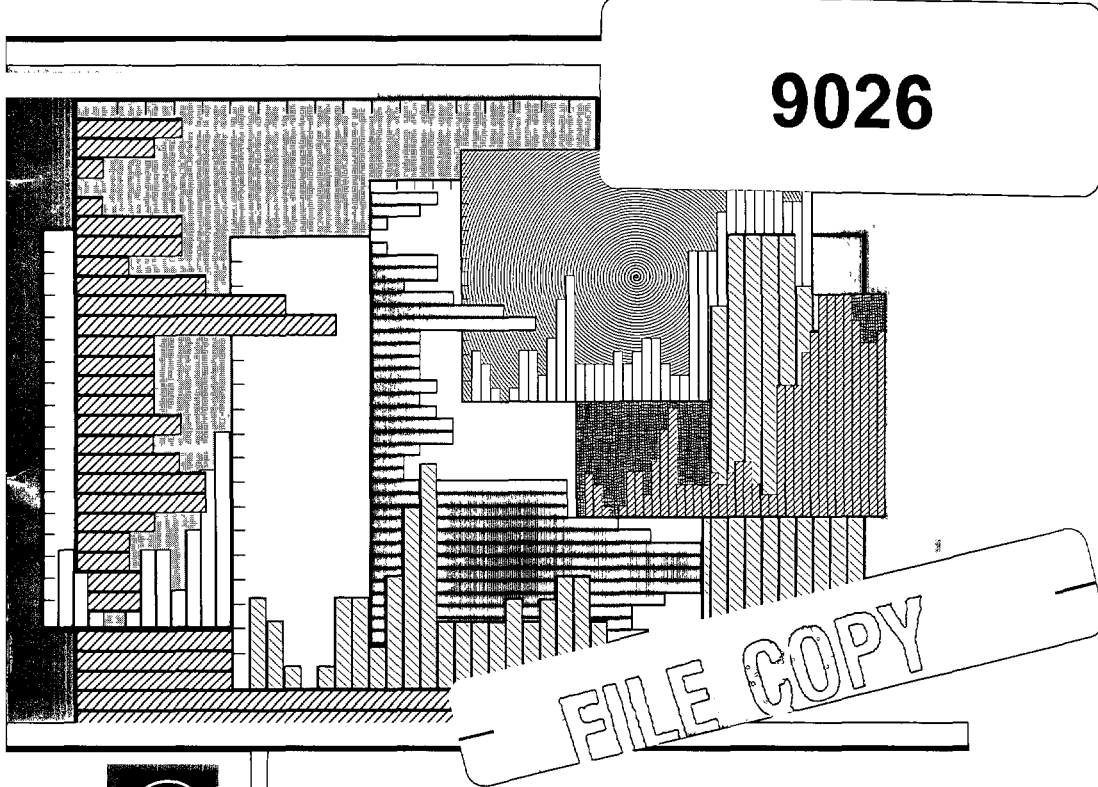


LIBERALIZING  
FOREIGN TRADE  
IN DEVELOPING  
COUNTRIES  
*THE LESSONS  
OF EXPERIENCE*

9026

DEMETRIOS PAPAGEORGIU  
ARMEANE M. CHOKSI  
MICHAEL MICHAELY



A WORLD BANK PUBLICATION



# *Liberalizing Foreign Trade in Developing Countries*

*The Lessons of Experience*

*Demetrios Papageorgiou*

*Armeane M. Choksi*

*Michael Michaely*

*The World Bank  
Washington, D.C.*

© 1990 The International Bank for Reconstruction  
and Development / THE WORLD BANK  
1818 H Street, N.W., Washington, D.C. 20433

All rights reserved  
Manufactured in the United States of America  
First printing September 1990

The findings, interpretations, and conclusions expressed in this publication are those of the authors and do not necessarily represent the views and policies of the World Bank or its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequences of their use.

The authors of this booklet are all in Country Department I (Brazil) of the Latin America and the Caribbean Region, the World Bank; Demetrios Papageorgiou is chief of the Country Operations Division, Armeane M. Choksi is the director of the department, and Michael Michaely is the department's lead economist. The authors wish to acknowledge Clive Crook for his contributions in the preparation of this booklet.

ISBN 0-8213-1651-6

## Contents

How Do Countries Liberalize?	1
Roads to Reform	4
Design and Sustainability	10
Strong or Weak Reforms?	10
Quantitative Restrictions	13
Real Exchange Rates	17
Macroeconomic Policy	20
The Importance of Countries' Initial Economic Conditions	22
Political Stability and the Long Haul	25
The Sequencing of Trade Liberalization and Capital Market Reforms	29
Liberalization at a Price?	31
The Balance of Payments	32
Employment and Growth	35
The Distribution of Income	37
Conclusions: Rules for Reformers	40
Further Reading	41



---

---

## How Do Countries Liberalize?

The view that a liberal trade regime promotes economic growth and efficiency has won wide acceptance in recent years. The reason is simple. Many developing countries—for a variety of reasons, and in a variety of different circumstances—have successfully moved from highly restrictive trade regimes toward policies that cause fewer economic distortions. But although most economists now agree that trade liberalization works, until recently much less was known about the process through which a country makes the transition from a distorted trade regime toward a more liberal one.

This has been an important gap in our understanding. Without a detailed grasp of the process of liberalization, economists lacked answers to questions of pressing interest to policymakers. Above all, they were unable to answer with much confidence basic questions about whether some approaches to liberalization were more likely to succeed than others. These questions include: What sort of initial conditions favor a lasting commitment to reform? Should reform programs be strong and sudden or moderate and gradual? Should reforms be attempted in a certain sequence? Is a stable political background essential for success or merely desirable? What role should the exchange rate play? Where does macroeconomic policy fit in?

Ignorance of the transition process meant that economists had little to say about the detailed design of policies to promote trade liberalization. In turn, policymakers have been hesitant to implement trade reforms because of the uncertainty associated with the transition process. But lack of knowledge has also obscured another set of questions—distinct from the questions about the process although related to them and of paramount importance to policymakers—about the costs of liberalization: Liberal trade regimes may be good for growth in the long term, but what about the short term? Do reform programs harm output at first? Does freer trade (especially in the form of lower import barriers) cause a deterioration in the balance of

payments, and if so over what time period? Because the goal of reform is to shift resources from inefficient to efficient uses, what are the implications for employment and for the distribution of income?

A recent study by the World Bank has shed some new light on these questions. The research was broad in scope. It analyzed the course of liberalization in nineteen countries during thirty-six distinct episodes of reform (see table 1; in the table and throughout this booklet the various episodes are denoted as follows: Chile 1 for its first program, Chile 2 for the next, and so on). The study covered, by and large, every attempt at significant trade reform undertaken by developing countries from World War II until as recently as 1984, depending on the country. This booklet summarizes the detailed results of the thirty-six liberalization episodes which are presented by the authors of this booklet in a synthesis volume, *Liberalizing Foreign Trade, Volume 7, Lessons of Experience in the Developing World*. (This volume, one of a series of seven, also presents the formal testing of the various hypotheses and conclusions outlined in this booklet. See the Further Reading section at the end of this booklet.) The results are encouraging, and in some cases surprising, for two reasons.

First, despite the complexities of the reform process and the differing circumstances that confronted each attempt at liberalization, the successful programs often had certain elements in common:

- *Momentum*. Programs that started boldly and then followed through with further measures proved more durable than ones that took a more hesitant approach.
- *Reduced quantitative restrictions*. Programs that decisively reduced such direct interventions as import quotas generally succeeded. Those that did not generally failed. This was one of the study's clearest findings.
- *Competitive real exchange rates*. Most of the successful programs began with a depreciation of the real exchange rate. Thereafter, no particular trend in the exchange rate was clearly associated with success—but most of the programs that lasted avoided sharp fluctuations.
- *Prudent macroeconomic policies*. On the whole, the successful reformers kept their budget deficits smaller in relation to output than the others. In fact, reversals of trade liberalization were more commonly associated with poor macroeconomic policies than *any* other factor, including the power of vested interests and short-run unemployment.



Table 1. *Episodes of Trade Liberalization*

<i>Latin America</i>		<i>Asia and Pacific</i>		<i>Mediterranean</i>	
Argentina 1	(1967-70)	Indonesia 1	(1950-51)	Greece 1	(1953-55)
Argentina 2	(1976-80)	Indonesia 2	(1966-72)	Greece 2	(1962-82)
Brazil	(1965-73)	Korea, Rep. 1	(1965-67)	Israel 1	(1952-55)
		Korea, Rep. 2	(1978-79)	Israel 2	(1962-68)
Chile 1	(1956-61)			Israel 3	(1969-77)
Chile 2	(1974-81)	New Zealand 1	(1951-56)		
		New Zealand 2	(1962-81)	Portugal 1	(1970-74)
Colombia 1	(1964-66)	New Zealand 3	(1982-84)	Portugal 2	(1977-80)
Colombia 2	(1968-82)				
Peru	(1979-80)	Pakistan 1	(1959-65)	Spain 1	(1960-66)
		Pakistan 2	(1972-78)	Spain 2	(1970-74)
				Spain 3	(1977-80)
Uruguay	(1974-82)	Philippines 1	(1960-65)	Turkey 1	(1970-73)
		Philippines 2	(1970-74)	Turkey 2	(1980-84)
		Singapore	(1968-73)		
		Sri Lanka 1	(1968-70)	Yugoslavia	(1965-67)
		Sri Lanka 2	(1977-79)		

*Note:* Periods of liberalization are in parentheses.

*Source:* Michael Michaely, Demetrios Papageorgiou, and Armeane M. Choksi, *Liberalizing Foreign Trade, Vol. 7, Lessons of Experience in the Developing World* (Oxford, England, and Cambridge, Mass.: Blackwell, forthcoming), table 2-1. This book is hereafter referred to as *Lessons*.

- *Proper sequencing of reform.* Programs tended to go wrong when capital-market liberalization preceded trade liberalization.
- *Political stability.* Reforms, once introduced, were difficult to sustain against a background of unstable government.

