 Another advanced reform issue, that of the nature of tariff classifications, is being addressed in Morocco. Even after some reduction in the protective effects of nontariff barriers and tariffs, a complex and finely differentiated classification code was being used to provide nontransparent protection to certain firms. This code is being revamped. Finally, some of the more advanced reformers — notably Indonesia, Mexico, and Morocco — are including measures in their programs aimed specifically at attracting foreign direct investment. For these countries, foreign direct investment can be an important source of new technology, entrepreneurial skills, and market contacts for expanding exports and efficient import substitutes (chapter 8). A few less-advanced reformers (Kenya and Nigeria) also have such measures. In these countries, care should be taken to ensure that potential investors understand that current protection to domestic markets will be dismantled, so that investment (foreign or domestic) does not take place in inappropriate sectors where protection is currently high.

2.30 Many programs include measures to grant exporters access to duty-free imported inputs to insulate them from the effects of import tariffs. These schemes take the form of duty drawbacks, waivers, temporary admission regimes, or export processing zones. Kenya's program includes steps to establish or improve three different schemes. Many such schemes, however, concentrate only on rebating tariffs paid on imported inputs, without insulating exporters from nontariff barriers that make the inputs difficult to get. Different types of exporters benefit from different types of schemes, yet few programs recognize this and differentiate their programs accordingly (see Chapter 6).

2.31 Finally, it is worth noting that some of the programs in Sub-Saharan Africa (Malawi, Nigeria, Togo), rather than reducing tariffs, are taking steps to harmonize production taxes and tariffs, so that a product is taxed at the same level whether its origin is foreign or domestic. If carried to completion, this will essentially convert a trade tax into a less distortionary consumption tax, presumably at a fairly low rate if the whole package is approximately revenue-neutral. This approach is especially appropriate in those cases where trade tax reductions would expand the budget deficit (chapter 7).

NOTES

1. Several authors have examined trade liberalization episodes of the past three decades. See, for example, S. Edwards, 1989, "Openness, Outward Orientation, Trade Liberalization, and Economic Performance in Developing Countries," PPR Working Paper No. 191, Washington, D.C.: World Bank; M. Michaely, D. Papageorgiou, and A. Choksi, forthcoming, "Liberalizing Foreign Trade: Lessons of Experience in the Developing World," World Bank, Washington, D.C.; and World Bank, 1987, *World Development Report 1987*.
2. The findings are based on N. Halevi, 1989, "Trade Liberalization in Adjustment Lending," background paper for this report, World Bank; see also S. Laird and J. Noguea, 1988, "Trade Policies and the Debt Crisis," PPR Working Paper No. 99, Washington, D.C.: World Bank. See also UNCTAD, op. cit.
3. Export restrictions have included prohibitions based on economic or safety grounds, restrictive licensing, export quotas, export taxes, and regulations limiting foreign exchange retention.
4. Quantitative restrictions have included import prohibitions, quotas, and restrictive licensing of various sorts. Other restrictions include foreign exchange licensing and control, advance import deposit requirements, and restricted import channels (as in the case of a state trading monopoly).
5. In addition to customs duties, common customs charges include customs surcharges, surtaxes, stamp taxes, and taxes on foreign exchange.
6. Loan recommendation reports; country memoranda; country briefs; audit reports; mission reports; background work for World Bank, 1988, *Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Series No. 1, Washington, D.C.; IMF reports; and the draft paper from a Ford Foundation project on "Trade Policy and the Developing World."
7. One should emphasize that tariff rates and the coverage of nontariff barriers are not comparable. Comparability would require estimating price differences resulting from the imposition of quantitative restrictions. While such data are not generally available, the tariff equivalents of quantitative import restrictions appear to be much higher than existing tariff rates.
8. R. Erzan, H. Kuwahara, S. Marchese, and R. Vosenaar, 1988, *The Profile of Protection in Developing Countries*, UNCTAD Discussion Paper No. 21, New York: United Nations Conference on Trade and Development.
9. GATT, 1980, *The Tokyo Round of Multilateral Trade Negotiations-II Supplementary Report*, Geneva. J. M. Finger and S. Laird (1987, "Protection in Developed and Developing Countries — An Overview," *Journal of World Trade Law* 2, no. 6) estimate the average tariff for eleven industrial countries weighted by import values at 4.6 percent for 1983. Reliable estimates are unavailable for agricultural products.
10. Finger and Laird, 1987, op cit.
11. S. Laird, and A. Yeats, 1988, "Trends in Nontariff Barriers of Developed Countries, 1966-86," PPR Working Paper No. 137, Washington, D.C.: World Bank. Including "secondary trade restrictive intent" raises the figure to 27.2 percent, while estimates for imports "affected," rather than covered, are even higher — 48 percent.
12. See, for example, B. Balassa, 1985, "Outward Orientation," World Bank Discussion Paper, Washington, D.C.; M. Corden, 1987, *Protection and Liberalization: A Review of Analytical Issues*, Washington, D.C.: IMF; M. Michaely, 1986, *Guidelines for Country Economists for the Review and Evaluation of Trade Policies*, CPD Discussion Paper No. 1986-7, Washington, D.C.: World Bank.
13. In some cases, particularly in Sub-Saharan Africa, additional incentives were introduced for import substitution — for example, higher duties on imported inputs that compete with domestic production. (Increasing the duties on imported inputs reduces the protection provided to the finished goods that use them, although this may increase overall protection; see chapter 7.)
14. World Bank, 1989, "Competition Policies for Industrializing Countries," Industry Development Division, Industry and Energy Department, Sector Policy and Research.

15. Guinea undertook a large devaluation followed by an abolition of import licensing. Tariffs were reduced to a uniform base rate of 10 percent with surcharges of 20-40 percent on luxury imports. Subsequently some ad hoc exemptions and controls have been instituted, but overall, Guinea's trade regime has become substantially more open than before.

16. When quantitative restrictions are binding before and after the depreciation, however, the exchange rate depreciation increases the price of exportables relative to importables.

17. D. Rodrik (1988, "Liberalization, Sustainability, and the Design of Structural Adjustment Programs," Trade Policy Division, Country Economics Department, World Bank) concludes that the sustainability of policies is more important than liberalization.

18. J. Bhagwati, 1978, *Foreign Trade Regimes and Economic Development*, New York: National Bureau of Economic Research; A. O. Krueger, 1978, *Liberalization Attempts and Consequences*, Cambridge, Mass.: Ballinger; I. M. D. Little, T. Scitovsky, and M. F. Scott, 1970, *Industry and Trade in Some Developing Countries: A Comparative Study*, New York: Oxford University Press.

3 PERFORMANCE OUTCOMES AND TRADE REFORMS

Summary and Conclusions

3.01 The findings presented here corroborate the positive association between exports and economic growth found in previous studies. Tracing the influence of individual measures in the mix of policies behind superior export and GDP growth is more complex, however, because of the simultaneous presence of a variety of potential causes. Both the longer-term experience and the adjustment episodes of the 1980s suggest a positive contribution to performance from trade policy and other structural reforms. Real exchange rate depreciation and reductions in antiexport bias are linked to improved performance in output and exports. In the context of adjustment lending, additional financing has been an important contributor to relative improvements, as have policy reforms. Trade adjustment loans are associated with a mild improvement in performance compared to their absence. This improvement is stronger when the focus is on early and intensive (three or more) loan recipients. The improvement in performance is also stronger and statistically more significant when the comparison is between those judged trade policy reformers and those judged nonreformers, rather than simply between loan recipients and nonrecipients.

3.02 The evidence suggests gains from the combination of exchange rate depreciation and commercial policy reform. Generally, the positive effects on exports and growth resulting from a real devaluation and export reform would be expected to be more immediate than those from a real devaluation and import liberalization. At the same time, experience suggests that longer-term and sustained development of exports and output depends not only on export policies but also on import liberalization. While import liberalization is often expected to cause short-term unemployment, a previous nineteen-country study found no clear empirical evidence linking the two on aggregate. There is evidence in another study, however, of an association between decreases in the real wages of low-income laborers and a real devaluation.

Exports and Output

3.03 While there is evidence of a positive association between economic performance and outward orientation, establishing the policy links between them is difficult. Economic performance is the result of a variety of factors whose influence is not easily accounted for fully. Even when factors other than trade reform — such as external shocks, size of the bureaucracy, status of property rights — are incorporated in the analysis, the observed association between trade policy and outcome may partly reflect other, ignored considerations. Given this caveat, we first examine evidence on the effects of export orientation on performance and then turn more specifically to the connection between policy reform and performance. We draw both on the experience of the 1980s and on a longer time period.

3.04 The evidence from the 1980s corroborates the positive association between trade policy reform and output growth found in previous work. The 1986 World Bank study on adjustment lending documented higher export and import growth rates in countries that experienced higher GDP growth during 1980-87.¹ Furthermore, recipients of trade adjustment loans have experienced a stronger expansion

in manufacturing and merchandise exports and a significantly higher GDP growth rate than others (table 3-1). A part of this recovery may not be unexpected, because performance was poorer among trade adjustment loan recipients at the outset of the lending than among nonrecipients. The receipt of adjustment loans and improved performance, in turn, have been associated with stronger trade policy reforms — for example, with greater depreciation of the real exchange rate and larger increases in import/GDP ratios. These observations suggest a broad linkage between policy change and performance and justify, as a means of understanding the policy-performance connection, the more in-depth look at the adjustment loan countries presented in this chapter.

Table 3-1 Average Annual Growth Rates of Export Volume and GDP for Selected Country Groupings, 1980-88
(unweighted averages in percentages)

Category/ country grouping	1980	1981	1982	1983	1984	1985	1986	1987	1988 ^a	Percentage change	
										1984-86/ 1980-82	1985-87/ 1981-83
<i>Merchandise exports</i>											
Developing countries	5.4	2.4	2.6	0.1	6.6	5.2	3.7	6.0	4.4	49.0	19.2
10 Intensive trade loan recipients	12.1	7.5	7.8	-4.9	11.5	3.5	9.2	7.5	3.5	-11.7**	94.2
26 Trade loan recipients	9.1	4.8	2.2	-2.9	7.3	3.6	8.3	7.8	5.1	19.3**	380.5**
40 Trade loan recipients	7.6	4.7	-0.4	-1.2	6.8	5.0	6.8	5.7	4.1	56.3**	464.5**
47 Nonrecipients	3.5	0.3	5.1	1.2	6.5	5.4	1.0	6.3	4.8	44.9	92.4
<i>Manufacturing exports^b</i>											
Developing countries	18.4	9.7	1.2	11.2	9.8	10.6	7.2	5.5	10.7	-5.8	5.4
10 Intensive trade loan recipients	26.8	20.2	-3.8	15.6	11.9	9.5	10.2	13.7	17.2	-26.9*	4.5**
26 Trade loan recipients	18.7	7.3	0.9	6.7	9.0	11.5	5.0	12.2	12.2	-5.2*	92.6**
40 Trade loan recipients	25.6	6.5	0.6	10.3	7.4	14.1	11.6	9.9	13.7	1.2**	104.6**
47 Nonrecipients	11.9	12.6	1.7	12.1	11.8	7.4	3.5	1.7	7.9	-13.4	-52.2
<i>GDP</i>											
Developing countries	3.6	3.4	1.3	1.2	2.5	3.1	3.2	2.3	3.3	-1.1	32.9
10 Intensive trade loan recipients	0.2	2.4	1.1	0.2	2.1	2.7	3.8	4.2	4.1	128.8**	188.7**
26 Trade loan recipients	3.4	2.2	0.7	0.6	2.7	3.3	4.2	3.7	3.8	60.2**	214.1**
40 Trade loan recipients	2.7	2.8	0.3	0.4	2.2	3.5	3.9	3.2	3.6	63.7**	198.2**
47 Nonrecipients	4.4	3.9	3.1	1.9	2.8	2.7	2.6	1.6	3.0	-29.8	-23.6

Note: See chapter 1, box 1-3 and annex table A-3, for the composition of country groupings.

* Differences in means between the trade adjustment loan recipients and nonrecipients were significant at the 5-percent level.

** Differences in means between the trade adjustment loan recipients and nonrecipients were significant at the 1-percent level.

a. Preliminary estimates.

b. The definition of manufactures is from the Foreign Trade Statistics, International Economics Department, World Bank; it includes line items 5+6+7+8-88 in the SITC.

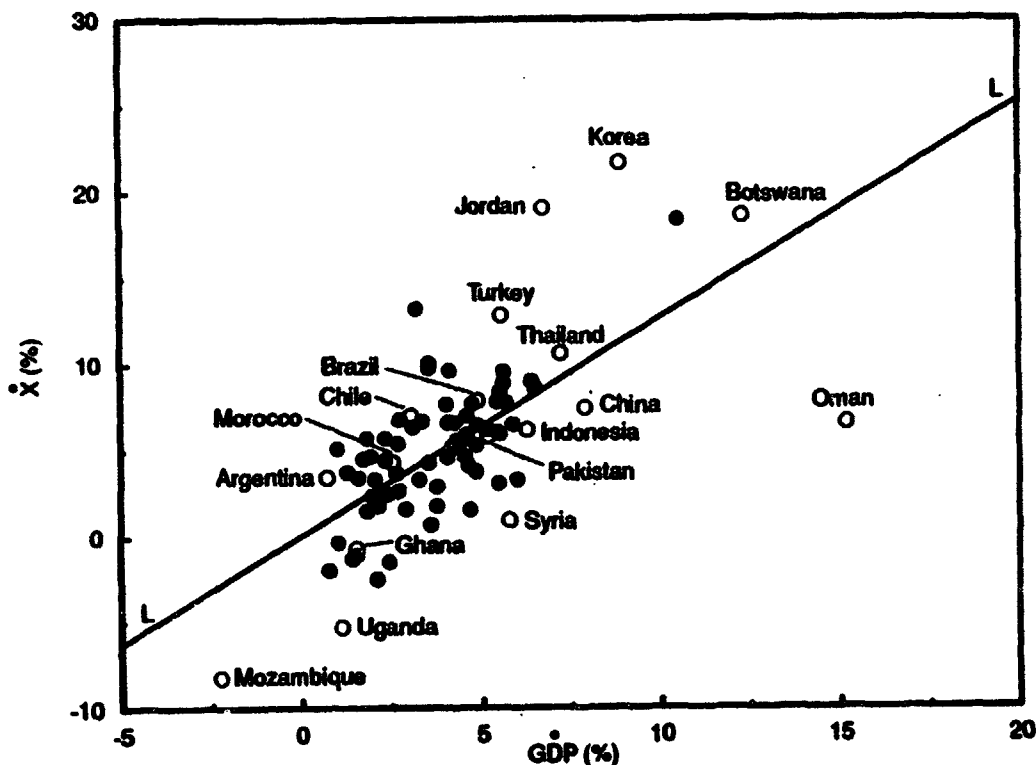
Source: World Bank data.

Trade Policy and Growth in the Long Term

Outward Orientation

3.05 A number of studies have documented a strong and positive association between growth in exports and growth in output (see figure 3-1 also). The literature on the export-GDP link also provides some conceptual basis for postulating a growth contribution from exports. Grounds for considering exports as an additional factor of production and as a source of growth include their technological diffusion effects (chapter 1) and positive externalities stemming from exposure to larger markets and greater competition (chapter 6). A growing number of empirical studies also bring out the contribution of export growth to output performance. Based on the experience of eleven economies during 1960-73 (Argentina; Brazil; Chile; Colombia; India; Israel; Mexico; Singapore; South Korea; Taiwan, China; and Yugoslavia), one study concluded that a high rate of export growth has positive effects on output growth.²

Figure 3-1: GDP and Export Growth for Developing Countries, 1965-88



GDP = Average GDP growth rate during 1965-88.
Ẋ = Average growth rate of exports of goods and nonfactor services during 1965-88.
LL = Filled line based on least square regression.
Source: Based on World Bank data

ksr/w45880d

3.06 Two limits to the observed export-GDP linkage are particularly noteworthy. First, exports are part of GDP and therefore it is hard to talk about causality between the two. In any event, the standard regression results do not permit the establishment of causality from export growth to output growth, which is often asserted.³ Where causality tests have been done, the results are mixed. However, while causality from exports to output has been confirmed for only a small number of countries, a lack of causality from exports to output has not been confirmed either. In most cases, a two-way causality seems to exist. Second, only a few studies are able to control for the actual trade policy bias of countries. Thus, even where the contribution of exports and outward orientation is established, this by itself provides only indirect evidence in favor of export-oriented policies.⁴

Impact of Trade Policy Reform

3.07 Evidence supports the view that outward-oriented approaches, in the context of macroeconomic stability, lead to better performance than do inward-looking strategies. The importance for export development of a favorable and relatively stable real exchange rate is also widely recognized. There is less agreement, however, on precisely which policy reforms underlie a greater outward orientation. Some authors conclude that government promotion of exports coupled with fiscal stability, rather than trade liberalization, explains the East Asian successes (see chapter 6 also).⁵ Others show that the movement to a more liberal trade regime increases exports and output (see below).

3.08 Trade policy reform, as defined in chapter 1, was found in a National Bureau of Economic Research (NBER) study to boost performance in a ten-country analysis (Brazil, Chile, Colombia, Egypt, Ghana, India, Israel, Philippines, South Korea, and Turkey).⁶ This study found that real devaluations generally resulted in important reductions in the premium on import licenses, lowered antiexport bias, and raised exports. The higher exports were associated with higher output and with no significant transitional costs of liberalization. Another NBER analysis, based on effective rates of protection and domestic resource costs, found that trade policy reform generated static efficiency gains and that a lowering of the bias against exports improved export performance.⁷ No evidence was found linking such reductions in trade bias to technological superiority or to higher savings ratios. In general, the literature provides theoretical and empirical support for static efficiency gains from trade reform. With respect to dynamic efficiency gains, *World Development Report 1987* suggests that growth in total factor productivity and overall GDP was better over the last quarter century in more outward-oriented economies than in more inward-oriented economies. Chenery, Robinson, and Syrquin found that the shift from a trade policy based on import substitution to a more neutral policy can account for an increase of as much as one percentage point in productivity growth, holding capital inflow and other indirect effects the same.⁸ Growth has also been shown to be enhanced by the increased growth rate of technology in outward oriented regimes (chapter 1).

Effects of Distortionary Interventions

3.09 A number of studies have focused on the effects of distortionary interventions (trade as well as other policy-induced distortions) on performance. Measuring interventions in a meaningful way is difficult, implying that the results of any single study should not be taken as definitive, but the results are consistent.

Romer (op. cit.), for example, used government spending as a share of GDP to proxy the effects of intervention in the economy. It estimated a production function using as inputs labor, human capital, the investment rate, and proxies for the effect of increased openness on technological change. It found that after accounting for these factors, the annual growth of GDP was reduced by about 1 percentage point for every increase of 10 percentage points in the government spending share in GDP. Balassa (1988, op. cit.) classified Sub-Saharan African countries as relatively market-oriented or interventionist, based on interventions in capital, labor, and foreign exchange markets. Using either a two-fold classification or a three-fold (by including an intermediate category), it found that private market economies on average gained shares in their total and agricultural export markets, while the interventionist economies lost shares. Scully (op. cit.) classified eighty-six countries according to the degree of public intervention directly determining resource allocation, regulating market activity, and redistributing income. Higher levels of intervention were associated with less openness of the economy and in turn with lower rates of growth. Finally, a background study for the report used an index of trade flow distortions based on the actual sectoral trade flows between countries and the flows that would be predicted from each country's comparative advantage.⁹ The index, which was taken to measure the degree to which policy interventions affected the composition of trade, was constructed from the difference between the predicted and actual flows. After taking into account the investment ratio, labor force growth, and educational attainment, countries with higher distortionary interventions tended to grow slower than others.

Effect of Export and Import Restrictions

3.10 Another background paper on long-term growth considered the effects of trade restrictions. It controls for growth of capital, labor, and imported intermediate inputs and considers the effects of export and import restrictions on growth. The inclusion of imported intermediate inputs (in addition to the usually considered capital and labor) takes into account the constraint on their use that results from binding trade restrictions. (It turns out that imported inputs are a binding constraint in countries with high export restrictions and not in others.) In this analysis, we also try to distinguish among the effects of export restrictions, import restrictions, and macroeconomic stability as measured by real exchange rate variability.

3.11 The regression estimates are based on thirty-five trade adjustment loan recipients for which 1975-85 data were available. The level of trade restrictiveness (see chapter 2) relates to trade regimes at the outset of trade adjustment lending.¹⁰ Thus, the year for which the trade restrictiveness is measured varies from country to country, in most cases falling between 1979 and 1983. Two time periods are considered: 1975-85 (subdivided into 1975-80 and 1981-85) and 1979-83, which corresponds more closely to the period in which restrictiveness was measured. Trade restrictiveness is represented by separate dummy variables for export and import restrictions. The dummy variable equals one for countries with high restrictiveness (according to judgments in World Bank reports) and zero for others.

3.12 Ordinary least squares estimates of per capita growth based on the dependent variables output growth and output growth per capita show a very good fit and a high level of significance for most variables. In addition to the expected positive effect of per capita growth in capital, the coefficient of the imported intermediate

inputs is generally positive and significant. The degree of real exchange rate variability is generally significant and is negatively associated with growth, which seems to confirm previous findings that economic uncertainty hurts growth. Furthermore, restrictions on exports and on imports used by exporters — as reflected by the coefficient of the export restriction dummy variable — are negatively and significantly associated with per capita growth. Import restrictiveness (as distinct from restrictions on imports for exporters and growth of imported inputs) is not found to be a statistically significant independent explanatory variable of per capita growth.

3.13 The above results seem to suggest that a reduction in export restrictions has a clearer association with GDP growth than does a reduction in import restrictions. They are also consistent with the generally held view that the efficiency effects of export liberalization are likely to be felt faster than of import liberalization. These results seem to suggest that the (Lerner) symmetry between direct export restrictions (and taxes) and import restrictions (and tariffs) may not necessarily hold in some situations, for example in periods of prolonged balance of payments imbalance. In general, however, import restrictions are expected to have a negative effect on growth and exports. The evidence from ten episodes of trade restrictions in the 1950s, 1960s, and 1970s is that more than half the burden of import protection, because of their effect on relative prices, translates into an implicit tax on exports.¹¹ Another study of thirty-two developing and five industrial economies found that both the level and dispersion of effective protection rates for importables were strongly and negatively correlated with growth rates, correcting for the effect of other factors (see also para. 3.20).¹²

Trade Reform and Economic Recovery in the 1980s

3.14 As background work to this report we also examined the links between changes in trade policy associated with adjustment lending and short- to medium-term recovery of GDP in the 1980s. As before, we examine the effect on growth of exchange rate depreciation as well as trade restrictions, but here we focus on changes in trade restrictions in the 1980s based on trade reform implementation data (discussed in chapter 2). Evidence is presented from regression estimates, cross-country comparisons, and selected country studies.

GDP Growth, Import Growth, and Reform

3.15 Short-term changes in the trade balance of goods and nonfactor services have been strongly negatively related with GDP growth as shown by regression results for developing countries in the 1980s. However, expenditure-switching and other adjustment policies induced by relative price changes (for example, as a result of real exchange rate adjustment) can, by improving efficiency, lessen the reduction in output that would otherwise result from stabilization measures. If these policy reforms lead to a supply response, a given resource balance improvement could be achieved at less foregone growth than otherwise.

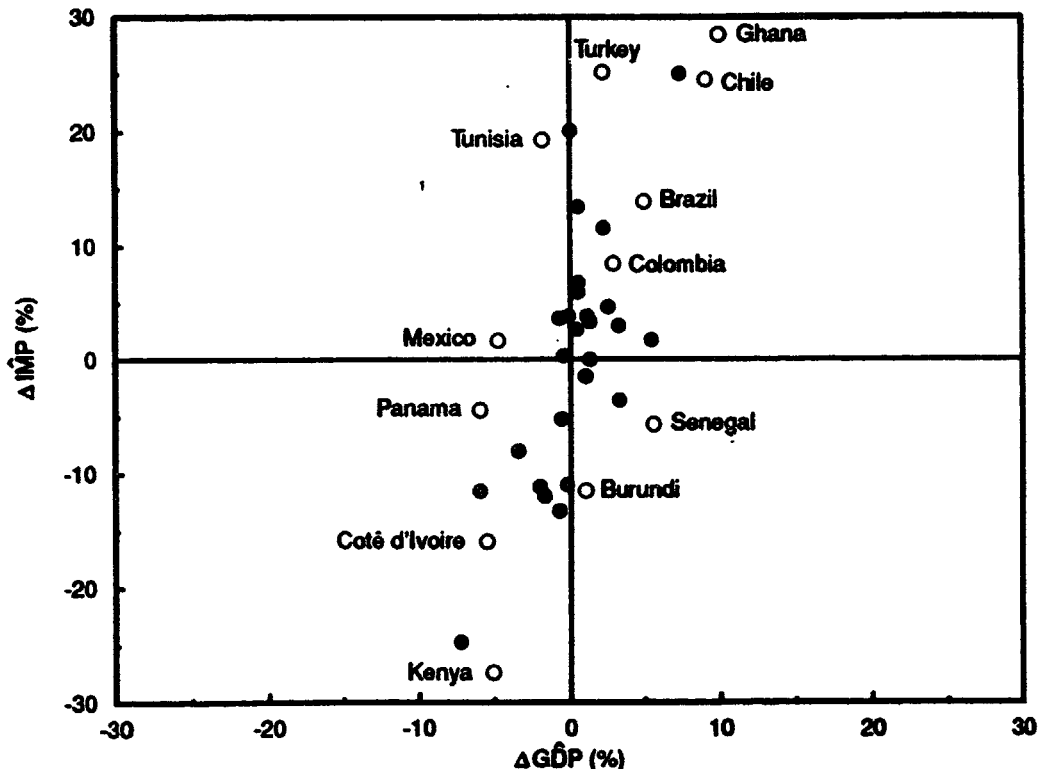
3.16 In the first half of the 1980s, import compression was the dominant force behind the negative relation between resource balance (goods and nonfactor services) and GDP. Figure 3-2 indicates the strong positive link between import growth and GDP growth for trade adjustment loan recipients, which is likely to be a two-way relationship. Imports can affect GDP in at least two ways. First, increased

competition from imports hurts inefficient production and is expected to lead over time to more efficient domestic production (see para. 3.35 for possible biases in estimation). Second, imported inputs of raw materials, intermediates, and capital goods affect production. When domestic savings are not easily converted into foreign exchange for imports, the relaxation of the foreign exchange constraint and of import controls can contribute directly to higher GDP.

3.17 Adjustment lending has supported import policy reform and has provided additional financing for imports. As indicated in table 3-2 overleaf, the ratio of IBRD and IDA financial flows (measured by disbursements and transfers) to imports increased for the recipients of trade adjustment loans in the periods following the trade adjustment loans. The increase in this ratio for these countries was greater than the increase for countries that did not receive such loans. However, total (official and unofficial) financial flows relative to imports decreased more for the loan recipients than for the others. Thus, it appears that any improved economic performance of the trade adjustment loan countries noted earlier is not simply attributable to increased financing facilitated by the loans.

3.18 Changes in trade policy, including real exchange rate adjustments, have been expected to boost GDP by improving the efficiency of resource use. To assess this, we investigate whether changes in GDP growth associated with changes in import growth and changes in other factors is statistically different for loan

Figure 3-2: Changes in GDP and Import Growth for Trade Adjustment Loan Countries Before and After Adjustment Lending



$\Delta\hat{GDP}$ = Percentage point improvement in the GDP growth rate for the three-year period after the first trade loan compared to the three-year period before.

$\Delta\hat{IMP}$ = Percentage point improvement in the import growth rate for the three-year period after the first trade loan compared to the three-year period before.

Source: Based on World Bank data

Table 3-2 Change in the Ratio of Financial Flows to Total Imports for Trade Adjustment Loan Recipients and Nonrecipients

Group/period	Disbursements			Transfers		
	Total	IBRD	IDA	Total	IBRD	IDA
40 trade loan recipients						
Unweighted						
Preloan	0.282	0.018	0.008	0.184	0.014	0.008
Postloan	0.257	0.038	0.028	0.142	0.026	0.028
Difference	-0.025	0.020	0.020	-0.042	0.012	0.020
Weighted						
Preloan	0.368	0.019	0.002	0.227	0.014	0.002
Postloan	0.251	0.043	0.005	0.109	0.030	0.004
Difference	-0.117	0.024	0.003	-0.118	0.016	0.002
47 nonrecipients^a						
Unweighted						
Preloan	0.243	0.012	0.015	0.162	0.009	0.015
Postloan	0.239	0.017	0.032	0.136	0.010	0.031
Difference	-0.004	0.005	0.017	-0.026	0.001	0.016
Weighted						
Preloan	0.259	0.014	0.005	0.147	0.011	0.005
Postloan	0.213	0.022	0.008	0.088	0.014	0.007
Difference	-0.046	0.008	0.003	-0.059	0.003	0.002

Note: Unweighted ratios were computed as $\sum(F_i/M_i)/N_i$, where F_i is average financial flows for the three-year period before or after the trade loan, M_i is average imports of goods and nonfactor services over the same periods, and N is the number of countries. Weighted ratios are computed as $(\sum F_i)/(\sum M_i)$.

a. For nonrecipients, the postloan period is 1984-88.

Source: World Bank data.

recipients than for nonrecipients. The dependent variable is the change in average GDP growth rate after the adjustment loan and reform compared to the rate before the loan. The independent variables are changes in imports,¹³ terms of trade, real exchange rate, and trade restrictions over the same periods. Changes in trade restrictions are represented by a dummy variable that assumes a value of one when there were policy reforms (according to chapter 2) and zero otherwise. A positive and significant coefficient of the dummy variable is interpreted as an improvement in the mean change in growth rate for the reformers relative to nonreformers.

3.19 We first consider the forty trade adjustment loan countries relative to nonrecipients. Any effect on average GDP growth found in this comparison is the result, among other things, of the financing and policy changes supported by the loan. In a second comparison, exclusion of the four loan recipients identified in chapter 2 as nonreformers or reform reversers (Guyana, Yugoslavia, Zambia, and Zimbabwe) permits a contrast between the thirty-six actual commercial policy reformers among loan recipients and the forty-seven nonrecipients. In a third comparison, reformers are contrasted with "nonreformers": Bolivia and Haiti, trade policy reformers in the 1980s that did not receive trade adjustment loans, are added to the thirty-six reformers that received loans, while the four nonreformer loan recipients mentioned above are added to the control group.

3.20 In general, the independent variables considered explain about 40 percent of the variation in GDP growth.¹⁴ The coefficient of the change in import growth is highly significant and robust. The terms of trade change has the expected effects on GDP and is sometimes significant. When the forty loan recipients are considered, the coefficient of the dummy is positive — that is, the reformers increased their growth rates on average between the two periods more than the others, given imports and terms of trade — but the increase is not statistically significant. When only the thirty-six trade loan recipients that were also commercial policy reformers are considered, the coefficient of the dummy variable becomes more significant (not shown in footnote 14). In considering the reformers versus nonreformers, the coefficient of the dummy variable is positive and statistically significant. Implementation data permit a separation of reforms on the export side (reduction of restrictions on exports and on imports needed by exporters) and reforms on the import side (reduction of quantitative restrictions and tariffs), although there is a very high overlap between the two. The use of separate dummy variables for the two sets of policies (reduced export restriction versus import liberalization) does not result in any differences in effect on GDP growth rates from export reform as opposed to import reform.

Performance Related to Trade Adjustment Lending

3.21 Changes in performance indicators for twenty-six countries that received trade adjustment loans before 1986 are compared with changes for nonrecipients in table 3-3 overleaf. The table shows average changes in indicators for the three-year period after the first trade loan (excluding the year of the loan) compared with the three-year period before the trade loan.¹⁵ The numbers in the table show how many trade loan recipient countries in each classification performed better on each indicator than their comparators after the start of trade adjustment lending. The plus and minus signs indicate an improvement (+) or worsening (-) of the average value of an indicator for the trade adjustment loan recipients in comparison with the average value of the same indicator for the comparator group of nonrecipients.¹⁶ For example, if the average export growth of recipients in a subgroup was 0.2 percentage points less than that of nonrecipients in the three-year period before trade adjustment lending started and 0.1 percentage points less in the three-year period after, the difference (0.1) is positive and the relative performance of the recipients improved.

3.22 Panel 1 shows that, on average, the change in performance on the trade indicators between 1981-83 and 1985-87 was better for the twenty-six pre-1986 trade loan recipients than for the forty-seven nonrecipient comparators. Improvements in export and import indicators were greater than improvements in other indicators. The relative performance of the twenty-six trade loan recipients for the three-year period after the loan compared with the three-year period before the loan is presented in panel 2. The last three rows in each panel show the total percentage of cases across all nine indicators in which trade adjustment loan countries (in three different classifications) did better than the others. The relative performance of trade adjustment loan countries is usually weaker when all forty recipients are considered than when the focus is on the twenty-six pre-1986 recipients or the ten intensive loan (three or more) recipients. A serious issue revealed by these comparisons is the relative worsening in the debt and investment indicators in several instances for these adjustment countries (a finding also reported in the 1988 World Bank report on adjustment lending).

Table 3-3 Performance Indicators for Trade Adjustment Loan Recipients Before and After Trade Adjustment Lending: 26 Pre-1986 Trade Loan Recipients versus 47 Nonrecipients

<i>Indicator</i>	<i>Low income</i>	<i>Middle income</i>	<i>Row sum</i>	<i>Sub-Saharan Africa</i>	<i>Highly indebted countries</i>	<i>Manufactures exporters</i>
Number of trade loan recipients	9	17	26	11	10	7
Number of nonrecipients	20	27	47	18	4	8
<i>Panel 1: 1985-87 compared to 1981-83</i>						
GDP growth	9 (+)**	12 (+)**	21	10 (+)**	3 (-)**	5 (+)
Investment/GDP	5 (+)	14 (+)	19	9 (+)	6 (-)	7 (+)
Real exchange rate	8 (+)*	15 (+)**	23	9 (+)*	8 (+)	7 (+)
Manufacturing exports growth	7 (+)**	12 (+)	19	10 (+)**	1 (-)**	4 (-)
Import growth	8 (+)**	12 (+)**	20	8 (+)**	4 (-)	6 (+)
Resource balance/GDP	4 (-)	12 (+)	16	5 (+)	10 (+)**	1 (-)
Inflation	8 (+)*	14 (+)	22	10 (+)**	7 (-)	1 (-)
External debt/exports	6 (+)	17 (+)*	23	8 (+)	10 (+)**	6 (+)
Debt service/exports	5 (+)	10 (+)	15	4 (-)	3 (-)	7 (+)
Share showing improvement ^a (10 intensive recipients)	0.74 (0.83)	0.77 (0.72)	0.76 (0.74)	0.74 (0.78)	0.58 (0.53)	0.70 (0.56)
(All 40 recipients)	(0.68)	(0.74)	(0.71)	(0.68)	(0.56)	(0.56)
<i>Panel 2: Three years after compared to three years before</i>						
GDP growth	5 (+)	13 (+)	18	6 (+)	5 (+)	4 (+)
Investment/GDP	4 (-)	11 (+)	15	5 (-)	8 (+)	4 (-)
Real exchange rate	7 (+)	16 (+)	23	10 (+)*	9 (+)	7 (+)
Manufacturing exports growth	7 (+)	14 (+)	21	9 (+)	5 (-)	4 (+)
Import growth	6 (+)	14 (+)*	20	6 (+)	5 (+)**	7 (+)*
Resource balance/GDP	5 (+)	11 (+)	16	8 (+)	8 (+)	2 (+)
Inflation	7 (+)	13 (+)	20	9 (+)	6 (+)	4 (-)
External debt/exports	5 (+)	14 (+)	19	7 (-)	9 (+)	5 (+)
Debt service/exports	5 (-)	9 (+)	14	3 (-)	5 (+)	4 (+)
Share showing improvement ^a (10 intensive recipients)	0.63 (0.78)	0.75 (0.69)	0.71 (0.71)	0.64 (0.71)	0.67 (0.71)	0.65 (0.78)
(All 40 recipients)	(0.58)	(0.70)	(0.64)	(0.62)	(0.63)	(0.54)

Note: The numbers in the table show for each indicator the number of trade adjustment loan recipients in each classification that improved in the period after the loan compared with the period before the loan relative to the change over the same periods for nonrecipient comparators. The year of receipt of the first loan is excluded from the comparison in panel 2. The plus and minus signs indicate an improvement or a worsening of the average value of an indicator for recipients compared with the change in average value for nonrecipients.

* The change in means for the recipients between the two periods relative to the change for nonrecipients is significant at a 10-percent confidence interval.

** The change in means for the recipients between the two periods relative to the change for nonrecipients is significant at a 5-percent confidence interval.

a. The share of the product of the number of variables and the number of countries showing improvement in the total.

