DM/87/4　　　　　　　　　　INTERNATIONAL MONETARY FUND

Exchange and Trade Relations Department

Approaches to Trade Liberalization in Developing Countries

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December 3, 1987

Abstract

Despite the evident benefits of trade liberalization the process
has often been slow and has needed to overcome considerable
opposition. The speed and form of liberalization has necessarily varied
with the characteristics of the country concerned but the process needs
to be supported by appropriate exchange rate and financial policies.
Progression from a highly restrictive to a liberal trade regime may
begin by replacing administrative restrictions with tariffs or other
price variables, then proceed to reducing levels of protection and dis-
crimination among goods. The approaches discussed give priority to
reducing anti-export bias and to correcting the most extreme
distortions. Quantitative indicators can be useful for identifying
problem areas, for setting goals and for monitoring policy
implementation.

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comments on earlier drafts were received from Shailendra Anjaria, Julian
Berengaut, Mario Blejer, David Burton, Max Corden, Augusto De La Torre,
G.G. Johnson, Jukka Paljarvi, Chanpen Puckahtikom, Markus Rodlauer, and
other members of the IMF staff, and Michael Michaely of the World
Bank. The author takes sole responsibility for any errors which still
remain and for the views expressed.

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Summary of
"Approaches to Trade Liberalization in Developing Countries"
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This paper discusses ways in which trade liberalization can be implemented and indicators that may be useful in formulating and implementing trade liberalization policy. It has been prepared as background material for staff work on issues in the monitoring of structural adjustment.

The paper briefly considers the arguments concerning trade liberalization and growth, and the problems that may accompany liberalization and create opposition to it. Trade liberalization itself is not a panacea for growth; supporting policies are needed, especially with respect to the exchange rate and financial stability. Experience suggests that the process of liberalization is usually slow and must overcome considerable opposition. Progression from a highly restrictive to a liberal trade regime can involve switching from administrative and quantitative restrictions to influencing trade via price variables, decreasing anti-export bias, reducing the variance of differentials in effective protection rates among exports and among import substitutes, and reducing levels of protection on import-competing domestic production.

Against this background, the paper discusses in some detail the various instruments of trade restrictions. It suggests the type of information, including quantitative measures, that can be used to indicate areas of serious distortions and their extent, to establish goals for policy, and to track the implementation of reform.

The paper suggests a number of possible approaches to implementing and monitoring trade liberalization. The suggested approaches recognize (i) that country differences, such as the degree of industrialization, will affect the speed and form of liberalization; (ii) that the role of the exchange rate can be critical; and (iii) that liberalization can be most effectively carried out in conditions of financial stability. Priority can be given to reducing anti-export bias and to correcting areas of most extreme distortions.

Introduction

The serious and persistent unfavorable external situation of many developing countries has led, in recent years, to the realization that the attainment of long-term balance of payments viability requires new emphasis on growth-promoting structural adjustment. One part of this adjustment process is trade liberalization. This paper discusses the ways in which trade liberalization can be implemented and the indicators that can be used by policymakers to formulate their policy goals and to monitor their implementation.

Section I considers, briefly, the arguments concerning trade liberalization and growth and the problems that can accompany liberalization and create opposition to it. Section II draws on the experience of developing countries that have attempted liberalization to infer some conclusions on timing and sequencing. Section III discusses in some detail the various instruments of trade restriction and suggests what type of information, including quantitative measures, can be used to show areas and extent of serious distortion, to specify goals for policy, and to track the implementation of these policies. Finally, Section IV suggests possible approaches to implementing and monitoring trade liberalization.

Trade liberalization by itself is not a panacea for growth; other policies are needed. Furthermore, the effectiveness and even the possibility of successful trade liberalization depends on other policy measures. Though some of this dependence is discussed in Section II, most issues related to other important policy measures, especially exchange rate adjustment which is most closely related to trade liberalization but also measures designed to improve financial stability, are outside the scope of this paper.