Second, the transitional costs of liberalization seem smaller than many feared:

- *Balance of payments.* In most of the reforming countries, exports increased faster than imports and the foreign-exchange reserves grew larger—not smaller, as feared by many policymakers—after the reforms were launched.
- *Employment and growth.* Even in the short run, liberalization went hand in hand with faster, rather than slower, growth. This was especially true of the stronger programs for which the rigidities to be overcome—and thus, it might have seemed, the costs of transition—were greatest. Trade liberalization did not, as a rule, raise unemployment even in individual sectors of the economy such as manufacturing or agriculture.
- *Distribution of income.* Because the reforms tended not to increase unemployment (even in the short run), they posed no direct threat to the distribution of income. There is no evidence that trade liberalization hurts the poor.

The remaining sections of this booklet provide an account of the study's main findings. The full results of the work, including eighteen separate country studies, are being published in eight volumes under the title *Liberalizing Foreign Trade*. (See the Further Reading section at the end of this booklet for information on the eight books.)

### Roads to Reform

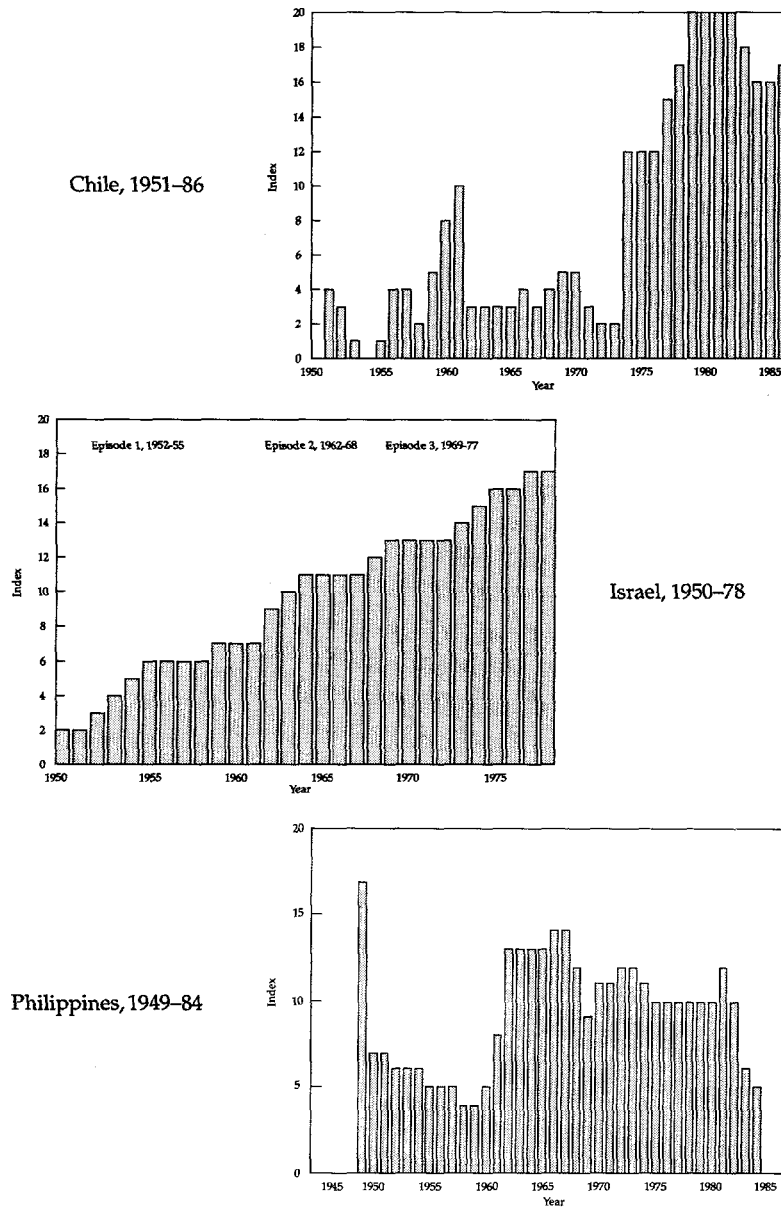
The study defines trade liberalization broadly. The benchmark is the idea of neutrality. A completely neutral trade regime is one that provides equal incentives to domestic sales and to exports. Thus, in principle, a trade regime that includes government intervention but also manages to provide equal incentives to exports and domestic sales is a neutral one, as is a completely free trade regime with no government intervention. A program of reform that moves a country's trade system closer to this paradigm is regarded as a liberalization; policies that move it further away are regarded as a reversal of liberalization.

Broadly, trade liberalization can take one of two forms: changes in price (lower tariffs, for instance), and changes in the form of intervention (such as a shift to tariffs from import quotas). Tariffs affect both the prices paid by consumers and the prices received by producers. The first of these distortions is adequately captured by the nominal rate of protection. But this measure does not fully capture the distortion in producer prices. For example, suppose high tariffs on consumer goods are combined with lower tariffs on imported goods that are used in their manufacture. Such a regime protects domestic producers twice over. The true (or "effective") rate of protection for producers of consumer goods is therefore higher than the nominal rate. As a result, a wide dispersion of different rates of protection should be seen as a distortion in its own right. Liberalizing trade means not just lowering tariffs on average, but also narrowing the range of nominal and effective rates of protection.

From the point of view of economic efficiency, the most damaging forms of trade intervention are quantitative restrictions (QRs) of different sorts. Tariffs distort prices but still leave the economy's price mechanism to allocate resources. Under extensive QRs the price mechanism has a much reduced role, so many opportunities to use resources more efficiently are lost. Moves toward liberalization, therefore, require a shift in the form of intervention: less reliance on QRs and greater reliance on measures, such as tariffs, that let the price mechanism work.

To provide a shorthand measure of liberalization, a liberalization index was constructed for each country. Year by year during the periods studied, a value was assigned ranging from 1 (for the highest possible degree of trade intervention) to 20 (complete trade liberalization). Figure 1 shows the indexes for Chile, the Philippines, and Israel as examples. Because many barriers to trade cannot be quantitatively defined, these indexes are based partly on quantitative criteria (that is, rates of effective protection, actual tariff rates, real exchange rates, and so forth) and partly on judgment. Therefore, these indexes cannot be used to compare the extent of liberalization across countries. But they do give a good impression of the course of reform and the change in the policy regime over time; they also make it possible to be more precise about the beginning and the ending of each liberalization episode in each country.

Figure 1. Indexes of Trade Liberalization for Chile, Israel, and the Philippines



Source: Michael Michaely, Demetrios Papageorgiou, and Armeane M. Choksi, *Liberalizing Foreign Trade, Volume 7, Lessons of Experience in the Developing World* (Oxford, England, and Cambridge, Mass.: Blackwell, forthcoming).

Even this broadbrush measure reveals big differences in the approach to reform. In some countries reforms were much more gradual than in others. Reforms often came in more than one phase. Sometimes the later episodes of liberalization built on measures taken earlier; in others, they had to make up ground lost in the meantime. So liberalization clearly means something different for each country, and indeed for each episode of reform within a country.

The challenge, nonetheless, was to look beyond the indexes and find the regularities among these diverse experiences. These might then be used to draw conclusions for policy. As a first step, table 2 provides a summary description of the core content of the thirty-six programs, together with a ruling on their fate: "sustained," "partially sustained," and "collapsed."

One of the most striking regularities was that QRs were relaxed in all but seven of the thirty-six episodes. (Table 2, however, lists only those liberalization episodes with major relaxation of QRs.) The exceptions were Brazil, Greece 2, Israel 3, New Zealand 3, Philippines 2, Portugal 1, and Turkey 1. In many of these cases QRs had been either insignificant to begin with or mostly removed in earlier episodes.

Lower tariffs, it might seem, should be the hallmark of trade liberalization. Surprisingly, however, governments cut tariffs in only sixteen of the liberalization episodes—fewer than half. Note that under certain circumstances higher, not lower, tariffs might shift a trade regime toward neutrality; for example, if it is bringing the tariffs on imported inputs and capital goods closer to the rates levied on other imports. In five cases, tariffs were indeed raised alongside a relaxation of QRs. And governments have quite often used higher export subsidies (also, on the face of it, an increase in trade intervention) to offset the anti-export bias of their other trade policies. However, there appears to be not a single case in which higher tariffs were *consciously* used to improve neutrality.

Among the episodes in which tariffs were cut, Chile 2 cut the highest first, then the next highest, and so on—the "concertina method." Greece 2 cut tariffs in proportion across the board. Other programs also succeeded in making their tariffs more uniform, either by following a mixture of these two approaches (Israel 3, Spain 2 and 3, and Uruguay), or else by following no clear rule at all (Argentina 1 and 2, Brazil, Colombia 2, Peru, and Portugal 2).

Table 2. Policy Elements of Trade Liberalization

<i>Episode by long-term outcome of liberalization</i>	<i>Major relaxation of quantitative restrictions?</i>	<i>Reduction of tariffs?</i>	<i>Devaluation?</i>	<i>Preannouncement?</i>
<i>Sustained</i>				
Chile 2	Yes	Yes	Yes	Yes
Greece 1	Yes	Yes	Yes	No
Greece 2	No	Yes	No	Yes
Indonesia 2	Yes	No	Yes	No
Israel 1	Yes	No	Yes	No
Israel 2	Yes	No	Yes	Yes
Israel 3	No	Yes	No	Yes
Korea, Rep. 1	No	No	No	No
Korea, Rep. 2	No	Yes	No	Yes
New Zealand 2	No	No	No	No
New Zealand 3	No	No	No	No
Singapore	Yes	No	No	Yes
Sri Lanka 2	Yes	No	Yes	No
Turkey 2	Yes	No	Yes	Yes
Uruguay	Yes	Yes	No	Yes
<i>Partially sustained</i>				
Colombia 2	No	No	Yes	No
Pakistan 1	No	No	Yes	No
Pakistan 2	No	Yes	Yes	No
Philippines 1	Yes	No	Yes	Yes
Philippines 2	No	No	Yes	No
Portugal 2	No	Yes	Yes	Yes
Spain 1	Yes	Yes	Yes	Yes
Spain 2	No	Yes	No	Yes
Spain 3	No	Yes	Yes	No
<i>Collapsed</i>				
Argentina 1	No	Yes	Yes	No
Argentina 2	No	Yes	Yes	Yes
Brazil	No	Yes	No	No
Chile 1	No	No	Yes	No
Colombia 1	No	No	No	No
Indonesia 1	No	No	No	No
New Zealand 1	No	No	No	No
Peru	No	Yes	No	Yes
Portugal 1	No	No	No	Yes
Sri Lanka 1	No	No	Yes	No
Turkey 1	No	No	Yes	No
Yugoslavia	No	Yes	Yes	Yes

Source: *Lessons*, tables 5-1, 10-1.