Country Experience

3.23 We now turn to country-specific information on selected trade reforms and their association with performance.¹⁷ Table 3-4 presents data on changes in commercial policy and the real exchange rate in eleven countries for which data are readily available. It should be noted that some of the data are not quite comparable over time and across countries, and therefore the figures should only be taken as broad indicators. Reductions in import restrictions were substantial over the periods considered in Chile, Korea, Mexico, Morocco, the Philippines, and Turkey. Chile's dramatic reforms of 1974-79 were followed by a period of increased import barriers and then, in 1985-88, by important new reforms. Korea's reforms

Table 3-4 Recent Changes in Trade Policy and Performance for Selected Countries

Country	Time period ^a	Average tariff rate (%)	Coverage of QRs (%)	Index of real exchange rate (1980=100)	Terms of trade (1980=100)	Growth in manufactures exports ^b	Growth in total exports	Growth in GDP
Argentina ^c	1978-82	28.0	0.0	74.6	99.6	-1.8	10.7	-1.3
	1983-87	35.0	42.0 ^d	44.3	89.4	-2.0	1.2	1.6
	1984-88	nc	nc	43.2	88.7	3.3	0.8	1.1
Chile	1983-85	35.0	none	80.3	82.0	4.7	4.8	2.7
	1986-87	20.0	none	56.0	74.9	3.8	9.2	5.6
	1987-88	nc	nc	52.2	85.4	14.7	7.5	6.6
Colombia	1983-85	61.0 ^e (1984)	65.7 ^f (1984)	103.4	97.3	-1.9	7.9	2.7
	1986-87	52.0 (1986)	50.2 (1986)	64.4	84.6	13.3	13.4	5.3
	1987-88	nc	nc	59.6	69.6	9.5	4.7	4.5
Kenya	1981-83	na	71.3 ^h	97.6	91.6	1.3	0.6	1.5
	1984-86	28,34,55 ^g	59.1	96.8	101.5	2.2	7.4	4.0
	1985-87	nc	nc	88.6	94.1	5.5	6.8	5.0
Korea	1980-82	28.3	27.7 ⁱ	103.8	99.2	9.5	10.6	3.4
	1983-85	22.3	16.7	99.8	100.8	7.5	9.2	8.3
	1984-86	nc	nc	92.5	103.8	13.8	17.6	8.6
Mexico	1983-85	24.4 ^j	92.2 ^k (1984-85)	80.6	97.9	42.7	5.1	0.7
	1986-87	20.5	37.0	58.0	69.5	27.0	6.9	-1.3
	1987-88	nc	nc	62.1	68.9	15.5	9.8	0.9
Morocco	1980-83	58.4 ^l (1983)	50.1 ^m (1983)	91.5	93.3	20.1	4.2	2.9
	1984-86	41.5	41.0	74.8	93.8	4.3	3.0	4.1
	1985-87	nc	nc	71.2	98.8	8.5	4.9	3.7
Pakistan	1980-82	77.0	na	105.6	97.3	6.8	8.6	8.0
	1983-85	66.0	na	99.3	92.1	9.4	9.2	6.6
	1984-86	nc	nc	68.5	91.5	6.4	10.7	6.8
Philippines	1980-83	36.5	37.0 ⁿ (1980)	100.1	92.4	9.9	5.4	3.3
	1985-87	28.1	16.7 (1986)	81.3	94.8	1.8	4.4	0.8
	1986-88	nc	nc	71.5	104.6	6.9	11.1	4.2
Thailand	1983-85	32.3	na	103.7	78.0	15.5	7.5	5.9
	1986-87	33.8	na	82.5	82.6	30.3	15.5	5.9
	1987-88	nc	nc	78.7	88.3	28.8	20.1	9.7
Turkey	1984-85	24.7	28.4 ^o	77.8	91.8	36.8	16.1	5.4
	1986-87	31.4	18.6 (1987)	63.5	109.6	6.8	14.0	7.9
	1987-88	nc	nc	61.9	108.9	24.3	20.3	5.5

QRs = quantitative restrictions; na = not available.

a. The latest period is lagged one year from the previous period in order to observe performance effects. Thus policy change in the last period is not considered, as indicated by nc. b. Manufactures include line items 5+6+7+8-68 in the SITC, based on World Bank data. c. Argentina is not among the twenty-four countries with implementation data (chapter 2) as it did not receive its first loan until 1987. Argentina was also not considered a country with low initial trade restrictions because the classification was based on restrictiveness just prior to the lending. d. Percentage of imports value. e. Including a 19.5 percent surcharge in both years. f. Percentage of imports value. g. Capital, intermediate, and consumer goods respectively, 1984-85. h. Globally allocated or restricted (i.e. not automatically approved). i. Percentage of import items not on the automatic approval list; about 40% in the latter list, however, are subject to exemptions. j. Weighted by 1986 production for all years; excludes 5 percent surcharge. k. Subject to licensing as percentage of value of 1986 production. l. Including surcharges. m. Licensed and prohibited items as percentage of total number of items. n. Restricted items as percentage of total number of items. o. Licensed items as percentage of total number of import items.

Source: A. Bhattacharya and J. F. Linn, 1988, *Trade and Industrial Policies in the Developing Countries of East Asia*, World Bank Discussion No. Paper 27, Washington, D.C.; World Bank, 1987a, "Colombia: Country Economic Memorandum," Washington, D.C.; World Bank, 1987b, "Kenya: Industrial Sector Policies for Investment and Export Growth," Report 6711.KE, Washington, D.C.; World Bank, 1988a, "Mexico: Trade Policy Reform and Economic Adjustment," Trade, Finance, and Industry Operations Division, Latin America and the Caribbean Country Department II, Washington, D.C.; World Bank, 1988b, "Morocco: The Impact of Liberalization on Trade and Industrial Adjustment," Report 6714-MOR, Washington, D.C.; World Bank, 1988c, "The Trade Regime in Pakistan," Europe, Middle East, and North Africa, Country Department I, Washington, D.C.; World Bank, IMF and UNCTAD data.

came in many waves from the 1960s onwards, with significant improvements in the 1980s. All the countries in this table, except Korea, also experienced a large depreciation in the real exchange rate. (Korea had no major misalignment in its exchange rate to begin with.)

3.24 Although table 3-4 gives trade policy-related indicators only, in most cases reforms included a much broader range of policies. Any improvements in performance, therefore, should not be attributed to trade reform alone. GDP growth accelerated in the reform and postreform periods in Chile, Korea, Morocco, and Turkey. In Mexico (box 3-1) and the Philippines, the growth rate recovered following reform. Total export growth also improved in most cases during the reform period and in all cases subsequently. In about half the cases, the growth rate of manufactured exports also picked up following reforms.

3.25 The association of a real exchange rate depreciation with a partial improvement (or recovery) in performance between the two periods is brought out by the

**Box 3-1. Trade Reform
and Performance in
Mexico**

Mexico's quantitative restrictions covered 60 percent of imports in 1981 and increased to 100 percent in 1982 in response to a balance of payments crisis. By 1980, effective protection had reached 128 percent for capital goods and consumer durables, 43 percent for intermediates, 9 percent for nondurable consumer goods, and 28 percent for the agriculture sector. Export controls were also pervasive, covering 797 of 3,026 export positions in 1976. There was a mild liberalization between 1976 and 1980, with export controls reduced to 578 positions, but they continued to cover 85 percent of nonoil exports. A cross-sectoral analysis found that total factor productivity growth for each sector between 1972 and 1982 was strongly and negatively correlated with the fraction of that sector covered by quantitative restrictions.

Beginning with a devaluation in 1982 and some tentative steps to free more products from export controls and to grant exporters access to credit and duty-free imported inputs, Mexico began to adopt trade reforms. In 1983, exporters in the domestic tariff area were allowed temporary admissions of inputs required for the production of exports. In mid-1985, quantitative restrictions on imports were removed from products representing about 45 percent of tradable production. By April 1988, quantitative restrictions covered only 23 percent of this production. Tariffs, after being raised slightly to cushion the decline in protection resulting from the reduction in quantitative restrictions, were gradually decreased from an average of 23.5 percent

(mid-1985) to 11 percent (April 1988), with a reduction in dispersion as well. Mexico also applied to accede to the GATT, which it formally did in August 1986.

In 1983 and 1984, manufactured exports showed strong growth in response to the devaluation of 1982 and a domestic recession brought about by the need to stabilize the economy. The devaluation was not sustained in real terms, however, and exports fell in 1985 as the real exchange rate appreciated. Between mid-1985 and the end of 1987, the exchange rate was essentially floated, and it depreciated significantly. This depreciation, together with the import reforms, encouraged exports, which grew strongly in 1986 and 1987. One study of the effect on private sector exports since 1980 of exchange rate movements and import liberalization concluded that for every 10 percent overvaluation of the real exchange rate compared to a hypothetical equilibrium, exports fell by about 11 percent (with a lag of four quarters) and for every 10 percent increase in quantitative restriction coverage, exports declined by about 6 percent (with a lag of two quarters).¹

While progress in commercial policy reform is commendable, sustained results will also depend on the real exchange rate and macroeconomic stability.

1. A. Ten Kate, undated, "Trade Liberalization in Mexico Since July 1985: Some Estimates of Its Economic Impact," background study for "Mexico — Trade Policy Reform and Economic Adjustment," World Bank Report No. 7314-ME, 1988.

experiences of several countries. Colombia, Kenya, Pakistan, and Thailand had little commercial policy reform between the two periods, but their real exchange rate adjustment was substantial. GDP growth in Colombia, Kenya, and Thailand recovered in the second period, while changes in export performance were mixed. In Argentina, which had increased protection coupled with real devaluation during the second period, export growth deteriorated while GDP growth recovered.

3.26 Commercial policy liberalization alone seemed helpful in Korea in the 1980s, but Korea had reasonable macroeconomic stability and its currency was not overvalued. Chile also provides an example of the far-reaching effects of strong commercial policy reform in the latter half of the 1970s (box 3-2 overleaf). The experience of Argentina seems to show that a reversal of commercial policy reform hurt export performance. The remaining examples involved contributions from both exchange rate and commercial policy reform. Of course, there are also many examples of little policy change or policy reversals, especially in the group of forty-seven countries that did not receive trade adjustment loans. Within the group of forty countries that did receive loans, policy reversals occurred in some cases (for example, Guyana, Yugoslavia, and Zambia), but partial reform was more common, as in the case of Côte d'Ivoire (box 3-3 on page 54).

Policy Implications

3.27 Trade policy reforms of the 1980s have relied on all three instruments to encourage export growth — policies to achieve real devaluation, direct reduction in the bias against exports (removal of export restrictions, provision of duty drawbacks, temporary admissions, and export subsidies), and a lowering of the protection provided to import substitutes. In most instances, a real devaluation raises equiproportionately the prices of exportables and importables (except for those importables for which quantitative restrictions are binding), inducing flows to all tradable sectors of resources from nontradable sectors or unused resources. Since a real devaluation both encourages exports and discourages imports, it can induce a reduction in the trade deficit (or produce a surplus) quickly.¹⁸ To sustain the devaluation in real terms, however, requires that less expansionary fiscal and monetary policies be followed domestically and that imports be liberalized.

3.28 Introducing direct export incentives without reducing import protection or depreciating the real exchange rate can lead to increased export growth and generate a trade surplus (or reduce a deficit). Like devaluation, this approach can imply a squeeze on nontradables. It also can require a high savings rate, that is, a reduction in current consumption. When devaluation or the introduction of direct export incentives is accompanied by a lowering of import protection, resources are released from inefficient protected sectors to exportables, nontradables, and the remaining efficient import-substituting sectors. The effect on exports, however, is indirect and usually not as immediate as with direct export measures. With this approach, however, a given increase in exports is accompanied by a smaller decline in real wages and smaller distortions in consumption, together with greater efficiency increases than with the previous strategy.

3.29 The relative emphasis that is given to each instrument of reform should reflect starting conditions in each country. Korea had a reasonably adequate exchange rate during its trade reforms of the 1980s, while the rate was substan-

Box 3-2. Trade Liberalization and Effects on Manufacturing in Chile

From 1940 to 1970, Chile pursued an import-substitution policy based on increasing intervention in commodity and factor markets. Interventions and protectionism increased during 1970-73, followed by rapid trade liberalization between September 1973 and June 1979. In September 1973 ad valorem tariff rates ranged from 0 to 750 percent, with half the tariffs above 80 percent. Import prohibitions affected 187 tariff positions as defined by the Brussels Tariff Nomenclature. For 2,872 tariff positions, there was a deposit requirement of 10,000 percent of the c.i.f. import value, due 90 days before importing. By August 1975, the maximum tariff rate had been reduced to 105 percent and the average to 65 percent. Most redundant protection had been eliminated, and within the next four years a uniform tariff of 10 percent was achieved (except for motor vehicles above 850 cc in engine size). All other restrictions

on imports and incentives to export were eliminated, reducing the level of protection and tariff dispersion (table 1). Between 1979 and 1982, average protection was 10 percent. Although serious macroeconomic imbalances and external shocks led to a major recession during 1982-84, trade reforms were not significantly rolled back. By 1988, average protection was down to 15 percent after having risen briefly to 30 percent. Since 1977, Chile has had no quantitative restrictions. Chile is now among the countries with the lowest and most uniform rates of protection in the world.

The share of foreign trade in GDP has fluctuated greatly during the century (table 2). As a result of changing trade policies since the mid-1970s, the share of trade in GDP has increased by more than 50 percent over levels during the 1960s and early 1970s. Econometric estimates of total factor productivity (TFP) growth for the manufacturing sector indicate that average annual TFP growth was - 0.61 percent during 1960-70 and 2.5 percent during 1977-81.¹ Economywide gains induced by the reforms have been estimated to have contributed up to 2.3 percentage points of GDP per year during the period 1977-81, when growth was high despite relatively low investment and employment levels.² At the same time, adjustment to trade liberalization has been estimated to have contributed about 5 percent to unemployment during the transition.³

Trade reforms have also resulted in changes in concentration and profitability. Table 3 shows profitability and concentration ratios derived from Chile's 1967 and 1979 manufacturing census. The change in economic re-

Table 1 Effective Protection in Chile, 1967, 1974, and 1979
(simple averages, in percentages)

Sector	Effective protection		
	1967	1974	1979
Consumer goods	138.8	189.7	13.2
Intermediate goods	172.9	139.6	14.0
Machinery and transport equipment	265.3	96.0	13.0
Equally weighted arithmetic mean	176.7	151.4	13.61
Standard deviation	279.0	60.4	1.70
Variability coefficient	1.57	0.399	0.124
Range	1,163.0	216.0	6.00

tially overvalued in most of the other trade adjustment loan countries. Impediments to exports and to imports needed for export production were also widespread. The majority of countries depreciated the exchange rate and reduced export restrictions significantly. Import liberalization was in general milder. The emphasis on exchange rate and "direct" export reform was justified, given the strong response of exports to direct incentives and the importance of insulating exporters from the effects of import duties as tariff reform is initiated (chapter 7). The more the restrictions in the export regime are corrected, however, the lower is likely to be the additional benefit from further action in this area, as opposed to undertaking reform of the import regime.

Employment Effects of Trade Policy Reform

3.30 Trade policy reform changes relative incentives, improves the profitability of exportable production, and reduces the incentives for import substitution and, in

gime (including trade liberalization) increased concentration but reduced profitability, suggesting both that economies of scale were realized as a result of trade liberalization and that oligopolistic interaction diminished. Comparisons of economies of scale for manufacturing between 1967 and 1979 indicate a greater exploitation of economies of scale in 1979 than in 1967. The evidence also suggests that the exploitation of economies of scale was greatest for sectors that experienced the largest reduction in effective protection between 1967 and 1979.⁴ The reduction in profitability is also consistent with an increase in the elasticity of demand facing domestic firms. Further econometric evidence supports the "import-discipline" hypothesis, namely that after the role of other factors is taken into account, sectors that had the highest import-penetration ratios between 1967 and 1979 also showed the largest decline in price-cost margins.

1. B. Mierau, 1987, "Trade Regimes and Productivity Performance: The Case of the Chilean Manufacturing Sector," World Bank, Washington, D.C.
2. T. Condon, V. Corbo, and J. de Melo, 1985, "Productivity Growth, External Shocks, and Capital Inflows in Chile during 1977-81: A General Equilibrium Analysis," Journal of Policy Modelling (January).
3. S. Edwards and A. Cox-Edwards, 1987, *Monetarism and Liberalization: The Chilean Experiment*, Cambridge, Mass.: Ballinger.
4. J. Tybout, V. Corbo, and J. de Melo, 1988, "The Effects of Trade Reforms on Scale and Technical Efficiency: New Evidence from Chile," Trade Policy Division, Country Economics Department, World Bank, Washington, D.C.

Table 2 Openness: Foreign Trade as a Percentage of GDP in Chile, Selected Years

Years	Average openness
1929	66.3
1951-55	21.7
1965-70	24.0
1971-73	20.3
1980-82	32.6
1985-87	47.6

Table 3 Protection, Price-Cost Margins, and Profitability in Chilean Manufacturing (percentages)

Year	Nominal protection	Price-cost margin ^a	Four-firm concentration ratio (number of establishments in parenthesis)
1967	74	48	49 (7,384)
1979	12	32	62 (5,010)

a. Sales price minus variable cost as a percentage of variable costs.
 Source: J. de Melo and S. Urata, 1988, "The Influence of Increased Foreign Competition on Industrial Concentration and Profitability," *International Journal of Industrial Organization* 4 (September): 287-304.

most cases, for the production of nontradables. Since the labor intensity in these sectors is not the same, trade liberalization is not likely to be neutral with respect to employment. Studies using input/output tables for several countries have shown that in most cases production of exportable commodities is the most labor intensive, followed by production of nontradables and then by production of import substitutes. Therefore, trade liberalization and exchange rate adjustment packages may be expected to have a beneficial effect on employment in the long term.

3.31 The previously mentioned NBER study by Krueger provides evidence that countries that have followed outward-oriented policies generally have a better record on employment creation and unemployment rates (in the nonresource-intensive sectors) in the long term than those that have adopted import-substitution strategies. This is consistent with the evidence that export production is in general more labor intensive than production in the rest of the economy. While these findings indicate the expected positive long-term effects on employment of

**Box 3-3. Trade Policy
in Côte d'Ivoire**

In the second half of the 1970s and in the early 1980s, Côte d'Ivoire introduced quantitative restrictions and arbitrary reference prices for calculating tariffs for a wide range of imports competitive with domestic manufacturing. During the boom years in the second half of the 1970s, Côte d'Ivoire benefited from the surge in world coffee and cocoa prices. The increases in revenue, most of which were captured by the government, were used to promote investment and expand public spending and infrastructure. The severe macroeconomic imbalances that followed forced the government to adopt an austerity program in 1982, followed by trade reform in mid-1984. Both programs were supported by structural adjustment loans from the World Bank.

The trade reform was extended in 1986 and early 1987. The reform removed quantitative restrictions and reference prices, rationalized the tariff structure so as to give approximately the same effective protection to all manufacturing activities, and introduced temporary tariff surcharges, which declined over a five-year period to allow firms previously protected by nontariff measures time to adjust. Côte d'Ivoire's nominal exchange rate is fixed in relation to the French franc at a rate that is the same for a number of franc-zone African countries. Since it was estimated to be considerably overvalued in real terms and could not be devalued, the reform simulated a partial devaluation by setting tar-

iffs at higher levels than would otherwise have been selected and by introducing an export subsidy scheme for manufactured and some primary exports.

The use of tariffs and export subsidies proved a poor substitute for devaluation, which could have given the same incentives to import substitution and export production with much lower tariffs and lower or no export subsidies. First, the system was inflexible and unable to handle the further substantial reduction in the competitiveness of Ivorian industry, which resulted from the appreciation of the French franc against the U.S. dollar and many other currencies during 1985-88. In 1987 an attempt was made to partially offset this appreciation by tariff increases, but this was done in a way that undermined some of the previous rationalization of the tariff structure and reduced incentives for exports. Second, the reforms depended on a competent and honest customs administration, but a declining trend in administrative capacity, which was already pronounced in the 1970s, continued in the 1980s. This led to large-scale underinvoicing and increased smuggling and contributed to delays and corruption in managing the export subsidy scheme. Third, the concept of the export subsidy as a devaluation substitute was never fully understood or accepted by the government. As a result of this and a continuing fiscal deficit, the first export subsidy payments were delayed until mid-1986 and payments were suspended in 1989. Even though the scheme allowed some major firms

trade reform after the adjustment process is complete, they do not provide insights into the short-run adjustment process that takes place immediately after trade policy reform is introduced.

3.32 In the short term, the decreased incentives to import substitution and possibly to nontradable sectors that are associated with trade liberalization could lead to a decrease in employment in those sectors. This decrease may not be immediately offset by an expansion of employment in the export sector. Furthermore, delays in increasing labor absorption may occur in the export sector because of the time lag before new investments mature, slow adjustments in labor skills to new requirements, and restrictions to labor mobility.

3.33 Country authors in the Michaely et al. study generally conclude that in individual countries causality cannot be established between trade liberalization and short-run unemployment in the manufacturing sector. In the aggregate, table 3-5 overleaf also shows no clear link between the evolution of unemployment and trade reform episodes. In eight of the eighteen cases, the rate of unemployment decreased, although in one case the progress in the last year of reform was reversed in the next year. In the remaining ten cases, the rate of unemployment increased following reform. Most reform episodes, however, took place simultaneously with

to maintain their exports in the face of the appreciating exchange rate, many other smaller exporters were never paid, and transaction and other lobbying costs were reported to be substantial. Finally, the inability to curtail underinvoicing directly was given as a reason for the reintroduction of reference prices and some quantitative import restrictions by 1989.

Côte d'Ivoire's experience underlines the problems faced to one degree or another by most of the franc-zone countries. One major prerequisite for realizing the potential advantages of the monetary arrangement with France is the imposition of a degree of fiscal discipline. In the case of Côte d'Ivoire, loss of fiscal discipline was triggered by the boom in 1975-77 in prices of coffee and cocoa, which account for 50 percent of export earnings. Public expenditure as a share of GDP increased sharply in response to the boom and continued to increase long after the boom had ended, rising from about 15 percent in 1977 to about 26 percent in 1983.¹ The resulting fiscal deficit rose from about 3 percent of GDP in 1977 to a high of 13 percent in 1982. This was financed by foreign aid flows and increased public debt. At the same time, some neighboring trading partners were devaluing. The net result was an appreciation of Côte d'Ivoire's real exchange rate and a severe erosion of the competitiveness of the manufacturing sector. Appreciation of the French franc reinforced this effect.

These are two major lessons from this experience. First an attempt to maintain a fixed exchange rate while following expansionary macroeconomic policies will create external imbalances. Second, while in theory commercial policy can be used to substitute for a nominal devaluation, in practice any serious reform of commercial policy is difficult to carry out successfully, especially when tariff evasion is a problem.² In these countries, the only realistic solutions may be either abandonment of the fixed exchange rate or a one-time devaluation to restore competitiveness followed by an improved mechanism to insure nonexpansionary fiscal policy in the future. Devaluation, of course, would carry its own costs, not the least of which may be the negative impact on the financial system, which in the Côte d'Ivoire has substantial French franc-dominated liabilities. The alternative means of achieving a real devaluation — maintaining a lower inflation rate than the country's trading partners — would be a relatively long and risky process.

1. See S. Devarajan and J. de Melo, "Adjustment with a Fixed Exchange Rate: Cameroon, Côte d'Ivoire, and Senegal," *The World Bank Economic Review*, May 1982.

2. See S.A. O'Connell, "Uniform Trade Taxes, Devaluation, and the Real Exchange Rate," *PPR Working Paper Series No. 185*, April 1989.

Source: Background note by A. Harrison and G. Pursell.

other ongoing changes in the economy (macroeconomic adjustment, changes in external terms of trade), which makes it difficult to attribute changes in unemployment to trade reform itself. In general, where economic growth was robust, unemployment decreased with reform. Where aggregate unemployment increased, country analyses under this study link it to factors other than trade liberalization that caused a downturn in growth.

3.34 Although hard evidence is lacking, anecdotal evidence alludes to unemployment effects from trade reform in the short term in some countries (see also boxes 3-2 and 3-3). Observers also suggest negative effects on income in the short-term from commercial policy reform and devaluation. A study of four Latin American countries concluded that in the case of a real exchange rate devaluation, the real wages of unskilled workers absorbed most of the required adjustment while wages of skilled labor (mostly in the formal sector) decreased substantially less.¹⁹ Real wages in large manufacturing firms appeared to be much more downwardly rigid than the real wages of nonprofessional self-employed workers (usually employees in the informal sector). Therefore, the burden of the short-run wage adjustment fell on the poorer segments of the labor force, but this was possibly associated with increases in employment.

Table 3-5 Unemployment During Selected Episodes of Trade Liberalization
(percentage of labor force)

<i>Liberalization episodes</i>	<i>Years of the episodes</i>	<i>Unemployment</i>			
		<i>a</i>	<i>b</i>	<i>c</i>	<i>d</i>
Argentina 1	1967-70	5.6	5.1	4.9	na
Chile 2	1974-81	4.8	13.6	23.7	22.5
Colombia 1	1964-66	7.9	8.7	10.1	12.2
Colombia 2	1968-82	8.8	10.0	9.4	9.4
Israel 1	1952-55	9.1	8.8	7.4	7.8
Israel 2	1962-68	3.6	5.4	6.1	4.5
Israel 3	1969-77	6.1	3.4	3.9	na
Korea 1	1965-67	9.9	7.0	6.3	5.2
Korea 2	1978-79	4.1	3.5	3.8	5.3
New Zealand 3	1982-84	3.7	4.8	4.9	na
Peru	1979-80	7.1	6.9	6.8	7.0
Philippines 1	1960-65	6.3	8.0	8.2	9.4
Philippines 2	1970-74	6.9	6.5	4.7	5.0
Singapore	1968-73	8.1	6.2	4.8	4.7
Spain 2	1970-74	1.1	2.1	2.9	3.9
Spain 3	1977-80	5.3	9.1	11.5	14.4
Turkey 2	1980-84	9.4	11.7	12.7	na
Yugoslavia	1965-67	5.6	6.6	7.1	8.0

na = not available.

a. Last year before liberalization episode.

b. Average during liberalization episode.

c. Last year of liberalization episode.

d. First year after liberalization episode.

Source: Michaely et al. (op. cit.)

Constraints to a Stronger Supply Response

3.35 There are difficulties in estimating accurately the supply response to policy reform. For one thing, there can be a negative bias in the estimates of changes in growth rates of "reformers." When GDP is valued in constant prereform prices, tradables, which are expected to expand the most, are undervalued because the prices at which their output is valued are artificially low. Thus GDP growth between pre- and post-reform periods can be underestimated for reformers. Another problem, already discussed, is that other factors that affect this response are never constant during reforms.

3.36 The evidence of thirty reform episodes in Michaely et. al., most of them before the 1980s, showed that the average growth rate of GDP increased from 4.45 percent for the three-year period before the reform to 5.45 percent one year after and declined slightly to 5.35 percent during the three-year period after.³⁰ The increase was greater for the episodes involving the strongest reforms. (The judgment on the strength of reform is subjective.) According to tables 3-1 and 3-3, trade policy loan recipients improved GDP growth relative to their own preloan growth rates, as well as relative to the nonrecipients as a group or to specific comparable countries. But table 3-3 also shows that almost half the recipients did not improve in terms of relative growth rates. There is considerable variation

across countries in the supply response. In many countries, it has been weaker than expected.

3.37 Several constraints to an adequate supply response can be identified.³¹ Some of these relate to the credibility of the reforms. Reforms that are not expected to last will not inspire entrepreneurs to make the investments needed to expand production in newly profitable sectors. To be credible, trade policy reforms must be consistent with fiscal and monetary policy (chapter 5). Credibility is also enhanced if the reform program is launched with strong steps and public commitment by the government (chapter 4).

3.38 Domestic regulatory policies can also inhibit the supply response (chapter 7). Price controls or laws governing wages keep firms from seeing the true social value of inputs and outputs and responding accordingly. An adequate supply response requires that labor as well as capital move from some sectors to others, and laws that make it hard to hire or fire workers or declare bankruptcy interfere with this process. Sometimes, regulations governing the transport sector increase the costs of shipping goods to and from the border, thereby discouraging investment in the tradable sector. Foreign direct investment can play an important role in some countries, so laws that discourage it may reduce the supply response (chapters 6 and 8).

3.39 Public sector policies in a number of countries are not supportive of rapid adjustment to a changed incentive structure (chapter 7). In centrally planned economies, the central allocation mechanism is insufficiently flexible in reallocating resources (see box 2-2 in chapter 2). Parastatal monopolies or market domination, especially in agricultural markets, sometimes prevents the effects of devaluation from being passed on to export producers. In a number of countries, a poorly functioning or corrupt customs service imposes additional burdens on international trade. The cost and delays caused by requirements for excessive and nonstandardized documentation for imports and exports can be of equal or greater importance.

3.40 Insufficient attention to the institutional needs of exporters has often been a problem (chapter 6). In particular, as long as tariffs or other restrictions are placed on products used by exporters as inputs, some mechanism must be introduced to allow exporters to import them duty-free. Inadequate infrastructure sometimes constrains a response to changed incentives (chapter 7). This is true not only of physical infrastructure (highways, ports, railways), but also of educational infrastructure. This constraint is particularly severe in Sub-Saharan Africa.

3.41 Protectionism in international markets in recent years may have discouraged exports in some cases (chapter 8). Although developed countries have quite low tariffs and generally represent promising markets for developing countries' manufactured exports (chapter 6), in a few important products (for example, textiles and clothing) trade restrictions have prevented some countries from realizing their full potential for expanding supply.

3.42 Finally, a realistic assessment of the constraints to supply response should recognize that cultural patterns generated by past policies may not change overnight. Decades of policies inimical to the private sector, and especially to mer-

chants and traders, have left some countries with only a small number of experienced entrepreneurs. This problem has become particularly manifest in several countries in Sub-Saharan Africa. As policies and incentives change, this nucleus of experienced entrepreneurs will grow, but this will be a learning process and will take time. Meanwhile, these few entrepreneurs should be expected to realize a high financial return on their scarce talents, thereby attracting more participants in the private sector.

NOTES

1. World Bank, 1988, op.cit.; *Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Series No. 1, Washington, D.C.
2. Output growth was higher not only because of the higher growth of exports (as a part of output), but because of higher growth of other components of output as well. See B. Balassa, ed., 1982, "Development Strategies and Economic Performance," in *Development Strategies in Semi-Industrialized Countries*, London: Oxford University Press. On the robustness of the export-GDP association in low-income countries, see, for example, R. Kavoussi, 1984, "Export Expansion and Economic Growth: Further Empirical Evidence," *Journal of Development Economics* 14:241-50; and R. Ram, 1985, "Exports and Economic Growth: Some Additional Evidence," *Economic Development and Cultural Change* 33:415-25. The results are not conclusive in this respect.
3. Nor does it determine if the causality runs in the opposite direction, as suggested, for instance, by R. Findlay, 1984, "Growth and Development in Trade Models," in R. Jones and P. Kenen, eds., *Handbook of International Economics*, vol. I, Amsterdam: North-Holland. On causality tests, see W. Jung and P. Marshall, 1985, "Exports, Growth and Causality in Developing Countries," *Journal of Development Economics* 18:1-12. There is, of course, considerable controversy on causality tests.
4. For the 1973-78 period Balassa shows that export orientation is positively correlated with economic growth (1985, "Exports, Policy Choices and Economic Growth in Developing Countries After the 1973 Oil Shock," *Journal of Development Economics*, May-June). These results are not subject to the two-way causality problem as they compare the effects on economic growth of export orientation, import substitution, and additional net external financing.
5. See J. Sachs, 1987, "Trade and Exchange Rate Policies in Growth-Oriented Adjustment Programs," in Corbo et. al., eds., *Growth Oriented Adjustment Programs*, Washington, D.C.: IMF-World Bank.
6. J. Bhagwati, 1978, *Anatomy and Consequences of Exchange Control Regimes*, Cambridge, Mass.: Ballinger Publishing Co. for National Bureau of Economic Research.
7. A. O. Krueger, 1978, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences*, Cambridge, Mass.: Ballinger Publishing Co. for National Bureau of Economic Research.
8. H. Chenery, S. Robinson, and M. Syrquin, 1986, *Industrialization and Growth: A Comparative Study*, New York: Oxford University Press.
9. The index is from E. Leamer, 1988, "Measures of Openness," in R. Baldwin, ed., *Trade Policy Issues and Empirical Analysis*, University of Chicago Press for NBER. The policy analysis is in the background paper for this report by S. Edwards (1989, "Openness, Outward Orientation, Trade Liberalization, and Economic Performance in Developing Countries," PPR Working Paper No. 191, Washington, D.C.: World Bank). One set of results are given below:

Dependent Variable: Output Growth

	Time period	Constant	Investment ratio	Labor force growth	Technology gap	Trade intervention	No. of countries	R ²
Equation 1	1960-82	-1.924 (-1.111)	0.260 (6.533)	1.461 (3.573)	-0.037 (-1.611)	-2.697 (-3.766)	28	0.702
Equation 2	1982	-7.935 (-2.575)	0.323 (4.506)	1.992 (2.966)	-0.020 (-0.575)	-3.137 (-2.491)	30	0.503

Numbers in parentheses are t-statistics.

Data sources: *World Development Report 1984* and IMF, *International Financial Statistics*.

10. From the background paper by R. Lopez (1989, "Trade Policy, Growth, and Investment," Trade Policy Division, Country Economics Department, World Bank, Washington, D.C.); one result is reported below:

Dependent Variable: Per Capita Output Growth

<i>Time period</i>	<i>Constant</i>	<i>Capital per capita growth</i>	<i>Imported intermediate inputs/per capita growth</i>	<i>Restrictions on exports and imports for exporters (dummy)</i>	<i>Restrictions on general imports (dummy)</i>	<i>Real exchange rate variability</i>	<i>No. of observations</i>	<i>R²</i>
1979-83	0.02 (1.96)	0.16 (3.35)	0.02 (0.68)	-0.01 (-2.09)	-0.005 (-0.61)	-0.05 (-1.55)	36	0.46
1975-85	0.02 (4.62)	0.19 (6.89)	0.06 (1.83)	-0.02 (-5.02)	0.002 (0.56)	-0.03 (-2.09)	70	0.72

Numbers in parentheses are t-statistics.

11. See World Bank, 1987, *World Development Report 1987*, Washington, D.C., p. 80.
12. B. Heitger, 1987, "Import Protection and Export Performance — Their Impact on Economic Growth," *Weltwirtschaftliches Archiv*.
13. Total imports rather than intermediate imported inputs are used since complete data are not available on the latter for the 1980s.
14. From the background paper by V. Thomas, 1989, "Developing Country Experience in Trade Reform," PPR Working Paper No. 295, World Bank, Washington, D.C.), a set of results are given below:

Dependent Variable: Change in Output Growth

<i>Time period</i>	<i>Constant</i>	<i>Import growth change</i>	<i>Terms of trade change</i>	<i>Trade adjustment (dummy)</i>	<i>No. of observations</i>	<i>F²</i>	<i>F-stat</i>
<i>Trade loan recipients vs. nonrecipients:</i> (40 countries vs. 47)							
1985-87 compared to 1981-83	-0.29 (-0.53)	0.16 (5.30)	0.01 (0.48)	1.40 (1.71)	79	0.35	13.3
3 years after vs. 3 years before loan	-0.21 (-0.37)	0.18 (5.73)	0.04 (1.62)	0.45 (0.52)	72	0.41	15.5
<i>Trade reformers vs. others</i> (38 countries vs. 49)							
1985-87 compared to 1981-83	-0.39 (-0.72)	0.16 (5.33)	0.01 (0.52)	1.69 (2.10)	79	0.36	14.1
3 years after vs. 3 years before	-0.53 (-0.97)	0.17 (5.52)	0.05 (1.92)	1.37 (1.58)	72	0.43	16.8

Numbers in parentheses are t-statistics.

15. See also R. Faini, J. de Melo, A. Senhadji-Semlali, and J. Stanton, 1988, "Macro Performance Under Adjustment Lending," PPR Working Paper No. 190, Washington, D.C.: World Bank; B. Balassa, 1989, "A Quantitative Appraisal of Adjustment Lending," PPR Working Paper No. 79, Washington, D.C.: World Bank. For the limitations of such comparisons, see M. Khan, 1988, "The Macroeconomic Effects of Fund-Supported Adjustment Program: An Empirical Assessment," IMF.

16. For most indicators, a positive change is an improvement. For four indicators — resource balance/GDP, current account deficit/GDP, external debt/exports, and debt service/exports — a positive change is a worsening (shown in the table by a minus sign). For the real exchange rate, a greater real depreciation between periods for recipients than that for comparators is an improvement.

17. While in chapter 2 we used qualitative information to assess changes during 1980-87, here we restrict the analysis to specific subperiods for which quantitative estimates of policy changes are

available. Thus the evidence in this subsection is not comprehensive and does not give precisely the same picture as the fuller discussion in chapter 2.

18. For evidence of the close relation between the real exchange rate and the trade balance, see A. C. Harberger, 1989, "Applications of Real Exchange Rate Analysis," *Contemporary Policy Issues* (April):1-25.

19. See R. Lopez and L. Riveros, 1988, "Wage Responsiveness and Labor Market Disequilibrium: Exploring the Components of Open Unemployment," PPR Working Paper Series (forthcoming), World Bank, Washington, D.C.

20. M. Michaely, D. Papageorgiou, and A. Choksi, forthcoming, "Liberalizing Foreign Trade: Lessons and Experience in the Developing World," World Bank, Washington, D.C.

21. These are closely related to the factors that contribute to the "enabling environment" for private sector development. See World Bank, 1989 "Developing the Private Sector: A Challenge for the World Bank Group," Washington, D.C.

4 POLITICAL ECONOMY OF TRADE REFORMS

Summary and Conclusions

4.01 A better understanding of what makes trade policy reform difficult should help reformers to promote policy change more effectively. Reformers must take into account the political dynamics of policy formation. As individuals, beneficiaries of trade reform usually perceive lower net benefits from attempts to influence decision making than do losers. Reform of illiberal trade regimes also threatens vested interests within government. Such vested interests can be found within protected state-owned enterprises, among trade regulators who derive prestige and profit from the status quo, or among those at the highest levels of government who may wish to use rents generated from illiberal trade regimes for personal ends or to cultivate political support.

4.02 Reformers often have to bide their time until a crisis or change in regime occurs. Premature and half-hearted reforms may be counter-productive. While awaiting the proper moment, reformers should amass their intellectual ammunition and be prepared to advance trade reform under alternative emerging circumstances. While the preferred reform paths depend on country situations, in general, reforms are likely to be more believable and sustainable if launched boldly with strong initial measures and with public explanation. Execution of reforms should be entrusted to agencies that have relatively little protectionist constituency and should proceed by simple and transparent stages that are not contingent on additional detailed studies. Partial and transitional compensation of losers (such as worker retraining) may be necessary for sustainability and for facilitating the reallocation of resources.

The Politics of Trade Policy Reform

4.03 At least since the time of Adam Smith, reformers have been trying to persuade governments to liberalize trade, but with only mixed success. In May of 1930 more than a thousand members of the American Economic Association issued a petition urging Congress to vote down the tariff bill then pending in the conference committee and the president to veto the measure should it come to him for signature. One month later President Hoover signed the Smoot-Hawley tariff act into law.¹ Although trade is much freer among industrial countries today than it was fifty years ago, restrictions remain significant and are increasing (chapter 8). Even in the face of pervasive distortions and an urgent need for reform in many developing countries and the support of international agencies for it, the resistance to trade reform has been considerable and unqualified successes have been few.