I. Conceptual Background

For the last half of the century there has been a continuous debate among economists and policymakers, particularly in developing economies, on the relative merits of free trade and trade restrictions in fostering economic growth. The differences in opinions often arise from differences in approach--trade economists versus development economists--and policymakers often imposing trade restrictions for pragmatic reasons, retaining them for reasons not necessarily related to national welfare, and adopting the most sympathetic economic rationale. Though international organizations have tried to use their influence to bring about reductions in trade restrictions, many developing countries have been equally persistent in their attempts to avoid or limit trade liberalization. An understanding of this reluctance to liberalize may be helped by a brief summary of two related but distinct issues: the arguments for trade restrictions in the context of growth, and the problems arising in the process of trade liberalization.

1. **Trade, protection, and growth** 1/

The neoclassical arguments for free trade are too well known to elaborate here and, in general terms, have not changed since the first formulations by the classical economists. Essentially, the arguments rest on the idea that market-determined prices are the most efficient means of allocating factors of production. For many years, opponents of free trade have maintained that this argument is irrelevant for growth because it refers only to maximization of welfare in a static frame-work. This, of course, is a misunderstanding: classical economists from Adam Smith on stressed the effects of free markets on capital formation and savings, and not merely on static allocative efficiency. Thus, the benefits to be achieved were not merely optimal immediate production but also efficient economic growth. 2/

Classical economists recognized the possible validity of two arguments in favor of imposing tariffs: infant industry protection and terms of trade improvement. The modern theory of international trade has refined and limited these long-accepted exceptions to the free trade argument. Scholars such as Johnson, Corden, and Bhagwati extended the theory of protection and in particular the justification for and the optimum forms of interference in situations where market distortions exist. As regards the latter, two important lessons are to be drawn from this literature. First, it is necessary to distinguish between internal distortions (which are quite prevalent) and trade distortions (which are less prevalent); only the latter can justify trade inter-vention as first choice corrective measures. 3/ Second, in those cases where trade intervention is justified to correct trade distortions, tariffs or quantitative restrictions on trade are not first-best solutions. The tariff-cum-subsidy arguments for first-best solutions, however, while theoretically correct, often cannot be adopted in many political-economic situations.

Development economists have created the theoretical basis for rejection of free trade as the most efficient method for structural change and growth. In the 1950s, economists such as Nurkse, Myrdal, and Prebisch, developed the case for basing industrialization on import substitution. Some emphasized the limited role that could be expected from expansion of primary exports in providing the resources for industrialization. Others emphasized a "generalized infant industry argument": import substitution behind protective walls meant ignoring immediate comparative advantage in the belief that a process would be initiated, leading to the creation of new comparative advantage and to

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1/ For a recent survey of these issues see Corden (1987).

2/ In recent years, discussion of the resource costs of interference include factors other than inefficient allocation (e.g., costs of admin-istration and rent seeking), ibid.

3/ Of course, it may sometimes be necessary to use a trade intervention as a second-best method of adjusting for an internal distortion.

future benefits outweighing the immediate welfare losses. This "dynamic comparative advantage" would result from linkages between industries, both on the demand and supply sides.

One aspect of the argument between trade and development economists had pretty much been settled by the 1960s: there is no valid theoretical argument for general discrimination against exports. Even Prebisch (UNCTAD 1964), who with his associates at ECLA had developed the thesis that only import substitution could prevent a shortage of foreign exchange from restraining industrialization, realized that the industrialization process required additional foreign exchange for capital formation and intermediate inputs. He therefore advocated reducing the bias against both traditional exports and new industrial exports. The gross inefficiencies resulting from excessive protectionism for import substitutes were clearly apparent. 1/

Though the case for anti-export bias is dead, structuralists' arguments for selective promotion of industry have not disappeared. The infant industry argument for protection, resting as it does on economies external to the firm, has been broadened to encompass a spectrum of benefits that the individual firm (and thus the potential investor) cannot internalize, such as creation of human capital by means of "learning by doing." These dynamic externalities, and capital market imperfections, are the main rationale for protection as part of an active industrial policy, with special accent being placed on the encouragement of activities leading to technological innovation.