Often, trade liberalization formed part of a broader economic stabilization package. Currency devaluation and a contractionary fiscal policy were elements in almost all such cases. Tight monetary policy was less commonly part of the formula, and in still fewer cases a formal prices and incomes policy played a role. Some episodes of liberalization mixed trade reform with expansionary fiscal policy: Israel 2, New Zealand 3, Peru, Spain 3, Sri Lanka 2, and Turkey 1. In two of these cases the liberalization was not sustained, and in one it was only partially sustained.

In six of the episodes, the liberalization package was introduced in one go; in the others a sequence of measures was involved. In about half of these, some sort of plan for the sequence was set out at the beginning. In several other cases, a vaguer commitment to further steps was made. In the rest, liberalization was a continuing process with no preannounced course.

How far does a simple description of the content of the programs go to explain their durability? Is one mixture of policies more likely to succeed than another? Unfortunately, the answer seem to be no. Few if any core elements of reform—that is, changes in trade policy narrowly defined—seem decisive for the reform's survival. One important exception appears to be a major relaxation of QRs. Most of the programs that included such a reform lasted well.

What about policies and circumstances beyond the core elements—exchange rate policy, macroeconomic policy, the political background, and so forth? Table 2 shows no clear association between durability and devaluations of the nominal exchange rate. However, there does seem to be a link between durability and preannouncement. This relationship is certainly not foolproof. In four cases preannounced schemes of reform collapsed completely, and even when the reform was sustained it was rarely in precisely the form that had been promised. But in a comfortable majority of cases, programs involving preannouncement did survive either fully or partially.

Evidently, to extract policy lessons for the survivability of trade liberalization from the thirty-six episodes of reform it is necessary to look beyond a mere listing of the measures undertaken. The links between survival and a range of other factors—the intensity of reforms, quantitative restrictions, the path of the real exchange rate, macroeconomic policy, the importance of economic circumstances at the time reforms are introduced, the political background during the

implementation of reforms, and the ordering of the different elements of reform—are all examined below.

### Design and Sustainability

A mere listing of the core elements of trade reform fails to reveal a recipe for success. The clearest finding of the study (examined in more detail below) is that a relaxation of QRs is very common among the programs that survived. But this single fact, however important, neither adds up to a program of reform nor offers much guidance to policymakers. The study therefore turned to other aspects of liberalization beyond the trade reforms themselves. From this further analysis, many useful lessons for policymakers can indeed be drawn.

#### *Strong or Weak Reforms?*

Some reforming countries have been bold and have radically altered their trade regimes in a comparatively short time. Other countries have been cautious and have chipped away at reform over many years. Which works better, radicalism or gradualism?

To answer this question, it is necessary to be a bit more precise about what radicalism and gradualism mean. The study judges the intensity of liberalization according to two criteria: the scale of the reforms and the pace at which they are introduced. The study therefore classified the thirty-six episodes as “strong” or “weak” and “fast” or “slow.” Because each country’s classification is based on its index of liberalization, this measurement of intensity is subject to the same caveats as the indexes themselves. The most extreme cases are easy enough to place. Most people would agree that Chile 2 and Greece 1 were strong programs, and that Turkey 1 and Pakistan 2 were weak (see table 2). Intermediate cases are a lot harder to categorize.

The categories are admittedly arbitrary. The only remedy for this is to examine the individual country studies, which space precludes here. So the broadbrush approach, despite its shortcomings, will have to serve.

One of the study’s most important findings is that strong programs lasted better than weak ones. Table 3 shows that nineteen episodes were strong and seventeen weak. Five of the strong programs (26 percent) collapsed, whereas seven of the weak ones (41 percent)



Table 3. *Attributes of Trade Liberalization*

<i>Episode</i>	<i>Strong or weak?</i>	<i>Sustained?</i>
Argentina 1	Weak	No
Argentina 2	Strong	No
Brazil	Strong	No
Chile 1	Strong	No
Chile 2	Strong	Yes
Colombia 1	Weak	Partially
Colombia 2	Strong	Partially
Greece 1	Strong	Yes
Greece 2	Weak	Yes
Indonesia 1	Weak	No
Indonesia 2	Strong	Yes
Israel 1	Strong	Yes
Israel 2	Strong	Yes
Israel 3	Strong	Yes
Korea, Rep. 1	Weak	Yes
Korea, Rep. 2	Weak	Yes
New Zealand 1	Weak	No
New Zealand 2	Weak	Yes
New Zealand 3	Weak	Yes
Pakistan 1	Weak	Partially
Pakistan 2	Weak	Partially
Peru	Strong	No
Philippines 1	Strong	Partially
Philippines 2	Weak	Partially
Portugal 1	Weak	No
Portugal 2	Weak	Partially
Singapore	Strong	Yes
Spain 1	Strong	Partially
Spain 2	Weak	Partially
Spain 3	Strong	Partially
Sri Lanka 1	Weak	No
Sri Lanka 2	Strong	Yes
Turkey 1	Weak	No
Turkey 2	Strong	Yes
Uruguay	Strong	Yes
Yugoslavia	Strong	No
	<i>Strong</i>	<i>Weak</i>
Sustained	10	5
Collapsed	5	7
Partially sustained	4	5
Total	19	17

Source: *Lessons*, tables 3-1, 3-2.

collapsed. If anything, these figures understate the superiority of the strong reforms. The study defined episodes of liberalization to exclude those that collapsed within two years. If these unsuccessful cases had been included in the table, they would have fallen overwhelmingly into the weak category. The golden rule of sustainable reform appears to be that bold is best.

How far is duration itself linked to long-term sustainability? In other words, is there a critical point beyond which, if the program has stayed in place, its long-term survival is assured? The study found that six years appears to be a watershed of sorts. If a liberalization program lasts that long, it is very likely to last indefinitely. This might be because a six-year span often involves a transition from one government to the next. A change of government presumably poses one of the sternest tests of any liberalization episode; if the program survives in the new political environment, it therefore stands a good chance of enduring into the long term. In addition, a new set of vested interests is usually created under a more efficient trade regime, and this provides the needed political resistance to reverse the process of reform.

Another question is whether the fate of earlier episodes of reform has an influence on the success of later attempts. Of the thirteen countries whose first episode collapsed or was only partially sustained, eleven made further efforts at reform. Five of these second attempts (Chile, Indonesia, New Zealand, Sri Lanka, and Turkey) were sustained. Another five (Colombia, Pakistan, the Philippines, Portugal, and Spain) were partially sustained. That leaves only one collapse at the second attempt: Argentina.

This is a striking result. The so-called Latin American pattern of repeated failed attempts at trade reform is in fact true only of Argentina. A closer look at the five countries which failed or only partially succeeded in their first attempt and then fully succeeded in their second one is also revealing. Four of the five successful second attempts were strong. Compare this with the six countries in which a first failure or partial success was followed by another. Five of the six disappointing second attempts were weak.

This suggests that an earlier failure makes it all the more important for the second attempt to be strong—which seems plausible. A history of failure undermines the credibility of reform. Other things being equal, a later package may have to be stronger to be credible.

More generally, a country's earlier history of trade-distorting policies is also likely to affect the credibility of reform, and thus the program's chances of success. For example, it seems reasonable to suppose that the longer distorting policies have been in place, and the more distorting they are, the harder it will be for reform to succeed. The study bears this out. For each episode, it looked at the duration and severity of the pre-reform trade restrictions. In twenty-nine cases out of thirty-six, reform had to deal with long-lived restrictions, and in eighteen the restrictions were both long-lived and severe. Seven of these eighteen worst-case episodes were sustained and two were partially sustained, but no less than nine collapsed. Altogether, eleven episodes faced restrictions that were long-lived but moderate; five of the eleven were sustained, four were partially sustained, and just two collapsed.

To sum up, strong programs of trade liberalization have a significantly better chance of enduring than do weak or hesitant programs. This is likely to be all the more true for countries that have a long history of severe trade restrictions, and for those that have made earlier, unsuccessful attempts at reform.

#### *Quantitative Restrictions*

Almost always, highly illiberal trade regimes involve the extensive use of quantitative restrictions. Relaxing these restrictions has been the main content—and sometimes the sole content—of many liberalization programs. Strong liberalizations, especially, have often included bold steps to reduce QRs. (Indeed, a radical reform of QRs is usually enough by itself to qualify a liberalization program as strong.) The evidence suggests a particularly powerful link between a bold relaxation of QRs and the long-term success of the liberalization effort. This is one of the clearest results to emerge from the entire study.

Eleven of the liberalization episodes in the study included a major reform of QRs (see table 4). No less than nine of the eleven were sustained, and the other two (Philippines 1 and Spain) were partially sustained.