4.04 A better understanding of the obstacles to successful trade reform should lead to greater success in introducing change. None of the obstacles discussed in this chapter is new to trade policy analysts and reformers; yet most reformers seldom acknowledge the difficulty of trade policy reform. The traditional paradigm treats policymaking as if it were conducted by a single decision maker who controls certain instruments in order to maximize a social welfare function consisting of a few target variables such as growth in per capita income and its distribution among broad groups. The policy maker is presumed to have available a variety of policy

instruments, adequate information about the external environment and the status of the target variables, and a correct model of the relationship between the instruments and the targets. Given this view, opposition to reform must be the result of ideological aversion or simple misinformation and must be overcome by political will. Consequently, reformers are steered toward a narrow set of options based on attempts to convince a small group of policy makers of the technical soundness of a specific reform package.

4.05 In actuality, decision making is an outcome of a complex political-economic process in which participants are guided by a variety of motives. Misinformation about the external environment, ideological aversion to certain policies, and an inadequate understanding of the relationship between policies and outcomes may distort the thinking of most or all of the participants. Trade reform would be difficult even if none of these conditions prevailed; in the presence of these conditions, it is an enormously complex task.

Obstacles to Trade Reform

Asymmetries Between Winners and Losers

4.06 The main difficulty of trade reform is the asymmetry in incentives for political action between those who benefit from reform and those who suffer. The potential gains from reform are large in the aggregate, but are spread over many beneficiaries. Thus, the potential gains to each one are relatively small, while the costs of organizing such a large group to exert political pressure are high. Potential losses from trade reform tend to be concentrated on smaller, more cohesive groups, making the incentives for political action by each individual higher and the costs of organizing them lower. This is easiest to see in a proposal to remove or reduce protection to producers of an import substitute. The potentially large benefits to such an action are diffused over the myriads of consumers of the product. The benefit to any one consumer may be so small that it is not worthwhile to attempt to influence the political decision. The loss to each producer, however, may be substantial, sometimes representing the difference between wealth and bankruptcy. Producers, therefore, will have a strong incentive to try to block liberalization.

4.07 Peru is a good example of this asymmetry at work. As the process of tariff reductions reached its peak in 1980, criticism mounted in the press. By a ratio of two to one, articles by opponents of trade reform, mainly organized groups and representatives of the largest firms in Peru, outnumbered articles by supporters of reform, written mainly by government officials.² A recognition of this asymmetry can help to mobilize support for reform. For example, in Chile reformers actively bolstered the political voice of those who stood to gain and increased their ranks. Thus, when Chile's tariff was raised from 10 to 35 percent in the early 1980s, one of the critical voices arguing that it should be reduced was the traditionally protectionist manufacturers' association. The association's character had been transformed by an influx of diversified exporters, who were willing to exert political pressure to keep the trade regime outward oriented.

4.08 In most countries, particularly in Sub-Saharan Africa, trade reform has a prorrural bias; protection has turned the internal terms of trade against agricul-

ture, and reform would reduce this bias. But the poverty and isolation of the farmers who would benefit make it difficult for their interests to be organized.³ Although large numbers of cocoa and other farmers in Ghana have benefited from devaluation and the marketing board's loss of control over prices, this has not been transformed into greater political support for the government.⁴ However, resentment over higher prices from a smaller number of concentrated and more easily organized urban dwellers is keenly felt, as evidenced in Ghana and Nigeria. Large landowners, who might serve as spokesmen for agricultural interests, often have conflicting interests, as they tend to be disproportional recipients of subsidized inputs.⁵

4.09 Another source of asymmetry is that the costs may be felt immediately whereas the benefits may not come for some time. This is especially true if benefits from reform depend on the response of investments that will take years to carry out and still more years to begin to bear visible fruit. Similarly, the bus rider whose transportation costs double or the urban bread consumer whose food outlays skyrocket because of the effect of devaluation on imported petroleum or wheat may discount heavily the possibility of one day earning high wages in an export firm.

4.10 Winners, moreover, may not be identifiable at the early stages of reform. In Colombia, for example, one of the principal beneficiaries of the trade and exchange rate reforms in the late 1960s and early 1970s were exporters of cut flowers and all those related to the industry through backward linkages. Yet none of these beneficiaries could have supported the reforms when the reform process began in 1968 because the activity, which had exports worth US\$120 million in 1982, virtually did not exist then. No one had predicted exports of flowers. Entrepreneurs may take advantage of reforms in ways that are entirely unpredictable *ex ante*.

4.11 The intellectual climate in many countries creates another asymmetry. "Export pessimism" suggests that there can be no winners from trade reform. And concern about rising protectionism in industrial countries reinforces this view. Export pessimism also receives support from the "illusion of inefficiency." When a trade regime is protectionist and the currency is highly overvalued, almost all producers or potential producers will conclude that they are hopelessly noncompetitive in the international market. At the exchange rate prevailing under a highly distorted trade regime, virtually every tradable activity "requires" either protection or export subsidies to survive.

4.12 A still more subtle problem is that exporters often do not see their interest in import liberalization. When they do, they often see only a part of that interest: obtaining inputs at international prices. They are less likely to make the macroeconomic connection between the liberalization and the implied devaluation of the sustainable equilibrium real exchange rate. This lack of understanding means that exporters may cease to be a part of the reform coalition once they have obtained some simple reforms (a reasonably well functioning duty drawback or bonded warehouse scheme, for example.) This was the case in Colombia in the 1970s, where the exporters association pushed for increased credit and insurance subsidies and the powerful Federation of Coffee Growers supported subsidized inputs and opposed overt taxation of coffee exports.⁶ Neither attempted to obtain a more depreciated real exchange rate or lower protection of manufacturing.

4.13 The difficulties discussed so far are those created by the interplay of extra-governmental interests acting on policy making. The government, however, is not a passive player pushed around by other interest groups. Government and government officials may be directly affected by trade reform. State-owned enterprises are often among those most threatened by competition from imports. In Chile in 1976, for example, when trade liberalization was fairly advanced, tariffs remained exceptionally high on imports of steel products that were also produced by the state-owned steel plant. Trade reform in Argentina has seldom dared attack the high-cost steel produced by the plant owned by the Argentine armed forces. Bangladesh sugar imports were tightly regulated to preserve the high-cost production of sugar in government-owned mills, even when the government had to subsidize the distribution of sugar. In Peru, the first reversals in the 1980 attempt at trade reform came in reprotecting outputs of state-owned enterprises.

4.14 Trade reform is also threatening to the officials who administer trade restrictions. Even in the least corrupt system, trade reform means less importance and smaller budgets if not outright elimination of the powers of trade regulators. In most cases, reform also means less opportunity for officials to make discretionary decisions, which can be traded for money and favor. The officials involved, of course, have good access to decision makers (and sometimes are themselves the decision makers), and most can be expected to oppose reform. In Indonesia, for example, corruption in the customs administration was so great that the government transferred the entire staff to other kinds of work and contracted with a foreign firm to provide customs services.⁷ Colombia provides another vivid but not atypical example. A proposal was made to raise tariffs on (noncompeting) automobile kits for assembly, with the aim of reducing effective protection on the final good and raising revenue. The proposal was defeated after vigorous opposition by the government body holding shares in the automobile assembly firm and the head of a trade regulatory body who had ties to the firm.

4.15 Theory and experience have identified the kinds of institutions that are more or less likely to favor reforms. In part these differences are explained by the same kinds of asymmetry that explain the behavior of private interests. A government agency that regulates or promotes a specific sector tends to identify with that sector. Its budget and prestige rise and fall with the standing of its clients. Like its clients, such an agency will oppose trade reforms with general benefits but with costs specific to existing firms in its sector. This is especially the case if the agency also has a role in administering existing trade policy, as is usual with respect to quantitative restrictions. Thus, ministries of industry or commerce have often opposed reform. In Sri Lanka in 1984-85, the Ministry of Industry was able to derail tariff reforms affecting state enterprises. In the United States in 1979, when protectionists wanted to make it easier to prove "dumping," they succeeded in shifting this decision-making function from the Department of Treasury to the Department of Commerce.

4.16 The specific-interest agency par excellence is, of course, the legislature, whose members represent specific, local interests. The post-World War II liberalization of trade policy in the United States would have been impossible without the

shift in the locus of tariff making from the Congress to the President permitted by the 1934 Reciprocal Trade Act. By the same token, increasing congressional involvement in U.S. trade policy in recent years has been associated with increasing protectionism. In most developing countries, trade policy is in the domain of the executive, but the legislature may become a focus of opposition to reform.

4.17 General-interest agencies, on the other hand, have little to lose from the discomfort of the firms and sectors harmed by trade reform and may expect to benefit from the aggregate improvement resulting from reform. Thus ministries of finance and economy and central banks are generally more sympathetic to trade reform than are ministries of commerce and industry. Because of cross-cutting pressures, ministries of agriculture often do not support trade reform even when agriculture as a whole is likely to benefit. Its constituents may see visible costs such as higher prices for fertilizers and imported machinery, while the effect on output prices is likely to be more diffuse. Ministries of planning or development are pulled in different directions. Although they are general-interest agencies and may not be closely identified with the "losing" sectors, they may be the repository of the regime's justification of illiberal policies.

4.18 In some regimes (Nicaragua was a typical case), trade policy is subordinated to income distribution considerations (such as distributing income to the personal estate, family, and friends of the chief of state). In other countries, illiberal trade regimes are an important source of rents that can be distributed to buy political support for the regime.

4.19 Finally, most governments seek to prevent changes in the existing income distribution, whatever it is. One explanation given for the prevalence of entrenched import-substituting trade policies in Latin America is an unwillingness to see the loss of the local manufacturing that had been stimulated by the massive decline in the terms of trade for agriculture during the Great Depression and by the unavailability of imports during World War II. Trade policy protected these sectors even though the workers and owners of manufacturing firms had incomes far above the national averages. The English Corn Laws were the result of pressure from agricultural interests for protection from the renewal of grain imports from the Continent, which had been interrupted by the Napoleonic Wars.⁸ In the United States, "voluntary" export restraints were negotiated for automobiles and steel, even though auto and steel workers were at the time among the highest-paid industrial workers.

Interests, Institutions, and Ideology

4.20 Reformers find they must deal simultaneously with a mutually reinforcing set of interests, institutions, and ideology. Given enough time, any one of these factors will create the other two. Protection originally given to satisfy the political demand of some interest group will be justified by an assertion of the special importance of that activity. Powerful vested interests can develop around activities promoted initially for "noneconomic" reasons. Specialized institutions are also required to administer, adjust, and expand protection. These institutions will themselves create a justification for their existence and the need for the protection they administer.

4.21 Reformers must bear in mind that an existing structure of trade policy is the outcome of a political equilibrium. If one group is favored and another harmed, this is unlikely to be wholly accidental. Protection of manufacturing has been adopted in many parts of Latin America as a way of undermining the political power of landowning oligarchies. In such a political economy, protectionism may be advanced by "modernizing elites" regardless of the economic costs it imposes. In Africa, trade liberalization may be resisted, at least in the short run, because nonindigenous traders or minority ethnic groups are seen as its chief beneficiaries. Freer trade may also be associated with a return to a "colonial" economic structure (although colonial governments did not allow their colonies to trade freely), and in the popular mercantilist view, importing is thought to benefit foreigners.

Implications for Reformers

Crisis and Change

4.22 Long periods of economic stability make trade reform difficult. Decision makers see little need for change. If illiberal policies have existed for long periods, substantial investment will have taken place based on those policies. Trade reform that would impose capital losses will be vigorously opposed. Vested interests will have developed good contacts with policy makers and will probably have a well-articulated justification for the privileges they enjoy. Good macroeconomic performance in India and Colombia, for example, has enabled these countries to avoid crises, notwithstanding their highly restrictive trade policies. So far, neither country has instituted major trade policy reform. Each has strong institutions that administer the policies and a tight-knit structure of import-substituting firms and trade associations that support the status quo.

4.23 Successful reform, therefore, often occurs when there is a sharply demarcated change in regime. A transition from a civilian to a military government (Pakistan in 1959, Chile in 1974) or vice versa (Argentina in 1976, Spain in 1977) is propitious for an attempt at trade reform, as is an overwhelming electoral victory of one party over another (Jamaica in 1980, Sri Lanka in 1977).

4.24 A time of external crisis is also propitious for attempting reform. A crisis undermines the justification of the existing policy. Even severe import and foreign exchange licensing was incapable of preventing a foreign exchange crisis in Nigeria in 1986, for example, and the failed attempt to use these instruments destroyed support for them. When imports virtually ceased, even beneficiaries of the previous licensing system became losers. In a crisis, the deteriorating situation under the old policies may seem more risky than reform. Crises also tend to make trade reforms more successful by depressing incomes, thereby ensuring against a flood of imports when restrictions are relaxed, and by creating excess capacity in productive sectors, encouraging greater orientation toward external markets.

4.25 Chances of lasting reform will be strengthened if illiberal trade policies (or the total cutoff of outside funds) have compressed the trade balance to the requisite degree before trade policy reform (in the sense of realigning the relative prices of tradable goods) begins. In this way, trade reform is less likely to be blamed for the distress caused by the needed decrease in absorption that accompanies most crises. In Zambia, in contrast, reform of the foreign exchange allocation mechanism

coincided with the shrinking availability of foreign exchange, thereby causing reform to be viewed by the public (and some international nongovernmental organizations!) as the cause of the shortage. Not surprisingly, the attempt at reform was abandoned.

4.26 Besides discrediting former policies, crises typically are dealt with by the general-interest agencies that are the most sympathetic to trade reform, thereby strengthening their position vis-a-vis other agencies. In Mexico, for example, the Salinas administration has used general interest agencies such as the central bank and the finance ministry as think tanks and as a source of staff for other agencies. These general-interest agencies also typically have closer links to external supporters of reform.

4.27 Even in circumstances of crisis and change, however, premature or indecisive trade reform can be worse than no reform at all. In the mid-1970s, the Lopez Michelsen administration in Colombia, elected with an extraordinarily large popular majority, announced a liberalization that would make Colombia the "South Korea of South America." In fact, liberalization was confined mainly to noncompeting imports, which probably increased rather than reduced the effective protection of import substitutes. Moreover, because of the coffee price boom, the real exchange rate was allowed to become highly overvalued, resulting in a decline in nontraditional exports, a flood of smuggled imports, and stagnation of the manufacturing sector. The succeeding Betancur government pointed to this failure of "liberalization" as an excuse to impose some of the most illiberal trade policies in the last two decades. Similarly, in Peru during 1978-80, reformist governments attempted trade liberalization, but government opinion became divided, the real exchange rate appreciated after 1980, and policy reversals soon began. The Garcia regime that followed adopted much more restrictive policies.

The Role of Ideas

4.28 New regimes are not wedded (or are less wedded) to the policies of the regimes they replace, but this does not guarantee that trade reforms will be adopted even if the regime change occurs in an atmosphere of crisis. Reformers still have to seize the moment, and their ability to do so depends in part on being intellectually prepared. An important reason for the success of reforms in Indonesia in 1984 and Chile in 1974 was that trade reformers had a ready critique of the old order and specific proposals for change. In Indonesia, reformers had begun a program of studies well before the crisis of 1983. Thus they were ready with estimates of levels and patterns of effective protection that could not be justified by any reasonable criteria, "horror stories" of inefficiency, instances of negative value added, and other arguments that were very persuasive. In Morocco in 1983 and Mexico in 1985, reform-oriented policy maker had detailed information on the protective structure (including the tariff equivalents of quantitative restrictions) because of studies prepared by small research teams that had been funded by the World Bank. (As noted in chapter 2, this kind of information is rarely available.) The power of ideas should not be undervalued.⁹ Reformers must also be prepared to answer the intellectual justification for the existing trade regime. The answers may be very different when protection is justified ideologically (to maintain state control of the "commanding heights" of the economy) than when it is explained pragmatically (to deal with a "structural" deficit in the balance of payments).

4.29 Once the reform process is under way, reformers need to maintain an applied research team to respond to complaints and answer attacks on the program. The importance of this effort was demonstrated in Indonesia and Chile and, in a negative way, by the lack of such a group in Peru. Although the government of Bangladesh has never been fully committed to trade reform, a group of reformers in the Trade and Industry Policy Reform Programme in the Planning Commission has made slow but steady progress by continuing to put forward liberalization measures.

Commitment, Pace, and Sequencing

4.30 Once the crisis has broken and decisions have been taken to initiate reform, bold, visible, and publicly justified measures seem most likely to ensure success. Public commitment of the head of the government, such as that of President Babangida of Nigeria or President Salinas of Mexico, can be crucial. Timid first steps cannot be hidden from those negatively affected, but they stand little chance of attracting support from potential winners. As in Korea, the program should be transparent and announced in sufficient detail and far enough in advance to allow parties to make the necessary adjustments. Combining multisector import liberalization steps with staged devaluations of the real exchange rate seems the best policy for attracting exporters and some import substituters to counterbalance the opposition of those whose protection is being removed. On the other hand, a large devaluation is a strong signal to exporters whose response will generate "proof" that the reform program is working and negate export pessimism. Strong commitment and bold first steps also send a signal that the reform effort is likely to be sustained and may thereby encourage a faster supply response. A multicountry study found strong evidence that sustainability of trade reform programs is enhanced if they are started with a strong, rather than tentative, move.¹⁰

4.31 The optimal pace of reform, which has been much debated from the standpoint of economic efficiency, is also important from the political standpoint. The outer bounds of the rate of reform are clear: administrative constraints prevent everything from being done at once, even if that were desirable economically, while a long, drawn-out execution of any one phase allows its opponents time to organize and re-establish links with officials carrying out the reforms. Nelson (op cit.) recommends "Fabian strategy and blitzkrieg tactics."

Execution

4.32 Reforms are more likely to be executed when there is a shift in the nature and locus of decision making on trade matters. In Nigeria, for example, foreign exchange allocation was shifted from the bureaucracy to an auction supervised by the central bank. In Venezuela, the foreign exchange allocating agency was abolished. At the beginning of trade reform in Peru, the subsecretariat of commerce was shifted from Industry to Finance. In Mexico, although the formal powers of the trade-regulating bureaucracy were not disturbed, its higher offices were filled with staff transferred from reform-friendly agencies. In Colombia, in contrast, attempts at liberalization of import licensing have been unsuccessful in part because the agency that administers import licenses has been in charge of the liberalization.

4.33 Reforms taking place according to simple rules that are easily understood and explained, such as periodic removal of a preannounced number of quantitative restrictions or phased reductions in maximum tariffs, have many advantages.¹¹ Conducting detailed studies of what to do during the implementation stage (unlike the precrisis stage) can be counterproductive if this gives opponents of reform time to organize. Reforms whose execution depends on detailed industry-specific knowledge shift the locus of decision making back to the institutions that administered the unreformed system, which increases the chances that reform will be subverted. This is apparently what happened during the later stages of reform in Indonesia.

4.34 Reformers have sometimes found necessary partial compensation of politically powerful losers from trade reform.¹² Elaborate "anti-dumping" procedures have been set up in Mexico and Chile, for example. Extremely protracted liberalization, as with import liberalization in Korea, which has been a stated policy since 1967, is another form of accommodation of losers, but with the disadvantage that it postpones benefits as well. Integration agreements, such as the "Europe 1992" plan, often establish or increase funding to compensate some regions that are expected to be adversely affected. The increase in the real exchange rate that accompanies a reduction in protection also serves this political and economic function. Paradoxically, compensation of losers may be particularly necessary from a political point of view if the losers are not among the poorest and most vulnerable groups of society. Compensatory measures to increase factor mobility (for example, worker retraining) could also increase the benefits of reform. In the United States, acceptance of the Kennedy Round tariff reductions was facilitated by the Trade Adjustment Assistance Act that provided training for displaced workers, a provision that was liberalized to help secure passage of the Trade Act of 1974. Still, the issue must be approached pragmatically. The feasible compensations that can be offered are dwarfed by the economic adjustments that even favored social groups undergo during crises, and compensation runs the risk of creating new distortions and difficulties in administering the reform program.

4.35 Once trade reform is well under way, international agreements may be used by reformers to fend off pressures to backtrack. Mexico and Chile have used the GATT in this way. In the United States, GATT agreements have often provided an effective way for the President to resist protectionist sentiment emanating from Congress. Unfortunately, GATT agreements provide less defense to policy makers against pressures for protection through quantitative restrictions than through tariff rates. This explains in large part why protectionist pressures in industrial countries have been expressed in the rising use of nontariff barriers. Agreements on trade reforms with multilateral institutions could conceivably play the same role in stabilizing reforms, but only if there was fairly broad support for the agreement to begin with. Reforms that are tainted by a suspicion of having been exacted under duress are probably less likely to last than those that have no external support at all.

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2. J. Noguez, 1987, "The Timing and Sequencing of Trade Liberalization - Peru," World Bank, Washington, D.C.
3. M. Olson, 1965 and 1971, *The Logic of Collective Action*, Cambridge, Mass.: Harvard University Press.
4. J.M. Nelson, 1989, "The Politics of Long-Haul Economic Reform," in J.M. Nelson et al., eds., *The Politics of Economic Adjustment*, Washington, D.C.: Overseas Development Council.
5. A.O. Krueger, 1989, "Some Preliminary Findings from the World Bank's Project on the Political Economy of Agricultural Pricing," in *XX International Conference of Agricultural Economists: Invited Papers*, Buenos Aires: IAAE.
6. J. Garcia-Garcia, forthcoming, "Impediments to Trade Liberalization in Colombia" in *Impediments to Trade Liberalization in Latin America*, Grower Publishing for the Trade Policy Research Center.
7. R.R. Barichello, 1988, "Indonesian Trade Reforms in the Mid-1980s: Policies, Processes, and Political Economy."
8. And they were repealed not because (or not only because) of the persuasiveness of economists, but because of the lobbying efforts of the Anti-Corn Law League, a cotton industry interest group. See G.M. Anderson and R.D. Tollison, 1988, "Ideology, Interest Groups, and the Repeal of the Corn Laws," in C.K. Rowley, R.D. Tollison, and G. Tullock, eds., *The Political Economy of Rent Seeking*, Boston: Kluwer Academic Publishers.
9. To a critic who complained to Thomas Carlyle that his books were "only ideas," Carlyle retorted, "There was once a man called Rousseau who wrote a book containing nothing but ideas. The second edition was bound in the skins of those who laughed at the first." (Quoted in J. Bhagwati, 1988, *Protectionism*, Cambridge, Mass.: MIT Press.)
10. M. Michaely, A. Choksi, and D. Papageorgiou, 1989, "The Design of Trade Liberalization," *Finance and Development* 26, no. 1 (March):2-5.
11. Even reforms relying on fairly complex rules, such as conversion of quantitative restrictions into tariff equivalents are feasible if executed outside the normal bureaucracy (Israel) and not "captured" by protectionist forces.
12. Of course, any important change in economic policy will probably be accompanied by partial compensation of the losers. For example, after the U.S. Civil War, western farmers were compensated for the increase in protection to northern manufacturers by the distribution of public lands and by rapidly growing markets. "Vote yourself a farm, vote yourself a tariff" had been a Republican slogan in the election of 1860. The free-trading South, then under Reconstruction government, did not have to be compensated.

5 MACROECONOMIC ENVIRONMENT AND TRADE POLICY

Summary and Conclusions

5.01 Macroeconomic stabilization and trade policy reform have generally been mutually supportive, although sometimes they have undermined each other. Stabilization efforts affect the real exchange rate and the real interest rate. The nature of these effects is determined by the extent of initial inflation and the policies used to reduce it. In countries that are highly dependent on trade taxes, some trade liberalization measures have, on occasions, worsened the fiscal deficit through their effect on government revenue. While a shift from quantitative restrictions to tariffs has raised revenue, tariff reductions have sometimes lowered it.

5.02 In most situations, it is desirable to carry out various types of trade reform simultaneously with stabilization. Under mild to high inflation, stabilization efforts, if appropriately managed, are generally supportive of trade policy reform. Balance of payments-induced restrictions on trade, especially quantitative controls, can be reduced as fiscal deficit and monetary financing of the deficit are reduced. Other restrictions can also be lowered as long as a devaluation or a crawling peg can maintain an appropriately depreciating real exchange rate. Supply response to reform depend, among other things, on the credibility of macroeconomic policy and supportive public investment. Under very high and variable inflation, policy credibility is easily undermined. Fluctuations in relative prices and interest rates provide confusing signals. Furthermore, if stabilization programs use the nominal exchange rate as an anchor for prices, the resulting real appreciation conflicts with the objectives of reform. Under such circumstances, it is preferable to postpone trade policy reform until the fiscal deficit and inflation are under control. Trade reforms that increase revenue support stabilization efforts by reducing the fiscal deficit. For this purpose, tariff reductions should preferably be combined with the elimination of bans and exemptions and the replacement of quantitative restrictions with tariffs. When this is not possible, tariff liberalization should be undertaken after a fiscal crisis is over or when alternative more efficient revenue-raising measures or expenditure reduction policies can be introduced to compensate for the loss in tariff revenue. In this respect, the timing of such measures is crucial.

Trade Policy Reform and Macroeconomic Crisis

5.03 The modern economic history of developing countries is replete with attempts to liberalize trade. During the 1980s, a large number of reform efforts were initiated with support from World Bank adjustment loans. Many of the efforts undertaken over the last three decades have failed to be sustained, however. In a large number of cases, failed liberalization attempts have been the result not of the trade reforms themselves but of inconsistent macroeconomic policies.¹

5.04 Countries often embark on trade liberalization in the wake of an economic crisis associated with unsustainable fiscal and balance of payments deficits and inflation (chapter 4). To restore macroeconomic balance, they seek to reduce the fiscal deficit through a reduction in government expenditure, and to lower restrictions on trade. In that situation the sequencing of stabilization and trade reform measures becomes a key issue. Should they be undertaken simultaneously, or is

there some specific pattern of sequencing that is more advisable? The answer to this question clearly depends on the extent of initial macroeconomic disequilibrium, because policy trade-offs differ under different initial conditions.

Stabilization in the 1980s

5.05 The sharp reductions in the availability of external financing to developing countries in the early 1980s required either an equally sharp reduction in the fiscal deficit or an increase in domestic borrowing or money creation leading to inflation. Trade policy reform was thus often initiated in an environment of mild to high inflation, large fiscal deficits, and serious balance of payments difficulties. Of the forty countries receiving World Bank trade adjustment loans between 1979 and 1987, four started with very high inflation rates (exceeding 100 percent a year), five with high rates (40 to 100 percent), and six with moderate rates (20 to 39 percent). The rest had relatively low rates of inflation. Thus, most World Bank-supported reform efforts occurred in countries with relatively mild inflation.

5.06 To investigate the interaction between macroeconomic adjustment and various degrees of trade reform, we examined the subset of twenty-four of the forty countries for which sufficient implementation data (chapter 2) were available.² Table 5-1 presents average data on inflation and fiscal deficits for those countries, grouped according to the intensity of their reforms with respect to exchange rate and commercial policy during 1980-87. Along those two dimensions of reform, a combination of high intensity in both or of high in one and moderate in the other is categorized as "significant" reform, while a combination of moderate and moderate or high and low is deemed as "moderate" reform. All other combinations, including policy reversals, are classified as "mild" reform.

5.07 Although aggregation hides country-specific details, the systematic differences that emerge are informative. The average fiscal disequilibrium in the years preceding trade reform, was greatest in the mild reform group; it was lower in the significant and moderate reform groups. (Chile and Korea among the significant group had lower initial deficits than the group average.) The significant and moderate trade reformers managed to reduce both their fiscal deficit and inflation rate by much more than the mild reformers, suggesting a degree of complementarity between stabilization and trade reform. This difference in relative success in stabilization is further strengthened when the significant trade reformer group, excluding Mexico, (second row of each panel) is compared with the rest. This group had the greatest success in reducing the fiscal deficit and inflation, followed by the moderate group. The mild trade reformers also had very little success in stabilization. Greater success in stabilization has been accompanied by greater success in trade reform.

Stabilization and the Effectiveness of Trade Reform

5.08 Stabilization affects not only the necessity for balance of payments-related restrictions on trade but also the behavior of two key variables critical to trade reform: the real exchange rate and the real interest rate. Movements of those variables during stabilization depend on the initial degree of macroeconomic disequilibrium, as manifested in the rate of inflation. In addition, stabilization-induced cuts in public investment, especially if they fall on infrastructure invest-

Table 5-1 Macroeconomic Indicators Before and After Reform in Trade Adjustment Loan Countries with Implementation Data
(unweighted average for each group in percentages)

<i>Indicator</i>	<i>3 years before</i>	<i>2 years before</i>	<i>1 year before</i>	<i>Year of program</i>	<i>1 year after</i>	<i>2 years after</i>	<i>3 years after</i>
<i>Inflation rate</i>							
Significant reform	31.5	34.3	30.6	55.5	25.9	22.9	22.6
Significant reform ¹	30.6	33.0	26.6	48.9	20.3	17.4	17.0
Moderate reform	12.4	11.8	12.3	9.3	8.9	8.1	7.6
Mild reform	15.5	15.7	15.3	17.4	14.8	16.9	19.3
<i>Fiscal balance/GDP</i>							
Significant reform	-4.8	-6.4	-7.8	-7.2	-6.1	-4.4	-4.6
Significant reform ¹	-5.1	-6.4	-6.5	-7.1	-5.9	-3.6	-2.6
Moderate reform	-7.2	-7.8	-6.0	-5.8	-5.4	-5.1	-4.7
Mild reform	-9.0	-6.8	-8.6	-8.9	-8.4	-8.0	-13.8
<i>Resource balance/GDP</i>							
Significant reform	-5.2	-3.4	-2.5	-1.5	0.4	-0.7	-1.1
Significant reform ¹	-5.6	-3.5	-3.6	-3.1	-0.7	-1.5	-1.9
Moderate reform	-8.8	-8.6	-7.1	-6.4	-7.1	-6.0	-4.4
Mild reform	-6.2	-9.9	-7.5	-7.8	-6.4	-6.4	-3.2

Note: Extent of reform (1980-87) is based on a combination of changes in policies (high, moderate, or low) with respect to exchange rate depreciation and commercial policy reforms. 1. Excludes Mexico, for which changes in operational deficit is a significantly more meaningful measure of fiscal effort. Countries in each group are as follows: significant (high in both categories or high in one and moderate in the other): Chile, Colombia, Ghana, Jamaica, Korea, Mauritius, Mexico, and Turkey; moderate (moderate and moderate, or high and low): Bangladesh, Madagascar, Morocco, Pakistan, Panama, Philippines, and Thailand; and mild (others): Côte d'Ivoire, Guyana, Kenya, Malawi, Senegal, Togo, Yugoslavia, Zambia, and Zimbabwe. (Mild includes countries that reversed reforms.)

Source: World Bank data. See table 2-2, chapter 2.

ment, influence the effectiveness of trade reform in generating a supply response. Thus the crucial question is how and under what conditions stabilization can hinder or help trade policy reform.

Fiscal Deficits and Trade Restrictions

5.09 There is ample evidence that large fiscal deficits are at the heart of major inflation and balance of payments crises in developing countries.³ An expansionary monetary policy, which is often the consequence of money financing of deficits, also contribute to the problems. In turn, these macroeconomic crises have frequently lead to generalized increases in tariffs and restrictions on trade and capital movements, in an effort to reduce the loss of international reserves. In countries where the fiscal deficit grows, the external balance is likely to worsen, inflation is likely to rise, and the balance of payments-motivated protection structure is likely to expand. Balance of payments-motivated trade restrictions are conceptually distinct from restrictions imposed mainly for resource allocation and income distribution purposes — generally to affect the patterns of production and consumption. Protection in low-inflation countries responds primarily to the resource-allocation motive.⁴

5.10 There is considerable evidence that the imposition of trade and foreign exchange controls closely follows the emergence of macroeconomic crises. Table 5-2 shows this relationship for selected countries of Latin America and Africa in the two years preceding a stabilization program and devaluation. The table reveals a clear rise in trade and foreign exchange restrictions in the years of falling reserves

Table 5-2 Evolution of Trade and Exchange Restrictions in the Two Years Preceding Fiscal and Exchange Rate Crises in Selected Countries

<i>Country/crisis year</i>	<i>Payments restrictions on transactions</i>	<i>Tariffs, duties, and cost-related measures</i>
Bolivia (1979)	<ul style="list-style-type: none"> Increased restrictions on a number of current payments in 1978. 	<ul style="list-style-type: none"> Since 1977 most imports subject to 5-25% advance deposit; increased to 500% for 600 items in 1978.
Bolivia (1982)	<ul style="list-style-type: none"> All sales of foreign exchange subject to authorization. Prohibition on imports of some industrial goods. 	<ul style="list-style-type: none"> Advance deposit requirement of 5-25% lowered in 1981.
Chile (1982)	<ul style="list-style-type: none"> Payments highly liberalized. No restrictions imposed. 	<ul style="list-style-type: none"> Flat (10%) import tariff not altered prior to devaluation.
Ecuador (1982)	<ul style="list-style-type: none"> Multiple exchange rates and two-list import structure. Restrictions successively increased after 1981. 	<ul style="list-style-type: none"> Increase in coverage and rates of advance deposits and hike in import tariffs in early 1981.
Mexico (1976)	<ul style="list-style-type: none"> Import licenses required for almost all items, and public imports severely restricted. 	<ul style="list-style-type: none"> Nonessential imports subject to 10% surcharge. Replaced by increase in average import duty from 15% to 20%.
Mexico (1982)	<ul style="list-style-type: none"> Import licensing and quotas; the first were greatly increased in 1981. 	<ul style="list-style-type: none"> Continued increase in import duties throughout 1981.
Malawi (1981)		<ul style="list-style-type: none"> Custom duties increased on a wide range of items and the rate of surtax raised from 15% to 20%. All imports subject to a 20% advance import deposit requirement.
Mauritius (1981)	<ul style="list-style-type: none"> Importers unable to obtain domestic or foreign credit for imports of "low-priority items" (goods with tariffs in excess of 20%). Licenses required for imports of noncapital goods. Foreign exchange license introduced as an additional requirement for importers with approved import licenses. 	<ul style="list-style-type: none"> A 10% across-the-board surcharge imposed on all duties payable on imports.
Senegal (1980)	<ul style="list-style-type: none"> Special license required for imports of textiles. Import licensing imposed on imports of electrical equipment. 	<ul style="list-style-type: none"> Import taxes raised for most foodstuffs and some manufactured products.
Zambia (1983)	<ul style="list-style-type: none"> All import applications to be approved by Bank of Zambia. All imports had to be financed by letters of credit with minimum term of 90 days. Foreign exchange allowances suspended for tourist travel. 	

Source: S. Edwards, 1989, "Exchange Controls, Devaluation and Real Exchange Rates," *Economic Development and Cultural Change*; and IMF, *International Financial Statistics* (various issues).

and growing balance of payments problems. Evidence on the forty trade adjustment loan countries also shows that the use of quantitative restrictions was greater in countries with severe balance of payments difficulties.

5.11 Liberalization involves the removal of such trade controls. In the absence of any reduction in the fiscal deficit, such liberalization would clearly enhance current account imbalance, which the controls were expected to restrain. However, so long as fiscal deficits are sufficiently reduced, before or simultaneously with liberalization the excess demand for imports can be lowered and the current account deficit kept in check. This is evident in table 5-1 where the significant reformers who succeeded in reducing fiscal deficit were also able to lower their current account deficit, notwithstanding substantial liberalization. Thus, stabilization and reduction of trade restrictions can go hand in hand without aggravating the current account.

Real Exchange Rates

5.12 An important source of tension between stabilization and liberalization programs is that successful trade liberalization has to be supported by a real depreciation while disinflation can result in an appreciation of the real exchange rate (see box 5-1, overleaf, on the real exchange rate).⁵ Nevertheless, as long as the necessary depreciation of the real exchange rate can be ensured and maintained, trade liberalization can be undertaken under disinflation.⁶

5.13 However, a nominal devaluation can lead to a real depreciation only if domestic prices do not rise by the same magnitude as the devaluation. As long as the fiscal deficit is reduced, the devaluation will not be inflationary and real depreciation will occur. Increase in domestic prices of imports following a nominal devaluation is inevitable, however. Any reform-induced reductions in tariff would mitigate this while the presence of wage indexation would aggravate it. In any event, the inflationary potential of a rise in the price-level because of a rise in domestic import prices need not be significant if sufficient fiscal restraint is in place. The experience of the significant reformers support this empirically. In addition, depreciation and liberalization (which often accompanies it) by enhancing competition and import availability, can help to dampen inflationary pressures (Tanzania, Uganda).

5.14 In countries with mild to high inflation, institution of a crawling peg system consistent with reductions in the fiscal deficit has been effective in ensuring real depreciation.⁷ For example, through some variant of a crawling peg, Chile, Colombia, and Morocco maintained a steadily depreciating real exchange rate during trade reform while Kenya and Mauritius maintained a constant real exchange rate after an initial real depreciation. Even under substantial disinflation, a depreciating real exchange rate has been maintained: ten countries reduced their moderate to high inflation rates in half within three years, and managed a real depreciation.⁸

5.15 The official exchange rate is a poor indicator of the opportunity cost of foreign exchange in countries where, because of a prolonged period of overvaluation of the official exchange rate and thus of trade and exchange controls, a large proportion of current transactions is undertaken through a parallel foreign exchange market.⁹

Box 5-1. Real Exchange Rate Realignment and Adjustment

Equilibrium Real Exchange Rate

In determining whether the real exchange rate (RER) is overvalued, it is necessary to evaluate the evolution of the equilibrium real exchange rate (ERER). The ERER is the price of tradables relative to non-tradables that, for given long-term equilibrium (or sustainable) values of other relevant variables such as trade taxes, international prices, capital and aid flows, and technology, leads to the simultaneous attainment of internal and external equilibrium and is compatible with long-term economic growth. Internal equilibrium means that the nontradable goods market clears in the current period and is expected to be in equilibrium in the future. External equilibrium means that the current account balances (present and future) are compatible with long-term sustainable capital flows. This definition of the equilibrium real exchange rate considers only real variables; monetary variables are normally the determinants of the actual RER.

Four implications follow from this definition of ERER. First, when there are changes in any of the other variables that affect the internal and external equilibriums (for example, the terms of trade), there will also be changes in the equilibrium real exchange rate. The ERER is itself a function of several variables including import tariffs, export taxes, real interest rates, and capital controls. Second, there is not one single ERER, but a path of ERERs through time. Third, the path of ERERs is affected not only by the current values of the fundamental determinants, but also by their expected future values. Fourth, in analyzing the interaction between fundamentals and ERERs, it is important to distinguish between permanent and temporary changes in the fundamentals.