The belief in the need for industrial policy is manifested in investment policy, both in restrictions on foreign investment and in the mobilization and allocation of resources. For the related trade policies, recommendations range from a general, but low, protective tariff for infant industries 2/ to high, more selective protection, 3/ and to broad nondiscriminating promotion (where possible) of technology-innovating activities. 4/

Empirical studies on the experience of developing countries in the last twenty years, and in particular the tremendous growth of several NICs have been accepted by most students of the field as validating the belief that outward-looking policies and macroeconomic stability have proven to be the best way to attain growth. 5/ In fact, the distortions caused by widespread controls and intervention are viewed as a major constraint on the growth of developing countries who retain them, limiting productivity, investment, and capital inflow. Balassa (1978)

1/ For a discussion of the role of first stage and second stage import substitution, see Balassa (1981, Essay 1).
2/ For example, Balassa (1975).
3/ For example, Westphal (1982).
4/ For example, Justman and Teubal (1985).
5/ For example, Little, Scitovsky, and Scott (1970), Donges (1976), Bhagwati and Krueger (1978), and Balassa (1985).

estimated that after a short-term adjustment, annual gross national product (GNP) growth rates can increase by two or three percentage points after removal of anti-trade bias. The 1987 World Bank World Development Report (Chapter 5) presents findings on the economic performance of 41 developing countries in the 1963-73 and 1973-85 periods, which demonstrate that countries with outward-looking policies (defined as nondiscrimination against exports) generally achieved higher rates of growth of gross domestic product (GDP), GDP per capita, manufacturing exports, and industrialization, as well as higher saving ratios and greater efficiency as indicated by increased factor productivity and lower incremental capital-output ratios.

Whereas the empirical studies have bolstered the current view, which is overwhelmingly in favor of nondiscrimination against exports, there is still no unanimity of opinion concerning complete nondiscrimination as against a "picking-winners" policy. There are still those who opt for selectivity. For example, Westphal, Kim, and Dahlman (1984) interpret the experience of Japan and Korea as proving that selective industrial strategy—choosing what specific industries to promote on the basis of predicted future comparative advantage—is desirable, and both Lin and Sachs (1987) maintain that export-led growth in Japan, Korea, and Taiwan Province of China was a result of export promotion policies not linked to import liberalization. It should be stressed that selective industrial promotion, proposed by some economists, does not imply resort to trade discrimination. Thus, though not all economists are ready to espouse absolutely free trade, the mainstream of economic thinking at this time is clearly in favor of freer trade as the optimal growth policy for developing countries. 1/

Economic growth, as measured by income per capita, is certainly the objective most commonly sought. Countries faced with balance of payments problems, whether current account imbalances or an external debt burden, must achieve the type of growth that will help solve these problems. In fact, if balance of payments viability is not achieved, sustained growth cannot be expected. Thus, economic growth not only must provide the additional resources, part of which can be allocated to improving the balance of payments, but also be steered toward tradables. Although completely free trade is neither theoretically justifiable nor attainable in practice, reliance on freer trade and internationally competitive prices is the most direct means to encourage growth in the sectors most relevant for balance of payments improvement.

1/ Ironically, in recent years there has been growing protectionism in many of the more developed countries. A review of these trends and their negative consequences is contained in OECD (1985) and in Anjaria, Kirmani, and Petersen (1987).

Trade liberalization alone will not ensure rapid economic growth. For the poorest countries, saving, foreign exchange, and skill constraints will still have to be overcome. Some heavy debtors will have to reduce domestic absorption, including investment, which may affect growth. But trade liberalization will create a framework for more efficient growth in all cases; where restrictions have led to a complex web of inefficiency, sustainable growth would require fundamental restructuring, in which trade liberalization would play an important role.

2. Problems of liberalization

Trade restrictions may be imposed initially for many reasons: ideological, theoretical, or, commonly, as a way to react to a balance of payments crisis or to create employment. The distinction is often made between restrictions imposed for reasons of protection and those for balance of payments. This is sometimes a useful distinction; indeed, in the approaches discussed later in this paper it is applied. Regardless of the original purpose of restrictions, they always have protective effects, direct and indirect, on current or future productive processes. Intervention, for whatever reason, usually leads to distortions, which in turn call for new interventions and over time a complex tangled system of often contradictory measures is created. Once in place, the trade restrictions are difficult to remove, even when policymakers can be convinced that their removal would be in the national interest.