Perhaps the most radical of these episodes were Chile 2 and Greece 1, during which a highly distorting array of QRs was virtually eliminated within a short time, that is, one year for Chile and overnight in Greece. But all ten of the episodes are classified as strong,

*Table 4. Attributes of Episodes with Major Relaxation of Quantitative Restrictions*

<i>Episode</i>	<i>Sustainability</i>	<i>Intensity</i>	<i>Change in tariff levels</i>	<i>Change in real exchange rate when liberalization introduced</i>
Chile 2	Sustained	Strong	Lowered	Depreciation
Greece 1	Sustained	Strong	Lowered	Depreciation
Indonesia 2	Sustained	Strong	No change	Depreciation
Israel 1	Sustained	Strong	No change	Depreciation
Israel 2	Sustained	Strong	Raised	Depreciation
Philippines 1	Partially sustained	Strong	Raised	Depreciation
Singapore	Sustained	Strong	Raised	No change
Spain 1	Partially sustained	Strong	Raised	Appreciation
Sri Lanka 2	Sustained	Strong	Raised	Depreciation
Turkey 2	Sustained	Strong	No change	Depreciation
Uruguay	Sustained	Strong	Lowered	Depreciation

*Source: Lessons, table 10-1.*

since in every case QRs had been the principal form of trade protection. All but two of these episodes (Israel 2 and Uruguay) were also fast liberalizations, with the reforms implemented over periods ranging from overnight (as in Greece 1) to within two years. Israel 2 is the only case of a trade liberalization that completely removed QRs over a long period and according to a preannounced schedule.

The significance of QR reforms can be most clearly seen by comparing these eleven episodes with reforms that were bold in other respects but did not include changes in QRs. Of all the strong programs, eight failed to reform QRs. Five of these collapsed, one was fully sustained, and two were partially sustained.

So the contrast is striking. About half of all strong liberalizations included a major reform of QRs. The success rate of these programs was nine out of eleven. The success rate for the strong programs that did *not* include a major reform of QRs was one out of eight. The superiority of strong programs is thus largely explained by the success of the episodes that included a major reform of QRs. In short, liberalization is likely to succeed if the overall reform program is strong and begins with a bold relaxation of QRs; otherwise it is likely to fail.

Might other factors explain these results? For example, did the programs that included a major relaxation of QRs also cut tariffs substantially? Broadly, the answer is no. The radical QR reformers varied widely in their tariff reforms: tariffs were cut in three cases, raised in four, and left unchanged in three. Changes in tariffs cannot explain the success of the ten QR-reforming episodes.

Exchange rate policy, however, seems to play a more consistent role. In almost every case, the QR-reforming programs also included a depreciation of the real exchange rate (and often a substantial one). Altogether, eighteen episodes involved a real depreciation in the early stages of the program. Nine of these were fully sustained; and all but one of these successes ([Republic of] Korea 2) also involved a strong reform of QRs. Of the other nine episodes involving a real depreciation, five were only partially sustained and four collapsed. It appears that the partial or complete reversal of these episodes was caused by the inability of the authorities to maintain the depreciated value of the exchange rate it reached at the time of trade liberalization. The removal of QRs may help maintain the depreciated value of the real

exchange rate beyond the initial period of liberalization and reduce the likelihood of a reversal of the program.

Later sections of this booklet will look at other aspects of the reform programs in more detail, starting with the real exchange rate. But the conclusion that the reform of QRs plays a key role in deciding success or failure will stand. This is hardly surprising. QRs are well-known to be a particularly damaging way of achieving any given degree of protection.

Under a system of tariffs, imported inputs are available to domestic producers at a price. QRs, in contrast, can deny many producers access at any price. This creates bottlenecks (and hence less output) and encourages enterprises to hoard essential supplies (which is wasteful and costly). Tariffs can cause scarcities, but the economic rents that these scarcities create are collected by the government: tariffs, in other words, are a source of government revenue. Under QRs, rents are collected by the holders of quota titles. So a QR system requires higher taxes for any given amount of government revenue, and it creates an incentive for unproductive rent-seeking activities. On top of all this, QRs mask the degree of protection and allow it to vary with movements in foreign and domestic prices; tariffs make the degree of protection both fixed and transparent.

With all these drawbacks, why have QRs proved so popular? In many cases they were introduced not to provide protection but as a means of allocating scarce foreign exchange. Once introduced, they proved hard to get rid of. Quantity regulation, once used for protection, has certain advantages for governments. It makes the level of official imports seemingly more predictable, because quantitative restrictions encourage smuggling. It also gives policymakers more power to discriminate among groups in the economy—a political benefit despite being an economic cost.

When governments have decided nonetheless to reform their QRs, the pattern has generally been as follows. Goods regarded as not competing with domestic production are liberalized first. The list typically includes raw materials, capital goods, and semifinished goods. Often consumer goods continue to be highly restricted, with automobiles usually at the end of the queue for reform. Such partial liberalization is, in principle, a mixed blessing. Under a tariff-based system, reform along these lines could actually raise effective rates of protection by increasing the dispersion of nominal rates of protection.

But quotas cause so much extra waste that the gains from reducing them seem likely in most cases to outweigh the losses.

A policy of replacing quotas with equivalent tariffs is certain to improve economic performance. A shift from allocated quotas to auctioned quotas (as in New Zealand 2) duplicates this in many ways, and it may be a more feasible approach in some countries. Shifting from a positive list of prohibited imports (that is, only those goods on the list may be imported) to a negative list (only those on the list are forbidden) can be a useful way to signal a change in attitude. (This approach was adopted in Korea 2 and Turkey 2.) As part of more radical reforms, dismantling the machinery used to administer a QR system also sends the right signal and has the further benefit of making a future return to QRs more difficult.

The problems facing governments that wish to liberalize their QRs may often be formidable. But the evidence from this study is that the gains from doing so should override their reservations in every case. Radical reform of QRs seems to be all but a necessary condition for the success of trade reform.

#### *Real Exchange Rates*

The previous section drew attention to the role of the real exchange rate in episodes that included a relaxation of QRs. In every case but one, the successful QR-reforming programs also involved a real depreciation of the currency.

A real depreciation is, in effect, an increase in the price of tradables relative to the price of nontradables. This relative price change should spur the production of tradables, thus helping to boost exports. At the same time, trade liberalizations usually entail less protection for import-competing activities. Without a real depreciation, this might cause (at least in the short term) a deterioration in the balance of payments. On both counts, a real depreciation is likely to reduce pressure for trade reforms to be reversed.

To examine this more carefully, the study looked at the behavior of each reformer's exchange rate at the outset of the program (initial change), during the program as a whole (the trend change), and in the final stages of the episode (the closing change). The link between real depreciation and sustained reform seems strong in every case.

First, consider the initial change in the exchange rate. Most of the episodes that were fully sustained followed a real depreciation; in not a single case did a fully successful reform follow a currency appreciation. Most of the partially sustained programs also began with a depreciation. The failed episodes are roughly evenly divided between those with a rise or fall in the real exchange rate (see table 5).

The association is only a little less clear for the trend change in the real exchange rate. Most of the sustained or partly sustained episodes saw the currency continue to depreciate in real terms during the course of the episode or else stay roughly stable. In more than half of the failed episodes the currency appreciated over time, and of the remaining failures all but one were episodes with no trend change.

The final change tells a similar story. A depreciation toward the end of a liberalization episode is a sign of likely survival, an appreciation a sign of likely collapse. Sometimes (as in Argentina 2 and Chile 1) the appreciation of the currency during and toward the end of the episode was the most important single cause of the program's collapse.

*Table 5. Relation between the Initial Change in the Real Exchange Rate and the Sustainability of Liberalizations*

<i>Long-term outcome of liberalization</i>	<i>Change in exchange rate</i>		
	<i>Depreciated</i>	<i>Stable</i>	<i>Appreciated</i>
<i>Sustained</i>	Chile 2 Greece 1 Indonesia 2 Israel 1 Israel 2 Korea 2 Sri Lanka 2 Turkey 2 Uruguay	Colombia 1 Greece 2 Israel 3 Korea 1 New Zealand 2 New Zealand 3 Singapore	
<i>Partially sustained</i>	Colombia 2 Pakistan 2 Philippines 1 Philippines 2 Portugal 2		Spain 1 Spain 2 Spain 3
<i>Collapsed</i>	Brazil Chile 1 Turkey 1 Yugoslavia		Argentina 1 Argentina 2 Peru Portugal 1 Sri Lanka 1

Source: *Lessons*, table 13-4.



As with QR reforms, changes in the exchange rate correspond closely to the study's classification of episodes into strong and weak programs—but with an important difference. A radical relaxation of QRs is, by itself, a strong program. In contrast, the study regards exchange rate policy as falling outside the direct content of a trade liberalization program. So the close association between strong programs and currency depreciation is not in this case a matter of definition: strong reformers tended, as matter of fact, to depreciate their currencies when launching their trade reforms.

In thirteen out of nineteen strong episodes, the currency depreciated shortly after the launch of the reforms; it remained roughly stable in three cases and appreciated in the other three. In weak episodes the currency seems to have been equally likely to depreciate, appreciate, or stay the same.

The trend (as opposed to the initial) change in the exchange rate is less clearly related to the strength of the episode. In other words, strong episodes of reform are generally accompanied by a real depreciation at the outset, but less commonly thereafter. This is suggestive. A depreciation that happens at the beginning of a program makes that program, in a sense, all the more powerful in its effects on relative prices. The association between early depreciation and the strength of reform therefore helps to explain why strong reforms (as the study defines them) have proved more successful than the others.

But this raises a question. The real exchange rate is not an instrument of policy like tariffs, tax rates, or public spending. So how does a government achieve the real depreciation that seems to be virtually a requirement for success? A nominal devaluation of the currency provides a real depreciation at least for a time, but if the inflation rate of the country concerned is higher than that of its trading partners, the real devaluation will gradually be eroded. After a while, the country's currency may even appreciate in real terms. So anti-inflationary monetary and fiscal policies are needed to ensure that an initial depreciation is not reversed. The next section looks at macroeconomic policy in greater detail.

As noted above, however, the initial change in the real exchange rate shows the closest association with the success or failure of reform. For an initial real depreciation, a nominal devaluation is almost—but not quite—a necessary and sufficient condition. There are isolated examples of a real depreciation occurring without a nominal devalu-

ation (because of a fall in domestic prices relative to world prices, as in Brazil and Indonesia 2). There are also cases in which nominal devaluation has failed to produce a real depreciation (because it was too small to offset domestic inflation, as in Argentina 1 and 2:). Despite such qualifications, it is safe to conclude that an early and substantial nominal devaluation greatly increases a program's chances of success.