In order to evaluate whether a country's RER is in equilibrium, it is not enough to compare its current value with historical

levels. The historical (and expected) behavior of the fundamental determinants of the ERER should be scrutinized. It is quite common to find situations where changes in fundamentals have affected the sustainable ERER to such an extent that even when the current RER is greatly depreciated relative to the past, overvaluation and disequilibrium still prevail.

The Chilean Experience

Between 1965 and 1970 there was a steady real depreciation in Chile, which broadly corresponds to a mild trade liberalization (figure 1). A crawling peg nominal exchange rate helped to achieve and maintain this depreciating real exchange rate. During 1970-73, expansive macropolicies and the imposition of massive exchange controls resulted in forces that appreciated the real exchange rate. The terms of trade fluctuated without exhibiting a trend. During this period, Chile's RER became severely overvalued.

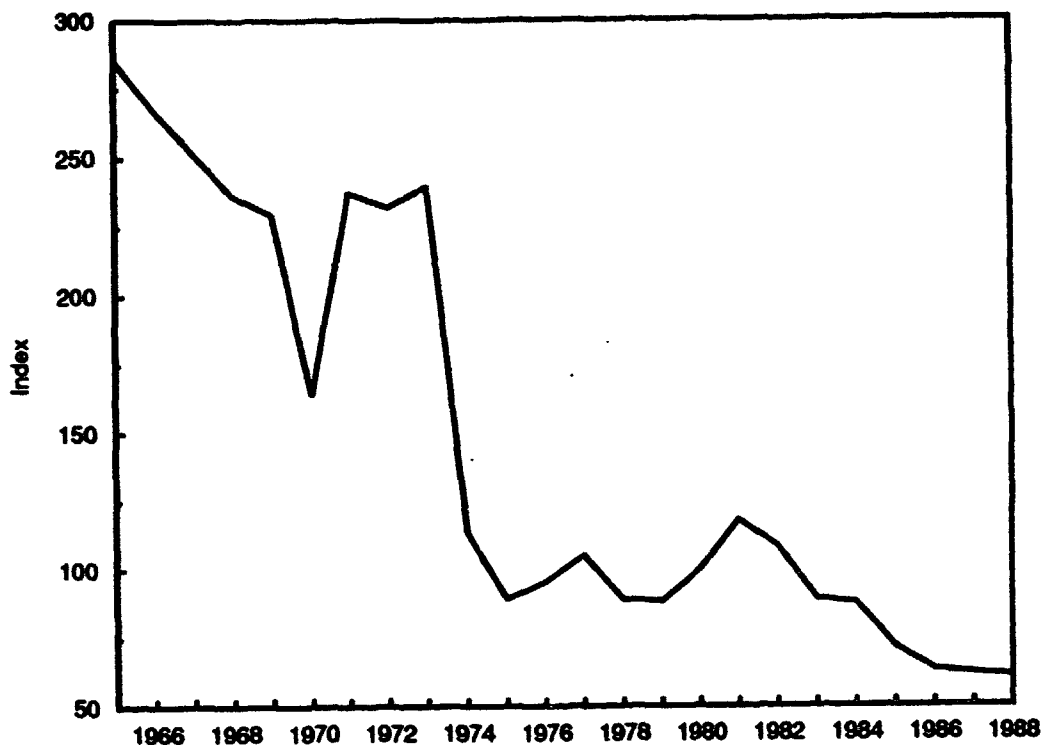
Between 1965-73 and 1974-84 there was a structural break in RER behavior in Chile. Throughout 1974-84, in spite of broad fluctuations, the RER was at all times significantly more depreciated than at any time during the previous ten years. Two main "real" events that greatly affected the behavior of RER fundamentals are behind the real depreciation between 1965-73 and 1979. First, there was a drastic liberalization of international trade. Second, there was a steep, and apparently permanent, deterioration of Chile's terms of trade, due to a decline in the price of its main export, copper. These two changes in fundamentals required a real depreciation to maintain external equilibrium.

Between 1979 and 1982 the real Chilean peso appreciated. This appreciation can be attributed to two interconnected factors: (1) between 1979 and 1981 capital controls were greatly relaxed, allowing a massive inflow of foreign funds; this caused the ERER to appreciate; and (2) the fixing of the nominal exchange rate in June 1979 as a way to bring

The extent of overvaluation is manifest in the large parallel market premium on foreign exchange. With exporters surrendering their foreign exchange receipts at the official rate, the premium shows the size of the tax on exports.

5.16 Elimination of overvaluation in the presence of a parallel market requires deft economic management because the parallel market is highly sensitive to expectations of current and future policy. Thus, periodic devaluations of the official rate may fail to lower the parallel market premium unless sufficient reductions in the fiscal deficit are expected to be initiated and sustained. Ghana (1983-86) and

Figure 1: Real Exchange Rate Index in Chile, 1965-88
 (1980 = 100; increase in index indicates real appreciation)



Source: World Bank estimate

ksr/w45860a

down inflation also contributed to the observed real appreciation. This loss in competitiveness after mid-1979 was, according to most observers, one of the main reasons for the collapse of the Chilean economy in 1982-83. Although the RER appreciated during 1979-82, it was much more depreciated rela-

tive to its 1965-73 level. This illustrates how changes in fundamentals can greatly change the ERER. A RER that would have been excessively depreciated in the 1970s, before the tariff liberalization and structural worsening of the terms of trade, was fatally appreciated in the early 1980s.

Zaire (1983-85) succeeded in lowering overvaluation through periodic depreciation of the official rate largely because of sustainable and credible reductions in their budget deficits. In contrast, Zambia's program failed precisely because the fiscal situation was out of control.

5.17 In countries with very high inflation and strong inflationary expectations, disinflation policies often involve a reduction in fiscal deficit and instruments to control expectations and to anchor domestic prices.¹⁰ The exchange rate is frequently used as a stabilization instrument. In such situations, either the rate is

fixed or the rate of crawl of the nominal exchange rate is less than what is necessary to compensate for the rate of inflation. The Southern Cone countries of Argentina, Chile, and Uruguay in the late 1970s provide the best examples of massive real exchange rate appreciation resulting from such exchange rate-guided disinflation.¹¹ It is best to postpone trade policy reform if the stabilization strategy is likely to lead to a period of real appreciation.

5.18 Despite this potential difficulty with using the exchange rate as a stabilization instrument, governments highly committed to reform may still be able to undertake both trade liberalization and a major anti-inflationary program. For example, a maxi-devaluation, leading to a large real depreciation, may be undertaken prior to deploying the nominal exchange rate as a price anchor. Notwithstanding the gradual appreciation that follows, the real exchange rate can remain at a more depreciated level than before the reform for a considerable period, thereby ensuring that the profitability of tradables relative to nontradables remains higher than it was before reform. Mexico (1985-89) has initiated such a program.

Real Interest Rates

5.19 In very high inflation economies, stabilization programs often raise the real interest rate, at least temporarily.¹² Real interest rates climbed to a monthly rate of 6 percent in Argentina in the aftermath of the Austral plan and surpassed an annual rate of 38 percent in Chile in 1981 and 34 percent in Uruguay in 1982. The increase in real interest rates appears to be unavoidable even if temporary. When a high expected rate of inflation results in a high nominal interest rate but the actual rate of inflation is lower than expected, the ex post measured real interest rate rises. Also, as the stabilization program lowers inflation, the level of real money balances can be too low relative to demand, leading to a high nominal interest rate. Although under such situations, interest rates may fall following adjustment, the consequent uncertainty in their levels is likely to inhibit private investment.¹³

5.20 The foregoing discussion suggests that countries with low rates of inflation can pursue trade policy reform fairly independently, since a depreciating real exchange rate is relatively easy to sustain when fiscal restraint is maintained. In the case of moderate to high inflation rates, a well-managed crawling peg can also ensure a depreciating real exchange rate during disinflation. In addition, as long as macroeconomic pressures are being controlled, balance of payments-motivated trade restrictions can be dismantled simultaneously. However, under conditions of very high and variable inflation, it may be advisable to postpone liberalization until some macroeconomic stability has been achieved. High relative price variability,¹⁴ as well as the potential for real appreciation arising from exchange-rate-based stabilization, is likely to provide confusing signals to both producers and investors, thereby making trade reform difficult to manage.

Public Investment

5.21 Even under relatively low rates of inflation, the supply response to reform-induced changes in relative prices may be weak under conditions of stabilization-induced reductions in public investment. In the 1980s, reductions in the fiscal

deficit came primarily from cuts in public expenditure rather than from increases in revenue, and the largest percentage of reductions came in capital spending.¹⁵ Public investment fell sharply in several trade reform countries, in particular, Côte d'Ivoire, Mexico, Morocco, and the Philippines. There is also evidence to suggest that spending on infrastructure experienced a steeper decline than other categories of capital expenditures. Only Chile, Colombia, Korea, and Turkey, three of which are among the significant trade reformers, managed to sustain or raise the rate of public investment as a share of GDP.

5.22 The mode of expenditure adjustment has important implications for trade policy reform. A sustained supply response to reform is critically dependent on new investment, especially private investment, but private investment in export sectors can be inhibited because of inadequate supporting infrastructure (see chapter 6). Thus, public investment in infrastructure can be complementary to private investment by reducing production and distribution costs. There is systematic country evidence for Malawi, Mexico, and Turkey that confirms that investment in infrastructure has a positive effect on private sector profitability. In contrast, public investment in noninfrastructure or manufacturing is likely to compete with and crowd out private sector investment.

5.23 What is important with respect to public investment is not only its level but also its composition (infrastructure versus noninfrastructure) and quality (effectiveness in raising total output). The World Bank's increasing involvement in extensive public investment reviews to assess the composition and quality of capital spending is a recognition of the importance of these factors. In prioritizing infrastructure investment projects, trade reform can sometimes help to identify sectors in which infrastructure is a more critical constraint (chapter 7). For example, in Tanzania the increase in cotton production following reform helped to highlight areas in which transportation was a critical bottleneck for cotton exports. So long as supporting public investment in infrastructure remains inadequate in terms of either its level or its focus on sectors and areas, the supply response to reform will be poor. While World Bank investment/expenditure reviews remain necessary and are useful for drawing attention to spending priorities, there is a need to get a country's own economic staff involved in a regular program of scrutinizing public investment, particularly when trade policy reform is underway.

Revenue Effects of Trade Reform

5.24 When liberalization and stabilization are pursued simultaneously, liberalization measures will improve efficiency but can improve or worsen the fiscal situation, both indirectly and directly. These effects will help or hinder stabilization efforts. The indirect effect can arise either from the impact of liberalization on the financial system (especially if a government tries to keep loss-making banks afloat — see box 5-2, overleaf) or from its effect on the profitability of public sector manufacturing enterprises.

5.25 The direct effect, which is discussed here, stems from the revenue implications of liberalization in countries in which trade tax revenues constitute a significant proportion of total government revenue. According to the World Development Report 1988, revenues from explicit trade taxes like tariffs, import surcharges, and export duties accounted for 38 percent of total tax revenue in low-income countries

Box 5-2. Trade Policy Reform and Financial Sector Reform

Trade policy reform involves changes in the profitability of firms. Exporters typically benefit from devaluation. Some import competitors with previously heavily protected markets lose as quotas are replaced by tariffs (the firms may also be importers that have had access to the quasi-rents generated by quotas), whereas others may gain because the benefits of devaluation more than compensate for the loss of protection. Sustained real devaluation also involves a fall in the foreign exchange price of nontradables and thus in the price of nontraded relative to traded goods.

The resulting resource shifts can have a major impact on the financial system. Banks and borrowers with foreign exchange-denominated debts experience a rise in debt burdens and debt service relative to asset values and earning streams (except, possibly, for exporters). Some countries, such as Brazil and Chile, have instituted measures to shift part of the loss from private firms to the government. If the capital account is open (or porous), real interest rates may rise to offset an anticipated real devaluation, so all debt service, whether domestic or foreign-funded, increases (Indonesia, Malaysia). Because of the confluence of trade reforms with macroeconomic adjustment, interest rates may be high due to moderate inflation or to restrictive monetary policies implemented for balance of payments purposes, or because of heavy domestic government borrowing to finance

the public sector's own higher external debt service (Brazil, Turkey).

The banking system is also typically heavily exposed to highly protected firms in the import-competing sectors, some of which may be heavily indebted. The impact of trade reforms can thus be to weaken the balance sheets of important borrowers and financial intermediaries; this is the "asset-value" stock impact of rearranging the flows of goods and payments. On the other hand, lenders do not capture much of the gains that accrue to firms that benefit from the reforms. This is so, first, because import-competing firms typically account for a larger share of the modern economy and are more capital intensive than exporting firms, and, second, because the distribution of returns is asymmetric between banks and borrowers. The upside potential for banks is quite limited, at most to complete service of loans, whereas the downside potential is large. The reverse is true for borrowers because of limited liability.

Anything causing greater dispersion of returns to borrowers is likely to weaken bank portfolios. As in Turkey, borrowers tend to become polarized. The stronger have less need of bank finance, as they are able to strengthen their balance sheets by retentions. The weaker come to rely more on loans and pose a greater risk to the banking system. The group into which a firm falls is generally determined by its initial level of indebtedness and the location of its market. Sometimes an ownership dimension is important; thus, while Brazil's

and 19 percent in middle-income developing countries in 1985. For individual countries, dependence on trade taxes ranges from 4 percent for Brazil to 58 percent for Gambia. Fiscal dependence on trade taxes is greatest in Sub-Saharan Africa, followed in order by Asia, the Middle East and North Africa, and Latin America and the Caribbean. Import taxes dominate trade tax revenue in most cases. Explicit export duties are relatively unimportant except in a few countries, but revenue from implicit export taxes can often be more significant than formal export duties.

5.26 The high dependence on trade taxes in developing countries makes their fiscal balance vulnerable to liberalization-induced changes in trade tax revenue. The key policy issue is how best to anticipate the effect of trade reform measures on fiscal balance and to develop alternative more efficient revenue measures. While tariff reduction has the potential for lowering import tax revenue, devaluation generally has a positive valuation effect on the revenue bases of import taxes; where the government is a net buyer of foreign exchange it has adverse fiscal effects. The positive effect of devaluation has in several cases been an important factor in mitigating the revenue effects of tariff liberalization. Elimination or reduction of exemptions from import duties, which relate mainly to imported inputs, is also unambiguously revenue enhancing. So is replacement of a ban by a

private corporate sector retrenched sharply in the mid-1980s, benefited from measures to shift exchange losses to the government, and strengthened balance sheets, the public enterprises, which were initially more highly leveraged, fell more and more deeply into debt.

The impact of this portfolio deterioration depends largely on the extent to which the financial institutions, and their regulators, are willing and able to maintain financial soundness. With good prudential regulation and supervision, losses are recognized rapidly and written off; this may provoke some difficulties, but in a reasonably well-diversified financial system and given reasonably good economic performance after reform, the impact should be manageable. Malaysia has managed to contain the ill-effects on the banking system, but even there unregulated financial institutions ran into difficulties. Usually, however, prudential regulation is weak, loans to loss-making firms are rolled over, and the portfolio quality of the financial system suffers an accelerating decline as distress borrowing crowds out borrowing by the potentially profitable firms which the trade reform sought to encourage. The financial system then becomes an impediment to the smooth reallocation of resources. At the same time, the fiscal cost implicit in the government's (usually unstated) commitment to bail out the system mounts rapidly. For developing countries, estimates of this cost

have ranged from 5 percent to 30 percent of GDP.

One special case of systemic reform (which may include trade reform as one component) is the liberalization of centrally planned economies. This poses special problems for the financial system, as shown by the recent experiences of East European countries and China. Sometimes enormous changes in relative prices and the profitability of different firms are superimposed onto a regulatory structure ill-adapted to a market economy. It is difficult to predict the impact on bank portfolios, but it appears that substantial parts of their portfolios would be nonperforming following a major reform.

Trade reforms are probably a less important source of financial sector problems than adjustment to adverse terms of trade or capital account shocks. Nevertheless, the consequences of trade reform for asset values and the financial sector should be factored into the initial evaluation of trade reform. Some components might be built in at an early stage to anticipate the problem — for example, an effective auditing and loan classification system might be included with initial trade reform operations. The alternative, as in Turkey, is to wait until the problem becomes widespread and very costly.

Source: Background note by A. Gelb.

nonprohibitive tariff, or a quota by an equivalent tariff. The total effect on revenue thus depends on the combination of measures contained in the trade reform program.

Import Tax Revenue

5.27 Since the revenue effect of liberalization will be most visible under episodes of substantial reform, we focus first on the fifteen trade adjustment loan countries that can be categorized as significant and moderate reformers (see note to table 5-1) during 1980-87. In seven of those countries, reform consisted predominantly of reductions in duty exemptions and a switching of protection from nonprice to price measures; this group is referred to as the "quota reformers." In the remaining eight countries, tariff reduction was a more dominant aspect of trade reform; this group is called the "tariff reformers." Import tax revenue as a share of GDP rose after reform for the quota-reformer group and fell for the tariff-reformer group (table 5-3, overleaf). However, because of differences in initial conditions, not all quota liberalizers experienced the same degree of change in revenue. The extent of the favorable impact on revenue differed according to the prereform shares of duty exemptions, import bans, and quota-imports not subject to tariffs.¹⁶

Table 5-3 Import Tax Revenue of 15 Substantial Reformers, by Type of Reform, Before and After Reform (percentage of GDP)

<i>Group^a</i>	<i>3 years before</i>	<i>2 years before</i>	<i>1 year before</i>	<i>Year of reform</i>	<i>1 year after</i>	<i>2 years after</i>	<i>3 years after</i>
Eight tariff reformers^b	2.8	2.8	2.7	2.5	2.2	2.2	2.3
Seven quota reformers^c	2.7	2.7	2.6	2.7	3.2	3.3	3.4

a. The assignment of countries to these two groups is based on information on programs and implementation in Halevi (1989, op. cit.).

b. Includes Chile, Korea, Mexico, Morocco, Panama, Philippines, Thailand, and Turkey.

c. Includes Bangladesh, Colombia, Ghana, Jamaica, Madagascar, Mauritius, and Pakistan.

Source: World Bank data.

5.28 Not all tariff liberalizers faced declines in revenue, nor can such declines be deemed inevitable. A lowering of very high duties can reduce customs evasion, thereby raising revenue by increasing the share of official transactions in total imports. The positive valuation effect of a nominal depreciation that accompanies reform has been useful in mitigating or avoiding revenue declines. Reductions in very high tariff rates (concertina cuts) can increase revenue under some conditions, while proportionate reductions in all tariffs (radial tariff reform, see chapter 7) are likely to be revenue reducing. If import demand is price elastic at the prereform tariff-inclusive price (which is the case if tariff rates exceed the maximum-revenue tariff), tariff liberalization can enhance revenue. A fall in tariff rates would then lead to a more than proportionate rise in imports and thus to an increase in revenue. The larger the share of imports with such high tariffs, the greater this positive impact.

5.29 In designing tariff reform programs, however, this response of imports to tariff reduction cannot always be relied upon because of three factors. First, tariff reductions in the presence of pervasive import quotas or foreign exchange rationing could prevent a rise in imports and thus in revenue. Concertina reductions in tariffs in the presence of quotas have been accompanied by lower import tax revenue in Kenya (1983-85), Tanzania (1981-83), and Thailand (1980-83). Other countries of Sub-Saharan Africa that have high tariffs and widespread quantitative controls could experience the same effect. Second, the negative income effect of stabilization policies on imports often leads to a substantial loss in revenue, as was clearly the case in Mexico (1982-84) and the Philippines (1980-83). Third, given aggregate demand, depreciation to a more realistic exchange rate will tend to lower imports. However, if realistic exchange rates and low tariffs are accompanied by a rise in exports, imports may also rise as a result of the income effect and relaxation of the foreign exchange constraint, if it was binding. In Chile (1985-88) and Korea (1985-88), reductions in tariffs were not accompanied by decreases in import-tax revenue even though initial tariffs were low. This was largely because of an autonomous rise in imports. Thus, before initiating tariff reductions amidst stabilization, it may be necessary to consider the likely changes in a country's overall level of imports that may arise from changes in trade policy, export growth, and aggregate demand policies.

5.30 Removal or reduction of explicit export taxes has proved problematic in only a few cases: Tanzania (1981-83), Uruguay (1984-86), and Argentina (1987-88). In Argentina, the failure to implement a new land tax measure, which was expected to compensate for the revenue decline, was followed by a reimposition of the export duties.

5.31 The effect of reform measures on implicit export tax revenues has been of greater concern. Implicit tax receipts in the form of public export marketing board surpluses (generated by setting the producer prices of export commodities at below border prices) have on occasion exceeded revenue from explicit export taxes.¹⁷ Generally, trade policy reform has had a positive revenue effect in this respect, even when the producer prices of export commodities were increased substantially, as in Ghana and Tanzania. The valuation effect of exchange rate depreciation and the volume response to higher producer prices have usually raised the surplus. However, where marketing boards were abolished on grounds of efficiency, as in Nigeria and Senegal, government receipts were hurt.

Effect on the Fiscal Deficit

5.32 In some instances, the adverse revenue effects of reform were offset by changes in domestic tax measures that increased revenue. Many such measures were introduced in the trade adjustment loan countries and included improved tax administration and collection (Ghana, Pakistan, and Thailand), increased rates and coverage of sales and excise taxes (Malawi, Mauritius, Mexico, and the Philippines), and introduction of a value-added tax (Jamaica, Morocco, and Turkey). On occasion, the measures were explicitly intended to offset the anticipated decline in trade tax revenue, although this did not always happen because of poor timing of the tax measures.

5.33 Mexico and Morocco provide an interesting contrast in this respect. Both countries had about the same level of revenue dependence on trade taxes, both made substantial reductions in expenditure, and both initiated radical tariff reform measures and suffered declines in explicit trade tax revenue.¹⁸ In Mexico, this loss was cushioned by increases in receipts resulting from increases in domestic indirect taxes (value-added taxes [VAT] as well as direct sales taxes) made possible largely because the VAT system had been put in place three years before the 1983 trade reform. By the time a more substantial import liberalization was initiated in 1985, trade tax revenue constituted only a miniscule proportion of total tax revenue. Morocco failed to generate the offsetting increases in revenue that were anticipated from initial increases in rates of sales taxes and subsequent introduction of a VAT system. Transitional difficulties in implementing the VAT led to lower than expected receipts from indirect taxes in the first two years (1986-87), although receipts rose substantially later.¹⁹ In addition, direct taxes failed to generate sufficient revenue because of new tax exemption provisions introduced in growing sectors. The collapse of world phosphate prices finally triggered a partial reversal of Morocco's tariff reform.

5.34 The experience of Ghana and Zambia provides a contrast with respect to another measure: correction of overvaluation leading to exchange rate unification

(see paras. 5.15 and 5.16). If the government is a net buyer of foreign exchange (as is the case in Ghana and Zambia) devaluation worsens the fiscal balance. This adverse effect has been quite significant in many countries where overvaluation was large.²⁰ In Ghana, but not in Zambia, this was offset by revenue from other sources. Through vastly improved administration, collection, and enforcement practices, Ghana doubled the share of tax revenue in GDP between 1983 and 1985. Reductions in distortions led to an increase in official transactions (relative to unofficial transactions) and hence contributed to increased revenues. Achieving additional increases in revenue from changes in the tax structure took time, however, and so Ghana proceeded slowly — and perhaps for that reason, successfully — with exchange rate unification. In contrast, Zambia implemented few new tax measures. A decline in nontrade tax receipts and a rise in expenditure increased the fiscal deficit in the first two years of the Zambian reform, leading to a reversal in 1987.

5.35 Reforms involving mainly a switch from quantitative restrictions to tariffs can be undertaken under most circumstances. Tariff reductions in revenue-constrained situations should preferably be accompanied by such a switch in import measures, together with a reduction in the coverage of exemptions and bans. In ascertaining the appropriate mix of liberalization measures, the potential revenue impact of the package should be assessed ahead of time. The World Bank should support such work in the future. If liberalization consists mainly of tariff reductions — which is often the case in later stages of trade reform — the declines in tariff revenue would need to be compensated for by increases in other government revenue, especially if expenditures have already been reduced substantially and cannot be squeezed much further. Such offsetting increases could be generated by increasing the prices of public sector services or output, or by higher domestic indirect taxes. The resulting shift away from reliance on import taxes, to increased dependence on domestic indirect taxes or value-added taxes, would improve the efficiency of revenue generation.²¹ However, institutional constraints can make implementation of the value-added tax difficult or that of a retail-level sales tax infeasible. Nevertheless, the scope for extending the coverage and increasing the rates of factory-level sales and excise taxes should be tapped.²² In any case, the timing of compensatory revenue measures is of critical importance.

Complications of the Debt Burden

5.36 Complications arising because of heavy debt overhang also need to be considered in the design of trade reform measures. In the 1980s, these problems have been particularly acute in countries with very high rates of inflation, but they have also affected countries with relatively lower inflation. In the presence of high debt-servicing requirements, substantial real devaluations are required to generate a trade surplus in the face of reduced capital inflows. The need for this large real depreciation under a disinflation program (given the difficulties discussed in paras. 5.12 to 5.17) demands competent macroeconomic management. This is more so because large devaluations put pressure on the fiscal deficit by increasing the domestic currency cost of servicing foreign debt.²³

5.37 Even if the necessary trade surplus is achieved, a fiscal problem remains since exports are generated mainly in the private sector. The resulting surplus has to be taxed to generate revenue for public sector debt servicing. With limited tax

options, there may be a temptation to raise revenue by increasing trade taxes, which would be undesirable. Even if that is not the case, there is likely to be, at the very least, some resistance to a reduction in trade tax rates. In some highly indebted countries, the need for revenue to service debt has led to taxes on financial intermediation. Such an outcome has had significantly adverse effects on investment and resource reallocation, both targets of liberalization. All these problems suggest careful management of trade reform, not its postponement, since the need for increased efficiency of the external sector is most pressing under a debt crisis.

Investment, Credibility of Liberalization, and Sustainability

5.38 Credibility is fundamental to successful liberalization. Trade reform works only to the extent that resources move to sectors that have become more productive under the reform. The process of moving resources involves costs that entrepreneurs will be willing to incur only if the new set of relative prices is expected to continue. Only then will new private investment be forthcoming. Expectations about the reform's unsustainability can be self-fulfilling: if lack of credibility leads to a low investment response from the private sector, reform becomes difficult to sustain.

5.39 Generally speaking, when fiscal and exchange rate policies are inconsistent and the real exchange rate appreciates, firms will perceive a high probability that exports will fail to develop and, consequently, that the reform may be reversed. In this case, firms will refrain from investing in sectors that have become more profitable under the reform since the reform-induced change in relative profitability is not expected to be sustained. The real exchange rate acts as a signal, conveying information to the private sector on the likelihood of a sustained liberalization. A steep real appreciation, by undermining the current account, generates expectations about a reimposition of trade controls. If stabilization policies require a real appreciation, as is often the case under very high and chronic inflation, there is a case for postponing trade reform.

5.40 Similarly, wildly fluctuating real exchange rates, resulting from half-hearted attempts at real depreciation or unsuccessful efforts at exchange rate unification, imply uncertain profitability for many sectors. Variability in other relative prices, such as interest rates, sends the same signals of impermanence. Since investment typically involves adjustment costs and irreversibilities, the greatest adverse impact of increased relative-price variability falls on private investment.²⁴ Trade policy reform should preferably be initiated after high relative-price variability has been reduced sufficiently to make reform-induced changes in relative prices, both meaningful and credible.

5.41 Failure to reduce the fiscal deficit also generates public skepticism about the ability of government to sustain trade reform, particularly because trade taxes are often invoked as the easiest and quickest means of increasing revenue.²⁵ Attempts by the private sector to anticipate the reversal of tariff reform can also destabilize the liberalization process.²⁶ It is therefore necessary, after initiating reform, to minimize any appearance of conflict between stabilization and trade policy reform. This could be done by pursuing policies that are likely to reduce relative-price variability, depreciate the real exchange rate, reduce the fiscal deficit, and produce steady or rising investment ratios.

1. A recently completed World Bank research project concludes: "[There are] extremely strong links between trade liberalization and the accompanying macroeconomic policies. The latter appear to be special in determining the survivability of the trade liberalization." (M. Michaely, A. Choksi, and D. Papageorgiou, 1986, *The Phasing of a Trade Liberalization Policy: Preliminary Evidence*, CPD Discussion Paper No. 1986-42, Washington, D.C.: World Bank, p. 14).
2. Fifteen of the twenty-four economies also started with low inflation. Five countries had moderate inflation. Two of them (Mexico and Ghana) experienced very high inflation while another two (Turkey and Yugoslavia) had high inflation. Three of these four are also among the significant reformers.
3. Although there is no one-to-one analytical link between fiscal deficit and inflation, large budget deficits do, sooner or later, tend to create high inflation. For an analysis, see S. Fischer, 1989, *The Economics of Government Budget Constraint*, PPR Working Paper No. 224, Washington, D.C.: World Bank; for some evidence, see A.O. Krueger, 1978, *Liberalization Attempts and Consequences*, Cambridge: Ballinger Publishing Co.; and World Bank, 1988, *World Development Report, 1988*, Washington, D.C.
4. Their level under sustainable macroeconomic equilibrium can be interpreted as resulting from political economy considerations — from competition among different pressure groups to obtain protection and other rents. This equilibrium is, however, inefficient.
5. Insufficient adjustments in the administered exchange rate during disinflation can result in appreciation. If the nominal exchange rate is explicitly used to anchor domestic prices to world prices for purposes of disinflation, real appreciation is unavoidable. Also, under a free-float, restrictive monetary policy can appreciate the real exchange rate by raising domestic interest rates above foreign rates.
6. See A.O. Krueger, 1981, "Interactions Between Inflation and Trade Objectives in Stabilization Programs," in W. Cline and S. Weintraub, eds., *Economic Stabilization in Developing Countries*, Washington, D.C.: Brookings Institution.
7. A comparison of the outcomes of eleven stepwise devaluations and seven crawling peg devaluations in Latin America during 1964-82 confirms this in S. Edwards, 1989, *Real Exchange Rates, Devaluation, and Adjustment: Exchange Rate Policy in Developing Countries*, Cambridge: MIT Press.
8. The countries were Bangladesh (1974-77); Ghana (1983-86); Madagascar (1982-85); Mauritius (1980-83); Nigeria (1984-86); Philippines (1984-87); Somalia (1980-82); Turkey (1980-83); Uruguay (1973-76); and Zaire (1979-82 and 1982-85).
9. If a large proportion of current (and illegal) capital transactions are carried out through a parallel foreign exchange market in which there is a high premium, as is true in many countries of Sub-Saharan Africa, the official exchange rate system becomes a surrogate for a tax, subsidy, and income transfer mechanism, rather than an indicator of foreign exchange cost. Under these conditions, the parallel market rate provides a better measure of the relative price of tradables. See B. Pinto and S. Van Wijnbergen, 1987, "Exchange Rate Regimes in Africa," World Bank, Washington, D.C.
10. See V. Corbo and J. de Melo, 1987, "Lessons from Southern Cone Policy Reforms," *World Bank Research Observer* 2, no. 2; and M. Kiguel and N. Liviatan, 1988, "Inflationary Rigidities and Orthodox Stabilization Policies: Lessons from Latin America," *World Bank Economic Review* 2, no. 3 (September).
11. In very high-inflation economies, generalized wage indexation also means that whenever inconsistent macroeconomic policies are translated into a real exchange rate overvaluation, they will also generate a rate of growth of real wages that will exceed productivity gains.
12. A number of studies have found that during major episodes of disinflation, the *ex post* real interest rate becomes very high. See R. Dornbusch, 1987, "Lessons from German Inflation Experience of 1920s," in R. Dornbusch et al., eds., *Macroeconomics and Finance*, Cambridge, Mass.: MIT Press; V. Corbo, J. de Melo, and J. Tybout, 1988, "What Went Wrong with Recent Reforms in Southern Cone Countries?" *Economic Development and Cultural Change* 24, no. 3; S. Edwards and A. Cox-Edwards, 1987, *Monetarism and Liberalization: The Chilean Experiment*, Cambridge, Mass.: Ballinger Publishing Co.; and J. Ramos, 1986, *Neoliberal Economics in the Southern Cone of Latin America (1973-83)*, Baltimore: John Hopkins University Press.
13. Interest rates can also rise when governments try to replace receipts from the inflation tax and foreign borrowing with those from domestic borrowing, as in the case of Turkey. See R. Anand et al.,

1989, "Turkey: External Debt, Fiscal Policy, and Sustainable Growth," World Bank, Washington, D.C.

14. See S. Fischer, 1984, *Real Balances, the Exchange Rate, and Indexation: Real Variables in Disinflation*, NBER Working Paper No. 1497, Cambridge, Mass.: National Bureau of Economic Research.

15. See A. Chhibber and J.K. Shirazi, 1988, *Public Finance in Adjustment Programs*, PPR Working Paper No. 128, Washington, D.C.: World Bank; W.R. Easterly, 1989, *Fiscal Adjustment and Deficit Financing During Debt Crisis*, PPR Working Paper No. 138, Washington, D.C.: World Bank; N. Hicks, 1989, "Expenditure Reductions in High-Debt Countries," *Finance and Development* 26, no. 1 (March).

16. For example, reductions in duty exemptions had a larger revenue-enhancing effect in Mauritius than in Jamaica, Kenya, and Senegal, in part because the prereform share of exempted imports was much larger in Mauritius. Similarly, the reduction in reliance on quantitative restrictions had a greater revenue-enhancing effect in Kenya (1980-82) than in Jamaica or Senegal, because the initial share of import bans was much greater and the prereform proportion of quota-imports not subject to tariffs was much larger.

17. For example, in Côte d'Ivoire, such revenue from cocoa and coffee averaged 6.2 percent of GDP over 1976-85 — considerably higher than the average of 2.5 percent accruing from explicit export duties. See C. Schiller, 1988, *The Fiscal Role of Price Stabilization Funds: The Case of Côte d'Ivoire*, IMF Working Paper, Washington, D.C., table 3, p. 9.

18. Both countries obtained about a quarter of tax revenue from trade taxes. Elimination of explicit export duties on forty-seven items and tariff reductions on forty-six items in 1983 led to a drop in Mexico's trade tax revenue of 4.5 percent of GDP (1982-84); Morocco suffered a fall of 2.5 percent of GDP (1983-86).

19. For example, tax credits were not fully offset by reductions in exemptions or by increases in tax rates, credits on existing inventories were granted in order to extend the VAT to the wholesale level, and the time period over which tax credits could be claimed was shortened.

20. Jamaica, Sierra Leone, Somalia, Uganda, and Zaire have experienced such effects since trade reform programs often included efforts to reduce or eliminate overvaluation and unify exchange rates. In countries where government is a net seller of foreign exchange (Nigeria, Mexico), such exchange rate reform has been fiscally advantageous.

21. Various studies show that the efficiency cost or economic cost of domestic taxes on the sale of final goods only (retail sales tax and value-added tax, VAT) is lower than the cost on all sales (turnover taxes), and that the economic cost of taxes on all sales is lower than the cost of taxes on international transactions. There is also evidence to suggest that collection costs are lowest for trade taxes.

22. For possibilities in Sub-Saharan Africa, refer to Z. Shalizi and L. Squire, 1986, *Consumption Taxes in Sub-Saharan Africa: Building on Existing Instruments*, CPD Discussion Paper No. 1986-34, Washington, D.C.: World Bank.

23. See D. Rodrik, 1988, *The Welfare Economics of Debt Service*, NBER Working Paper No. 2655, Cambridge, Mass.: National Bureau of Economic Research. On fiscal implications see also W.R. Easterly, 1989, *Fiscal Adjustment and Deficit Financing During the Debt Crisis*, PPR Working Paper No. 138, Washington, D.C.: World Bank.

24. Instability in foreign exchange availability and monetary conditions has been found to inhibit investment and growth. See G.K. Helleiner, 1986, "Outward Orientation, Import Instability and African Economic Growth," in S. Lall and F. Stewart, eds., *Theory and Reality in Development*, New York: St. Martin's Press; R. Kormendi and P. Meguire, 1985, "Macroeconomic Determinants of Growth: Cross-Country Evidence," *Journal of Monetary Economics*. For an analytical model showing this effect see D. Rodrik, 1988, "Liberalization, Sustainability and Design of Structural Adjustment Programs," Trade Policy Division, Country Economics Department, World Bank, Washington, D.C.

25. Although its dependence on trade taxes was negligible, Chile raised its uniform tariff rate when faced with declining nontrade tax revenue. See V. Corbo, 1989, *Public Finance, Trade and Development*, PPR Working Paper No. 218, Washington, D.C.: World Bank.

26. In the absence of credibility, trade reform can lead to welfare losses via (excessive) foreign borrowing to finance an increase in imports or to finance capital flight. Argentinian tariff reform during the Martínez de Hoz period suffered a reversal because import-competing firms used foreign funds in order to avoid adjustment in the short run.

6 POLICIES FOR EXPORT DEVELOPMENT

Summary and Conclusions

6.01 Manufactured exports from developing countries as a whole grew rapidly in the 1980s, but country performances varied greatly. With some exceptions, growth of primary exports has been slower. Two conditions have been particularly important for developing manufactured exports: maintaining macroeconomic stability around a real exchange rate that is compatible with long-term expansion of exports and output, and providing exporters access to inputs at tax-free international prices. One way of ensuring the latter is to have zero tariffs on imported inputs as in Hong Kong and Singapore, which are virtual free trade zones. Otherwise, some means should be used to give exporters quick, duty-free access to imported inputs, such as duty waivers, temporary admission, in-bond manufacturing, or export processing zones. These schemes may be helpful where tariffs raise the prices of inputs, but they do little to offset the effects of nontariff barriers. Reforms aimed at improving or creating duty waivers or temporary admission regimes have generally shown the best export supply response. Other important measures include reforms of the institutional, legal, regulatory, and industrial policy frameworks.

6.02 Expanding manufactured exports requires sustained, vigorous, and many-sided efforts on both macroeconomic and microeconomic levels. Reviving primary exports calls for attention to macroeconomic stability, price incentives (for example, appropriate real exchange rates and reduced export taxes), investment and other policies that raise productivity and reduce costs, and institutional changes, such as eliminating the monopsony power of marketing boards. It has proven difficult to develop strong export sectors while maintaining high import protection, which usually produces overvalued exchange rates. The higher the protection, the more difficult it is to counteract the adverse effects on exports. The few countries that have been successful exporters with protective import policies (for example, Korea) have avoided exchange rate overvaluation and antiexport bias. Korea's approach during the 1960s and 1970s, however, would be difficult to replicate. It included export subsidies, which have proven too costly in many cases and which would be counter-vailed by other countries today.