The first complication arises from vested interests: it is only natural that bureaucrats are reluctant to give up their powers and source of influence. 1/ Moreover, protected firms use all their influence to retain their preferential positions: the most common objection to the infant industry protective tariff is that infants are never ready to be declared mature. The income redistribution effects of liberalization can create major political difficulties. These redistributional effects are potentially more explosive when they concern ethnic groups or major sectors of the population, for example, rural agricultural interests as opposed to urban industrial interests, often concentrated geographically. 2/

1/ This is especially true when this influence is used for personal gain. For a clear example of how this can foil liberalization attempts, see Pitt's (1987) analysis of the liberalization episodes in Indonesia prior to 1966.

2/ Sachs (1987) argues that income distribution policy, specifically land reform, is crucial to economic growth and affects attitudes toward liberalization. He shows how devaluation can shift income from industrial to rural areas, a factor of considerable significance in developing opponent or supportive groups.

A second complication is fiscal: many developing countries have come to rely on tariff revenue as a major fiscal source. A recent study on the fiscal dimensions of trade policy (Katz and Farhadian-Lorie (1987)) assembles data showing that taxes on trade in non-oil exporting developing countries in 1973-84 averaged 16.2 percent of total revenue, compared with 1.9 percent in developed countries. 1/ Moreover, in some countries, particularly in Africa, ratios above 25 percent are not uncommon. Particularly problematic are those cases where taxes on exports are major sources of revenue and serve as a substitute for income tax on the agricultural sector. 2/ Clearly, substantial reductions in such taxes cannot be undertaken unless equally effective alternative sources of income are found. On the other hand, import-related revenues may actually increase if quantitative restrictions are replaced by tariffs and liberalization is accompanied by devaluation.

Two more general economic problems of liberalization must be taken into account in determining the timing and sequencing of a liberalization program 3/: temporary unemployment and immediate balance of payments problems.

3. Unemployment

Liberalization of competitive imports will have effects on employment, both in the short term and in the longer run. The fears concerning unemployment focus on individual industries that are now exposed to competition. A protected industry faced with import competition may respond in several ways. If prices fall below minimum average variable costs, production may cease at once. If prices still cover variable costs, output and employment may decline in the short run. 4/ The firm may close in the long run, but this is not the only possible outcome. In cases where protection provided substantial rents to specific factors, these may decrease without reducing output and employment levels. In other cases, the response to competition may be improved efficiency and increased productivity, and the long-term employment in the affected industry will depend on the flexibility of capital and labor in adapting new techniques and switching to more competitive products.

Import liberalization also includes removal of restrictions on imports of inputs. These should have expansionary effects on exports and the production of existing and new products. Thus, the total net

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1/ This same study illustrates that the use of these revenues is crucial in determining the macroeconomic effects of trade intervention.

2/ See Tanzi (1983).

3/ Detailed discussion of timing and sequencing is deferred to Section II below.

4/ The decline in employment will occur only if liberalization consists of actual reduction in protection levels; a mere change in the form of protection will not have any negative immediate employment effects.

long-term employment effects of liberalization, as well as the general growth effects, can be expected to be beneficial, particularly if anti-export bias is removed; nonetheless, the possible temporary decline in employment, especially if concentrated in particular regions or involving problematic sectors of the labor force, will generate strong opposition to liberalization. This possibility will affect the timing of liberalization, and may require adjustment aid designed to decrease the net short-term unemployment resulting from liberalization and to hasten the transition to net growth in employment.