### *Macroeconomic Policy*

The relation between a government's macroeconomic policies and its program of trade reforms is one of the most important findings of this study; it runs both ways. Trade liberalization is likely to have implications for government revenues, and hence for the fiscal deficit. Lower tariffs, for instance, could mean lower revenues; unless other taxes were increased to make good the shortfall or government expenditures reduced, the government's fiscal policy would have shifted toward a more expansionary stance. As the previous section indicated, however, anti-inflationary macroeconomic policies are needed to ensure that nominal currency depreciation yields a real depreciation beyond the short term. In this and other ways, monetary and fiscal policies may have a big influence on the outcome of trade reform.

Consider first the implications of trade liberalization for fiscal policy. Is the effect of trade reform on government revenues bound to be negative? No: liberalization might entail replacing QRs with tariffs, which would cause revenues to rise. Moreover, even when tariffs are cut, the effect on revenues will depend on the change in the volume of imports. (Revenues are sure to increase if a prohibitive tariff is reduced enough to permit some imports.)

In general, the higher the tariffs are when reform begins, the better the chance that lower tariffs will mean higher revenue. A real devaluation will increase revenue from tariffs by increasing the local-currency price of imports. Yet liberalization might include export subsidies to offset the anti-export bias caused by import barriers: this would reduce net revenues from trade taxes and subsidies combined.

In principle, then, the effect of trade reform on the government's budget is ambiguous. The study's results on what happened in practice are only partial. A detailed analysis was beyond its scope. In the

two cases that were most closely examined in this context—Indonesia 2 and Peru—trade reform increased government revenues substantially. Both these programs relied heavily on a shift from QRs to tariffs. *Indonesia's revenues from trade taxes quadrupled in real terms within two years of the start of the reforms; in Peru, the increase in revenues was equivalent to 1 percent of gross domestic product in the first year.*

The results in other cases are mixed. Revenues increased after reforms in Argentina, Greece, Sri Lanka, Turkey, Uruguay, and Yugoslavia. But New Zealand's fiscal position deteriorated sharply during its second reform program (which consisted mainly of export promotion). Revenues also fell after reforms in Portugal and Singapore. The lesson is that no hard and fast conclusions can be drawn. All depends on the particular mix of policies.

So much for the effects of trade reform on fiscal policy. Consider now the effects of fiscal policy on trade reform. Expansionary fiscal policy, other things equal, will cause a deterioration in the trade balance. It will also raise prices in the nontradables sector relative to those in the tradables sector, thus promoting the production of the former at the expense of the latter. On both counts, its effects would be similar to those of a currency appreciation—adding to pressure for the trade reforms to be reversed. Against this, an expansionary policy would be likely to reduce unemployment (in the short term), thus reducing any pressure from that quarter.

Macroeconomic policy's most useful role in liberalization is to keep inflation low and thus support a real depreciation of the currency. Is there more to be said? One striking fact is that only a single episode of reform (Israel 2) was fully sustained after being introduced alongside an expansionary fiscal policy. But the stance of fiscal policy at the beginning of the reform does not discriminate between the partially sustained programs on the one hand and outright failures on the other (see table 6). Much the same is true for the stance of monetary policy at the outset of reform.

The stance of macroeconomic policy at the end of the reform episodes seems to be a bigger factor in the success or failure of reform. Sustained reform was usually accompanied by either a restrictive or neutral fiscal policy; the same is true for monetary policy. If fiscal policy was expansionary and monetary policy accommodating at the end, the programs were as a rule only partially sustained or else

*Table 6. Direction of Fiscal Policy and Sustainability of Liberalizations*

<i>Long-term outcome of liberalization</i>	<i>Direction of fiscal policy</i>		
	<i>Restrictive</i>	<i>Neutral</i>	<i>Expansionary</i>
<i>Sustained</i>	Chile 2 Greece 1 Indonesia 2 Israel 1 Israel 3 Sri Lanka 2 Turkey 2	Korea 1 Korea 2 New Zealand 2 New Zealand 3 Singapore	Israel 2
<i>Partially sustained</i>	Colombia 2 Pakistan 1 Philippines 1 Philippines 2 Spain 1		Pakistan 2 Portugal 2 Spain 2 Spain 3
<i>Collapsed</i>	Argentina 1 Argentina 2 Brazil Chile 1		Peru Sri Lanka 1 Turkey 1

*Source: Lessons, table 14-8.*

collapsed altogether. The study indicates that expansionary fiscal and monetary policies are the single most important cause of a reversal of trade reforms. Altogether, then, restrictive monetary and fiscal policies significantly improve the chances that trade reform will prove a success.

#### *The Importance of Countries' Initial Economic Conditions*

Countries have embarked on trade liberalization in a wide variety of economic circumstances. What effect did these different starting points have on the outcome? At the risk of oversimplifying, initial conditions might be grouped under three broad headings: distress, stability, and intermediate cases. The study indicates that programs begun under great economic strain tended to be strong and fast, and therefore relatively durable. The programs undertaken in placid circumstances, and especially those that followed earlier successful episodes of reform, also fared quite well. The in-between cases—reforms which began amid signs of economic deterioration but not a full-blown crisis—were the least likely to succeed.

The main elements of an economic collapse are usually an acute balance of payments crisis and high inflation. In the worst cases, unsurprisingly, these difficulties have been accompanied by a political upheaval. The combined effect is then a perception of total economic collapse. Three of the thirty-six episodes fall into this worst-case category (Argentina 2, Chile 2, and Indonesia 2). Three other episodes (Chile 1, Israel 1, and Turkey 2) began with similar economic distress, but without the political upheaval. In all six of these cases of distress, the reform programs were strong; four of them were fully sustained, and two failed (see table 7).

At the other end of the range are eighteen episodes—half the total—which began in circumstances that were stable, by and large. Performance within this group is mixed. The proportions of the programs that survived, partially survived, or failed are roughly the same as for the sample as a whole. Nine of the episodes were sustained and five were partially sustained; four failed.

The twelve remaining episodes—the in-between cases—can be divided into two further groups. Five were marked by balance of payments and inflation difficulties, but in a milder form than in the earlier cases of distress. The other seven episodes faced initial circumstances that included mounting balance of payments difficulties without a worrying rise in the inflation rate, or rising inflation without a pronounced balance of payments problem. Taking the twelve together, only two (Sri Lanka 2 and Uruguay) fully survived; three more partially survived (Philippines 2, Portugal 2, and Spain 1); the rest failed.

These results broadly confirm the importance of adopting strong programs of reform. Initial conditions, it seems, promote success to the extent that they promote bold reforms and the monetary, fiscal, and exchange rate policies that are needed to back them up. Economic distress has this effect. Conversely, a relatively stable economic background means that reform has a smaller task. Even weak programs stand a good chance under such circumstances. When the economic background is unstable, but not so unstable that strong measures are deemed necessary, the reforms that tend to be adopted are rarely up to the task.

The study also tried to examine the influence that policymakers' motives—so far as these can be judged by outsiders—had on the outcome of reform. Motives for reform might be any or all of the

Table 7. *Economic Conditions of Liberalizing Countries*

<i>Long-term outcome of liberalization</i>	<i>Extreme economic distress</i>		<i>In between</i>		<i>Stable economy</i>
	<i>Political upheaval</i>	<i>No political upheaval</i>	<i>Mild economic distress</i>	<i>Minor economic problems</i>	
Sustained	Chile 2 Indonesia 2	Israel 1 Turkey 2	Uruguay	Sri Lanka 2	Greece 1 Greece 2 Israel 2 Israel 3 Korea, Rep. 1 Korea, Rep. 2 Singapore
Partially sustained			Spain 1 Spain 3	Philippines 2 Portugal 2	Colombia 2 Pakistan 1 Pakistan 2 Philippines 1 Spain 2
Collapsed	Argentina 2	Chile 1	Argentina 1 Yugoslavia	Brazil New Zealand 1 Portugal 1 Sri Lanka 1 Turkey 1	Colombia 1 Indonesia 1 Peru

Source: *Lessons*, chap. 4.

following: ideological conviction (especially after a political upheaval); a broad desire to improve economic performance; a narrower aim of improving a particular aspect of economic performance (typically exports); the need to satisfy other countries (partners in a trade treaty, for instance) or lending institutions (such as the World Bank or the International Monetary Fund).

Surprisingly, no single motive or set of motives appeared particularly conducive to success. It might seem, for instance, that a program associated with a new government, especially when founded in a new political ideology, would have more credibility than the others and thus be more likely to survive. Only five episodes fit this description. Chile 2, Indonesia 2, and Sri Lanka 2 were fully sustained, and Spain 3 was partially sustained—but Argentina 2 collapsed.

A program adopted at the behest (or under the guidance) of outsiders runs the risk that the commitment to change will fade as soon as the outside pressure is relaxed. This prospect will undermine the program's credibility. Yet a promise to outsiders may make the policy harder to reverse for as long as the pressure lasts. In fact, agreements with outsiders seem to have little influence on the outcome. Programs undertaken at the urging of outsiders were roughly as likely to fail or succeed as programs undertaken unilaterally. Agreements of this sort (and, even more so, trade agreements made between the European Economic Community and the European countries in the sample) had an influence on the timing of reform. But the eventual outcome seems to have rested with other factors such as macroeconomic policies, government commitment to reform, and political stability.

### *Political Stability and the Long Haul*

To discover guidelines for policymakers, the previous sections have discussed various aspects of the design of trade reform, the economic policies that have accompanied those reforms, and other features specific to episodes of liberalization. But might there not be other factors that assist or hinder reform—factors related not to particular programs but to particular countries?

Postwar experience seems to divide countries, by and large, into two groups: liberalizers and nonliberalizers. The keen reformers are Chile, Greece, Indonesia, Israel, Korea, New Zealand, Singapore, Spain, and Uruguay. Over the years, these nine countries have pur-

sued a clear (though sometimes interrupted) course of reform. The nonreformers are Argentina, Brazil, Colombia, Pakistan, Peru, the Philippines, Portugal, Sri Lanka, Turkey (until very recently), and Yugoslavia. Even these countries have adopted trade reforms from time to time, but their efforts have generally been unambitious and hesitant. Only in Peru has the long-term trend has actually been toward a more, not less, restrictive trade regime.