Overview of Export Policy Reform

6.03 Rising export earnings make adjustment less painful, lighten heavy debt burdens, and support higher growth and employment rates, in part by increasing import capacity. Many countries urgently need to expand international trade in order to allow the economy to grow and develop. Growth of exports and imports increases access to the benefits of international trade, including new ideas, modern technology, competition, scale economies, and the creation of new domestic industries around new markets.

6.04 Increasing exports through policy reforms in developing countries has proved to be no simple task. In almost every case, achieving a satisfactory response has required attacking the task vigorously over a period of several years from different sides, including the supply side, and at several levels. Both broad economywide and narrower trade policy and institutional measures are required.

6.05 Development of both manufactured and primary exports is predicated on supportive macroeconomic policies. In most cases, a substantial real devaluation is needed, followed by stability in the real exchange rate and fiscal and monetary stability. With respect to the exchange rate, both overvaluation and wide, unpredictable fluctuations are inimical to exports and the latter because it contributes to uncertainty in the business climate.¹ There have been substantial reforms of exchange rate policies in the 1980s,² but lessons in managing adequate exchange rates for better export performance have seldom been fully applied. A reduction of import protection is also fundamental for the long-term growth of exports. The importance of a stable macroeconomic environment and low import protection is discussed in detail in chapters 5 and 7.

6.06 High protection levels for manufacturing industries, as well as measures that keep export prices artificially low, such as export restrictions and implicit or explicit export taxes, have been important in depressing primary exports in a number of countries. However, manufactured exports, which for most countries have the best prospects for long-term growth, are seldom burdened by export taxes. Substantial growth in manufactured exports depends on a variety of institutional reforms (in addition to macroeconomic and trade policies), and these reforms are the main focus of this chapter. In general, improvements in policy exert a powerful effect only when they are visible, sustained, and when entrepreneurs expect them to continue.

Export Performance in the 1980s

6.07 Table 6-1 summarizes trends from 1974 to 1987 in the exports of developing countries.³ It brings out the superior growth rate in manufactured exports compared with other exports. During 1974-87, manufactured exports grew at high annual rates averaging over 11 percent in volume and over 9 percent in purchasing power as measured against industrial country manufactured exports.⁴ The growth rates were somewhat lower after 1980 than before, reflecting the expanded absolute size of these exports as well as less favorable conditions in the world economy. By 1987, manufactured exports constituted 40 percent of the value of developing countries' merchandise and nonfactor service exports, up from 18 percent in 1974. In a wide range of manufactured products, exports from some developing countries to OECD countries have been so competitive in price and so acceptable in quality that their swift growth seems to have been limited mainly by learning processes and the ability to increase export supply. This has been true in spite of the increasing use of nontariff barriers by developed countries (chapter 8). Even so, the share of developing economies in world manufactured exports had reached 12 percent by 1987.

6.08 Primary product exports grew in volume at slow to moderate rates in 1974-87 but suffered large price declines during 1980-87. Their combined purchasing power relative to industrial country manufactured exports rose sharply up to 1980 as oil prices soared, but then fell severely to well below their 1974 level.

6.09 Exports of nonfactor services are a major component of overall export expansion. Tourism is an important source of export receipts in a number of countries (Egypt and Jamaica, for example). Exports of nonfactor services increased in purchasing power during 1974-87 at faster rates than total merchandise exports and are now about one-fifth as large as merchandise exports. Growth rates of both

Table 6-1 Exports of Merchandise and Nonfactor Services from Developing Countries, 1974-87

Export category	Value (US\$ bil.) 1987	% share of merchandise and nonfactor services			Average annual growth					
					Volume		Unit value index		Value/MU ^a	
		1974	1980	1987	1974-80	1981-87	1974-80	1981-87	1974-80	1981-87
Merchandise exports	380.7	86.6	84.9	82.4	6.2	4.3	10.0	-2.3	6.2	-1.0
of which:										
Fuel	66.2	23.1	29.6	14.3	2.7	0.5	21.3	-5.8	13.0	-8.3
Manufactures	185.0	18.3	27.2	40.0	13.4	9.4	10.2	-1.1	14.0	4.7
Food and beverages	57.6	19.8	15.6	12.5	4.6	3.4	8.1	-4.0	2.3	-3.7
Nonfood agriculture	21.2	7.7	5.6	4.6	-0.3	1.7	12.1	-1.9	1.9	-3.5
Metals and minerals	25.0	9.8	6.7	5.4	5.6	2.5	4.8	-3.2	1.0	-3.8
Nonfactor services	81.6	13.4	15.1	17.6	—	—	—	—	8.2	1.3
of which:										
Travel and tourism	29.0	4.6	5.0	6.3	—	—	—	—	7.7	2.3
Transport and shipment	22.1	4.0	5.0	4.8	—	—	—	—	10.5	-1.3
Memorandum:										
OECD manuf. exports	1299.2	—	—	—	4.6	3.7	10.3	2.8	4.7	3.0

— not relevant

Note: The figures in this table are derived by aggregating data for the developing countries listed in Chapter I. Value and share figures for merchandise and nonfactor services do not add up to totals shown above. The sum of commodity group figures for merchandise exports does not equal reported total due to uneven country data availability.

a. MUV = index of unit value of manufactured exports from industrial countries (see also footnote 4)

Source: Merchandise exports - World Bank; nonfactor services - IMF Balance of Payments Statistics.

types of exports have fallen since 1980, however. Even more significant in their impact on export receipts for some countries (Yemen Arab Republic and Pakistan, for example) have been trends in factor service receipts — particularly workers' remittances — which are not presented in the table.

6.10 Export performance has varied widely: it has been poor in many countries, good in some, and spectacular in a few such as Korea and Turkey. The exports of the poorer developing countries continue to be particularly meager and their growth rates often weak. In low-income countries, exports per person in 1987 averaged US\$46 excluding China and India and US\$34 including them, compared to US\$2,476 in high-income countries and US\$356 in middle-income ones. Official development assistance received in 1987 exceeded merchandise exports in at least fifteen countries with populations over five million and nearly matched them in others.

6.11 Exports in a majority of developing countries have suffered serious setbacks in the 1980s compared to earlier periods. Of the eighty-seven developing countries, more than half had absolutely lower merchandise exports in 1987 than in 1977 in terms of purchasing power measured against industrial country manufactured exports. The purchasing power of exports in terms of manufactured products fell over this decade by more than half in seventeen countries and by one-quarter to one-half in eighteen others. Moreover, many of the countries that did make a gain managed little increase — not enough to offset their own population growth or the rising costs of servicing their debts.

6.12 On the positive side, ten countries more than doubled the purchasing power of their exports. They include China, Mexico (based mainly on the oil discoveries of the 1970s), Portugal, and Turkey as well as perennial star performer Korea. The other four were Benin, Burkina Faso, Congo (People's Republic), and Jordan. (Macao and Taiwan, China, which are not included, more than tripled their exports.) Seven other countries increased the purchasing power of their exports by more than half — Malaysia, Mauritania, Mauritius, Niger, Pakistan, Paraguay, and Thailand. Swift, spectacular growth of manufactured exports has continued from some Asian economies, such as Korea, Hong Kong, and Singapore, which have maintained policy regimes strongly favorable to these exports for well over twenty years. The last two now have per capita incomes too high for them to be considered as developing economies, while the first two account for about two-fifths of the developing countries' combined manufactured exports and rank second and first in total exports. Of the trade adjustment lending countries, about one-third increased their share in developing country exports to industrial countries (table 6-2).

6.13 Manufactured exports have continued to rise, and exchange rate and other policies which affect them have improved in some respects in nearly all developing market economies in which manufactured exports were already important by 1980. Turkey has achieved striking increases in these exports based on devaluation and reforms in the early 1980s. Recent policy changes have led to strong responses in Mexico and, on a smaller scale, in Indonesia. Several countries that already had promising policies before the 1980s, including Malaysia, Mauritius, Portugal, and Thailand, have improved them further, with impressive results. Exchange rate and other reforms are beginning to achieve substantial responses in India and Morocco and have led to responses in Bangladesh, Sri Lanka, and Tunisia. Other countries that are now heavily dependent on manufactured exports and are striving to make them grow faster include Brazil, Costa Rica, Cyprus, Dominican Republic, Haiti, Hungary, Jordan, Malta, Pakistan, the Philippines, Poland, Uruguay, Yugoslavia, and Zimbabwe. These exports are also important for other economies such as Argentina, Colombia, Egypt, El Salvador, Guatemala, and Jamaica. The largest and most striking increase in manufactured exports has come in socialist China. Its manufactured exports grew from about US\$3.7 billion in 1977 to about US\$28 billion in 1987. In 1978, China began to reverse its long-standing "closed door" policies, which for many years had actively discouraged exports. Rapid growth was achieved partly by removing many inhibiting central controls and by effectively offering exporters a much more favorable exchange rate, not least through the use of foreign exchange retention allowances. In addition, manufactured exports have been facilitated by energetic, pragmatic, multilevel measures that pay painstaking attention to the specific requirements of such exports. Much of the support has taken place at the regional level through provincial, city, and local allocation decisions, and much has been done to meet the needs of Hong Kong firms exporting from China.

Practical Ways to Develop Manufactured Exports

Business Realities

6.14 Manufactured exports tend to get started in developing countries with relatively low labor costs. Over time, important conditions for continued growth of exports are a reasonably educated work force, law and order, well-developed infrastructure, and efficient and reliable administration. Low-cost skilled manpower,

Table 6-2 Export Shares from 75 Nonoil Exporting Developing Countries to Industrial Countries, 1978-88

Category	Number of countries	Export share (%)		Least squares growth rate (%) in share from 1978-88
		1981	1988	
<i>Nonoil developing countries</i>	74	100.0	100.0	0.0
<i>Trade adjustment countries</i>	37 ^a	55.9	59.5	0.9
With rising share	12	30.4	42.4	4.7
Korea		9.8	18.5	7.7
Pakistan		0.8	1.2	0.1
Turkey		1.7	2.9	8.2
Yugoslavia		3.2	3.6	2.4
With declining share	25	25.1	16.9	-5.0
Argentina		4.1	1.3	-6.9
Côte d'Ivoire		1.6	0.7	-7.5
Philippines		4.1	2.9	-3.5
Zambia		1.4	0.7	
<i>Nontrade adjustment loan countries</i>	37 ^b	44.1	40.5	-1.1
With rising share	9	12.3	17.5	7.2
China		8.4	11.8	8.9
Gambia		0.02	0.04	1.9
Portugal		2.7	4.2	6.4
Sri Lanka		0.3	0.4	2.0
With declining share	28	31.8	23.0	-4.5
Bolivia		0.3	0.1	-13.8
Peru		1.9	0.9	-7.5
Poland		2.7	2.3	-6.7
Sudan		0.3	0.1	-10.4

Note: Exports of the seventy-five nonoil exporting developing countries in the sample of eighty-seven countries considered in this report as a percentage of exports from all developing countries (IMF definition) to industrial countries.

a. The forty trade adjustment countries excluding oil exporters (Indonesia, Mexico, and Nigeria).

b. The forty-seven non-trade adjustment countries excluding ten oil exporters.

Source: IMF, *Direction of Trade Statistics*.

structure, and efficient and reliable administration. Low-cost skilled manpower, experienced entrepreneurs, and stable property rights are also highly desirable. As the East Asian countries have shown, once the economy is oriented toward export production and the appropriate skills are learned, the export mix can be upgraded as wages rise.

6.15 Local firms (not foreign-owned firms) responding to orders from foreign buyers account for the largest share of developing country manufactured exports. Their products usually have to meet exacting and frequently changing specifications in regard to materials and technical specifications. For consumer goods, finish, styling, packaging, labels, and the like are also important. The delivered product must be ready to go straight to the final customer or the retailer's display rack, and the order must be delivered reliably by a given date. Thus everything

needed to make the product must be locally available at modest cost, or the country will be disqualified as a source of supply.

6.16 Most foreign buyers prefer to give orders to firms that already have considerable export experience and require little instruction and assistance. This is one reason that success is cumulative. Nonetheless, some risk-taking buyers, in exchange for very low prices, will work closely with inexperienced suppliers to teach them what is required and how to improve their management, technology, work flow, and much else. Assistance from foreign buyers to local firms continues as exports expand and leads to much valuable learning and technology acquisition at little cost. But these buyers too prefer firms with considerable industrial experience and capacity, and located in countries with a favorable policy environment rather than artificial incentives. As a result, much more seems to be learned from the production of manufactured exports made to order for advanced countries than from exports of natural-resource products and standard local products made possible because of subsidies, a recession, preferences from neighbors, or barter trade deals.

Requirements for Success of Manufactured Exports

6.17 One central pillar of export success has been macroeconomic stability together with an adequate (that is, favorable) exchange rate (see chapter 5). These features have been the hallmark of rapid manufactured export growth in East Asia from Hong Kong, Japan, Korea, Malaysia, and Singapore earlier to Thailand and Indonesia today.

6.18 The other central pillar is an efficient system for providing exporters with rapid, reliable access to needed inputs at prices that are equal or close to tax-free international prices. To ensure that this is the case, imported inputs required for exports, whether directly or indirectly, ought to be systematically freed from delays, quantitative restrictions and other nontariff barriers, customs tariffs and other import taxes, and indirect taxes — even if domestic substitutes for these imported inputs are available. Exporters also benefit if consumables (such as fuel oil) and spare parts are readily available at close to international prices. Most of the world's manufactured exports from market economies come from places where exports enjoy a virtual free-trade environment in regard to the taxation and availability of inputs. In most developing countries, however, the scope for improvement in access to inputs is still considerable.

6.19 One way in which successful exporting countries have provided exporters with easy, duty-free access to imported inputs has been to follow a policy of zero tariffs on imported inputs across the board. Hong Kong and Singapore are virtual free ports, and their export results have been spectacular.

6.20 Only a few countries have managed to develop strong manufactured export sectors while simultaneously maintaining high protection for import-competing domestic industry. The reason is twofold. First, high protection discourages exports indirectly by overvaluing the exchange rate and attracting domestic productive resources to import-competing industries. Second, heavily protected economies are typically characterized by administrative rationing of foreign exchange and import licenses, so it is administratively difficult to provide access to inputs at

international prices. Duty waiver or temporary admission schemes are difficult to manage when high protection causes domestic prices for imports to diverge greatly from international prices, since this multiplies the incentives for cheating, abuses, and diversion of inputs.

6.21 Economies that have achieved strong export growth with protectionist policies — notably Korea — did so through a complex combination of policies and circumstances not easily replicated in other countries (see box 6-1 overleaf). The unique circumstances included authoritarian regimes that were able to suppress rent-seeking behavior that conflicted with the goal of export-oriented development. These economies also offset their protectionist policies with measures that would be difficult to administer and open to abuse elsewhere and augmented them at times by forms of export subsidies that are now usually countervailed by developed economies.⁵ Furthermore, both economies increasingly recognized the disadvantages of protection and undertook to liberalize imports. Korea has been engaged since 1967 in a gradual process of import policy reform, which was greatly accelerated in the 1980s. This has resulted in fairly low protection in recent years. Korea's spectacular export growth has continued, and the share of exports in GDP increased during the import reforms of the 1980s.

6.22 One lesson for other countries from the East Asian experience is that where import substitutes remain protected, exporters must be insulated from the tendency of such protection to raise the prices of inputs above world prices and to reduce the availability and quality of inputs. Reliable, tax-free access to imported inputs is best provided by offering at least three alternative schemes at once. While each may serve a different set of export requirements, the schemes should be available to all exporters and potential exporters. These schemes are not without cost, however. Apart from some possible loss of government revenue, in some circumstances they may allow exporters that use imported inputs intensively to draw resources from other efficient activities, including, for example, exports based on local resources. In an environment of high import protection they also create opportunities for cheating and abuse. Their design and implementation require the attention of policy makers and consume administrative resources; these costs need to be balanced against the likely economic gains.

6.23 Most important is a scheme that provides duty waivers (together with exemptions from other restrictions on imported inputs) for larger firms inside the domestic tariff area, including enterprises that import inputs for both export and domestic market production. This may be a rebate scheme on account as in Taiwan, China, a deferred drawback scheme as in Korea, a temporary admissions scheme such as the ones set up or improved in Mexico and Morocco starting in 1983, or duty exemptions as in Indonesia and Thailand and Korea before 1975. In Indonesia, to illustrate, a special government unit gives out import licenses for the imported inputs required by manufacturing enterprises exporting directly; to obtain such a license the exporter must submit an export plan that includes technical coefficients for the inputs required together with a bank guarantee for the value of the duties to be paid if the exports are not realized within the period allowed. Manufacturers who export 85 percent of their output receive licenses for 100 percent of their imported inputs. Generally similar are the import entitlements scheme introduced in Turkey in early 1980 and the advance licenses scheme started in India in 1978 and then greatly improved in the later 1980s.

Korea and Taiwan (China) in the 1960s and 1970s and Japan earlier maintained quantitative restrictions in their import regimes while encouraging strong export growth. In Korea the shares of exports in GDP and manufacturing value-added increased from 3.5 percent and 19.3 percent in 1965 to 23.9 percent and 85.4 percent in 1981. Korea succeeded by following sound macroeconomic management while providing broadly neutral incentives for manufactured goods.

Macroeconomic Management

The real exchange rate consistently kept exports profitable and minimized excess demand for imports. This was achieved by periodic nominal devaluations and aggregate demand policies that never allowed inflation to get out of hand. In only two of the years from 1970 to 1986 did the real exchange rate deviate significantly (by over 14 percent) from the base year of 1980.¹ Macroeconomic policy was subordinated to the commitment to export, since it was clear that expansionary fiscal and monetary policies and the consequent overvaluation of the exchange rate were fundamentally inconsistent with that goal.

Trade and Investment Policies:

The Basic Approach

The government created special regimes for exporters that enabled them to obtain inputs rapidly and at world or near-world prices. This input facility applied not only to direct exporters but also to indirect exporters, including manufacturers of raw materials sold to exporters and their suppliers. This was supplemented by a facility that covered all the working capital requirements of direct and indirect exporters at rates lower than normal bank lending rates for rationed domestic credit and much lower than informal curb market rates. Both these facilities were operated according to well-established rules and were automatically available to all exporters.

New investments in manufacturing needed government approval and finance from the government banks. In most cases, these decisions reflected consultation with private entrepreneurs, but in others the government was a leading promoter and, in a few cases, the entrepreneur. With some exceptions, however, the predominant criterion for these decisions was whether the investment could be profitable when exporting with no more than the standard export incentives. No advance assurance of special emergency assistance was generally given, and, in fact, there was a relatively high bankruptcy rate among exporting firms.

Once investments were approved, policies ensured that firms did not withdraw from exports to the quantitative restriction-protected domestic market. Above all, the government managed policies consistently and credibly to support export profitability of efficient firms. In some industries with substantial economies of scale, export profitability meant building

plants that were too large to be profitable if they were to rely on domestic sales. Exports were regularly monitored against targets, and even though there were no explicit penalties for underachieving, firms strove to meet or exceed them in order to improve their image and chances of receiving discretionary benefits. The most important was favorable consideration in the competition to invest in new plants for exports, together with credit for expansion. Some firms received valuable import licenses and government contracts as well. In some cases, relatively low export targets were agreed on for firms pioneering new processes or products, and for a few years they were permitted to sell most of their output at high and profitable prices in the domestic market. Thereafter, however, their export targets usually increased year by year until they exceeded their domestic sales. The pressure on such firms was further increased by allowing investments in the same product line by competing firms soon after the initial investments appeared to be successful. Capacity soon exceeded domestic demand, and its utilization was therefore dependent on direct or indirect exporting.

Export markets were highly competitive and risky, subject to cyclical influences and protectionist lobbies in importing countries. These changing conditions in export markets were reflected in the Korean domestic markets, which were generally highly competitive even though imports were prohibited or tightly restricted and even though seller concentration was sometimes high, especially in the markets for intermediate materials and engineering goods. Firms in these latter industries, due to fluctuating and not easily predictable capacity utilization arising from their predominant export activities, were seldom able to coordinate their policies and benefit from their potential market power. Studies of effective protection in Korean manufacturing in the 1960s and 1970s reflected these competitive conditions. Because imported raw materials used to produce goods for the domestic market were subject to import duties, domestic ex-factory prices were generally higher — sometimes considerably — than export prices. But, even after allowing for the preferential credit and tax advantages of exporters, processing margins in most export industries were broadly similar in domestic sales and exports.

Heavy Industry Promotion, 1973-79

In 1973, policies were superimposed for the targeted development of heavy and chemical industries, including petrochemicals, steel, metal products, shipbuilding, machinery, and automobiles. Selective policies were followed, including substantial subsidies through long-term lending, tax holidays, accelerated depreciation, and import protection. These promotional policies eventually succeeded for some industries (for example, steel and automobiles) but were expensive failures in others (for example, petrochemicals) and had mixed results

in others (for example, heavy machinery). These policies contributed to an economic crisis in 1960 and, on average, produced low economic returns.² Their deficiencies were rapidly recognized, and drastic restructuring of some industries began as early as 1979. These problems influenced the new liberalizing policy direction followed in the 1980s.³

Resource Allocation

The resource allocations associated with the Korean and other East Asian trade regimes were much less costly than those associated with typical import-substitution regimes in other developing countries. In Korea, apart from the heavy and chemical industry episode, there were generally no major longstanding resource misallocations within the manufacturing sector. This in turn was due to Korea's export orientation, in particular to (1) the temporary nature of the special protection given to new exporting industries, (2) the nondiscretionary and uniform incentives for manufactured exports, and (3) the competition among exporters in domestic markets, which tended to equalize the profitability of exports and domestic sales. The higher protection of some nonexporting industries in the 1960s became quantitatively less important as the shares of direct and indirect exports in manufacturing rapidly increased.

Agriculture, however, was heavily and increasingly protected. This protection was costly for consumers and for the government budget, but was never as serious a brake on efficiency and growth as the more typical promanufacturing and antiagriculture bias of other trade regimes. For one thing, the resulting distortion of consumption was in part offset by the tariffs on imported materials and equipment, which raised the prices of domestically produced manufactured consumer goods, and also by relatively high indirect taxes, especially on luxuries and durables. For another, most of agriculture was inherently high-cost, and the protection and subsidies it received were always kept below the level that would have required exports to absorb domestic production. Thus the protection policies maintained agriculture as a protected import-substitute enclave, but as real incomes rose, agriculture's share in consumer budgets and in GDP declined much more rapidly than its increasing level of protection, leading to a rapid decline in the importance of agricultural protection.

Trade Liberalization in the 1980s

In the late 1960s, Korea began a slow but steady process of import liberalization. In the 1980s, the reforms accelerated. The fraction of customs-code items exempt from quantitative restrictions rose from about 60 percent in 1977 to 80 percent in 1985, with a target of 95 percent by 1988. The average tariff was reduced from 41 percent in 1978 to 22 percent in 1985, with a target of 18 percent in 1988. This change was partly in response to pressure from the

United States and others to open its markets to imports. It also reflected recognition of problems produced by previous policies and the fact that the economy was becoming less amenable to selective intervention, especially on investment. Greatly improved living standards and democratization of the political system also meant that the government was less able to control the activities of interest groups and to administer discretionary controls in the consistent and focused way it had previously done. Growth of exports and output, after slowing in 1979 and 1980 as a result of policy-induced imbalances and external shocks, continued at a rapid pace during the trade liberalization of the 1980s.

Lessons from the Korean Experience

One lesson of the Korean and other experiences is the importance of maintaining a stable and adequate real exchange rate. It is also important not to allow import protection to tip the terms of trade against exports, either directly (by raising imported input costs) or indirectly (by causing competition for resources). However, it is not clear that other countries can or should emulate Korea in more specific strategies. In particular, for strong export growth to coexist with protection of imports requires conditions that are not likely to be met in many countries. They include investment controls on the local production of luxury and other consumer goods whose import is banned or restricted, the control of rent-seeking and lobbying (by suppressing unions and penalizing executives of companies that misuse their privileges), and control of smuggling. In Korea, this was facilitated by the authoritarian nature of the regime and a widely shared national pride in the country's growing international status and the increased political security this implied. Even in Korea, incentives targeted to specific industries produced some expensive mistakes, and this problem would be compounded in a political system in which rent-seeking is less effectively controlled. Finally, the credit subsidies offered to exports to offset the effects of import protection are now more likely to be countervailed by developed countries.⁴

1. World Bank, 1987, "Trade and Industrial Policies in the Developing Countries of East Asia," Report No. 6952.

2. World Bank, 1986, "Korea: Managing the Industrial Transition," Report No. 6138-KO.

3. Kim Mahnje (former Deputy Prime Minister), 1987, "Korea's Adjustment Policies and Their Implications for Other Countries," in V. Corbo, M. Goldstein, and M. Khan, eds., *Growth Oriented Adjustment Programs*, Washington, D.C.: IMF and World Bank.

4. Chong-Hyun Nam, 1986, *Export Promoting Policies Under Countervailing Threats: GATT Rules and Practices*, Discussion Paper No. VPER59, Development Policy Issues Series, Washington, D.C.: World Bank.

6.24 What is administratively difficult in such schemes is, first, to extend them to indirect exporters, thereby making domestically made inputs competitive with imports and increasing the net value of exports, and second, to ensure that exporting firms get tax-free only as much of each input as is needed for export production to the extent that this is desirable. This approach safeguards government revenue and prevents imported inputs from spilling over into the domestic market, disprotecting local production of the same inputs. For this second challenge, one solution, efficiently used in Taiwan, China and Korea, is to work out, record, and routinely apply technical coefficients for each of the usual export products (see box 6-2). Technical coefficients are used in a similar way for firms sponsored by the Board of Investments in Thailand. The approach has recently been expanded in Bangladesh, India, and Pakistan with World Bank encouragement, but it is still almost unknown outside Asia. Another approach, used for example in Morocco, is a system of rebates based on self-declaration by exporters, with verification by customs officials within six months.

6.25 A second arrangement is needed to meet the needs of small or irregular exporters, and for materials required in small quantities. A quick, reliable system of drawbacks or rebates of duties and indirect taxes actually paid is essential so that exporters can choose to buy their inputs duty-paid and later get back the duties, rather than having to import inputs in small lots or pay duties. This alternative is built into rebates in Taiwan, China and drawbacks in Korea, while some other countries such as India, Indonesia, and Thailand offer drawbacks as a separate alternative. However, collecting duties and then giving them back later is administratively more expensive compared to waiving duties, and drawbacks do not offset nontariff barriers against imported inputs. For administrative simplicity and convenience to exporters, the scheme should offer a standard drawback for each product regularly exported but should also allow each exporter the option of presenting evidence to justify a considerably higher individual drawback.

6.26 Third, at least one duty-free scheme can usefully be provided for firms specializing in exports. It should serve to move shipments in and out quickly and at little expense to the firms involved. The most flexible approach is in-bond manufacturing for export, which entails bringing in the inputs and shipping out the outputs under customs seal. Bonded factories can locate practically anywhere. An example is Mexico's *maquilas* in-bond assembly plants. Modern, streamlined in-bond schemes involve only minimal bonding and customs expenses for enterprises, in contrast to obsolete procedures, still widely practiced, that involve customs officers on duty in a warehouse and expensive bonds for every shipment. Mauritius's export processing zone is based on a streamlined in-bond system that functions wherever an exporter wants to locate. The main alternative to these systems is physically separate export processing zones. Each is an industrial zone specializing in exports, with its own customs office to provide the enterprises inside with duty-free trade and quick customs clearances.

6.27 Over thirty developing countries now have export processing zones of this type. Many of these zones have proved to be poor investments as a result of unwise location, high investment costs, mediocre management, or uncooperative customs officials, but the best (some private) have done well. Manufactured exports from Malaysia and, on a much smaller scale, the Dominican Republic and Haiti come

Box 6-2. Duty Rebates in Taiwan, China

Since 1955, Taiwan, China's support for exports has included rebates of import duties and other indirect taxes on inputs used directly or indirectly to produce manufactured exports. A firm that is a major, regular, law-abiding manufacturer-exporter is allowed to put its duty liabilities "on account," to be cancelled against evidence of subsequent exports. Firms must furnish a bank guarantee that the duty plus penalties will be paid if the exports are not forthcoming within eighteen months. Since 1965, exporting firms have had the further options of locating in an export-processing zone or becoming in-bond manufacturers, but these schemes account for only modest shares of the economy's exports. Firms (including trading firms) not involved in either of these schemes must pay duties on their imported inputs. These duties are reimbursed or cancelled for exporters by the customs administration following presentation of documentation showing (1) completed exports, (2) receipt and appropriate disposition of foreign exchange proceeds, and (3) the amount of the rebate to which the firm is entitled. The customs administration handles over half a million rebate applications a year with a staff of about 200.

Either the direct exporter or one indirect exporter collects the entire rebate. The indirect exporter (for example, a firm supplying inputs into exports) can collect the rebate only if the direct exporter signs over the necessary documents. Often, a large input supplier that is dependent on imported raw materials systematically acquires these documents from its small exporter customers and collects the rebates. Typically, it sells to direct exporters (or extends them credit by accepting postdated checks) at a duty-free price, but it also requires a postdated check covering the duty. This check is returned uncashed once the exporting firm signs over its documents.

Rebates on new products are calculated on a case-by-case basis, while rebates for established products are determined on the basis of published fixed rates. Both methods involve the systematic application by customs rebate officials of preestablished physical input coefficients for each physical unit of output.

To export a product not previously exported, an exporter must obtain an export license and a list of the product's physical input-output coefficients. To work out the coefficients, government staff or consultants visit the factory, inspect its records, and examine or test the product. The list is then certified and supplied to the customs administration within a month of the exporter's application. To get a rebate, the exporter must then provide evidence on the source and quantity of all imported and dutiable inputs used. In calculating the rebate, any input valued at less than 1 percent of the value (fob) of the exported product is dropped from the calculation, to save administrative time.

Once a product has had a long enough production history for its input and output coefficients to be fairly stable, it is switched over to the fixed-rate method. To work out the fixed rate, the customs administration calculates the duties rebated on all inputs (direct or indirect) into the product over the previous twelve months compared with the combined value or volume of the corresponding exports for all makers of the product. The result is a standard rate based on value or a physical unit such as weight. Where technical processes and input coefficients of different firms vary widely, their exports are defined as different products with their own fixed rates. Fixed rates on about 6,000 products are published each July, reflecting changes in prices, duties, and sources of inputs.

Once a fixed rate is in effect, exporters receive the stipulated amount of rebate only after providing evidence that they paid (directly or indirectly) duties and indirect taxes equal to that amount. If not, they receive rebates equal only to the amount they actually paid. However, details are no longer examined. If an exporting firm shows that its actual payments were more than 20 percent higher than the standard rebate and it can give good reasons why it needs these extra imported inputs, it can apply to an interagency committee for a redefinition of its export as a separate product eligible for a higher rebate.

Source: R. Wade, 1988, "Taiwan, China's Duty Rebate System," Trade Policy Division, Country Economics Department, World Bank.

mainly from such zones. China's special economic zones, all created since 1979, are larger versions.

6.28 In addition to these two central pillars (a favorable exchange rate with macroeconomic stability and access to inputs at world prices), exports, just like other activities, benefit from many other developments: for example, well-designed and well-located infrastructure including telecommunications, power grids, containerized ports, highways, airports, and industrial estates. Exporters have a special need for access to foreign exchange for marketing and service expenses as well as for imports. They also have a variety of service needs, starting with ready access to pre-shipment credit for working capital and term finance for investments. Well-functioning capital markets are therefore important. In addition, exporters benefit from restriction-free access to imported capital equipment and technology and from low import duties and indirect taxes on machinery. They also benefit from investment procedures — including those governing foreign investment — that are transparent and efficient.

6.29 Attracting foreign direct investment is crucial for success in very small countries with little industry. Results have been strongest where the investment promotion authorities are also responsible for the development and operation of state-owned industrial estates (parks) and can help ensure the availability of sites and infrastructure, as in Singapore since 1961 and in Mauritius since the World Bank helped to launch the Mauritius Export Development and Investment Authority in 1965. (Chapter 8 discusses foreign direct investment in more detail.)

6.30 Judging by what has been done in East Asia, it also pays to adjust some other — often politically sensitive — laws, regulations, and administrative procedures, not just for exporters but for all firms. Labor regulations on laying off workers, fringe benefits, minimum wages, collective action, and the like are important and may need to be adjusted to reduce labor costs and increase flexibility at the enterprise level. Industrial location and regional development policy may have to be changed — exports cannot be expected from backward areas with poor infrastructure. Measures to quicken competition and facilitate rapid economic change, such as those discussed in chapter 7, can indirectly contribute to export expansion. Successful Asian economies also strive to make world-quality services available to exporters, including, for example, design, trade information, and consultant services. Organizations initially funded by government in close collaboration with private industry offer visits and consulting services to manufacturing firms to help them improve productivity, technology, and quality control. Korea and, to a lesser extent, others also have fostered large trading companies that organize and market exports from smaller firms through a network of offices overseas. Korea and Taiwan, China, have systematically fostered the establishment of industries that supply industrial intermediate inputs at world prices. This has been achieved by building well-located, large-scale, state-of-the-art plants and by generating competition to attain excellence in each production process.

Unsatisfactory Means of Increasing Exports

6.31 Numerous examples show that unsatisfactory methods can achieve minor, but usually only temporary, increases in exports. Most common are high export subsidies or a severe recession. Contractionary macroeconomic policies often serve

to increase some exports rather quickly as domestic demand shrinks, but the effect is reversed as the economy recovers. Other generally unsatisfactory means include barter trade agreements or pressure on foreign-owned enterprises to export as a condition of being allowed to retain a profitable share of the domestic market. Several episodes in Latin American countries in which manufactured exports have begun to rise, then fallen back, have involved heavy dependence on these methods, although economywide influences have contributed to the downturn.

6.32 Export subsidies have been used in lieu of devaluation and to try to offset domestic protection. Results are generally disappointing. Used with appropriate macroeconomic and exchange rate policies and access to imported inputs, however, subsidies as a temporary measure can have a direct and immediate impact on exports. Subsidies had a powerful impact on exports from Turkey, for example. Many countries have also tried to promote exports by providing subsidized credit, sometimes with positive effects on exports. These subsidies have not proved as important, however, as assuring exporters ready access to pre-shipment credit.

6.33 In general, subsidies — including income tax rebates, which have long been used in Latin America — have not had satisfactory effects on exports. High subsidies have also usually resulted in cheating, production of fictitious exports in order to get the subsidies, and wasteful rent-seeking, as experience in Turkey, Yugoslavia, and other countries illustrates.⁶ Furthermore, the heavy fiscal burden of the high subsidies needed to offset a strong antiexport bias may generate macroeconomic disequilibrium and an external debt problem, as in Yugoslavia, or burden efficient export sectors, as in Argentina.⁷ Policies involving special treatment of exporters, including subsidies, foreign exchange retention allowances, and favorable exchange rates, can also be a problem in socialist countries. For example, according to the 1988 World Bank report on adjustment lending, China's dramatic success in achieving rapid aggregate export growth is tempered by the possibility that a significant but unknown proportion of exports may have been economically unprofitable due to excessive incentives (resulting from competitive subsidies between provinces and regions) and its highly distorted price system.⁸

6.34 Most countries that have recorded strong export growth have avoided serious disincentives to exports by a combination of exchange rate, export, and import policies. Some of the fastest and most sustained growth rates in exports have been attained in Japan and Korea within policy frameworks that included sound macroeconomic management as well as targeted and selective interventions to develop manufactured exports. Such industrial policy and selective interventions, however, have proven costly and unsuccessful in most countries; in Korea, as well, the results in some areas were poor or mixed (box 6-1).⁹

World Bank Experience

6.35 World Bank involvement in policy dialogue has had a substantial impact in encouraging a movement away from policies entailing a strong antiexport bias. Bank advice and project assistance relating to manufactured exports, however, have to catch up with the practical lessons of experience and need to encompass a wider set of measures. Much more can be learned and applied from the leading Asian successes. Especially disappointing have been the results of technical assistance to official trade promotion organizations to improve their information serv-

ices and support for export marketing; World Bank loan components for this purpose in about a dozen countries do not seem to have been effective in expanding exports. More promising approaches for improving support services seem to be through supply-side assistance by consultants of international caliber to firms in export industries for partly subsidized fees; the establishment of grant funds (as in India) that offer matching grants to firms to purchase services from consultants and suppliers of their choice, including those from high-income economies, as part of the firms' well-conceived export expansion program; and the systematic fostering of a broad range of competitive private service suppliers, including experienced foreign firms. Examples would be management consultants, engineering consultants, accounting firms, banks, insurance companies, business publication firms, trading companies, foreign firms' buying offices, export market research firms, product inspection firms, and testing laboratories.¹⁰

6.36 World Bank lending in many countries has sought to improve the availability of preshipment export credit for working capital, an important requirement of manufactured exports, but has had only limited and mixed results. Meaningful institutional reforms in this area have proved frustratingly difficult. Revolving fund arrangements for imported inputs, as in Mexico or Zimbabwe, have proved to be unneeded or have turned into giveaway programs. Some reforms inspired by Korean examples have yet to work well outside Korea. These include automatic preshipment export credit guarantees to banks to ensure that exporters with suitable letters of credit receive access to preshipment credit. Also based on Korea's example is the use by exporters of domestic (inland) letters of credit to order inputs from local suppliers. The letters of credit identify the recipients as indirect exporters eligible for export credit and other prerequisites of exporting.

6.37 The most satisfactory export results from reforms in this area encouraged by World Bank advice or lending programs in the 1980s have come from improving or creating duty waiver or temporary admissions schemes, especially in India, Indonesia, Mexico, Morocco, and Turkey. Positive export effects also followed an increase in the range of tax-free imported inputs allowed in Brazil beginning in 1983, until this reform was reversed. Argentina, Tunisia, and Uruguay have taken a broadly similar approach. By contrast, results for manufactured exports have been unsatisfactory or disappointing where efforts have been seen as aimed at setting up or improving drawback systems (as in Chile, Ghana, Jamaica, Nepal, Senegal, or Zambia). In spite of this experience, many World Bank loans in 1988 and 1989 supported drawback schemes without provisions to exempt exporters from the effects of nontariff barriers to imported inputs. The outcome has been positive where the effort has concentrated on in-bond systems and the use of technical coefficients by customs officials (Bangladesh, Pakistan). Only one significant export processing zone has been set up in the 1980s under World Bank-assisted reforms.