4. Balance of payments

Unless completely compensated for by exchange rate changes, liberalization that includes reduction in restrictions could lead to an immediate worsening of the current account. Imports could increase, unless restrictions were replaced fully by tariffs and even if the liberalization involves only noncompetitive imports. Reduction in anti-export bias would benefit the balance of payments but exports may respond more slowly. Thus, in terms of economic conditions, liberalization may be more practical when there is no balance of payments crisis. On the other hand, in times of crisis it may be politically easier to accept drastic policy changes. Obviously, in the case of countries already facing balance of payments problems, trade liberalization could, other things equal, intensify the problems in the short run; consequently, the "normal" macroeconomic policy package would have to be more intensive. 1/ Devaluation may have to be larger to compensate for tariff reductions; monetary, fiscal, and wage restraint stronger to make sure that inflation does not completely erode the devaluation; and, finally, the impact on export expansion maximized by removing export restrictions and eliminating anti-export biases. In severe inflationary situations, some aspects of trade liberalization may have to be deferred till after a stabilization program has been introduced.

The exchange rate regime has a crucial role. If it is very flexible--and many developing countries have adopted more flexible exchange rate regimes in recent years--it is much easier to integrate trade liberalization measures with exchange rate adjustments. It is more difficult to liberalize when devaluation is a rarely used and unpopular tool and a special problem exists in cases where the exchange rate cannot be adjusted at all; as Corden (1987) points out, for a country whose exchange rate is tied in a currency zone the only solution may be to achieve effective devaluation by use of uniform taxes and subsidies as substitutes for official devaluation.

1/ A clear discussion of macropolicy and trade liberalization is contained in Mussa (1987).

There are those who prefer use of trade restrictions to devaluation to correct current account imbalances, arguing that there are cases where selective restrictions might have less inflationary impact and more favorable (or less contractionary) impact on growth. 1/ Preliminary findings, based on an empirical analysis of over 100 devaluations by developing countries (Kamin (1987)) strongly indicate that devaluations do have beneficial effects on the current account of the balance of payments, do not lead to contractions of output, and do not have lasting effects on the rate of inflation. Thus, balance of payments problems are generally better addressed by exchange rate adjustments than by quantitative trade restrictions.

The appropriate combination of trade liberalization, exchange rate adjustment, and other macroeconomic policy is crucial to effective liberalization, and the possibility of implementing suitable combinations may determine the timing of liberalization. This is considered in the following section.

II. Designing Liberalization: General Observations on Timing and Sequencing 2/

Whereas the desirability of a liberal trade regime can be justified both on theoretical and empirical grounds, no such solid foundations are as yet available for choosing the optimal path for movement from a restrictive to a liberal regime. Many developing countries have attempted to liberalize their foreign trade, with varying degrees of persistence and success. Clearly, there is no one answer that is universally suitable. Rather, the experience of developing countries with liberalization can at most give suggestive inferences of what can be expected to work under given circumstances, those circumstances varying widely between countries and over time.

1/ Taylor (1981) stresses short-term employment losses resulting from rising prices of imported inputs. The Cambridge Policy Group (e.g., Cripps and Godfrey (1976)) advocated trade restrictions for the United Kingdom in the mid-1970s; a convincing reply to their analysis is contained in Corden, Little, and Scott (1980).

2/ The main source for this section is an ongoing World Bank project that attempts to generalize about timing and sequencing from the liberalization experience of 19 developing countries. Though the study is not yet complete, preliminary results based on the 19 country manuscripts are available. This study will hereafter be referred to as WBP, and the preliminary findings by the project supervisors, as presented by Papageorgiou, Michaely, and Choksi, as PMC (1987). A member of the external panel for this study published his inferences in Wolf (1986). The views of the present writer, who was one of the country authors, were of course also influenced by his participation in five intensive conferences during the course of that project and by the study of other analyses of liberalization attempts.

Because the expected beneficial effects on growth may be clearly apparent only in the longer run, the success of a liberalization attempt must usually be judged on its viability. Is a major reform sustained or reversed, or in the case of a slower, multistage program, are the initial steps followed by the more far-reaching reforms? The experience of others should be used to minimize making the mistakes that are most likely to lead to reversal of liberalization and its discrediting.

To avoid possible confusion, it is advisable to preface the discussion by making clear what is meant here by "trade liberalization." Four components of policy reform are envisioned in this term:

(1) Changing the form of trade intervention from administrative measures to reliance on price-interference variables (e.g., tariffs).