What, if anything, do the liberalizing countries have in common? First, they tend to be small economies. Only one of the liberalizers (Indonesia) is relatively large, whereas another three (Chile, New Zealand, and Spain) are of medium size; five out of the nine are small countries. Among the nonliberalizers, only two out of ten (Portugal and Sri Lanka) are small economically or geographically. A second point, related to the first, is that the liberalizers tend to be poor in natural resources. Combining these factors produces a slightly stronger association: countries that are both small and lacking in natural resources are likely to be liberalizers. But the correlation is hardly overwhelming (see table 8).

Poor countries seem no more likely to be liberalizers than rich ones. Thus it is unsurprising that liberalizers and nonliberalizers are also alike, on average, in educational standards. The size of the local market seems to have little influence, and (more surprisingly) the same goes for the share of manufacturing in both output and exports.

As compared with the nonliberalizers, the reforming countries saw, on average, much faster growth of exports, lower budget deficits, lower government spending (on the whole), and (in almost every case) greater stability in the real exchange rate. But each of these factors, as discussed above, is intimately connected with the success of programs of reform. So they add little to our understanding of why some countries have been better than others at stringing together a series of successful episodes.

On this question, however, one factor does stand out: political stability. Clearly, measuring this is a highly subjective affair. The study's main criterion was political continuity, which need not mean one continuous government over a long period. A single government by no means guarantees continuity in policy; equally, changes of government can be consistent with continuity if the new arrivals abide by the policies of their predecessors. In judging continuity, the political stance of the regime (democratic or authoritarian) is irrele-



Table 8. Country Attributes

Country	Size of territory (1)	Political regime (2)	Natural resources (3)	Share of manufactures (percent)		Aggregate annual income (billions of dollars <sup>a</sup> ) (6)	Per capita annual income (dollars) (7)
				In exports (4)	In gross domestic product (5)		
<i>Long-term liberalizers</i>							
Chile	Medium	Stable	Rich	6.9	19.3	1.73	228
Greece	Small	Stable	Poor	9.9	14.3	3.41	410
Indonesia	Large	Stable	Rich	n.a.	12.1	6.91	73
Israel	Small	Stable	Poor	n.a.	n.a.	1.88	891
Korea, Rep.	Small	Stable	Poor	11.3	17.9	3.58	143
New Zealand	Medium	Stable	Rich	n.a.	n.a.	3.43	1,445
Singapore	Small	Stable	Poor	4.8	13.0	0.68	419
Spain	Medium	Stable	Poor	37.6	27.0	9.65	317
Uruguay	Small	Unstable	Rich	n.a.	23.1	1.45	571
Mean	—	—	—	n.a.	18.1	3.64	500
Median	—	—	—	n.a.	17.9	3.41	410
<i>Others</i>							
Argentina	Large	Unstable	Rich	n.a.	33.9	12.12	588
Brazil	Large	Stable	Rich	8.2	33.1	16.91	233
Colombia	Large	Stable	Rich	4.1	16.5	3.53	224
Pakistan	Medium	Unstable	Poor	n.a.	12.0	3.44	75
Peru	Large	Unstable	Rich	n.a.	20.0	1.85	191

(Table continues on the following page.)

Table 8 (continued)

Country	Size of territory (1)	Political regime (2)	Natural resources (3)	Share of manufactures (percent)		Aggregate annual income (billions of dollars <sup>a</sup> ) (6)	Per capita annual income (dollars) (7)
				In exports (4)	In gross domestic product (5)		
Philippines	Medium	Stable	Rich	n.a.	17.6	4.47	163
Portugal	Small	Unstable	Poor	53.2	30.0	2.29	260
Sri Lanka	Small	Unstable	Poor	14.9	6.1	1.33	134
Turkey	Medium	Unstable	Poor	n.a.	13.7	4.90	178
Yugoslavia	Medium	Stable	Poor	37.6	24.5	n.a.	n.a.
Mean	—	—	—	n.a.	20.7	5.65	227
Median	—	—	—	n.a.	18.8	3.53	191

— Not applicable.

n.a. Not available.

Note: The data in columns 4, 5, 6, and 7 are from 1960 or thereabouts.

a. Billion = 1,000 million. Amounts are U.S. dollars.

Source: *Lessons*, table 9-1.

vant. Note also that the classification refers to limited periods. Chile, Indonesia, and the Philippines are counted as stable despite their troubled postwar political histories: their various regimes were stable during the periods in which they settled on their long-term courses of trade reform.

Despite these caveats, the result is striking. All eight of the long-term liberalizers had stable political regimes. In contrast, seven of the eleven nonliberalizers had unstable regimes (see table 8). This finding is probably related to the fact, noted above, that liberalization episodes seem to reach a turning point after roughly six years. All but one of the episodes that lasted six years saw its reforms endure. A commitment to reform over that period is almost a necessary condition for success. But such a commitment, in turn, requires a corresponding degree of political continuity.

Policymakers, of course, have less control over the political stability of their regimes than they might wish. Yet the link between stability and success does have implications for the design of reform. It suggests, for instance, that there is little point in embarking upon reform if a political upheaval seems imminent, and especially if the next regime is unlikely to share its predecessors' convictions. By the same token, the best time for a new government to begin a course of reform is at once. The more time a reform can be given to work, the better.

#### *The Sequencing of Trade Liberalization and Capital Market Reforms*

The study's central concern was trade liberalization. But trade liberalizations have also been undertaken alongside other sorts of economic reform—deregulation of the capital market, in particular. This raises the question whether the ordering of such a package of reforms has any effect on its chances of success. The study tried to answer this, but to do so it had to look beyond its main area of research. The results, therefore, are not as well-based as the findings on trade reform proper.

Three markets, broadly defined, are involved in a country's economic relationships with the outside world: the goods market (the subject of the study), the labor market, and the capital market. The interaction between reforms in each area has attracted the attention of many researchers in recent years. At first sight it might seem that if all three markets are to be liberalized, it would be best to tackle all three together. But in practice this may not be feasible. Because some

reforms take longer to have an effect than others, trying to do everything at once can cause problems.

Consider first the effects of reform on the allocation of resources. The capital market adjusts to changes much faster than the goods market. Liberalizing the capital market typically means removing all or most restrictions on external capital flows. The effects of that will be nearly instantaneous. Synchronizing the benefits of reform will therefore usually require the goods market to be liberalized first. Moreover, the capital flows released by capital market reform may be very large, and a source of instability in their own right. Reform of the goods market may actually be harder to push through against such a background. Finally, opening the capital market while trade is still highly distorted frees more resources to flow to the wrong uses, thereby increasing the overall costs of the distortions.

Yet delaying reform of the capital market too long also has costs. Liberalizing the capital accounts promptly after the goods market has adjusted to trade liberalization is likely to make the economy's production structure much more responsive to the new pattern of incentives. So the a priori arguments concerning the allocation of resources suggest that trade should be liberalized first, followed (without an unduly long delay) by the capital market.

The sequencing of reform has macroeconomic as well as microeconomic implications. These come mainly through its effect on the exchange rate. Suppose the capital market is already open when adjustment to the trade reforms is still under way. A heavy inflow of foreign capital is possible under these circumstances (partly because the real interest rate in the trade-reforming country is likely to be higher than foreign interest rates). This will cause the currency to appreciate. Currency appreciation will in turn undermine the trade reform by discouraging producers of tradables, and thus reduce the whole program's chances of success. But that is not the end of the story. The currency appreciation would soon be followed by a sharp deterioration in the balance of payments, a reversal of the capital inflow, and a currency depreciation. If economic agents had perfect foresight, these swings in capital flows and the exchange rate would be greatly reduced or even eliminated. But without perfect foresight, this sequence of reform would be likely to fail.

So much for the principles. What does the evidence tell us? Not much, because few episodes of trade reform in developing countries

have been accompanied by capital market reform. The study looks in detail at episodes of reform in just four countries: Argentina 2, Chile 2, Uruguay (where capital markets were opened while trade reform was still in progress), and Israel 3 (where the capital market was opened only when adjustment to trade reform was largely complete).

In all four cases, the capital movements that initially followed the opening of the capital market were inflows rather than outflows. In the three Latin American cases, the capital inflow caused a massive real appreciation of the currency. Once the capital inflow stopped, equally sharp depreciations followed.

In Argentina, trade reform collapsed because of this. The currency appreciation discouraged new export activities, and the reforms were perceived to bring no benefits. When the flow of capital changed direction, the reforms were immediately aborted. Uruguay's experience is more ambiguous. Trade liberalization was halted after a time, partly because of the currency appreciation, but it was not reversed. Chile's capital market was opened later in the trade reforms. In this case the currency appreciation caused heavy unemployment, but the reforms were sustained because of the government's strong commitment to them. Israel opened its capital market later still. The currency appreciation was smaller (about a tenth of the Latin American appreciations) and lasted less than a year. The reform program was sustained. This evidence is narrowly based and far from conclusive. As far as it goes, however, it supports the presumption that capital market liberalization should be left until trade liberalization is undertaken.

### Liberalization at a Price?

The political and economic costs of trade reform are understandably of great concern to governments. The presumption of the study was that trade reform works in the long term and so will eventually yield perceptible economic gains. But its short-term benefits are less clear. Trade reform will succeed only if it shifts resources from inefficient uses to new tasks. The bigger the projected long-term gains, the greater this shift will need to be. But this short-term reallocation of resources carries economic costs and political risks.

An obvious danger when barriers to imports are first lowered is that the balance of payments might deteriorate. Another is that un-

employment might rise if workers displaced from inefficient jobs are not quickly reemployed. For similar reasons, output might also be lower during the transition. In addition, the changes could have an adverse effect on the distribution of income. In principle, if these short-term costs are too large, the long-term gains (suitably discounted) may never be enough to make reform worthwhile. But even if the long-term gains are substantial (as the study assumes) the short-term pain may make liberalization politically infeasible.

The difficulties of reform are not to be underestimated. The study found, however, that fears concerning the effects of liberalization on the balance of payments, output and employment, and the distribution of income are all misplaced. To a surprising extent, the signs are that the costs of adjustments are very small, even in the short term.