6.38 Even if they were otherwise desirable, export subsidies for manufactured products are generally subject to countervailing duties. Because of this and concern over potential abuses, the World Bank has seldom recommended export subsidies, except as part of a surrogate devaluation (in the Côte d'Ivoire structural adjustment loan [SAL] II). The World Bank has sometimes supported reform or continuation of an existing subsidy scheme (Kenya SAL I; Turkey SALs I, II, and III) when this was viewed as a temporary measure to offset an antiexport bias. (In

conjunction with SAL V, Turkey began to scale down the subsidies.) Measures to give exporters improved infrastructure, inputs, services, and credit access; to help them with services; and to rebate indirect taxes to them are not considered subsidies under international trade rules. However, giving exporters better prices or interest rates than other domestic firms is not generally recommended, in view of the costs and complications involved. Consequently, in some operations (the Korea SAL II), the World Bank has supported their phaseout.

Primary Sector Exports

6.39 Growth in exports from primary sectors is constrained to some extent by protectionist policies in developed countries (chapter 8). In addition, exports are frequently depressed directly by currency overvaluation, restrictions on exports, taxes on exports or production, artificially low administered prices, and inefficient monopolistic government production or marketing enterprises. Low demand elasticities are sometimes cited as constraints in Africa, although the evidence on this is far from clear (box 6-3 overleaf), especially when it is recognized that real income may be increased by greater exports, even if revenue declines. Indirectly, primary sector exports are reduced by protection of industry and by laws that discourage investment (especially foreign investment) in the sector. In some countries, the cumulative effect of distortions has been to depress agriculture so severely that the foregone exports are a major macroeconomic cost. In Argentina, where agriculture provides about 75 percent of exports, agricultural exports might be twice as high were it not for the antiexport policy bias.¹¹ A few countries (for example, Malaysia in the 1960s and Chile in the later 1970s) have undertaken comprehensive programs to create a positive policy environment for primary exports, with good results. Chile's reforms helped reinvigorate the export-oriented mining sector, based to a large extent on foreign private initiative. They also led a spectacular increase in agricultural and wood product exports, which grew from US\$44 million in 1972 to US\$1,102 million in 1986.¹²

6.40 Reform programs in the 1980s aimed at primary exports have been more modest, with results that are less spectacular, but in some cases, still significant. A few countries (for example, Bolivia and Ghana) have followed Chile's example and opened up mining to foreign investment. In agriculture, prices for leading primary product exports have been improved (Côte d'Ivoire, Malawi, Turkey). Taxes on agricultural exports were significantly reduced in Argentina and Uruguay as part of agricultural sector adjustment loan operations, although this was quickly reversed in Argentina. Regulatory controls on exports have been abolished or greatly reduced (Colombia, Mexico, Morocco), and taxes on many exports have been eliminated (Bangladesh, Côte d'Ivoire, Ghana, Madagascar, Philippines.)

6.41 Exchange rate reforms have also supported expansion of primary exports. Malaysia and Thailand have achieved sustained strong growth in primary exports by consistently avoiding major currency overvaluation, heavy taxation of the sector, and high protection for manufactured exports. Especially since 1986, Indonesia has generated booming manufacturing and nonfuel primary exports through devaluation supported by sound macroeconomic policy. Correction of overvalued exchange rates and/or foreign exchange retention schemes to exporters have played a central role in reviving primary exports from Ghana and Tanzania and nonoil exports from Nigeria.

Box 6-3. Structural Adjustment and External Demand Constraints for Agricultural Exports in Africa

A consequence of adjustment programs is likely to be an expansion of the production of tradables, including agricultural commodities, especially in Sub-Saharan Africa. One important concern, however, is that the expansion of agricultural exports by several countries may lead to a reduction in world prices which may, in turn, reduce export revenues and possibly the real incomes of the adjusting countries.

At the global level, the impact of an increase in export volume on the total earnings of all exporters of a commodity will depend on the elasticity of world import demand for that commodity. Aggregate export revenues will rise if the elasticity is more than one or fall if it is less than one. How does that translate to the regional and country level, and what does it imply for the World Bank's policy advice?

The elasticity of demand facing Africa's exports is larger than the elasticity of world import demand. However, for several commodities, Africa's share in world exports is large. Hence, Africa may face an elasticity of demand for its exports that is smaller than one for some commodities, and an increase in the exports of these commodities may lead to a fall in export revenues. This concern may be valid for certain commodities such as cocoa (where Africa had about 61 percent of world exports in 1985), palm kernels (53 percent), sisal (43 percent), coffee (22 percent), groundnut oil (21 percent), tea (15 percent), cotton and tobacco (9 percent), and groundnuts (7 percent).¹

It is much less likely that the elasticity of demand facing an individual country's exports will be smaller than one, so the expansion of exports by one country should lead to larger export revenues for that country in most cases. Hence, from an individual country's viewpoint, correcting distortions in incentives, improving efficiency, and letting the market work (possibly with some export taxation) would seem to be the optimal policy, assuming that the policies of other countries remain unchanged.

The World Bank, however, is advising a large number of countries in Africa (and elsewhere) to correct price distortions, in-

cluding currency overvaluation, and remove inefficient controls. This is likely to result in a supply response in a large number of countries simultaneously and may lead to a fall in export revenues for some important commodities. The advice to correct basic relative price distortions, remove controls, and improve overall economic and productive efficiency is generally sound since it will ensure that countries produce the goods they can produce most cheaply. When increased production is the result of reductions in cost, real incomes may rise, even if revenues fall. But the problem remains that this may lead to losses in export revenues and income at the regional level for some commodities.

Moreover, this problem may be more severe for countries whose exports are concentrated in a few commodities for which Africa's share is large (for example, Côte d'Ivoire, which exports coffee and cocoa) than for countries with a more diversified export base. Also, improvements in productive efficiency (say, through liberalization of markets and marketing functions) should lead to regional income gains, but may result in losses in countries where the improvement in efficiency is below the average.

In promoting greater market-orientation, the question then arises whether the World Bank should support individual countries' policies with respect to the commodities in question, or whether it should support efforts at regional coordination of policies with respect to these products. The evidence needed for a complete examination of this issue is scant, and the analytical, empirical, and implementation problems underlying it deserve further analysis. It should be noted, however, that coordination of production among primary exporting countries has been tried many times, with very few successes.

1. U. Koester, H. Schafer, and A. Valdes, "External Demand Constraints for Agricultural Exports - An Impediment to Structural Adjustment Policies in Sub-Saharan African Countries", *Food Policy*, 14, no. 3.

Source: Background note by M. Schiff.

6.42 A number of trade reforms have included eliminating public sector marketing boards or stripping them of their monopoly procurement powers, as in Ghana, Mali, Morocco, Nigeria and Senegal. In Africa, these reforms were aimed mostly at raising producer prices of export crops, which had been implicitly taxed by paying

producer prices far below border prices. For export crops, the implicit taxation was mainly a revenue-generating device for the boards and the countries; for import crops (such as rice in Madagascar), producer prices were depressed to keep prices low for urban consumers. In Latin America, where producer prices have not been seriously depressed by the marketing boards, such reforms were aimed more at increasing the efficiency of marketing and alleviating the fiscal drain on the government.

6.43 While the vagaries of weather and international price fluctuations make the effects of these reforms hard to verify, in at least some cases the results have been impressive. Nigeria's abolition of marketing boards for palm oil, cocoa, rubber, cotton, and groundnuts, together with exchange reforms in 1986, led almost immediately to a 6 percent increase in cash crop production in 1987 in spite of bad weather. In Madagascar, the marketing role of the rice board was replaced by a well-designed buffer stock scheme, supplemented by modest imports. The result was an increased producer price for rice and a rejuvenation of the rice-producing sector, together with the rapid development of private marketing channels.

6.44 Apart from their effects on average producer prices over a long period, marketing boards also are intended to stabilize domestic prices, by insulating domestic producers and consumers from at least some fluctuations in international prices. While their record of success in this regard is mixed,¹³ there is little question that governments attach considerable importance to this goal. Consequently, it may be difficult to eliminate or reduce the role of these boards unless some alternative means is substituted to achieve the stabilization objective. The Ecuador agricultural sector adjustment loan called for the abolition of a marketing board without proposing an alternative system to stabilize prices; this condition was never implemented.¹⁴ In contrast, in Madagascar, a marketing board is being successfully phased out, in part because a buffer stock/import scheme has served the stabilization role. Other potential models include the Revenue Stabilization Fund for copper in Chile, the Buffer Funds for agricultural exports in Papua New Guinea, and coffee stabilization policy in Colombia (box 6-4 overleaf). The arrangement in Chile aims at stabilizing government revenues from export taxes by making payments into a fund from which a relatively stable amount is withdrawn each year. The scheme in Papua New Guinea relies on moderate taxes (when world prices are high) to fund subsidies (when prices are low), but tries to maintain average prices to exporters at their long-run international levels.

6.45 Cross-country evidence suggests an exchange rate supply elasticity of primary exports for all developing countries of 0.68, which is almost as large as that for all merchandise (including primary) exports (0.77).¹⁵ For Sub-Saharan Africa, the elasticity for agricultural exports (1.35) is even larger than that for all exports (1.01). Ghana and, more recently, Nigeria and Tanzania have increased primary exports to a considerable extent in response to incentives. In a number of markets (cocoa, coffee, palm oil, rubber, copra, tea, and cotton), African countries have lost market shares over the last 20 years to other countries (especially Asian) that have more liberal price and marketing regimes and have encouraged private investment and improved productivity. These pieces of evidence, together with the importance of the distortions in the sector, indicate that policy reform aimed at primary sectors (particularly agriculture) can play an important role in adjustment programs by quickly increasing exports.¹⁶

Box 6-4. The "Dutch Disease" and Policy Responses

When export earnings from a commodity are a large fraction of a country's supply of foreign exchange, booms and busts in its price (or output) can have significant economic effects. Increases in the price or volume of an export cause the country's real income to rise, but do not affect all sectors equally. The increased foreign exchange earnings tend to appreciate the real exchange rate, reducing producer incomes in tradable goods sectors, except for the booming sector itself or sectors whose prices are delinked from world prices (by nontariff barriers to trade, for example). This adverse effect on other sectors has come to be commonly known as the "Dutch disease," after the effect on the Dutch economy of such changes in its natural gas exports. Similar effects have occurred in other commodities and countries.

In spite of the pejorative label, the Dutch disease is not necessarily bad. Appreciation of the exchange rate sends the appropriate signal that a change in relative prices in external markets should lead to a change in domestic resource allocation. However, inappropriate macroeconomic policy responses that treat temporary increases as if they were permanent can have serious, adverse macroeconomic consequences. In response to the oil booms, governments of a number of oil-exporting countries greatly increased consumption spending and foreign borrowing, on the assumption that the debt could be repaid with proceeds of the future earnings. Pinto, for example, has documented that such a response in Nigeria exacerbated the appreciation from the oil boom, devastated the agricultural sector, and created severe macroeconomic imbalances after the boom ended.¹ Similar responses to commodity booms in Côte d'Ivoire (coffee and cocoa) and Senegal (phosphates) had the same effects.² Trade policy can also play a role in

determining the effects of a boom. When restrictions prevent foreign exchange from being spent on increased imports, the negative effect on the exchange rate (and exportable sectors) is that much much more severe, while the incentives for import-substitute production increase. Restrictions also may create unforeseen distributional consequences. Higher coffee prices in 1976-79 initially greatly improved producers' incomes in Kenya, but restrictions on imports and capital controls increased rents to suppliers of capital and consumer goods so that much of the gain ended up going to urban areas.³

The Experience of Colombia

A comparative study of Colombia's two recent coffee booms (a major one in 1976-80 and a smaller scale one in 1985-86) provides some interesting lessons.⁴ In response to the first boom, both fiscal and monetary policy magnified the expansionary effect of the boom. Government expenditures began growing rapidly in 1977 and accelerated even after prices peaked in 1978. On average, they grew at an annual rate of 38.5 percent during 1977-80. Most of the increase was in government consumption, which rose from 7.7 percent of GDP in 1977 to 10.1 percent in 1980. Meanwhile, revenue grew modestly in comparison, and the fiscal deficit expanded, financed in large part by foreign borrowing. Monetary policy was basically expansionary, with little or no reduction in government net credit to offset the large build-up of foreign assets. Eventually, trade policy was liberalized somewhat, but the reform was slow and then was reversed in 1983-85 as reserves fell. The rapid fall of reserves appears to be at least partially due to the rapid spending on imports as it became clear that the liberalization was only temporary.

The net effect of the shock and the subse-

6.46 Perhaps the most important of the policy reforms in Africa should be aimed at increasing the role of the private sector in pricing and marketing agricultural imports and outputs. As noted above, one important reform is eliminating or reducing the power of state marketing boards. Another is encouraging the development of informal rural credit markets, and attracting commercial banks into agricultural lending by freeing interest rates. Other priorities to improve the

quent policies was a significant appreciation of the real exchange rate. The trade-weighted real effective exchange rate appreciated almost 30 percent between 1975 and 1982, before beginning to depreciate.⁵ Noncoffee exports fell from 7.7 percent of GDP in 1976 to 4.3 percent in 1983, completely reversing the diversification of the export base that had occurred between 1967 and 1974.

When prices again rose at the end of 1985 and early in 1986, the government responded with much less expansionary fiscal and monetary policy. Relatively small portions of the increased revenues were passed to producers (in the form of higher prices) or taxed away directly by the central government. By an agreement between the central government and the National Coffee Fund, most of the increase was retained by the fund to be used to strengthen its finances and support several development programs. A fraction of the proceeds was to be invested in dollar-denominated instruments, a fraction was to be used to purchase bonds from the Central Bank, and a fraction was to be used to repay external debt, both by the fund directly and by lending to public entities that would in turn repay their debt. The net effect was to sterilize about 60 percent of the windfall by external debt repayment, and about 20 percent by the second mechanism cited above, which was equivalent to an open market operation. Thus, only 20 percent of the increased revenue entered the money supply. On the fiscal side, the increased coffee tax revenues were used to turn the public deficit of 5.2 percent of GDP in 1984 into a small surplus in 1986.

Alternative Mechanisms

The mechanism used in Colombia in 1985-86 was helpful in controlling the fiscal and monetary response to the boom. However, it

was complex and had costs of its own, including the segmentation of financial markets by the use of various special financial instruments carrying non-market interest rates. Furthermore, it was specifically designed for the circumstances of the period. Other mechanisms have been used in other countries to accomplish similar goals in a simpler and more automatic manner, and they deserve further study. Chile, for example, has established a revenue stabilization fund for government receipts from copper exports, with rules of operation that allow withdrawal of only a part of the annual earnings in a boom year. Papua New Guinea operates buffer funds for several commodities, with producer prices taxed or subsidized, depending on whether current world prices are above or below their long-term trends. The taxes or subsidies are withdrawn from or deposited into funds, part of which are required to be maintained in a special foreign currency account that does not constitute a part of the monetary base, thus automatically sterilizing fluctuating earnings.

1. B. Pinto, 1987, "Nigeria During and After the Oil Boom: A Policy Comparison with Indonesia," *World Bank Economic Review* 1 (May).

2. S. Devarajan and J. de Melo, 1987, "Adjustment with a Fixed Exchange Rate: Cameroon, Côte d'Ivoire, and Senegal," *The World Bank Economic Review* 1 (May).

3. I.L. Bevan, P. Collier, and J.W. Gunning, 1987, "Consequences of a Commodity Boom in a Controlled Economy: Accumulation and Redistribution in Kenya 1975-83," *The World Bank Economic Review* 1 (May).

4. W. Easterly and J. Cuddington, 1986, "Management of Coffee Export Booms in Colombia."

5. V. Thomas, 1985, *Linking Macroeconomic and Agricultural Policies for Adjustment and Growth: The Colombian Experience*, Baltimore, Md.: Johns Hopkins University Press.

efficiency of agriculture in general are improving the use of new appropriate technologies to increase productivity, enhancing environmental protection, developing infrastructure (particularly transportation), encouraging rural participation (including women) in decision-making, and improving the security of land tenure.¹⁷

1. R.J. Caballero and V. Corbo, 1989, "How Does Uncertainty about the Real Exchange Rate Affect Exports?" PPR Working Paper No. 221, Washington, D.C.: World Bank.
2. Combined with other measures, a real depreciation of the exchange rate has played a major role in increasing exports, as in Chile and Colombia in the 1970s or, more recently, in India, Mexico, Pakistan, Turkey, and (in some years) China. As an interim measure in situations of severe exchange rate uncertainty and multiple rates, exporters of manufactures in China, Ghana, Nigeria, Poland, and Tanzania (and in Turkey from 1980 to 1984) have been given the right to use a substantial percentage of their foreign exchange earnings for production-related imports and other payments abroad. Such foreign exchange retention schemes have usually helped increase hard-currency exports under disequilibrium conditions.
3. Developing countries are defined here as synonymous with low- and middle-income countries in the World Bank's World Development Report 1989. Apart from centrally planned economies that are not World Bank members, they include all economies with per capita GNP under US\$6,000 in 1987 (less than Ireland or Spain, for example).
4. The last two columns in table 6-1 include estimates of export growth in terms of purchasing power calculated from an index of the unit values of industrial countries' manufactured exports. These growth rates understate the real growth of purchasing power owing to continuing improvements in the technology and quality of industrial country manufactured products (especially of machinery), which are not reflected in the price indices. Furthermore, to varying degrees, developing countries are importers of crude oil and primary commodities, and to this extent the overall growth of the purchasing power of their exports was lower than shown during the 1970s and higher than shown during the 1980s until 1987. After 1987 world primary commodity prices recovered, and the purchasing power of exports was again affected in the opposite direction.
5. B. Balassa et al., 1982, *Development Strategies in Semi-Industrial Economies*, Baltimore, Md.: Johns Hopkins University Press for the World Bank.
6. See World Bank, 1986, "The Timing and Sequencing of a Trade Liberalization Policy: Inferences from Country Studies and Emerging Hypotheses for Further Analysis: Discussion," edited transcript of a conference in Lisbon, Portugal, June 15, pp. 65-70 (Yugoslavia) and pp. 77-87 (Turkey); also pp. 66-67 (New Zealand) and p. 72 (Sri Lanka).
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7 ISSUES IN IMPORT POLICY REFORMS

Summary and Conclusions

7.01 Import protection dominated by quantitative restrictions leads to inefficiencies and rent-seeking. Many developing countries have attempted to reform their import regimes by liberalizing quantitative restrictions and reducing tariffs. By reducing rent-seeking, the liberalization of quantitative restrictions can substantially improve economic efficiency, but liberalization should be coordinated with exchange rate and tariff reform. Comprehensive, intense, and reasonably fast reforms are preferable — providing they can be sustained — because the economic benefits are larger and come sooner than with slower, less intensive reform. Prior studies of the effective protection and industry-level effects of import reforms can improve understanding of the benefits and costs of reforms and help mobilize support for them — provided they do not unduly delay the reforms.

7.02 Allocative efficiency can be improved even by reforms that only replace quantitative restrictions with tariffs that keep domestic prices roughly at prereform levels. However, the full benefits of reform are only realized by reducing distortions in relative prices by making tariff rates lower and less dispersed. There are major practical advantages in aiming for as low and as uniform a tariff structure as is sustainable politically and consistent with revenue needs. Preannounced tariff reductions applied across the whole tariff structure are preferable to an industry-by-industry approach. Domestic pricing policies and market structure, the state of infrastructure, and regulation of market entry and exit of firms can magnify or reduce the economic gains of import policy reform. For example, the benefits are greater when import liberalization provides competition to a domestic monopoly. Conversely, internal price controls and entry/exit regulations reduce the gains from import liberalization. But generally import policy reforms ought not to be delayed, pending prior internal sector reforms, since the infrastructure and internal reforms required to support the post-import-reform configuration of the economy are not easy to predict, and such concerns may be used to postpone trade policy reforms indefinitely.

The Economic Costs of Protection

7.03 The economic costs of protection include direct resource allocation costs and a variety of indirect costs that derive from the nature of the import regime and its administration (chapter 1). The indirect costs are associated primarily with nontariff barriers to imports. Removal of these barriers may lead to substantial (but not easily quantifiable) economic gains, even if the level and structure of protection for local industries provided by tariffs remain roughly unchanged.

7.04 Import regimes based predominantly on tariffs rather than nontariff barriers also have indirect economic costs which, although generally lower, may not be negligible. When the system has a wide range of frequently changed tariffs, many specific (rather than ad valorem) tariffs, administratively granted exemptions, antidumping surcharges, and arbitrary prices used for assessing duties, its protective effects may be obscured and rent-seeking activity encouraged. Furthermore,

when the gap between domestic and world prices is large, export mechanisms such as duty-free admission and drawbacks may be difficult to administer and subject to abuse.

7.05 It is often argued that the costs of initially nurturing and protecting high-cost "infant industries" are justified by the economic benefits that eventually flow from these industries once they become efficient. The various versions of the argument rely on the idea that costs diminish over time as industries "learn by doing," but that entrepreneurs and capital suppliers are unable to fully capture the eventual future benefits or they discount them excessively.¹ Systematic evidence and satisfactory empirical research on the subject are lacking, principally because this would require simulating the counterfactual situation (that is, what would have happened in the absence of infant industry promotional policies). However, the World Bank's experience with protection policies and their general outcome in the majority of developing countries suggests that infant industry arguments are generally used as a rationale by politically powerful protection-seeking interests, without any serious consideration of whether and under what conditions the economic benefits of the protection will exceed its economic costs. Thus the policies seldom recognize that if the initial economic costs are to be offset, the learning-by-doing benefits (weighted for risks and discounted for the opportunity cost of the capital invested) must appear in a period of, say five or seven years.

7.06 The World Bank has generally found that industries and firms that are inefficient received high protection for relatively long periods, while those that are efficient (notably exporting industries) received relatively low protection and incentives in earlier periods. Moreover, there are well-documented cases in which industrial performance (in terms of production costs, quality, technology, and the like) steadily deteriorated over prolonged periods of insulation from world markets as a result of protection policies (for example, the steel, glass, and many engineering industries in India). Thus, the evidence indicates that protection is usually not associated with increasing efficiency over time and frequently has the opposite effect, and on pragmatic grounds, the World Bank has usually recommended that protection not be given to support infant industries.

7.07 A few economies — notably Japan in the 1950s and 1960s and Korea and Taiwan, China, in the 1960s and 1970s — have had outstanding records of economic growth with approximate neutrality in incentives despite import regimes characterized by significant protection and quantitative restrictions. It has also been argued that they have successfully followed selective infant industry policies. Some analysts have argued that they provide an alternative trade policy model for developing countries (see chapter 6). The Korean success was due to a combination of sound and consistent macroeconomic policies, a system of automatic and nondiscriminatory mechanisms for exports, competition between exporting firms in the domestic market, and rigorous and single-minded administration of the discretionary controls over imports and investment in the interests of rapid expansion of manufactured exports. Temporary protection was given to new firms in new industries, but they were generally pushed to directly or indirectly export a substantial share of their output within short periods (say four to five years) and to rapidly become internationally competitive, with no guarantee that they would be rescued if they failed to do so (see box 6-1). Furthermore, import policy liberalization began quite early but slowly in Korea in the late 1960s and then proceeded rapidly in the 1980s following a crisis brought on by policy-induced imbalances and

external shocks. Currently, the fraction of imports subject to restriction is only about 5 percent, with the average tariff about 20 percent. For most developing countries, given their economic and political conditions and their poor record of administering quantitative restrictions on imports, a growth model based on import protection is unlikely to be successful. With a relatively liberal regime, Korea has been growing as fast or faster than in earlier periods.³ The same is true of other economies, such as Chile, Hong Kong, and Singapore, during periods of liberal import policy. The design and implementation of import policy reform programs emphasizing liberalization is therefore the subject of this chapter.

Comprehensiveness, Intensity, and Speed

7.08 Other things being equal, a reform program that is comprehensive, intense, and rapid is preferable to one that is not because the benefits are greater and begin sooner. The political economy arguments in favor of such an approach are given in chapter 4. Two major qualifying arguments could temper this broad conclusion.

7.09 One argument concerns the economic loss from transitional unemployment, which in theory could be larger with radical programs than when changes are preannounced and phased-in over time. The gradual approach may allow enterprises and individuals to begin to adjust before the reforms are implemented, thereby reducing transitional unemployment. However, there is evidence that labor has in fact been absorbed quite rapidly into expanding industries (chapter 3), especially when they had excess capacity, were labor intensive, and required little or easily obtained capital equipment. This finding raises at least some doubt about the severity of the problem of transitional unemployment, whether change is rapid or gradual. Moreover, import regimes dominated by quantitative restrictions are typically characterized by delays and uncertainties in the procurement of raw materials, components, and capital equipment and sometimes by the requirement for government approval of new investment, which can greatly delay the response to new opportunities. Under such circumstances, introducing import reforms gradually could worsen temporary unemployment because firms wishing to expand would continue to face these delays and procurement problems, which would not be the case were reforms more drastic and rapid.

7.09 A second argument suggesting that comprehensive, drastic, and rapid import reforms may not be optimal concerns their credibility and the likelihood of reversal. Gradual reforms may be preferable if they are more likely to be sustained than alternative, radical reforms. Rapid, radical import reform concentrates the disruption of existing patterns within a short time period. Whether this is politically more difficult to handle than a less concentrated disruption that is spread over a longer period depends on individual country circumstances.

7.10 In practice, reform episodes have followed many patterns with respect to their comprehensiveness, intensity, and speed. Some very successful reforms have been extremely comprehensive, intensive, and fast, as in Bolivia, where controls were abolished and tariffs drastically slashed virtually overnight. Others have been more moderate in speed; Chile and Mexico quickly reduced the coverage of quantitative restrictions, but then reduced tariffs more slowly, over periods of about five and two years, respectively. These reformers have now achieved relatively uniform rate structures (one or two rates) of around 15 percent. Still others have been quite slow; Korea's very comprehensive reforms have been carried out

over twenty years, although the most important reforms have been adopted since 1980. India, although instituting no major reforms, has been very slowly relaxing import controls in a low key but consistent manner since about 1978. An overview of many successful and unsuccessful episodes suggests that while many countries could benefit from more rapid reforms, six to seven years is a reasonable period for moving from massive restrictions to substantially open trade regimes.³ Constraints related to revenue needs or politically sensitive protection may prevent comprehensive liberalization in such a time span, but a reasonable and practical first-stage goal would be to phase out quantitative restrictions and reduce tariffs to a range of 15-30 percent. Several of the programs supported by trade policy loans in calendar years 1988-1989 have been ongoing for a number of years and have been supported by previous adjustment loans, yet they are still chipping away at only the first of several redundant layers of protection (chapter 2). In these countries, it remains unclear how long it will take to actually reduce protection.

7.11 Apart from its speed and comprehensiveness, another important aspect of reform is the manner in which it is begun. Reforms begun with strong measures have more often survived than those begun with weak or tentative steps. There is also evidence that preannouncement of the future time-table of the reform, even if the schedule is not adhered to rigidly, enhances the reform's sustainability since it allows economic agents time to adjust to the new order.

Removal of Quantitative Restrictions

7.12 When quantitative restrictions are to be reduced in stages, the key elements to be considered in designing the reform are the exchange rate, the existing and the desired structure of tariffs, the relationships between them, and the phasing of changes over time.

The Role of the Exchange Rate

7.13 A real devaluation, by increasing the supply and cutting the demand for foreign exchange, makes it relatively easy to drop quantitative restrictions that have been imposed for balance of payments rather than protective reasons. In addition, by raising the domestic currency price of imports, devaluation reduces the protective effects of quantitative restrictions (that is, the quota premiums). This often makes the restrictions redundant and so reduces the opposition to their removal among protected industries. For this reason (among others), reforms involving the rapid removal of a large number of quantitative restrictions have often been preceded or accompanied by large devaluations; for example, in Bolivia (1985), Chile (1974), Ghana (1986), Guinea (1986), Laos (1988), Mexico (1985), Nigeria (1986), Sri Lanka (1977), and Zaire (1986).

7.14 Devaluation may also play a key role in reform programs in which quantitative restrictions are removed on noncompeting imports of capital equipment and intermediate materials but retained on competing imports, as was the case in the reforms beginning in India in 1978, in Pakistan in 1983, and in Tunisia in 1986. If unaccompanied by devaluation, reforms of this nature can worsen resource allocation by increasing the effective protection of industries that use imported intermediates and capital equipment. Devaluation can offset this effect and reduce the strain on the import licensing system, and hence can reduce the quota rents and

the many associated indirect costs of protection. Insofar as devaluation narrows the gap between the world and domestic prices of the import substitutes that are still protected by quantitative restrictions, it also reduces the incentives for diverting duty-free raw materials to the domestic market or otherwise misusing facilities designed to promote exports. Thus devaluation can have a double impact on exports: a direct impact resulting from the devaluation and an indirect impact resulting from the increased efficiency it permits in the administration of export incentives.

7.15 The importance of accompanying the removal of quantitative restrictions with devaluation is underlined by the difficulties of the franc zone countries in Africa, whose currencies are fixed in terms of the French franc. Côte d'Ivoire, in a program initiated in 1984 to remove quantitative restrictions, attempted to compensate for its inability to devalue the nominal exchange rate by using a combination of higher tariffs and export subsidies (see box 3-3). This strategy proved to be a poor substitute for devaluation, owing largely to extensive smuggling and an unwillingness to fully finance the export subsidies.

7.16 Devaluation and more general exchange rate reforms are also fundamental in countries in which the government allocates foreign exchange at officially controlled rates, while at the same time, a large proportion of foreign exchange transactions take place in illegal or legal parallel markets. This is the rule rather than the exception in most of the nonfranc zone countries of Sub-Saharan Africa and occurs frequently in Latin America and in a number of socialist countries. Such foreign exchange controls are generally accompanied by import controls. Even when they are not, however, their direct and indirect economic costs are similar to those associated with quantitative restriction-dominated import regimes with a unified exchange rate. They are typically characterized not only by a general antiexport bias, but also by substantial differences in effective protection within and between import-substitution and export sectors. Effective protection rates vary because foreign exchange retention allowances for exporters differ and because allocations of foreign exchange at the official rate are not the same for imports of intermediate inputs and machinery (see box 2-2 on Poland). To reduce the antiexport bias of such systems and move them toward a more neutral incentive structure, the dual or multiple exchange rates for imports and exports must be unified into a single rate, usually by a substantial devaluation of the official rate (chapter 5).

Phasing Out Quantitative Restrictions

7.18 Phased removal strategies frequently involve transitional problems, with the nature of the problem depending on the type of restriction being removed. Some of these problems, if not handled carefully, may increase rather than diminish the resource misallocation and indirect costs of protection during the transitional period.

7.19 For import control systems³ based on clearly defined product quotas, there are various well-tried methods of phasing out their removal that have the important advantages of being reasonably transparent and monitorable.⁴ One method is to simply raise the quota ceiling, preferably according to a preannounced schedule, until the quotas become redundant and can be abolished. This method was used by

the original members of the European Economic Community (EEC) and has also been used in Australia and New Zealand. Another method, also used in Australia and New Zealand, is to replace quotas with tariff-quotas, which permit imports of a specified amount of a product at the going tariff rate and an unlimited amount at a higher, initially prohibitive tariff rate. The high rate can then be reduced in steps until the two rates are identical. This method has the advantage of clearly indicating the declining level of protection during the transition phase. A third method, used in Australia, Brazil, and New Zealand, is to auction import quotas, steadily increasing the amount auctioned until the bids fall to a level at which the quotas appear to be no longer binding, at which point they can be abolished. Alternatively, the auction prices can be viewed as a proxy for the tariff equivalent of the quota and can be used to set quota-replacement tariff levels, which can then be progressively reduced.

7.20 Most developing countries have import control regimes based on import licensing rather than explicit quotas for specific quantities. These systems generally operate on the basis of product lists of various types, usually lists of banned products, lists of restricted products that require licenses, or lists of uncontrolled products. Part of the cost imposed by such a system is due to the uncertainty, excessive paperwork, and rent-seeking that accompany a system in which licenses are issued at the discretion of the relevant authorities. Without any change in the value of licenses issued, the restrictiveness of licensing in these systems can be reduced by broadening the list of products for which individual licenses can be used and by making the licenses transferable. Under a license-based system, the phasing out of import restrictions usually consists of shifting products from banned and restricted lists to unrestricted lists. If pursued consistently and completed in a reasonably short period, this method can be effective in eliminating import licensing. If, however, the process is slow, problems involving important economic costs can arise. Thus, for example, if governments remove licensing requirements for imports that do not compete with domestic production (often industrial raw materials and machinery), while leaving decisions on when to remove restrictions on competing imports to a distant (often indefinite) future, the effective protection of local import-substitution industries will tend to increase and resource allocation to worsen. Or, less commonly, if competitive imports are allowed but imports of intermediate materials and machinery are not liberalized and these goods must continue to be purchased locally, economically efficient industries may be penalized by a large fall in their effective protection. Both of these results can be offset by devaluation and temporary tariff increases, although once tariffs have been raised it is often difficult to reduce them again later.

7.21 Another issue with respect to liberalization of import licensing systems concerns the nature of the product lists. In systems that list both products subject to licensing and products not subject to licensing, many products will be on neither list, and thus will fall in a no-man's land where the need for a license is uncertain. This uncertainty increases the discretionary component of such systems and leads to a corresponding increase in delays. The switching to a negative-list system, which permits unrestricted imports of all products not listed as subject to licensing, can on its own constitute an important liberalization of quantitative controls. Apart from reducing the scope of discretionary decisions, this change shifts the burden of import control lobbying away from importers trying to get controls removed and onto local producers trying to get controls installed on new import

product classes. This change has been a key step in freeing up import licensing in a number of countries and is a standard element in both the IMF's and the World Bank's approaches to import policy reform. It also facilitates the monitoring of reform programs, which is preferably based on data on the proportion of domestic production in product categories whose imports are subject to quantitative restrictions.

7.22 Various transitional issues also arise in liberalizing imports that are controlled by government monopoly trading organizations. One way to liberalize such imports is to reduce the number of products that can be imported only by these organizations, as was done in India. Another way is to establish operating rules that remove or reduce the organization's discretionary behavior in areas that can distort competition between imports and domestic production; for example, they can be instructed to import on behalf of all customers, subject only to commercial criteria such as solvency. In practice, however, some discretionary behavior is highly likely to remain as long as the legal right to import remains limited to the monopoly trading organization. Consequently, the introduction of competitive conditions to importing activities will generally be an important step in the removal of quantitative restrictions under such systems. Many governments have been reluctant to take this step for some products, however, especially agricultural commodities, because it involves important changes in domestic policies, such as price support and stabilization policies for agriculture.

7.23 Local-content or "indigenization" programs to force use of domestic inputs are another type of nontariff barrier that has proved difficult to remove. For example, these barriers remain even in Chile and Mexico, which have removed virtually all other nontariff barriers against manufactured imports. The difficulty lies in the origins of these arrangements, which are usually part of agreements dealing with the investments of individual firms and are not directly related to the country's general import policies. Removing them, whether abruptly or gradually, may conflict with the desire to maintain a favorable climate for investment, especially by foreign firms. One approach is to renegotiate the agreements and replace quantitative local-content requirements with tariff-quotas having low and high rates that are progressively merged.

The Role of Tariffs during Removal of Quantitative Restrictions

7.24 In an import regime in which quantitative restrictions have been the only or primary instrument of protection, the removal of binding quantitative restrictions will generally lead to a sudden reduction of protection. Consequently, a transitional measure has been to use tariffs to allow a more gradual reduction in protection. One approach adopted in a number of reform programs has been to set tariffs at approximately the level of the actual difference between domestic and international prices before removing quantitative restrictions. These tariffs are subsequently reduced in stages. In some reform programs (for example, the Philippines in 1977 and Nigeria in 1988), the future tariff rates were written into the new tariff schedule, while in others (for example, Côte d'Ivoire in 1984) they were published in advance, while temporary but declining tariff surcharges were imposed on products for which domestic prices exceeded world prices by more than the amount of the published tariffs. Such preannouncement makes the future rates clear and enables informed business and investment decisions to be made.

7.25 While this strategy of replacing quantitative restrictions with tariffs can reduce the initial impact of the removal of quantitative restrictions, tariffs cannot replicate all the effects of quantitative restrictions, nor would this be desirable. Thus, for example, inefficient firms that received import licenses under a regime of administratively allocated and nontransferable licenses will not be able to afford them under a reformed system if they have to pay the tariff equivalent of the economic rent they previously received. This improvement in the efficiency of allocation, which is a major economic benefit of quantitative restriction removal, will occur unless different, firm-specific tariffs are charged for the same products. A second difference is that quantitative restrictions cut the link between world and domestic prices, whereas tariffs permit world and domestic prices to move up or down together. A third is that a quantitative restriction on a particular product will generally cover a wide range of product qualities and specifications; thus, the effects of quantitative restrictions on domestic prices will depend on how import licenses are allocated and will vary by product quality and specifications and from period to period. Such diverse effects are impossible to replicate with tariffs. Fourth, there are many difficulties in measuring the actual difference between domestic and world prices, including product complexity, lack of information on world prices (especially if imports have been banned), and differences between domestic and imported products in terms of credit, service, and other selling conditions. Finally, quantitative restrictions, especially when arbitrary or haphazardly administered, have a greater deterrent effect on importers than do tariffs because importers are reluctant to invest in distribution networks and marketing if the markets they develop can be arbitrarily closed off.

7.26 Domestic industries protected by quantitative restrictions are largely insulated from fluctuations in world markets and, in particular, from temporary episodes of world surpluses. When these restrictions are removed, local industries are exposed to these fluctuations, and strong pressures are often exerted to implement special protective measures against dumping. These pressures have become a major problem and threaten to undermine or at least reduce the favorable economic impact of many of the import policy reforms undertaken in the 1980s. In countries in which the customs administration is weak and underinvoicing of imports to reduce duty payments is prevalent, the pressure is particularly strong to base import duties on reference or check prices, as in Morocco. A reaction along these lines, or the introduction of antidumping procedures as permitted by GATT, although not desirable in itself, is preferable to the reintroduction of quantitative restrictions, for which many affected industries have pressed.