(2) Decreasing anti-export bias--an alternative term is movement toward "outward-orientation"--by reducing the differential in incentives as between import substitutes and exports.

(3) Reducing the variance of differentials in effective protection rates among exports and among import substitutes.

(4) Reducing levels of protection on import-competing domestic production. 1/ This has two aspects: it is one form of reducing anti-export bias ((2) above) and it reduces the discrimination in incentives to different types of domestic production and consumption.

Among the possible instruments for placing greater reliance on the price mechanism and reduction of differentials between products is exchange rate adjustment. This has led to a semantic argument: is devaluation part of a liberalization package, or an accompanying policy? Clearly, it may be either, or completely unrelated. A liberalization aspect of devaluation exists whenever exchange rate adjustment has elements of switching from administrative to price intervention or decreasing price differentials between or among imports and exports. An overvalued exchange rate discourages both exports and import substitution, and its adjustment may be recommended independently of liberalization considerations. But overvalued rates often lead to

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1/ It is not uncommon in the literature to find the term "trade liberalization" referring only to this last item; in such cases, liberalization is associated with increased imports, and the latter is used as a test to determine if liberalization has taken place.

compensating interventions, which can be reduced when a more appropriate exchange rate is adopted.

1.   Liberalization and macroeconomic policy

There is widespread agreement among students of the subject that the major cause of reversal of liberalization has been the inability to solve macroeconomic problems. Specifically, following import liberalization, a deterioration in the current account of the balance of payments and the ensuing loss of foreign exchange reserves has sometimes led to reimposition of controls. For 10 of the 19 countries studied in the WBP, the country authors concluded that balance of payments problems prevented sustaining liberalization; on the other hand, when the balance of payments position was viable, all other problems--political antagonism, pressure groups, even temporary economic hardships such as unemployment--were usually not sufficient to lead to reversal. Balance of payments crises may arise from external sources, for example, the oil shock, or worsening terms of trade. But in many cases they also arose from domestic policy mismanagement. The inadequacy of accompanying policy consisted of one or both of two components: failure to contain inflation, usually as a result of inability to reduce the government deficit sufficiently, and inadequate exchange rate management.

In some cases much of the fault may have been related to simultaneous liberalization of the capital and current account; 1/ exceptional inducements to capital inflows may have led to an appreciation of the exchange rate, which may have hampered trade liberalization. 2/ The order of current and capital account liberalization is still subject to dispute, 3/ although most developing countries that have adopted liberalization reforms started with trade liberalization.

Of the four components of trade liberalization listed above, only the last--actual reduction of protection levels--need lead to increased imports. The reductions of differential incentives may do so, but not necessarily in a significant amount, and induced exports may more likely bring about net improvement in the current account. Thus, some aspects of liberalization do not have important macroeconomic implications, though the net effect on effective exchange rates must be taken into account. Consequently, these steps may be taken even in the midst of a crisis requiring strong stabilization measures. Actual reduction in levels of import restrictions, however, is likely to require coordinated exchange rate and stabilization policy action. The ability to implement the necessary macroeconomic policy, more often a function of political

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1/   Argentina has been cited as a prime example.
2/   Lin (1987) suggests that Korea in the 1960s was less successful than Japan and Taiwan Province of China in containing inflation because it was more liberal as regards short-term capital flows.
3/   For a survey of the literature on the order of capital and trade liberalization, see Edwards (1986).

power and conviction than of economic knowledge, is relevant for decisions on the suitable conditions for implementing a liberalization program.

2. Time dimensions of liberalization programs

A crucial question faced by policymakers is how long a transition period is required to move from a restrictive to a liberal trade regime. This is a question of trade-offs between reducing transition costs (and thus, pressures for reversal) and speeding up the benefits of liberalization. Unfortunately, no clear answer can be given, either on theoretical or empirical grounds. The experience among developing countries (and indeed among the now more developed countries after World War II) has been varied. The duration of liberalization episodes studied in the WBP ranges from a minimum of two years to as long as a generation. Among the successful significant liberalizations defined in terms of extent and sustainability was Chile, which did it quickly, within five years; 1/ Israel and Greece had drawn out, fairly monotonic processes, lasting 20-25 years, and Korea took a 10-year pause (1967-77) before resuming its liberalization.