### *The Balance of Payments*

Trade liberalization, by definition, erodes the protection enjoyed by certain domestic producers, generally with the deliberate aim of opening the economy to a greater volume of imports. So it is natural to fear at least a short-term deterioration in the balance of payments. In fact, the study found that this was rare.

In the great majority of liberalization episodes, countries added to their foreign exchange reserves in the months immediately following the start of their program. Reserves declined in just two cases (Korea 2 and Israel 3), whereas in a few others there was little change in either direction. In most cases, liberalization rescued the country from a worsening balance of payments position and falling reserves. Indeed, a rapidly worsening external position was quite often the reason why the reforms had been implemented in the first place.

In about half of the reform episodes, imports did tend to increase in the months after liberalization began. In most of the other episodes they showed no trend, either upward or downward. Imports actually fell in only four episodes. Many of the programs that included a major relaxation of QRs saw particularly big increases in imports. Of the eleven such episodes, suitable data were available for eight; imports increased sharply in six of them. This is unsurprising. The countries that had relied on highly restrictive QRs were the ones most likely to be suffering from the greatest pent-up demand.

Because imports, by and large, either showed no trend or increased, the overall improvement in balance of payments positions logically must have been the result of rising exports. And so it was. In every case but one, countries that imported more exported more as well. (The exception was New Zealand 3, whose exports remained steady). In the sample as a whole, roughly two-thirds of the episodes saw a clearly rising trend of exports in the months immediately after the launch of the reforms. Usually this represented an improvement over the pre-reform position. Taking an average of the thirty-one episodes for which good trade data were available, the growth rate of exports rose from 4.9 percent in the year preceding the reforms to 11.3 percent in the year of liberalization (see table 9).

In just three episodes (Argentina 2, Chile 2, and Indonesia 2), exports had been falling before the liberalization. In two of these (Argentina and Chile), they then began to expand. In the third (Indonesia), the earlier fall was halted. In ten episodes, a postlaunch expansion of exports followed a pre-reform stagnation of exports. In just two cases (Philippines 1 and Uruguay), the reverse happened: a rising pre-reform trend gave way to stagnation. Some of the successful turnarounds were dramatic. Argentina's annual export growth rate went from an average of minus 1.2 percent before its second episode of reforms to an average of 16.1 percent in the three years after the year of liberalization; the corresponding figures for Chile 2 were minus 1.6 percent and 13.6 percent, and for Turkey 2, minus 4.4 percent and 46.4 percent.

Clearly, then, export performance improves markedly after the introduction of trade reforms—which is perhaps to be expected. What may be more surprising is that the improvement is both quick enough and big enough to bring about, as a rule, an immediate improvement in the balance of payments.

What role did specific export incentives (subsidies, for instance) play in all this? Looking at a slightly smaller sample, export incentives were used in twenty-one episodes and were absent in seven. But, as noted earlier, a depreciation of the real exchange rate (usually a very large depreciation) was equally common at the outset of the reforms. The study used econometric methods to gauge the relative importance of these two export-promoting devices. Exchange rate depreciation was statistically correlated with export growth, but the use of incentives was not. Indeed, the statistical tests could not say whether

Table 9. Trade Liberalization and Export Performance  
(percent)

Type of episode	Year before liberalization			Annual rate for period	Year of liberalization and after				Annual rate for period <sup>b</sup>	Annual rate for period <sup>c</sup>
	1	2	3		1 <sup>a</sup>	2	3	4		
Strong	-1.1	9.0	3.9	3.9 (17)	12.4	17.3	10.8	8.6	12.3 (17)	12.3 (17)
Weak	4.0	3.8	6.1	4.6 (14)	9.9	8.1	8.3	12.2	9.6 (14)	9.5 (14)
Sustained <sup>d</sup>	0.5	8.6	9.6	6.2 (16)	12.0	18.3	15.8	10.3	14.1 (16)	14.8 (16)
Collapsed <sup>d</sup>	2.0	4.6	-0.1	2.1 (15)	10.5	7.6	3.1	10.3	7.9 (15)	7.0 (15)
All	1.2	6.6	4.9	4.2 (31)	11.3	13.1	9.7	10.2	11.1 (31)	11.0 (31)

Note: The numbers of episodes are given in parentheses.

a. This is the year of liberalization.

b. This is the average annual real export growth rate after liberalization, which *includes* the year of liberalization.

c. This is the average annual real export growth rate after liberalization, which *excludes* the year of liberalization.

d. All partially sustained episodes have been grouped here with "collapsed," except for Spain 2 and 3, which are classified here as "sustained."

Source: *Lessons*, table 12-3.



export incentives were more likely to help exports or hinder them. This finding confirms the importance of an exchange rate policy that supports trade adjustment and raises some doubts about the efficiency of export incentives.

The study stresses the distinction between the balance of payments in the short term and in the medium term. Evidently there is no reason to fear that trade reform will jeopardize the balance of payments position in the short term. Later, however, the balance of payments may deteriorate for other reasons (because of an appreciation of the domestic currency, say, as a result of ill-considered macroeconomic policies). If it does, the whole program will then be in danger. This link appears to be quite strong. None of the episodes in which foreign exchange reserves stayed on their initial upward trend failed, and most of them were fully sustained. But only two of the episodes in which reserves fell in the later stages of reform were fully sustained; eight such episodes failed altogether.

Cast in terms of export performance, the link between the external position and the sustainability of reform seems even stronger. This reflects the fact that a slowdown in exports rather than an acceleration of imports was usually to blame for a deterioration in the balance of payments. The sample of thirty-one episodes included nine in which exports continued to rise, nine in which they later fell, and thirteen in which they showed no clear trend. Six out of the nine rising-export programs fully survived, three partially survived, and none failed. Seven out of the nine falling-export programs failed, two partially survived, and none fully survived. Of all the country studies, in only one (Israel) did the study conclude that the balance of payments position had played no role in deciding the fate of a reform program.

#### *Employment and Growth*

The separate country studies used a variety of methods to estimate the effects of liberalization on employment. What matters in judging the overall change in welfare is the net effect of trade reform on jobs—that is, the extent to which jobs lost in industries obliged to contract were offset by gains in employment elsewhere. To trace this in detail is difficult. It would require a great deal of information at the level of individual economic sectors and industries, and preferably individual firms. The data were not always available.

Moreover, the pattern of employment after liberalization should ideally be compared not with the recent past but with the pattern that would have happened otherwise. For a few countries, simulation studies were used to attach numbers to these hypothetical outcomes. But of course it is difficult to more than approximate the effects of liberalization separately from the effects of changes caused by other factors.

Altogether, the evidence suggests that the effects of trade liberalization on unemployment have been small. In most countries, employment was not lowered even in broad individual sectors of the economy such as manufacturing. This implies that the reallocation of labor was achieved largely within sectors, causing less disruption than might have been feared.

Chile shows how important it is to distinguish between the effects of trade liberalization and the effects of other factors. Its overall rate of unemployment went up from 4.8 percent in the last year before its reform episode began to an average of 12.3 percent during the course of the program. Yet simulation studies suggest that the net impact of trade reform on jobs was positive. The rise in unemployment was the result of macroeconomic policies, and especially exchange rate policy. The implication is that if it had not been for trade reforms those policies would have caused an even sharper rise in unemployment.

In any case, Chile is unusual. Its second liberalization program was the only one which reduced employment in a broad sector of the economy. The number of jobs in the electrical and nonelectrical machinery sectors fell by nearly half, and in manufacturing as a whole employment fell by about 10 percent. (These losses, as already noted, were then more than offset by gains in farming and in other sectors.) In most of the other countries studied, trade liberalization merely reduced the rate of growth of jobs in manufacturing and other previously protected sectors; it did not reduce the absolute number of jobs (see table 10). In such cases employment gains in the sectors that had previously been discriminated against became net gains for the economy.

As we know, this low transitional unemployment cost cannot be explained by supposing that all the liberalization programs were weak and gradual. Many were strong and fast—Chile especially so. By and large, the unemployment cost of trade reforms in countries with strong and fast programs was as low as in the others.

In line with these results, the study also found that liberalization has not meant lower output or lower economic growth, even in the short term. If anything, trade reform—especially strong and fast reform—is associated with higher growth from the beginning. If not for the findings on trade liberalization and employment, this result would have been rather surprising (see table 11).

In most cases, the pre-reform trade regimes had discriminated against agriculture. As soon as this policy was reversed, agricultural output began to grow faster and the sector started to increase its share of the national income. This experience contradicts the popular view that farmers react slowly to changed incentives. Meanwhile, the growth of output in the countries' manufacturing sectors (the most heavily protected part of these economies) did slow, as a rule, in the first year of reform. But the slowdown was temporary and quickly recouped. Even in the first year of liberalization, manufacturing output did not fall below earlier levels.

#### *The Distribution of Income*

As well as worrying about the effects of trade reform on aggregate income, governments may fear that the short-term costs of liberaliza-

*Table 10. Employment in Manufacturing during Episodes of Liberalization*  
(thousands of persons)

<i>Episode</i>	<i>Year before liberalization</i>	<i>Average<sup>a</sup></i>	<i>Year after liberalization</i>
Argentina 1 (1967–70)	1,836	1,847	1,914
Argentina 2 (1976–80)	1,863	2,099	2,132
Brazil (1965–73)	1,780	2,182	3,397
Chile 2 (1974–81)	515	487	351
Korea 2 (1978–79)	2,000	2,196	2,099
Peru (1979–80)	675	717	736
Philippines 1 (1960–65)	1,456	1,647	1,825
Philippines 2 (1970–74)	2,056	2,313	2,596
Singapore (1968–73)	61	139	210
Sri Lanka 1 (1968–70)	74	108	97
Sri Lanka 2 (1977–79)	112	134	155
Turkey 1 (1970–73)	485	551	651
Turkey 2 (1980–84)	799	829	n.a.

n.a. Not available.

a. Average for the liberalization period.

Source: *Lessons*, table 6–1.