Tariff Reform

The Level and Structure of the Target Tariff System

7.27 Import tariffs instituted for protectionist purposes typically have a number of major deficiencies. Tariffs on products whose domestic production is being favored are too high and give too much protection, raising prices to consumers and frequently leading to smuggling and corruption. Tariffs on products that are important to influential consumers or enterprises are low, discouraging or preventing their domestic production. The tariff structure is generally escalated, with tariffs rising according to the degree of processing. This increases the effective protection of later-stage processes above the nominal protection afforded by tariffs on the finished product, while providing low or negative effective protection to

processes at early stages in the processing chain. Big differences between tariff rates on substitute goods artificially encourage the consumption of those with the lower tariffs. In addition, the tariff structure is often greatly complicated by special provisions introduced in response to lobbying pressures. In many cases, the actual effects of the tariff structure are determined more by exemptions than by the nominal structure.

7.28 The lower the general level of tariffs, the less severe all these problems become. A major lesson of experience is that tariff reforms should aim at an eventual tariff structure with levels as low as possible. Sometimes, however, other policies conflict with the goal of low tariff levels, including political constraints, the need to use tariffs as a surrogate for exchange rate policy (as in the CFA franc zone), or budgetary constraints (chapter 5). In cases where tariffs cannot be lowered, priority may be given to eliminating exemptions and imposing (or increasing) taxes on the domestic production of final goods whose imports are subject to high tariffs, so each good is taxed at the same rate, irrespective of its origin (foreign or domestic). This response has the dual advantage of reducing the distortionary effects of tariffs and raising revenue. If the need for revenue is a binding constraint, this would allow further reduction of tariff rates or, if needed, would permit transitional assistance to help restructure the economy in line with the changed incentives. The domestic taxes, of course, should not be at rates higher than the tariff rates nor should the type of tax used be one that applies on top of the tariffs, since this would tax imports twice. More generally, reform of the tariff structure and domestic tax system should proceed simultaneously wherever possible.⁵ In countries with the necessary collection apparatus, the system should be designed so that it taxes consumption of products, whether domestically produced or imported, at the same low rate. This could be designed as a value-added tax or as a retail sales tax collected at the point of import or ex factory, with exemptions for exports and inputs (Swaziland).⁶ An alternative which would be less efficient but still preferable to reliance only on tariffs would be a sales tax. World Bank adjustment operations during calendar years 1988 and 1989 in Malawi, Nigeria, and Togo have begun to harmonize tariff rates on imports with tax rates on domestic production of import-competing products, but it is still too early to judge the results.

7.29 A second important issue concerns whether all rates should be equal. There is little question that uniformity would be beneficial from an economic point of view if all rates were unified at the level of the lowest rates. A more controversial question is whether, if high rates cannot be reduced to the lowest level, low rates on imported inputs should be raised (see also para. 7.34). (Of course, the lower the top rates, the less important is the issue of uniformity.) The answer depends to a large extent on whether a temporary admission or duty drawback scheme is in operation for exports (see para. 7.35). If not, the marginal net economic benefits of raising input tariffs (see below) should be traded off against the marginal economic costs resulting from the reduced incentives for export production, to the point where the former fall to level of the latter. There is no reason to think that this point would coincide with the level at which tariff rates are uniform, except under special conditions.

7.30 When exporters are assured of duty-free inputs, the case for a relatively uniform structure between intermediate and final good imports is more compelling.⁷ When the focus is on minimizing the productive efficiency costs of providing

a given level of protection or achieving a target level of self-sufficiency in importables, there is also a strong case for uniform tariffs among final goods (box 7-1). While in theory a carefully designed non-uniform rate structure could be more economically efficient for raising revenue than a uniform structure, the design of such a system depends on parameters that are difficult to estimate, and in practice, such a structure would be more difficult to insulate from lobbying pressures. By contrast, a uniform structure gives the appearance of fairness and is easier to administer. In addition, in complicated, nonuniform systems, concessions to particular firms or groups are less apparent, especially tariff reductions or exemptions on inputs that affect government revenue but not buyers of the finished products.

7.31 Some tariff reforms have actually achieved uniformity (Chile's uniform tariff is 15 percent), and others are close (Bolivia currently has two rates, 10 and 17 percent, with the goal of a unified rate by 1991). Most World Bank recommenda-

**Box 7-1. On
the Desirable Tariff
Structure**

Assuming that some level of tariffs must be retained, countries confront two important questions. First, is a uniform tariff structure desirable? Second, should intermediate inputs be subject to import duties and if so are export duty drawbacks justified? The answers depend to some extent on the objectives of policy. Tariffs may be aimed at goals related to self sufficiency, protection, or revenue. Administrative convenience and political economy considerations also determine the best tariff policy.

Under the self-sufficiency objective, the government wishes to limit the value of total imports of final goods (at world prices) to a specified level. The least costly way to achieve this objective is a uniform tariff, because it equalizes the marginal (distortion) cost of restricting imports in production and consumption across commodities.

Under the protection objective, suppose that the government wishes to maintain the value (at world prices) of output of final goods importables at a level above that achieved under free trade. The optimal policy for this is a uniform output subsidy on these importables, provided revenue can be raised costlessly. If revenue cannot be raised costlessly, however, tariffs may be used as an instrument of protection. The main difference between output subsidies and tariffs is that the former distort only production while the latter also distort consumption. Therefore, if we ignore the distortion in consumption or can correct it by a set of commodity-specific taxes and subsidies, optimal tariffs for protection will be uniform across final goods. Otherwise, optimal tariffs for protection will be nonuniform. A superior alternative to using tariffs alone is to com-

bine them with output subsidies, reducing the necessary tariffs and therefore the consumption distortion.

For the revenue objective with no other constraints, consumption taxes are usually the first best instrument. However, if we assume that adequate administrative machinery to collect such taxes does not exist, then tariffs may be the primary source of revenue. Optimal tariffs for raising a given amount of revenue will be generally nonuniform across final goods. Ignoring the cross-price effects, goods with low elasticity of demand for imports should be subject to higher tariffs than goods with high elasticity. Intuitively, when the import-demand elasticity is low, a high tariff enables us to raise a substantial revenue without causing large movements away from the Pareto efficient equilibrium.

To highlight the potential conflict between protective and revenue raising tariffs, let us ignore the distortion costs of tariffs in consumption. Then a commodity with highly inelastic supply is a perfect candidate for raising revenue. But the same commodity is a poor candidate for protection in the sense that a large expansion in the value of its output will be much more distortionary than a similar expansion of an elastically supplied good.

To analyze the issue of whether tariffs should be uniform between inputs and final goods imports, consider a country producing a final good importable and an exportable. Assume that the production of these goods requires an imported intermediate input and that, for some unspecified reason, there is a tariff on final imports. In this situation, the introduction of a tariff on the intermediate

tions for tariff reform have emphasized reducing the dispersion of rates, although only a few have explicitly envisioned a uniform structure as even a long-term goal.⁶ It is not often clear whether this reticence results from a judgment that a uniform structure is undesirable or politically unattainable, or from a failure to establish a long-term target.

Tariff Reform During the Transition

7.32 When tariff reforms are to be phased in over time, one approach is to proceed industry by industry. Ideally, in such a sequential process, governments would first make the changes involving large economic benefits. This may be politically feasible in some cases, especially if it involves increases in protection for previously underprotected industries. But more often it involves adjusting tariffs to reduce protection for large, highly protected industries. Thus, governments are frequently

input will by itself have an ambiguous effect on welfare. In particular, if the input is more important in the production of exportable than that of the importable, the change will be welfare reducing. If we combine the tariff with an export-duty drawback, however, the net effect is unambiguously positive. The tariff on the use of the intermediate input in the importable reduces the output of the latter, which is beneficial. (In fact, if the tariff on the input is raised sufficiently high, it can eliminate completely the effective protection to the final good.)

This analysis remains valid in the presence of a revenue constraint. If revenue is to be kept constant, the introduction of a positive tariff on the intermediate input along with an export-duty drawback will enable us to lower the tariff on the final import which will add further to welfare improvement. However, for a given amount of revenue, the optimal rate of tariff on the final good may be different from that on the intermediate input.

An important question concerns the effect of a duty drawback when some of the exports do not use the intermediate input. The typical fear is that the duty drawback on the exports of manufactures may reduce welfare by expanding the latter at the expense of resource-based exports. However, if the policy package consists of introducing a small tariff on the imported input, an export-duty drawback and a reduction in the tariff on the final import to hold revenue fixed, it is equivalent to a tax on the production of the importable, a consumption tax on the exportable using the input and a reduction in tariff on the final import. All three of these changes

are normally welfare improving, in the absence of other distortions.

Special circumstances would temper these conclusions. Thus, if smuggling is a serious problem, uniform tariffs may not be optimal, since not all goods can be smuggled with uniform ease (for example, wrist watches versus automobiles). Similarly, the presence of monopoly power in the world markets, domestic taxes and, most importantly, economies of scale and imperfect competition may alter the conclusions.

Nonuniform tariffs conflict with administrative simplicity and transparency. It is also extremely difficult to determine at what level particular tariffs should be set. Nonuniform tariffs also encourage more smuggling and are more prone to rent seeking and lobbying activities aimed at raising tariffs. Under a uniform tariff, the structure of tariffs is nonnegotiable. Therefore, if tariffs are to be raised, all of them must be raised simultaneously. But gains to a particular industry from raising all tariffs are relatively small so that collective action in this direction is unlikely. By contrast, if tariffs are nonuniform, it is much more profitable for a low-tariff industry to lobby for a higher tariff. The costs of raising the tariff on a single industry are diffused so that counter lobbying is unlikely. Moreover, it is easier to obtain higher protection when someone else in the economy already enjoys that benefit. Thus, under nonuniformity, tariff rates are likely to escalate and be determined by relative political power of interest groups rather than efficiency considerations.

Source: Background paper by A. Panagariya.

tempted to leave these difficult cases to the end and to introduce tariff changes at the early stages that have relatively low economic benefits. And, indeed, it may be better to postpone dealing with some especially intractable cases in order to avoid undermining or delaying the whole reform program. Then, once all other tariffs have been reduced and restructured, these cases may stand out in such an obvious way (the "sore thumb" principle) that support can be mobilized to deal with them. In the meantime, it may be possible to limit the resource allocation costs of delay by using other policies to prevent or slow down investment in these industries.

7.33 While prior studies of the impact of reform on individual industries are useful, an industry-by-industry approach to tariff reform creates problems. Tariff actions in one industry have repercussions for other industries via input-output linkages or substitution or complementarity in consumption. These repercussions may reduce economic benefits and increase economic costs along the way, and attempting to respond to them may slow down or even abort the tariff reform process. For this reason, there are many advantages in making general phased changes in all tariffs without discriminating between industries. This approach is attractive because of its even-handedness, the avoidance of discretionary decision making on the sectoral order of reform, and the absence of a need for interim measures, which might subsequently be removed because of the impact of reforms on industries for which tariffs have not yet been adjusted.

7.34 In designing general rather than industry-by-industry approaches, the issue again arises of whether to raise the rates at the low end of the tariff structure, especially when they apply to intermediate inputs. Doing so is beneficial in two respects. First, for the final goods that use these inputs and whose domestic production is protected by higher tariffs, raising these import tariffs reduces the effective rate of protection.⁹ Second, as noted previously, if reform is constrained by the need to raise some target level of revenue or provide some target level of average nominal protection to importables as a group, raising low tariffs on inputs allows tariffs on outputs to be reduced further than they could be otherwise, reducing their adverse effects. Weighed against these salutary effects, however, are three potential costs. First, if importable inputs are produced domestically, the higher protection will increase the flow of resources to these sectors. To the extent that resources coming from nontradable and relatively unprotected sectors (such as exportables) outweigh those coming from heavily protected importable sectors, the net effect is to worsen resource allocation. Second, if these inputs are used in the production of exportables, raising their tariffs may directly reduce profits and production in this sector. Finally, if the net effect is to cause the exchange rate to appreciate, exportables will be further penalized.

7.35 How these costs and benefits should be evaluated depends to a large extent on other characteristics of the reform program and the economy. If there is a well-functioning duty drawback scheme, raising input tariffs will have little negative direct effect on the profitability of export production. If inputs are not produced domestically or if they compete more strongly for domestic resources with other more highly protected importables than with less protected exports and nontradables,¹⁰ raising their tariffs will not have a net adverse indirect effect. If both these conditions are met, then raising low tariffs will improve resource allocation.

7.36 Even without a duty drawback system, other conditions can make it more likely that this will be the case. First, if raising low tariff rates means that the higher rates can be reduced further than they could be otherwise (the revenue- or nominal protection-constrained cases), there is no adverse effect on overall protection levels and thus no pressure on the exchange rate to appreciate. Under these conditions, it is also likely that a larger share of the resources flowing into the low-tariff sectors will come from the high-tariff sectors, so the negative effect on exportables is at least mitigated. Second, the more dispersed the initial structure, the more likely it is that raising low tariffs on inputs will improve resource allocation. In fact, if input tariffs initially are close to zero while final-good tariffs are much higher, and the reform is revenue-neutral (lowering final-good tariffs while raising those on inputs), the welfare effect will usually be positive even with no duty drawback in effect for exports. However, it is important to keep in mind the eventual goal; if increases will be difficult to reverse for administrative or political reasons, it may be better not to raise tariffs above their eventual target levels.

7.37 During transition periods, one objective is to reduce the dispersion of protection and a second is to reduce the average level of protection. One way of achieving both objectives (currently being followed in Guatemala and Costa Rica) is the concertina approach, which collapses the structure by reducing the top rate at each step of the transition to the next highest level, while leaving lower rates the same. Another method (followed in Mexico) is radial or proportionate reduction, whereby at each stage all tariffs are reduced to an equal fraction of their previous levels. A properly designed radial reduction is usually superior to a concertina reduction because in the initial stages of the concertina method there will be little impact on protection if, as is typical, the top rates are redundant for many products and cover only a small fraction of production. In addition, a concertina reduction may, without offsetting policy changes, send conflicting signals at different steps in the process since each step depreciates the real exchange rate, thereby improving the incentives for all products whose tariffs have not yet been reduced. For example, the price of a product covered by the median tariff will increase at each step until mid-way through the process, when it will finally begin to fall.¹¹ This change in signals may produce first an expansion and then a contraction of each sector, with attendant costs of resource movement. (If the reform is preannounced, however, and if it is widely expected to proceed as planned, these costs will be reduced, since long-term planning and investment will be based on the target structure of incentives.) With a radial reduction, the signals are more likely to be uniform for each protected importable product at each step. However, radial reductions are more likely to reduce revenue than concertina reductions, making it more important to take care that the reform does not exacerbate the budget deficit.

7.38 Once a new target tariff structure is in place or a process for reaching it has been put in motion, there are many advantages in attempting to develop standard and, if possible, public procedures for dealing with pressures for further changes. These procedures can be designed along the lines followed by the Australian Industries Assistance Commission, which gives opponents of changes a chance to be heard and requires an objective economic analysis to be done. The analysis is publicly available and must be taken into account before final decisions are taken.

Import Policy Reforms and Internal Sector Reforms

7.39 When domestic markets are distorted because of the monopoly power of domestic firms or constraints related to the regulatory, institutional, or infrastructural framework, standard analyses of the effects of trade reform must be modified. The traditional gains from trade reform are magnified with some types of domestic distortions, but in other cases, the supply response to reforms is reduced.

7.40 When domestic firms exercise market power, the gains from trade can be magnified. In addition to the usual efficiency gains, the liberalizing country also benefits from reductions in the monopoly profits of domestic firms. Evidence from Chile's dramatic trade liberalization episode in the 1970s shows that profits declined most in the highly concentrated sectors. The Chilean experience is confirmed by enterprise-level surveys conducted in Morocco following trade reforms that began in 1983. Domestic firms that previously enjoyed considerable market power due to limited competition from abroad were induced by liberalization to slash profit margins and increase the efficiency of factor use. Korea's successful trade reform experience in the 1980s is particularly instructive in this regard. Liberalization in the manufacturing sector emphasized industries with monopolistic market structures, many of which had been encouraged and supported by government policies during the 1970s.

7.41 Trade and internal policies often contribute to fragmented production patterns. High levels of protection have encouraged firms to enter import-substituting sectors (the automobile industry is a classic example), and continued protection has allowed firms operating below minimum efficient scale to remain profitable. In markets where plant sizes are below efficient scales, trade reform can act to rationalize the market structure. Import competition accompanying reforms in Argentina, Chile, and Mexico led to narrower and more specialized product lines as well as to mergers, consolidations, and plant closings. In Chile, increased exploitation of scale economies accompanied declining protection. Some firms that were insufficiently specialized and seemed to need high protection before the 1974 reform were able to concentrate on a few product lines and export after the reform.

7.42 Yet in the presence of other types of domestic market distortions, the welfare benefits of trade reform can be reduced. In countries as diverse as India and Mexico domestic regulatory policies that control market entry and expansion of firms have deterred growth in capacity and establishment of new firms. For example, Mexico's regulations in these areas slowed the pace of adjustment for several years despite decisive trade liberalization. Restrictions on exit also reduce the welfare gains of trade liberalization. The procompetitive effect of reform should lead some firms to exit and others to enter; if exit is not possible, inefficient firms remain and funds that would enable new firms to enter are limited. Regulations that make it costly or impossible for firms to restructure or shut down (including requirements for high severance payments to workers and rules inhibiting liquidation or bankruptcy) have been a factor in failed liberalization attempts in Poland, Turkey (in the early 1970s), and Yugoslavia. By contrast, an absence of exit restrictions was important for the success of the 1974-79 trade reforms in Chile, which were carried out concurrently with the reduction or elimination of many regulatory interventions, including those affecting the labor market.¹²

7.43 Comprehensive and rigid price controls are by definition incompatible with trade policy reform since its purpose is to alter relative prices. However, even relatively flexible or partial price controls can limit the ability of the economy to respond. Wage and employment controls can also reduce the benefits of trade liberalization. In the presence of minimum wages set above market-clearing levels, whether by law or collective bargaining, firms may have to shed labor or close down in response to import competition even though workers could have been profitably employed at lower rates; at the same time, expanding industries may find it difficult or expensive to bid labor away from contracting sectors with high minimum wages.

7.44 Other policies and conditions that can inhibit a supply response to trade policy reforms include the centralized allocation of major material inputs (as in many socialist countries); lack of competition and poor performance in transport, banking, and telecommunications; and excessive or poorly managed regulation of financial markets. For example, when banks are not allowed to write off bad debts from inefficient import-competing firms, new credit may not be available for the firms that should be expanding after trade policy reforms (box 5-2). Another example is Mexico's transport regulations, which have made it costly and difficult for exporting manufacturers to ship their products to ports or to the U.S. border.

7.45 The structure of the public sector or policies relating to the sector may affect trade policy reform or be affected by it. The desire to protect state-owned manufacturing enterprises has interfered with liberalization programs in a number of countries, including Argentina, Bangladesh, Chile, and Peru (para. 4.13). In other cases, when governments have privatized unprofitable firms instead of liquidating them, the buyers have required guarantees of continuing high protection, as when the government of Togo privatized its steel mill. The structure of the public sector in socialist countries is such that trade policy liberalization by itself would accomplish little unless accompanied by significant changes in other policies (box 2-2 on Poland).

7.46 In agriculture and agroindustry, unintended effects may result from interactions between trade policy reforms and existing interventions in input and output markets. Many of these are indirect effects on the welfare and budgetary costs of agricultural price policies.¹³ Liberalization of imports of agricultural commodities, for example, can increase the budgetary cost of output price supports and reduce the budgetary cost of input subsidies. To take another issue, parastatal domination (or other distortions) of crop output markets may mean that a devaluation may affect producer prices very slowly, while causing input prices to rise quickly. Or a protected processed product (for example, textiles) may rapidly become disprotected if its tariffs are reduced, while its input (cotton) price remains high because it is determined by a monopolistic parastatal. Meaningful trade liberalization in such cases may call for abolition of the parastatal (as in the Ecuador agricultural sector adjustment loan) or elimination of its legal monopoly in the import market (as in the Mexico agricultural sector adjustment loan).

7.47 Public sector policies or characteristics, by increasing the costs of importing and exporting, may have the effect of taxing trade. One obvious way this can occur is through an inefficient or corrupt customs service (Guinea, Madagascar, see box

7-2). Requirements for excessive paperwork can have the same result: documentation requirements not only impose the direct cost associated with filling out the forms, but delays in processing may cause imports to pile up on ships or at the docks and exports in company warehouses. This has been identified as a significant problem in Morocco, where the World Bank is sponsoring research aimed at ameliorating the problem.

7.48 Infrastructural inadequacies and lack of important services can interfere with the response to trade reforms and are especially important constraints,

Box 7-2. Constraints to Adjustment to Trade Policy Reform in Madagascar

The recent experience of Madagascar illustrates how the potential salutary impact of trade-related reforms can be much reduced by domestic regulatory constraints.

Foreign Exchange Market

Madagascar introduced a new system to improve the foreign exchange market, but the system, as implemented, is highly inflexible and limited. Foreign exchange requests have to be specified at the ten-digit product classification level and product substitution is not permitted. Average processing time for an application is four weeks — or six weeks if even a minor mistake is made on the application. The system covers only imports of goods, not services. The unavailability of foreign exchange for business travel or for participation in international product fairs has become a major barrier to entry in the export markets. Exchange regulations clearly increase the risks of doing business in an export market. Foreign currency from export proceeds must be repatriated within ninety days of the day of export. Exporters who fail to do so — even for reasons that are beyond their control (theft or damage of merchandise or lack of payment from client) — are subject to prosecution and imprisonment. These regulations are designed to reduce foreign exchange outlays, but their effect is the opposite. Entrepreneurs must establish a foreign exchange buffer fund abroad (by transfer pricing) to cover future risks in the export market or for capital/dividend flight.

Labor Regulation

Restrictions on closing down public as well as private enterprises result in continued operation of a number of unprofitable firms, while deterring entry and expansion by others. Government permission is required for the release of employees, even temporarily. Laws prohibit firms from closing

if this would result in the firing of permanent employees. Closure is further circumscribed by the banking system, as firms with outstanding loans cannot close without the agreement of their creditor.

Import Tax Administration

While import taxation has been reformed and export procedures simplified, the positive effects of the reforms are obstructed by inefficiencies in tax administration and corruption in the customs service. Most firms surveyed claimed that customs employees will only work if paid directly by the importing or exporting firm. Rent-seeking is fueled by the numerous formalities of customs and the excessively heavy documentation required for temporary admission (fifty-one documents that need to be stamped and verified three times, on average). Exporters normally employ a specialized firm to deal with customs requirements, at a fee equivalent to about one percent of the value of the export. Some exporters use their own employees for this purpose, which requires three days of full-time work by one employee for a normal merchandise expedition. Large-scale customs tax evasion is also widespread; for example, the Ministry of Commerce imports free of import duties on a regular basis. Such practices partly explain why the nominal import tariff in 1987 was about 35 percent while the actual tariff collection rate did not reach 10 percent.

Infrastructure

In addition to these policy-created constraints, a survey of industrialists found that poor infrastructure was a concern. In particular, the respondents cited poor road maintenance, the condition and administration of the ports, the poor telecommunications system, and the scarcity of industrial buildings as constraints to entry.

Source: AF3 department.

especially in many low-income countries. In many instances, publicly owned utilities provide very inefficient service, imposing large costs on businesses and forcing businesses that can afford them to install their own electric generators, water supply systems, and communication equipment. One study in Nigeria found that virtually all firms were hooked to (and paid for) the public power grid, although every one with more than twenty employees had its own generator.¹⁴ In some countries, fewer than 20 percent of all telephone calls and 10 percent of international calls are completed. Lack of road maintenance increases costs to vehicle owners and shippers (by up to 50 percent on paved roads and even more on unpaved roads). Adjustment to international competition is made more difficult by these added costs. Human infrastructure is also deficient in many respects. Hostile policies toward the private sector in general and middlemen brokers in particular in the past discouraged the development of entrepreneurial talent. For this reason, in Guinea new private investment remains very weak, notwithstanding significant reform of the trade regime. Education in some countries has been concentrated too heavily on upper levels, providing a labor pool mismatched to job opportunities. These factors also impede adjustment. Correction of these problems will require major changes in official policies and attitudes, and considerable time.

7.49 The importance of domestic market distortions suggests that action to remove them or reduce their incidence and severity should accompany the introduction of trade policy reforms. A recent assessment of the World Bank's role in promoting competition concludes that policy dialogues with developing countries have not sufficiently emphasized the role of domestic regulatory barriers in adjustment.¹⁵ The Bank's lending operations (including adjustment lending and lending to industry through financial intermediaries) have emphasized the importance of import competition but have neglected the influence of industrial regulatory policies. For example, only 2 percent of adjustment operations have included specific conditions related to entry and exit policies. Yet the evidence suggests that policy action in the area of trade reform should, whenever possible, include a consideration of domestic regulatory reform.

7.50 In practice, however, political considerations and administrative capacity greatly constrain what can be achieved in a given time (chapter 4). Thus, some trade reforms will precede some domestic reforms and vice versa, but most of these choices have their attendant costs. For example, if domestic investment and price controls are removed before trade is liberalized, new investment and expanded production may occur in highly protected sectors, making it more difficult to reduce this protection when trade policy reforms are introduced. The economic cost will be even greater if there are economies of scale in the industry but new high-cost plants of suboptimal scale are established. Similar considerations apply to infrastructure. New investments and other measures to expand and improve infrastructure that are undertaken before trade liberalization takes place may not be appropriate for the patterns of production and demand that emerge after liberalization. However, when trade liberalization precedes actions to extend and improve infrastructure and services such as ports, roads, railways, electricity, and telecommunications, infrastructure deficiencies can slow down the desirable reallocation of resources.

7.51 Despite these difficulties, there are many regulatory reforms and infrastructure improvements that can increase economic efficiency in both the prereform and postreform periods; for example, actions to increase competition in domestic finan-

cial markets and to facilitate exiting and restructuring of firms. To some extent, it may also be possible to design current domestic policies that will support future trade liberalization. But such policies may be difficult to implement, especially if it is uncertain whether and when previously announced future trade measures will be introduced. Furthermore, it is extremely difficult to predict the new pattern of production that will develop after a substantial liberalization. In many cases, large industries have emerged that did not exist before reform or existed only in embryonic form (for example, fresh fruit exports in Chile or cut flowers in Mexico). Korea and Taiwan have many industries based almost entirely on foreign demand (for example, the wig, cutlery, fur, and color television industries in Korea). Because of this unpredictability, it is difficult to institute the required complementary domestic policies or to make appropriate complementary infrastructure investments until the need becomes manifest following the trade policy reforms. For this reason, there are advantages in implementing both domestic regulatory and trade reforms concurrently.

7.52 These uncertainties make it unwise to postpone trade policy reforms until all the domestic reforms and infrastructure investments expected to be required are in place. (Furthermore, arguments of this kind may be used to postpone trade liberalization indefinitely.) A similar argument can be made against delaying domestic regulatory reform. If internal sector reforms are postponed until after trade liberalization occurs, then industry avoids adjustment to a more competitive environment. The transition from a protected to a more open regime may be smoother if firms are exposed to domestic competition while or before trade barriers are reduced.

7.53 It is also sometimes argued that trade liberalization should await the success of policies aimed at making domestic industries "internationally competitive." A basic problem with this argument is that every industry cannot become internationally competitive. A general trade liberalization by definition will lead to the contraction of some industries and the expansion of others — even if at some sufficiently devalued exchange rate, all of them would appear to be "internationally competitive." Furthermore, if an economy is starting from a situation of greatly dispersed effective protection, all existing industries will not pass this test. If this condition had to be met, trade liberalization would never take place, or it would consist only of the liberalization of imports competing with the country's lowest-cost industries, with high protection remaining for the least competitive. Such a "cost plus" criterion for protection is the opposite of neutrality and is incompatible with any trade reform aimed at improving the country's ability to benefit from the opportunities presented by international trade.

7.54 Finally, there are practical political arguments for initiating reforms wherever possible. Trade liberalization undertaken in advance of domestic reforms can help create the effective demand and mobilize political support for domestic reforms that might not otherwise be feasible to introduce — even if their need could be foreseen. For example, in a typical import-substitution regime with high protection of manufacturing and discrimination against exports and agriculture, there may be little demand for expanded and improved transport and communication services, technical education, or banking, accounting, international marketing, extension, and other services required by manufacturing firms and agricultural industries. Once the trade reforms occur, however, the bottlenecks and

deficiencies may become obvious and urgent and generate pressures from interested groups to remedy them. Conversely, however, insofar as domestic regulatory reforms reduce costs and improve industrial performance, resistance to allowing import competition may decline.

7.55 All these considerations taken together argue that it is counterproductive to seek a unique prescription that all trade reform should precede internal sector reform, or vice versa. Rather, they should be viewed as complements. As the reform process advances, specific trade and internal policy changes that are highly complementary should be made simultaneously.

1. A recent review of infant industry arguments is given by G.M. Grossman, 1989, "Promoting New Industrial Activities: A Survey of Recent Arguments and Evidence," prepared for Economics and Statistics Department, OECD, Paris.
2. From 1965-80, GDP growth averaged 9.5 percent per year. From 1983 (the year of the second structural adjustment loan) to 1987, growth averaged about the same. Following the completion of the second phase of adjustment (1985), GDP grew 11.9 in 1986 and 11.1 percent in 1987. See World Bank, 1988, *World Development Report 1988*, Washington, D.C.; and World Bank, 1988, *Adjustment Lending: An Evaluation of Ten Years of Experience*, Policy and Research Series No. 1, Washington, D.C., pp. 79 and 92.
3. M. Michaely, A. Choksi, and D. Papageorgiou, 1989, "The Design of Trade Liberalization," *Finance and Development* 28, no. 1 (March):2-5.
4. These and other gradual methods of removing import quotas are discussed in W.E. Takacs, 1982, *Alternative Transitional Measures to Liberalize Quantitative Trade Restrictions*, UNDP/World Bank Trade Expansion Program Occasional Paper No. 3, Washington, D.C.
5. The Public Economics Division (CECPE) is developing a unified framework for integrating trade and domestic tax reform.
6. See Z. Shalizi and L. Squire, 1986, "Tax Policy for Sub-Saharan Africa," Country Policy Department, Resource Mobilization Division, World Bank, Washington, D.C.; and the background paper for this report by R. Chambers, 1989, "Tariff Reform and the Uniform Tariff," Trade Policy Division, Country Economics Department, World Bank, Washington, D.C.
7. However, if different productive sectors are taxed at different rates by non-tariff measures, the optimum tariff structure may be one that places a lower tariff on sectors that are taxed the most with other instruments. In Ghana, one study found that because of other taxes, a uniform import tariff of 30 percent would result in rates of effective protection varying from 0 to 50 percent. See Shalizi and Squire (1986, op. cit.). In cases like this, it is particularly important to coordinate reforms of the domestic and trade tax systems.

Other constraints may prevent a country from achieving a uniform structure. For example, when for political or other reasons the protection for local producers must be higher than would be provided by a low uniform rate, the desirability of uniformity may need to be balanced against the capability of the customs administration to control smuggling and corruption. If noncompeting intermediate inputs are subject to low or zero tariffs, a desired level of effective protection can be given to domestic producers with relatively low final-product tariffs. But if input tariffs are higher — especially if all tariffs are uniform — the final-good tariffs required to achieve the desired level of effective protection must also be higher.
8. A. Rajaram 1989, "Tariff and Tax Reforms: Do Bank Recommendations Adequately Integrate Revenue and Protection Objectives?" Public Economics Division, World Bank, Washington, D.C.
9. If a duty waiver system is in effect for exporters, the distortionary effect can be eliminated entirely by raising input rates to a level higher than the final-good rate. See A.C. Harberger, 1988, "Issues in the Design of Tariff Reform," Trade Policy Division, World Bank, Washington, D.C.
10. This is likely to be the case for at least two reasons. First, in many developing countries, a large number of intermediates are not produced domestically. Second, the basic principle of comparative advantage indicates that import substitutes are likely to be intensive users of the same or similar resources as imports, rather than of the resources used by exports.
11. See A.C. Harberger, 1974, "Notes on the Dynamics of Trade Liberalization," prepared for a Conference on Trade Liberalization, Santiago, Chile (October).
12. See D. Hachette, 1988, "Chile: Trade Liberalization Since 1974," paper prepared for Conference in Sao Paulo, April 1988, World Bank, Washington, D.C.

13. For an analysis and application to Bangladesh, Korea, Thailand, and Venezuela, see C.S. Tolley, V. Thomas, and C.M. Wans, 1982, *Agricultural Price Policies and the Developing Countries*, Baltimore, Md.: Johns Hopkins University Press.

14. World Bank, 1989, "The Long-Term Perspectives for Sub-Saharan Africa: a Strategy for Recovery and Growth," Washington, D.C.

15. See Industry Development Division, World Bank, 1989, "Competition Policies for Industrializing Countries," Section IV.

8 EXTERNAL CONSTRAINTS AND OPPORTUNITIES

Summary and Conclusions

8.01 Declining tariff rates, expanding international markets, and preferential arrangements for some countries have provided new trade opportunities for developing countries in recent years. However, rising protectionism in industrial countries in the 1980s has adversely affected developing countries export prospects. Many developing countries have a major incentive to participate in the Uruguay Round of multilateral trade negotiations, but there are important differences in the bargaining power and the interests of various countries. Many fear that unilateral trade policy reforms would prejudice their negotiating positions. Unilateral reformers could in theory reduce tariffs while also binding them at higher levels, which would maintain their bargaining position in GATT negotiations. However, this strategy implies a threat to raise tariffs back to their bound level, which may hurt the credibility of the tariff reform or, conversely, may be met with skepticism if, for example, the country has a commitment to the World Bank to maintain low tariffs. Consequently, an unambiguous clarification is needed by negotiating parties in the GATT that unilateral reforms will be credited in the negotiations. In the meantime, economic arguments suggest that developing countries should continue to liberalize unilaterally. Industrial countries should reduce their trade barriers.

8.02 In the past, the potential for expanding trade with neighbors has led countries to form regionally integrated groups. The benefits of these schemes are most likely to be realized when integration takes place among countries with complementary but dissimilar production conditions in goods they can produce efficiently, provided they are accompanied by large tariff reductions and only modest regional preferences. In practice, few integration schemes have been carried out along these lines, and the benefits have proven to be illusory. The biggest gains from integration will come not from direct trade policy measures, but from steps such as cooperation to develop physical and human infrastructure and services. Any formation of customs unions should be based on lowering external barriers to extraregional trade.

External Factors Affecting Trade Policy

Changes in External Protection

8.03 External factors have a strong influence on trade policy in developing countries. Perceptions concerning changes in protectionism abroad affect the attitudes of developing countries toward domestic trade policy reform. While economic analysts may argue that protection in export markets does not affect the gains from increased trade, higher trade barriers make production for the domestic market more attractive politically while international liberalization increases the attractiveness of outward-oriented trade reforms. Over the last three decades a major, positive external factor has been the general reduction of developed country tariffs. The average most-favored-nation tariff in developed countries has been progressively lowered through a series of multilateral negotiations from approximately 40 percent in the late 1940s to under 5.5 percent today. Another strong stimulus for outward-oriented trade policy reforms was the high growth rates in the OECD

countries over most of this interval, which generated a strong and persistent demand for developing country imports.

8.04 While tariffs have been steadily reduced, nontariff barriers have assumed increased importance.¹ Overall, the proportion of developed country imports affected by nontariff barriers nearly doubled over the 1966-86 period (table 8-1). Foodstuffs recorded one of the largest increases for a major product sector: over 90 percent of OECD imports of foodstuffs are now affected by some type of nontariff barrier.

8.05 Aside from the impact on trade levels, external protection can influence the composition of developing countries' trade. For example, the structure of tariffs and other trade barriers in major industrial country markets is frequently biased against imports of processed goods relative to unprocessed goods, thereby working against domestic processing in developing countries. While low tariffs are generally applied to industrial countries' imports of primary (unprocessed) commodities, duties increase as the product undergoes increased fabrication. Such tariff escalation is sometimes reinforced by nontariff barriers as well.

8.06 Protectionism and subsidization of exports (particularly of primary agricultural products) in industrial countries has a major impact on international markets that can invoke a trade policy response by developing countries.² For example, high domestic price support policies for such products as sugar, dairy, beef, and veal in the United States, Japan, and the European Community (EC), coupled with export incentives and restrictive trade barriers, have had a destabilizing and depressing effect on world prices. Domestic producers in developing countries, who could compete with foreign agricultural goods under freer markets, may be uncompetitive because of the influence of such external factors. This problem is particu-

Table 8-1 Trade Indices for Major Product Groups Affected by Nontariff Barriers in Developed Countries (1966 index expressed as percentage of imports affected by nontariff barriers; 1966-86 change in percentage points)

Country	All foods		Agricultural raw materials		Fuels		Ores and metals		Manufactures		All goods	
	1966 index	1966-86 change	1966 index	1986-86 change	1966 index	1966-86 change	1966 index	1966-86 change	1966 index	1966-86 change	1966 index	1966-86 change
All countries	56 ^a	36	4	37	27	0	1	22	19	39	25	23
European Community	61 ^b	39	3	24	11	26	0	40	10	46	21	33
Finland	na	(70) ^c	0	55	67	28	4	-1	8	20	15	36
Japan	73	26	0	59	33	-5	2	29	48	2	31	12
Norway	43	52	3	13	0	0	0	15	38	-16	31	-8
Switzerland	53	37	4	51	0	99	0	9	15	24	19	31
United States	32	42	14	31	92	-92	0	16	39	32	36	9

na = data not available.

Note: The table shows the value of trade "affected" by nontariff barriers. The "affected trade" concept holds that a nontariff barrier applied to one or more tariff lines within a four-digit SITC group affects all trade in the group since exporters often modify trade to halt the spread of barriers. See Laird and Yeats for a list of nontariff barriers included in these tabulations.

a. Finland, Greece, and Ireland are excluded from the totals since complete information on their agricultural trade barriers was not available in 1966.

b. Ireland and Greece are excluded from the EC totals since complete information on their agricultural trade barriers was not available in 1966.

c. Since 1966 data are not available, the figures are the actual share of trade affected by nontariff measures in 1986.

Source: S. Laird and A. Yeats, 1988, "Nontariff Barriers of Developed Countries, 1966-1986," *Finance and Development* 25 (March):12-13.

larly acute in the case of sugar. Extensive export subsidies have often pushed world prices below the costs of production in the Dominican Republic and other efficient Caribbean countries. Under these conditions, Caribbean producers would be displaced in their own domestic market by foreign (subsidized) exports if their governments did not restrict sugar imports. Recent evidence suggests that the nontariff trade control measures in developing countries frequently applied to foodstuffs (variable levies, licensing arrangements, or minimum import prices) are often intended to shield domestic markets from this induced external instability.³

8.07 Analyses of developing country goods subject to nontariff barriers suggest why so many developing countries have a major interest in achieving progress on liberalization of agricultural trade barriers under the Uruguay Round. One study tabulated the total value of thirty-one food exports from developing countries to the EC and computed the value and share of this trade subject to major forms of nontariff barriers.⁴ Approximately one-third of Argentina's agricultural exports were found to be subject to quotas and variable levies, while over 90 percent of those of Barbados, Botswana, Colombia, Mauritius, and Uruguay face similar barriers. Projections by Valdes and Zie'z indicate that developing countries experience large export revenue losses as a result of such barriers, with the rural poor experiencing the greatest direct immediate economic impact.⁵ The gains from eliminating all barriers — to agricultural and manufactured — products would be even greater than from eliminating only those on agricultural products, of course. Finger and Messerlin,⁶ citing other studies, estimate that elimination of developed country trade restrictions could increase developing country exports by 10 percent⁷ and GNP by 3 percent⁸ (4 percent for manufactured exports and 2 to 2.5 percent for others).⁹ As Finger and Messerlin point out, these estimates are conservative.

Discriminatory Trade Measures

8.08 Some trade-restraining measures are applied in a discriminatory manner to exports of a specific developing country or group of countries. Some of these, such as "voluntary" export restraints, quotas (bilateral or global), and international commodity agreements, often require developing country complicity (contrary to GATT article XIII) in adopting measures that limit the supply or control the price at which goods are traded. In addition, these restrictions are often accompanied by measures aimed at upgrading the quality and cost of the affected product in order to increase export revenues or to divert trade to markets not covered by the restraint arrangement.

8.09 Voluntary export restraints are typically quantitative restrictions that have been negotiated bilaterally and are enforced by the exporting country's government. These "negotiations" generally involve some implied threat by the importing nation's government that it will apply more restrictive trade control measures unless agreement is reached on the voluntary export restraint. World Bank tabulations show that voluntary export restraints (excluding the Multifibre Arrangement) constituted, on average, the most important of sixteen categories of nontariff barriers in 1986. In the United States, for example, 14.5 percent of U.S. imports were affected by voluntary export restraints, which is more than four times higher than the next most significant nontariff barrier. In the EC countries, the percentage of imports affected by voluntary export restraints was 7.2 percent, second only to nonautomatic authorizations.

8.10 Garment and textile exports from developing countries are restricted by an enormously complex system of bilaterally negotiated voluntary export restraints under the Multifibre Arrangement.¹⁰ This framework, although encumbering, does have several aspects that mitigate its adverse impact on developing countries. It allows countries to establish themselves as exporters of textile products before being hit by quotas, which are subject to predictable rules and international scrutiny. The quotas transfer many billions of dollars of quota rents from consumers in North America and Western Europe to efficient producers organized to capture these rents, helping them finance investments in promising exports. The quota system creates pressures to diversify exports both within and away from textile products, thereby accelerating the learning associated with exports. The system causes established firms from leading developing economies to set up production in other developing economies before they are seriously restricted by quotas. China attained rapid export growth despite the quota system and has become one of the biggest exporters of textiles and garments.

8.11 The negative aspects of the Multifibre Arrangement also loom large. Populous, low-income developing countries outside Africa are all now subject to slow-growing quotas. The system becomes ever more restrictive and has been extended to additional products and fibers. The system favors imports from developed countries over those from developing ones and safeguards the exports of major, established developing country suppliers at the expense of new suppliers. It thus prevents creative changes in market shares through open competition. The bilateral quota agreements oblige governments to allocate quotas among firms, a process that is inherently arbitrary, and to monitor and regulate exports of textile products in great detail. Usually the bulk of the quota is given out on the basis of previous exports while the allocation of the rest is contested.

8.12 Special developed country tariff provisions also influence trade policies and reforms in developing countries. One type of measure includes the Generalized System of Preferences (GSP) and related schemes such as the EC's Lomé Convention and the U.S. Caribbean Basin Initiative. Under these schemes, goods from developing countries are imported at lower than most-favored nation rates. Each program has its limitations, such as value limits or applicability only to certain commodities. Nonetheless, exports receiving GSP treatment have increased four-fold since 1976, the first year in which all 16 current GSP schemes were in operation, and exceeded US\$50 billion in 1988.¹¹ A second type of measure relates to offshore assembly provisions that allow domestically produced components assembled abroad to reenter the country under tariffs that apply only to the value added. The EC also has established similar beneficial tariff provisions for many intermediate goods. Developing countries, on their part, have adopted trade reforms to effectively utilize such external incentives. These have included development of required infrastructure and liberalization of barriers facing production inputs. Also, some developing countries have attempted to utilize offshore assembly provisions by establishing export processing zones and supportive trade policy measures, while others have enacted reforms that enable domestic producers to take better advantage of existing preferential trade arrangements.

8.13 For countries liberalizing their trade regimes, there are strong reasons to participate fully in the GATT. Hudec has identified at least four ways that GATT obligations can have a positive influence on trade reforms in developing countries.¹² First, respect for international legal obligations can strongly influence the position of some government officials on trade reforms, especially those new to the process or otherwise undecided. Second, international legal obligations can serve as an acceptable public explanation for decisions taken for other reasons that might be difficult to defend politically. Third, international legal obligations may be a concise way of defining the bounds of policy for government officials. Liberal trade policy might not fare too well if every new administration were permitted to review the case for free trade, especially in the context of new political obligations to their constituency. Fourth, international legal obligations can be an effective warning against investing too much in trade-distorting measures and can provide effective ground rules for making trade, investment, and production decisions. In addition, these obligations would almost certainly raise the cost of reversing policy reform measures and therefore gives them added credibility.

8.14 Several Uruguay Round negotiating groups and special GATT committees have been established to deal with the trade policy issues that are of major concern to developing countries. It is important that developing countries make effective use of these arrangements and help to ensure that the negotiations take their interests into account. If developing countries emerge from the multilateral trade negotiations with the belief that their interests have been generally neglected, this could increase their incentive to negotiate bilateral deals or to adopt trade and production policies geared toward the (more secure) domestic market.

8.15 Several factors influence a country's relative preference for multilateral, bilateral, or unilateral trade reforms and the ability to effectively utilize GATT arrangements. These factors include differences in relative bargaining power and differences in the effects of external protectionism on individual countries. Also important are how the issue of credit for unilateral reform is resolved and how developing countries perceive the costs incurred in joining the GATT.

Differences Among Developing Countries in the Negotiations

8.16 A major influence on a developing country's position in trade negotiations is its relative importance in world trade. Thus, the newly industrialized economies will be under major pressure from industrial countries in the multilateral trade negotiations to act as full participants¹³ because of their importance in world trade. For example, in 1987 the value of exports of manufactured goods to developed country market economies from the Republic of Korea (US\$33 billion); Hong Kong (US\$21 billion); China (US\$14 billion); Mexico (US\$14 billion); and Brazil (US\$9 billion) exceeded that of OECD countries like Denmark and Finland (about US\$12 billion); Norway (US\$6 billion); or Australia (US\$4 billion). Also, several of the newly industrialized economies have been running large and persistent trade surpluses with developed countries, which has been a major point of contention. In 1987, for example, the Republic of Korea ran a total surplus on all goods that exceeded US\$6 billion, while the trade surplus of Taiwan, China, was about US\$21 billion. These imbalances have led developed countries to put direct economic

pressure on them to negotiate bilateral deals and to participate fully in the international negotiations. The implication is that the developed countries will request that these newly industrialized economies reduce import barriers in the same way as other developed countries.

8.17 Newly industrialized economies like Argentina, Brazil, Mexico, and Korea are among the economies that have been most frequently subject to antisubsidy action in the 1980s.¹⁴ Their export products are also among the goods most heavily affected by various forms of nontariff barriers. This should be an added incentive for them to enter fully into the multilateral trade negotiations on nontariff barriers.

8.18 In contrast, some other developing countries appear to have less to gain from full participation in the GATT. These countries usually are very poor (hence eligible for trade and aid preferences), figure insignificantly in world trade¹⁵ (and therefore are not subject to discretionary protection), and are exporters of primary products that do not compete directly with OECD products. While they would benefit from market-opening reforms by the newly industrialized countries, their major direct interest in the negotiations may be to protect the preferences they receive and to ensure that they are compensated if the value of the preferences is eroded by cuts in most-favored-nation tariffs. Domestic supply-side constraints are normally far more important than external trade barriers in determining the exports of these countries. All these considerations argue that, for these countries, immediate unilateral reform should receive priority over waiting for multilateral negotiations.

8.19 Developing countries whose major concerns relate to agricultural trade barriers may need to rely on somewhat different strategies to effectively exploit the multilateral negotiations than do developing countries concerned primarily with manufactured goods. Size is one important factor, since the value of agricultural exports from individual developing countries is quite small. For example, foodstuff exports from Argentina, India, Malaysia, Mexico, or the Philippines range from US\$1 to US\$3 billion, which is exceeded even by Denmark, at US\$6.4 billion. Countries such as these would not appear to have sufficient leverage to extract meaningful agricultural concessions unless some new negotiating positions or coalitions are formed. Indeed, even developed countries like Australia and New Zealand essentially withdrew from the Tokyo Round negotiations because of the failure to make any progress on agricultural issues. More recently, a major positive effort to advance serious negotiations on agriculture has come from a coalition of developed and developing countries known as the Cairns group. When this issue was stalemated at the December 1988 Montreal ministerial meeting, pressure from Cairns group members was instrumental in forcing discussion on a possible compromise between the EC and the United States.

Other Influences on Unilateral versus Multilateral Approaches to Reform

8.20 Aside from these broad policy issues, there are several more specific problems that can have a major impact on developing countries' views of the relative merits of unilateral versus multilateral approaches to trade reforms. Among these are the "credit" issue (that is, the extent to which developing countries can use

previously enacted trade reform to negotiate concessions from other parties), the value of tariff bindings in the negotiations, and the perceived costs of joining the GATT.

8.21 One key question is whether the unilateral liberalizations that have recently occurred in a number of countries will prejudice their bargaining position in the Uruguay Round negotiations. The concerns of developing countries on this issue have been sufficiently important that a statement was issued at the Montreal ministerial meeting that they should receive "appropriate" credit for such past unilateral trade reforms. The statement was so vague, however, that it failed to clarify key questions. Box 8-1, overleaf, illustrates some of the problems relating to this point and also indicates the kind of information needed to make an informed decision on unilateral versus multilateral approach.¹⁶ Unfortunately, because of different concerns during past multilateral trade negotiations, much of the required information is missing or incomplete.¹⁷ Based on the criteria explained in box 8-1, however, it is clear that countries with little bargaining power or facing relatively low external barriers to their exports (most Sub-Saharan African countries fit both categories) have little to gain from waiting. For other developing countries, preliminary evidence points in favor of the unilateral approach as well; projections indicate that the economic losses resulting from their own trade barriers exceed those from external barriers.¹⁸ One point is very clear: if credit is given for unilateral action, there is nothing to be gained from deferring reform.

8.22 An issue related to the credit question concerns the value of tariff bindings in the multilateral trade negotiations. Finger and Holmes argue that legally binding tariffs were a major objective in previous multilateral negotiations and that such legal bindings were used to extract reciprocal concessions.¹⁹ If the same importance is attached to legal bindings in the Uruguay Round, developing countries could adopt unilateral tariff reforms at any time and then offer to legally bind these reductions in the multilateral trade negotiations. If these bindings are viewed by trading partners as major concessions, this strategy will resolve the credit issue. When Mexico acceded to the GATT, it bound its top rate at 50-percent. Even though its actual top rate is currently 20 percent, it may use the 50 percent rate as the basis of future negotiated reductions. But developing countries' potentially easy recourse to Article XVIII, which has been used to justify trade barriers for balance of payments purposes, could reduce the value of such bindings.

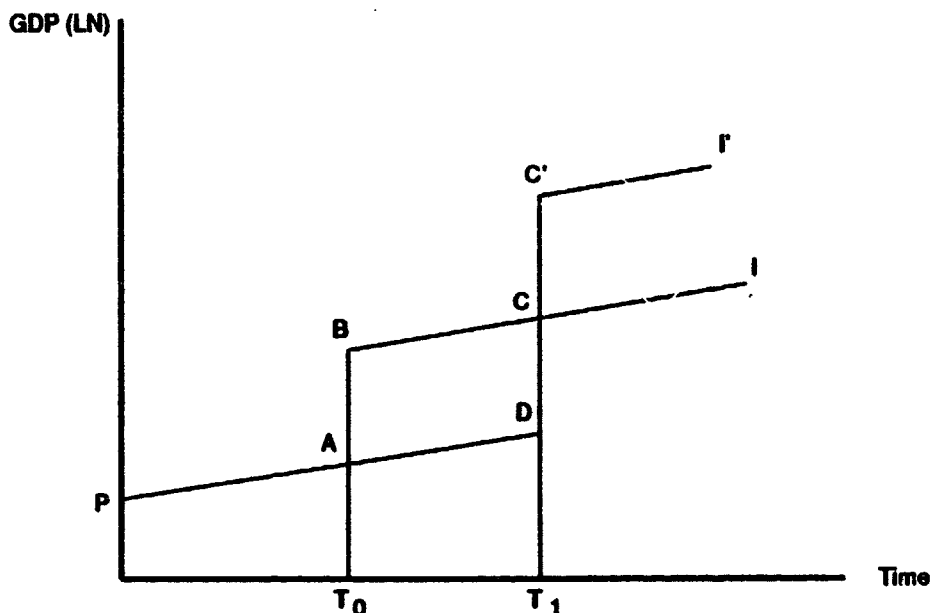
8.23 Another potentially important influence on developing countries' views of unilateral versus multilateral trade reforms is the perceived extent of obligations that will be incurred in joining the GATT. There is some indication that new developing country entrants face more extensive obligations than did developing countries that joined earlier.²⁰ Perhaps even more important would be a shift from what many see as GATT's "no-obligation" policy toward developing countries to a policy requiring acceptance of roughly the same obligations as those imposed on developed countries.²¹ The elimination of developing countries' ability to impose restrictions based on justifications not available to other GATT signatories would limit policy options, but it would also make accession to GATT a more credible signal of the future direction of trade policy, as well as helping to resolve the credit issue by increasing the value of "bindings."

Box 8-1. The Gains from Unilateral and Multilateral Liberalization of Trade Barriers Under Alternative Time Paths

The following chart illustrates some of the key parameters that can influence the decision to pursue unilateral liberalization or

to wait for multilateral negotiations. The lines in the graph show the time path of the natural logarithm of GDP growing at a con-

The Gains from Unilateral and Multilateral Liberalization of Trade Barriers Under Alternative Time Paths



Source: J. Nogués, 1989, "The Choice Between Unilateral and Multilateral Trade Liberalization Strategies," Policy Planning and Research PPR Working Paper No. 230, Washington, D.C.: World Bank.

Foreign Direct Investment

8.24 Historically, outward-oriented countries have encouraged and benefited from foreign direct investment (FDI). FDI has had important benefits in improving access to export markets, transferring technology and management skills, training the labor force, creating employment, and increasing productive efficiency and competition. A study found that foreign majority-owned firms in Mexico were most efficient in eighteen of forty-one sectors in which they competed, with the reverse true in only two sectors.²³ These benefits may be mitigated, however, if not entirely offset, when the investment "tariff hops" into heavily protected sectors or takes place in response to some other artificial incentives. Consequently, FDI is most effective in promoting growth in economies characterized by relatively liberal trade regimes.

stant rate. At time T_0 , a decision needs to be made to liberalize or wait until time T_1 , when a multilateral agreement will be negotiated. Waiting involves a true cost (in losses of domestic economic efficiency) and an uncertain benefit (the country cannot be sure what it will gain in the multilateral negotiations). Two specific types of gains are represented in the graph: the shift from A to B at T_0 represents the efficiency gains (increase in GDP) associated with the unilateral liberalization; the shift from D to C' at T_1 represents the efficiency gains plus the gains from the increased market access associated with participation in the negotiations. Two key assumptions are made: that the unilateral and multilateral liberalizations are equal whether done unilaterally or multilaterally and that the country receives no credit for its unilateral liberalization at time T_1 in the multilateral negotiations.

The net economic return of a multilateral liberalization strategy is given by the difference between the present value (at time T_0) of (1) the area ABCD and (2) the gain CC' carried out to infinity. If the former is larger, the unilateral approach is optimal in an economic sense, and if the latter is larger, than the multilateral approach is optimal. Although simplistic, the graph indicates several key points about the economics of the unilateral versus multilateral liberalization approach:

- The credit issue can be of key importance: the greater the credit for a unilateral reduction the stronger the economic argument in favor of a unilateral reduction. If full credit is given, the gains for a country liberalizing at time T_0 would be the present value of ABCD plus CC'TI to infinity. In this case, the unilateral strategy is clearly optimal.

- Another key factor affecting the economics of the liberalization decision is the relative costs to the country of its own trade barriers (AB) versus the costs of other countries' barriers to its exports (CC'). The greater the relative cost from other countries' trade barriers, the more likely the country will favor a multilateral approach.

- A country's bargaining power and the amount of concessions it can extract from other countries are uncertain, so holding off until T_1 is something of a gamble, particularly when the country has a relatively good idea of the immediate gains from a unilateral liberalization.

- The time until the multilateral agreement may be important since the country may have an incentive to hold off a unilateral liberalization if the time between T_0 and T_1 is small.

- The discount rate is a factor influencing the present value of present (unilateral) versus future (multilateral) gains. The higher the interest rate the greater the incentive for a unilateral liberalization.

8.25 Interest in FDI has been renewed recently as a potential source of finance to replace commercial bank lending. However, its benefits in this respect are not as large as sometimes thought; net foreign exchange flows from FDI to nonoil developing countries in 1987 were only SDR3 billion. In 1984-87, four developing economies (Brazil, China, Mexico, and Singapore) accounted for 60 percent of FDI in developing countries. Other economies such as Hong Kong, Indonesia, Malaysia, the Philippines, and Thailand have historically relied upon FDI for a significant share of their total investment. The distribution of FDI among countries as well as among sectors has varied substantially over time. Much of the volatility of such flows results from fluctuations in the oil market. For nonoil developing countries, gross FDI peaked in 1981 at SDR15 billion then fluctuated at around SDR11 billion in 1982-86 before recovering to SDR14 billion in 1987. Gross FDI flows to all developing countries peaked at SDR25 billion in 1982, then fell to SDR13 billion in 1987.

8.26 The most significant factor in encouraging FDI is domestic economic and political stability. This has been the cornerstone of East Asia's success in attracting FDI, while failure to maintain macroeconomic stability was a key factor in the decline of FDI in Brazil in the 1980s. A second set of important factors relates to general protection of property rights (including intellectual property rights, particularly for high technology industries) and respect for private sector activities. Fears of pressure to indigenize ownership or of outright nationalization discourage prospective investors. Regulations governing FDI should be transparent and stable. It is particularly important to allow liberal access to foreign exchange for profit remittances and imported inputs. Policies that create a good climate for investment in general are likely to be superior to special incentives for FDI, such as tax holidays, which may attract "footloose" industries that leave when the holiday is over. One special incentive — debt/equity swaps — may be worthwhile and has apparently played a role in increasing FDI in some countries, notably Mexico.²³ However, swaps may have adverse macroeconomic effects, and they are not necessarily better for attracting FDI than the alternative policies discussed above.

8.27 The World Bank Group assists countries in attracting FDI in a number of ways, including supporting programs to reform general economic policies, providing technical advice in attracting the right kinds of investments through the Foreign Investment Advisory Service, and financing projects that act as catalysts for foreign investment. One example is the Pakistan Energy Sector Loan, which opens the door for joint consortia of domestic and foreign firms to build, own, and operate power plants. More direct support has been provided by adjustment loan programs that are aimed specifically at reducing policy-induced disincentives to FDI, such as operations in Indonesia and Mexico. About 40 percent of the International Finance Corporation's operations have been joint ventures between foreign and local sponsors, and the Multilateral Investment Guarantee Agency specializes in reducing risks to facilitate FDI.

Trade Policy Issues in Regional Integration

The Experience with Regional Integration

8.28 Over the last several decades, a large number of schemes have promoted the goal of regional integration or cooperation among developing countries, including about twenty countries in Africa and nearly as many elsewhere. The steps taken by various groups of countries have included cooperation in services and infrastructure (for example, education and training, telecommunications, agricultural research, tourism, marketing, water, and transport development projects), abolition of virtually all trade barriers among members, establishment of a common external tariff, and forging of joint positions in international negotiations. The most recent plan along these lines is an ambitious Global System of Trade Preferences among developing countries that became effective with fifteen signatories in April 1989. Yet, despite the numerous attempts, most of these schemes have fallen apart or failed to achieve their objective, with intraregional trade falling or remaining constant in almost all cases (table 8-2).

8.29 The benefits anticipated from integration, at least from its trade policy measures, are supported by three main arguments. One is the gain that comes from more efficient production when producers specialize in what they can make

Table 8-2 Characteristics of Trade among Members of Selected Economic Integration and Cooperation Schemes

Group	Major trade-related characteristics ^a	Export among members in 1987 (US\$ mils)	Intrascheme exports as percent of total exports					
			1970	1975	1980	1983	1985	1987
Central American Common Market	1,2,7	492	26.8	23.4	22.0	21.8	15.0	11.9
Andean Group	1,2,7	683	2.8	5.4	3.3 ^b	3.5	3.1	3.2
Caribbean Community	1	323	7.3	7.2	6.4	9.3	8.0	6.3
UDEAC in Central Africa	1,2,4	38	3.4	3.9	4.1	2.0	0.7	0.9
West African Ec. Community	2,3,4	383	9.1	6.7	6.9	12.6	8.9	7.7
East African Common Market	5	142	16.9	12.6	7.8 ^b	6.5	6.7	7.4
Economic Community of West African States		885	2.1	3.1	3.9	4.1	4.2	5.5
RCD (Iran, Pakistan, Turkey)		1,305	1.0	0.8	5.3 ^b	8.5	9.9	5.2
Latin American Integration Association	6	8,103	10.2	13.5	13.5	10.2	8.9	11.3
Association of Southeast Asian Nations	6,7	14,529 ^c	14.7	15.7	17.8	23.1	16.8	17.7
Memorandum item: European Economic Community		555,616	48.9	49.4	52.8	52.4	54.9	58.8

a. 1 = Free trade among members; 2 = common external tariff; 3 = redistribution of proceeds from tariff to settle payments imbalances among members; 4 = common currency; 5 = now defunct; 6 = some preferential trade treatment among members; 7 = joint positions in international trade negotiations.

b. 1981.

c. This total and the shares do not include Singapore's very large exports to Indonesia, which are not reported by mutual agreement.

Source: A. Inotai, 1986, *Regional Integrations in the New World Economic Environment*, Budapest: Akademiai Kiado, table 1, p. 44; P. Robson, 1987, *The Economics of International Integration*, London: Allen & Unwin; OECD, *Foreign Trade Statistics*, Paris; IMF, 1988, *Direction of Trade Yearbook*, Washington, D.C.

most cheaply. Another concerns the possibilities for the development of import-substitution industries involving economies of scale, which could not be economically set up in any individual member country but can be justified by the larger regional market. The other is based on the learning and other benefits of competition among the generally high-cost industries already established in countries of the region. Integration is seen as a halfway house on the path leading to the full benefits of trade liberalization and wider markets. Particularly useful in moving toward this goal is the export experience expected to be gained in exporting manufactured goods to other member countries.

8.30 Weighed against these prospective benefits are several disadvantages of integration. One is that the production of regional exports drains resources that could otherwise be devoted to exporting to world markets. Another is the cost of "diverting" trade, that is, importing from high-cost regional producers instead of low-cost international producers when regional tariffs are reduced below extraregional tariffs.²⁴ There are other costs as well, since integration requires complex negotiations that may deflect the time and energies of scarce decision-makers from other pressing tasks.²⁵

8.31 There is no presumption in theory about the outcome of the cost-benefit calculus in integration schemes; this depends on the particulars of each case. The benefits from trade creation will tend to be greater the larger is the reduction of tariffs among members, the more members differ with respect to resource endowment and other factors affecting their cost of producing the goods they can produce most efficiently, and the lower are barriers to intraregional trade (for example, transport cost) relative to barriers to extraregional trade (for example, transport cost, tariff or nontariff barriers). The costs of diversion will tend to be greater the greater the postintegration disparity between intraregional and extraregional tariffs.

8.32 In practice, many of the industries established as a result of integration schemes among developing countries have had high production costs. This factor, together with high regional transportation costs and substantial barriers to extraregional trade, has meant that member countries have often ended up paying a substantial premium over the prices of comparable imports from outside the region. Thus the costs of diversion have been high. Furthermore, the goods and marketing channels employed in trade with neighbors are generally so different from those required for exporting to industrial market economies that the experience is not transferable to exports outside the region. In sum, the expected benefits have failed to materialize, and structural inefficiencies have been created or exacerbated.

8.33 The schemes have floundered on a number of practical problems in implementation as well. The most serious has been payments: how to settle the net balances among member countries when some have inconvertible currencies or severe payments difficulties in their overall trade. Typically, some members have persistently run deficits but have had no means to pay, while others became their creditors and then eventually stopped giving them credit. Balance of payments difficulties have been a main reason for the sharp decline of intraregional trade in the Central American Common Market (CACM). Payment difficulties led to a breakdown of trade in the Andean Group as well and now plague the Economic and Customs Union of Central Africa (UDEAC) despite a common currency.

8.34 Other implementation difficulties have been encountered in integration schemes that have tried to negotiate a structure of uniform external protection with preferential treatment for regional trade. For one thing, many developing countries rely heavily on quantitative import restrictions and foreign exchange controls, making it inherently impossible to find a general formula for assuring partners of systematic preferential treatment. Apart from this, harmonization of tariffs among more and less protected countries at different levels of development not only has required fractious and prolonged negotiation, but also has frequently led to increased protection levels in several member countries. Aggravating these difficulties has been a tendency to view any product made in a neighboring country as a good candidate for national import substitution. As a result of these problems, as well as the chronic balance of payments difficulties of some countries, member states have, sooner or later, increased protection against external trading partners and sometimes against other members. In some cases, the relatively high common external tariff has become an obstacle to later trade liberalization by some members, especially in CACM (Guatemala, Costa Rica) and the Andean Group (Colom-

bia, Bolivia). The net effect of many integration efforts, then, has been a reduction in the level and efficiency of trade.

8.35 A final serious problem with integration efforts has been that industries have gravitated disproportionately to certain countries in the integration groups, generally those with the best-developed industries and infrastructure. This outcome, has, at least in the short run, magnified disparities between countries and created friction. It has also brought about a demand for complex compensation arrangements.

8.36 On balance, integration based on trade policy measures has generated benefits for countries that are already well-developed with generally outward-oriented economies, such as the members of ASEAN and, earlier, the European Community. The countries in these groups have dynamic productive sectors, with products that are competitive on world markets. They are thus able to respond to increased regional trade opportunities. Integration efforts have been much less successful in economies, such as those in many African countries, with a limited product mix and economic agents not accustomed to responding to market opportunities. Thus, in practice, the training ground rationale for integration has been turned on its head: international competition has been necessary to train producers for regional trade, rather than the reverse.

Lessons from Experience

8.37 It is clear that the potential benefits from expanded trade among neighboring developing countries are currently quite limited. Such countries are likely to have similar factor endowments and production costs (relative to potential trading partners among developed countries), generally making the gains from trade small, even under ideal circumstances. These gains are further limited by the poor transportation and communication infrastructures among members. Significant gains from trade may be possible for some products, such as those for which economies of scale are important and which can be produced regionally at a cost that is competitive with imports, bulky items for which high transport costs make importation from outside the region relatively expensive, or products whose exports to traditional markets are artificially limited. But overall, the biggest gains from enhanced trade opportunities will come not from regional trade but from broader external trade.

8.38 Two important corollaries follow from this conclusion. The first is that other measures should generally be used instead of trade policy to move toward greater regional cooperation or integration. Recent efforts have emphasized steps to increase factor (mainly labor) movements or to improve the infrastructure linking member countries. In the Middle East, for example, plans are being made to link national electrical grids to improve reliability. Some joint water supply projects are also being planned. In regions such as Africa, where individual country markets are too small to support efficient construction firms, coordination of public sector procurement regulations would encourage the development of firms serving regional markets. As a natural byproduct of such coordination, improved infrastructure and factor movement will support the expansion of both interregional and intraregional trade by eliminating some of the major bottlenecks. Another

potentially beneficial use for cooperative arrangements is to forge unified positions and increase leverage in negotiations with other countries. The members of ASEAN have used their association in this way (although not in GATT negotiations).

8.39 The second corollary, equally important, is that in the trade policy area, the top priority of any integration effort must be to emphasize outward orientation and trade creation, rather than diversion. This generally requires making all members' currencies convertible. It may also involve reducing existing artificial nontariff impediments to neighbor markets (for example, regulatory requirements and paperwork). In some cases, there is considerable scope for this kind of action. Some African countries have easier access to the EC markets than to neighboring African ones. Up to seventy administrative steps are involved in legally moving goods across some African borders.²⁶ But above all, the integration should accelerate, or at least should not interfere with, liberalization of member countries' trade policies and reduction of their external trade barriers. (The CACM has recently made explicit that member countries are not constrained by their commitments to CACM in reducing external barriers.)

8.40 This implies that if the goal is a common external tariff, the target should be set at approximately the level of the least protective member, rather than that of the most protective, as was the case in some schemes in the past.²⁷ This level should be reduced over time, while the levels of the more protective members should decline faster, in order to eventually catch up. If any preference is granted to members, it should be modest, on the order of 10 to 20 percent, and should be reduced according to a preannounced schedule.²⁸ This would allow the realization in a temporarily protected environment of the potential gains from learning, while limiting the potential losses from excessive protection and trade diversion. The regional integration, in other words, should be viewed as a transitional stage in a process of integrating all the member countries into the world economy. The end result would be uniformly low barriers to trade, with no preferences for member countries. This goal should be announced at the beginning of the process and a reasonable schedule (no longer than, say, five to seven years) set to reach it. This kind of agreement would be hard to negotiate, especially because some economies (the most protected) must adjust more than others. In a situation where countries are more willing to undertake a liberalization program as part of an integration package than on their own, the World Bank might consider providing financial assistance to ease this adjustment.

NOTES

1. S. Laird and A. Yeats, 1988, "Nontariff Barriers of Developed Countries, 1966-1986," *Finance and Development* 25 (March):12-13. For an overview of the evolution of industrial countries' trade policies, see M. Kelly, N. Kirmani, M. Kafa, C. Boonekamp, and P. Wingle, 1988, *Issues and Developments in International Trade Policy*, International Monetary Fund Occasional Paper No. 63, Washington, D.C.
2. See World Bank, 1986, *World Development Report 1986*, New York: Oxford University Press.
3. See R. Erzan, H. Kuwahara, S. Marchese, and R. Bossenaar, 1988, *The Profile of Protection in Developing Countries*, UNCTAD Discussion Paper No. 21, New York: United Nations Conference on Trade and Development. For an overview of major agricultural policies in developed countries, including their main features, costs, and effects, see OECD, 1987, *National Policies and Agricultural Trade*, Paris. The OECD also produced a number of detailed studies of individual countries' agricultural trade policies that quantify their external effects (see OECD, 1987, *National Policies and Agricultural Trade: Country Study Japan*, Paris; and OECD, 1987, *National Policies and Agricultural Trade: Study on European Economic Community*, Paris. S. Laird and A. Yeats (1989, *Quantitative Methods for Trade Barrier Analysis*, London: Macmillan) survey and evaluate studies that have attempted to quantify the effects of agricultural trade barriers in OECD countries.
4. A. Yeats, 1981, "Agricultural Protectionism: An Analysis of Its International Economic Effects and Options for Institutional Reform," *Trade and Development* no. 3 (Winter).
5. A. Valdes and J. Zietz, 1980, *Agricultural Protection in OECD Countries: Its Costs to Less Developed Countries*, Washington, D.C.: International Food Policy Research Institute.
6. J.M. Finger and P.A. Messerlin, 1989, *The Effects of Industrial Countries' Policies on Developing Countries*, Policy and Research Series No. 3, Washington, D.C.: World Bank.
7. UNCTAD, 1986, *Protectionism and Structural Adjustment, Introduction and Part I*, TD/B/1081, Geneva.
8. J. Whalley, 1985, *Trade Liberalization among Major World Trading Areas*, Cambridge, Mass.: MIT Press.
9. J.I. Haaland and V.D. Norman, 1987, *EFTA and the World Economy: Comparative Advantage and Trade Policy*, EFTA Occasional Paper No. 19, Geneva: European Free Trade Association.
10. For a thorough survey of the issues, see J. Goto, 1988, "Effects of the Multifibre Arrangement on Developing Countries: A Survey," PPR Working Paper No. 102, Washington, D.C.: World Bank.
11. United Nations Conference on Trade and Development, 1989, "Salient Features of Policies Relating to Trade of Manufacturers and Semi-manufacturers," (August 17), Report by the UNCTAD secretariat: Geneva.
12. R. Hudec, 1987, *Developing Countries in the GATT Legal System*, London: Gower Press, for the Trade Policy Research Center.
13. A subject that deserves further attention is whether the newly industrialized developing economies could enhance their bargaining power by negotiating as a group or through a regional association like the Association of South East Asian Nations (ASEAN). For example, the combined exports of Brazil; China; Hong Kong; Republic of Korea; and Taiwan, China (US\$146 billion) are almost 30-percent larger than those of France. It should also be noted that the EC countries have found it advantageous to negotiate in common in the Uruguay Round and in previous multilateral trade negotiations, so a joint approach might be useful for developing countries as well.
14. J.M. Finger and A. Olechnowski, eds., 1987, *The Uruguay Round: A Handbook for the Multilateral Trade Negotiations*, Washington, D.C.: World Bank, p. 260.
15. The total value of manufactured exports of all Sub-Saharan African developing countries to developed countries, for example, was approximately one-tenth that of the Republic of Korea (US\$33 billion), while the total value of their nonoil exports was less than that of Mexico (US\$19 billion).
16. Box 8-1 refers to the economics of unilateral versus multilateral liberalizations. There are various reasons for believing that political factors in some situations may favor the multilateral approach.

Note, for example, the almost total reliance of developed countries on the multilateral approach over the last four decades.

17. The basic difficulty is that developing countries adopted a position of nonreciprocity in previous multilateral trade negotiations, arguing that their special economic situation precluded the direct exchange of trade concessions. Consequently, there is little factual information that bears directly on issues like the "credit" problem, so it is difficult to speculate how this will be handled in the GATT negotiations.

18. The evidence is far from complete, but existing data do seem to point in favor of the economics of a unilateral liberalization. For example, in the case of Argentina, the net present value of exports under a unilateral liberalization strategy are estimated to exceed that under a multilateral approach by US\$23 billion. See J. Nogués, 1989, "The Choice Between Unilateral and Multilateral Trade Liberalization Strategies," PPR Working Paper No. 239, Washington, D.C.: World Bank.

19. J.M. Finger and P. Holmes, 1987, "Unilateral Liberalization and the MTNs," in J.M. Finger and A. Olechowski, eds., *The Uruguay Round: A Handbook for the Multilateral Trade Negotiations*, Washington, D.C.: World Bank.

20. See, for example, the description of the conditions of Morocco's accession to the GATT in GATT, 1986, *Report of the Working Party on the Accession of Morocco, L/5967*, Geneva. In contrast, many African and Caribbean countries that were former colonies gained immediate membership in the GATT under Article XXVI by being sponsored by their developed country associate.

21. See Hudec (op. cit. chap. 9) for an analysis of specific GATT articles and regulations that might be applied to developing countries. Hudec (p. 173) specifically notes that GATT article XVIII "has lain rusting and unused for several decades." Developing countries have stopped asking for permission to impose new trade barriers under article XVII, mainly because developed countries have stopped challenging them. The reason for developed country disinterest has been the seeming impossibility of the task, given the almost perpetual balance of payments problems and other development-related excuses. And if developed countries begin to increase regulatory pressure on balance of payment applications of article XVIII, the article's infant industry provisions would still be available as an alternative legal defense of new tariff barriers.

22. World Bank, 1989, "The Role of Foreign Direct Investment in Financing Developing Countries," Board Memorandum (July 11).

23. Some evidence indicates that such swaps did actually increase investment, as opposed to just subsidizing investment that would have been made anyway.

24. To illustrate the principle of diversion, suppose country A originally imposes a tariff of 40 percent on all imports of widgets. Importers in country A buy the widgets from world markets at a cost of \$1, plus the \$0.40 tariff, which is revenue for the government and not a real resource cost. Country B could potentially produce and sell widgets to A for \$1.20, plus the \$0.48 tariff, but since this is more expensive than producers on the world market, B cannot sell widgets and so devotes its resources to producing other things. Now suppose A and B agree to drop all tariffs between themselves, leaving tariffs toward other countries unchanged. B finds it profitable to produce widgets at a real resource cost of \$1.20 and sell them to importers in A, who now find it cheaper to buy from B than from world markets. But, the real cost of acquiring a widget has risen from \$1 to \$1.20. The cost of trade diversion is 20 percent of the value of widget imports.

25. B. Balassa and A. Stoutjesdijk, 1978, "Economic Integration Among Developing Countries," *Journal of Common Market Studies* 14 (April):37-55.

26. See World Bank, 1988, "Intra-Regional Trade in Sub-Saharan Africa," Trade and Finance Division, Africa Technical Department, World Bank, p. 51.

27. Article XXIV of the GATT makes explicit provisions for integration schemes. Although the conditions are rather vague, some of them seem to be aimed at making it more likely that, on balance, trade is created not diverted. These include a condition that extraregional trade barriers on the whole should be raised, while barriers must be eliminated on virtually all trade among members. See V. Lachler, 1989, "Regional Integration and Economic Development," Industry Development Division, World Bank, Washington, D.C.

28. Other schemes could in principle be welfare-improving, but they would have to be evaluated on a case-by-case basis according to their costs and benefits (paras. 8.29-8.31). Any scheme that involved significant increases in the extraregional tariff of some members or large differences between regional and extraregional tariffs should be viewed with caution.