Table 11. *Trade Liberalization and Economic Performance*  
(percent)

Type of episode	Year before liberalization	1 <sup>a</sup>	2	3	4	Annual rate for period <sup>b</sup>	Annual rate for period <sup>c</sup>
<i>Real annual growth of gross domestic product</i>							
All episodes	4.4	4.7	5.4	5.3	6.0	5.6 (31)	5.3 (31)
Strong	3.5	4.9	4.8	5.2	6.2	5.4 (17)	5.3 (17)
Weak	5.6	4.4	6.2	5.4	5.7	5.7 (14)	5.4 (14)
Sustained <sup>d</sup>	4.7	6.1	5.4	5.8	6.8	6.0 (16)	6.0 (16)
Collapsed <sup>d</sup>	4.1	3.2	5.5	4.6	5.2	5.1 (15)	4.6 (15)
<i>Real annual growth of agricultural sector</i>							
All episodes	2.8	2.9	5.5	2.8	3.9	4.1 (29)	3.8 (29)
Strong	2.7	4.7	5.3	5.1	3.9	4.8 (17)	4.8 (17)
Weak	2.9	0.4	5.7	-0.4	4.1	3.1 (12)	2.4 (12)
Sustained <sup>d</sup>	2.8	3.4	8.4	2.5	6.3	5.7 (15)	5.2 (15)
Collapsed <sup>d</sup>	2.8	2.3	2.4	3.2	1.4	2.3 (14)	2.3 (14)
<i>Real annual growth of manufacturing sector</i>							
All episodes	6.7	5.3	6.9	6.9	8.0	7.3 (29)	6.8 (29)
Strong	5.6	3.5	6.0	5.8	6.6	6.2 (17)	5.5 (17)
Weak	8.4	7.8	8.2	8.4	9.9	8.8 (12)	8.6 (12)
Sustained <sup>d</sup>	7.0	7.7	6.6	7.7	9.3	7.9 (15)	7.8 (15)
Collapsed <sup>d</sup>	6.5	2.7	7.2	6.1	6.5	6.6 (14)	5.6 (14)

Note: The numbers of episodes are given in parentheses.

a. This is the year of liberalization.

b. This is the average annual real export growth rate after liberalization, which includes the year of liberalization.

c. This is the average annual real export growth rate after liberalization, which excludes the year of trade liberalization.

d. All partially sustained episodes have been grouped here with "collapsed," except for Spain 2 and 3, which are classified here as "sustained."

Source: *Lessons*, tables 7-1, 7-10.

tion, such as they are, will fall disproportionately on the poor. This risk would be great if the short-term costs in lost output and unemployment were large. An increase in unemployment would be almost sure to have an adverse effect on the distribution of income. In fact, as we have seen, these aggregate short-term costs are small. Does this mean that fears of a worsening of the income distribution are entirely misguided?

In principle the answer is no, because trade reform will cause other changes that may have an impact on income shares. For instance, by relaxing and perhaps eliminating the anti-export bias of most pre-reform trade regimes, reform will tend to increase the share of exports in national income and reduce the share of import substitutes. The effect this has on income distribution will then depend on labor intensity in these two parts of the economy.

Evidence from previous studies strongly suggests that in developing countries the export sector is relatively labor-intensive, whereas import substitutes tend to be quite capital-intensive. If so, liberalization will increase the demand for labor and the share of wages in national income. In developing countries, this improvement in the distribution of income should be reinforced by the fact that the sector to expand most rapidly after liberalization will usually be agriculture, where wages are low. The sector most likely to contract (at least in relative terms) will usually be manufacturing, where wages are higher.

Similarly, a depreciation of the currency (which has generally accompanied successful trade reform) promotes the production of tradable goods relative to services. So if incomes are higher in services than in manufacturing and primary production taken together (which they often are), there should be an improvement in the distribution of income.

The distributional implications of relaxing QRs, as opposed to reducing tariffs, are a bit more complicated. Relaxing QRs makes consumers, on average, better off, and the previous owners of the quota rents worse off. This should improve the income distribution. If the QRs are replaced by equivalent tariffs, then taxpayers (rather than consumers) gain a big slice of the benefit, again at the expense of the rent holders. In this case too, the income distribution should be improved. But the removal of QRs often happens alongside the relaxation of price controls and rationing. Although this ought to bring

considerable aggregate benefits, the end of rationing in itself could worsen the income distribution if it were to deny the poor preferential access to goods.

These are all a priori arguments. What does the evidence show? Unfortunately, it is mixed and fragmentary. In some cases (for example, Argentina 1 and 2, Israel 1, and Philippines 1 and perhaps 2) the income distribution worsened during the course of liberalization. In roughly as many others (Colombia 2; Greece 2; Indonesia 2; Pakistan 1 and 2; and Spain 1, 2, and 3) the reforms improved the income distribution. But in most cases it is hard to be sure. Often liberalization appeared to have no clear effect (for example, Korea 1 and 2, Brazil, and Chile 2); sometimes it seemed to worsen the income distribution at first, then later improve it (Sri Lanka 2).

The empirical evidence leaves the issue open. There is no proof that low-income groups gain particular benefits from liberalization (beyond sharing in the aggregate benefits). Equally, there is no support for the popular view that reform is bound to make the poor worse off.

Any disadvantaged group (workers in protected manufacturing sectors in the case of straightforward trade reform, workers in services in the case of a real depreciation) will resist changes that will make it worse off. In this sense, the income distribution is likely to be a political problem for governments regardless of whether it is "improved" (that is, made less unequal) by the reforms. Clearly, however, the desire to protect the least well-off is one sort of argument against reform; the desire to protect groups that are already privileged is quite another.

### Conclusions: Rules for Reformers

The blueprint for trade liberalization will vary from country to country, and according to a host of fluctuating circumstances. Obviously, this study did not attempt and could not hope to answer all the questions that policymakers considering a program of reform must address. But this detailed and exhaustive analytical study of recent experiences in developing countries does offer some broad guidelines for would-be reformers.

First, there is nothing in a country's basic economic profile (its size, its per capita income, and so on) that need put reform out of reach. Second, apparently unhelpful initial circumstances can work to the

advantage of reform if they make it possible for governments to be bolder than they otherwise would have been. Third, the short-term costs of reform, if any, are small. Economies adjust to a more open trade regime more quickly than has generally been thought. So the economic benefits of liberalization are not unduly postponed: they begin to arrive almost at once.

In other words, reform can work anywhere, regardless of initially unfavorable circumstances, and without serious short-term drawbacks. Governments with highly distorted trade regimes need not fear the consequences of a well-designed liberalization program.

What does a well-designed program look like? Many aspects of policy will influence the outcome over the long term. Noninflationary macroeconomic policy plays a very important role. So does the proper sequencing of reform. Credible preannouncement of further measures can help. Other factors in the program's success or failure may be partly or entirely beyond the government's control: for instance, external events and domestic political stability.

But for reform to succeed, a small group of factors—each entirely within the government's control—appears to really count: The program should be bold and it should start with a bang. Any quantitative restrictions should be rapidly dismantled. Where appropriate, the program should begin within a substantial real depreciation of the currency. And there must be a stable macroeconomic environment. Almost every program that has followed these four simple rules has succeeded.

### Further Reading

The results of the World Bank study, "The Timing and Sequencing of a Trade Liberalization Policy," are being published in 1990–91 in a seven-volume series titled *Liberalizing Foreign Trade*. The series is edited by Demetrios Papageorgiou, Michael Michaely, and Armeane M. Choksi (the books are being published by Basil Blackwell, Oxford, England, and Cambridge, Mass.). The seven volumes are:

1. *The Experience of Argentina, Chile, and Uruguay*. Study of Argentina by Domingo Cavallo and Joaquin Cottani. Study of Chile by Sergio de la Cuadra and Dominique Hachette. Study of Uruguay by Edgardo Favaro and Pablo T. Spiller.

2. *The Experience of Korea, the Philippines, and Singapore.* Study of Korea by Kwang Suk Kim. Study of the Philippines by Geoffrey Shepherd and Florian Albuero. Study of Singapore by Bee-Yan Aw.

3. *The Experience of Israel and Yugoslavia.* Study of Israel by Nadav Halevi and Joseph Baruh. Study of Yugoslavia by Oli Havrylyshyn.

4. *The Experience of Brazil, Colombia, and Peru.* Study of Brazil by Donald V. Coes. Study of Colombia by Jorge Garcia. Study of Peru by Julio J. Nogués.

5. *The Experience of Indonesia, Pakistan, and Sri Lanka.* Study of Indonesia by Mark M. Pitt. Study of Pakistan by Stephen Guisinger and Gerald Scully. Study of Sri Lanka by Andrew G. Cuthbertson and Premachandra Athukorala.

6. *The Experience of New Zealand, Spain, and Turkey.* Study of New Zealand by Anthony C. Rayner and Ralph Lattimore. Study of Spain by Guillermo de la Dehesa, Jose Juan Ruiz, and Angel Torres. Study of Turkey by Tercan Baysan and Charles Blitzer.

7. *Lessons of Experience in the Developing World.* By Michael Michaely, Demetrios Papageorgiou, and Armeane M. Choksi.

Another volume on the results of the study, published by the World Bank in 1989, is *Liberalizing Foreign Trade: The Experience of Greece*, by George C. Kottis.







## **The World Bank**

### **Headquarters**

1818 H Street, N.W.  
Washington, D.C. 20433, U.S.A.

Telephone: (202) 477-1234  
Facsimile: (202) 477-6391  
Telex: WUI 64145 WORLDBANK  
RCA 248423 WORLDBK  
Cable Address: INTBAFRAD  
WASHINGTONDC

### **European Office**

66, avenue d'Iéna  
75116 Paris, France

Telephone: (1) 40.69.30.00  
Facsimile: (1) 47.20.19.66  
Telex: 842-620628

### **Tokyo Office**

Kokusai Building  
1-1, Marunouchi 3-chome  
Chiyoda-ku, Tokyo 100, Japan

Telephone: (3) 214-5001  
Facsimile (3) 214-3657  
Telex: 781-26838

ISBN 0-8213-1651-6