Adjustment costs in terms of unemployment were in most cases not high. In a number of cases this was a result of the protracted nature of liberalization. 2/ Based on the analysis of successful liberalizations and the advisability of gradualism (see below), it seems reasonable at this stage of knowledge to agree with Wolf (1986) that four or five years could be the lower bound for the time needed to implement a far-reaching reform. Thus, significant liberalization must be accepted as at least a medium-term, if not a long-term, objective; it may be unrealistic to expect comprehensive reforms in the short run.

Does this imply that, given the normal time horizons of governments, it is futile to design a liberalization program, as opposed to simple adoption of a long-term objective? Can any realistic timetable be formulated? The answers are not necessarily negative. They depend on the initial conditions of each country, the extent of liberalization expected to be achieved in the short run, and the possibility of incorporating short-term measures into preannounced longer term programs.

Policy recommendations must deal with the questions of gradualism, intensity of reform, and sequencing. The WBP provides no examples of one-shot immediate transition from restrictive to liberal trade. It cannot therefore be concluded that such immediate transition would not

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1/ However, Chile did regress somewhat on tariffs, which had been reduced to a uniform level of 10 percent by 1980. Tariffs were raised to 30 percent and their variance was widened in 1982.

2/ Strictly speaking, it is the protraction of actual lowering of protection levels that softens the negative adjustment costs; however, there may be an optimum time span--not yet clearly identified--for absorbing the earlier stages of liberalization.

work. However, this experience might suggest that gradualism is a more realistic approach. Should the first reforms be dramatic or small steps? PMC (1987) infers that major and significant initial steps are more likely to lead to success. Major steps did often end in failure, but in no such case were they followed by a subsequent successful minor reform. On the other hand, even after failure of a liberalization attempt, a renewed attempt at a later stage, when consisting of a major policy shift, often succeeded. The extremely important inference which this suggests is that "...countries with histories of failures of liberalization attempts may still succeed in implementing a liberalization policy, and are likely to achieve it by bold policy changes at the very beginning of the trade policy reforms." 1/

3.   Sequencing

Should particular components of liberalization precede others? The evidence of the WBP clearly supports the conclusion that transformation of the methods of restrictions, specifically moving from quantitative restrictions to reliance on price variables, should precede significant reductions in levels of protection. A major advantage of price measures is transparency; without some clear indication of levels of protection it is impossible to devise rational decreases in them. Given visible price differentials, targets can be set for their reduction and timetables established. This is crucial not only for policymakers, but even more as signaling devices to economic agents.

It may be necessary, in the movement from quantitative to price instruments of restriction, to distinguish between imports that compete with domestic production and those that do not. There is no theoretical reason to make this distinction, and it would be desirable to switch from quantitative restrictions to tariff or equivalent measures simultaneously for both kinds of imports, but it may be necessary for pragmatic reasons to make a two-stage transfer. One reason is inability to overcome in one stroke the fears, among producers and policymakers alike, of what may happen to domestic output as a result of the switch. A second reason may be the time required to determine and set the tariff protection that is substituting for quantitative restriction protection. The objections to switching the form of protection on import substitutes, even without intentional reduction of levels, should not be allowed to delay the use of price measures rather than quantitative restrictions to control the level of noncompetitive imports. By quickly absorbing quota profits, fiscal benefits are obtained that will ease further liberalization.

Removal of anti-export bias need not be deferred to a second stage, but the appropriate timing and methods depend on a number of factors.

1/ Papageorgiou, D. et al (1987), page 8.

Clearly, the sooner exports can be stimulated the better, 1/ and it is
to be expected that there will be a slow reaction time, particularly for
the establishment of newly competitive industries. Outward-looking
orientation can be obtained by adjustment of the exchange rate in cases
where it is overvalued. If nominal exchange rate adjustment is not a
policy option, reduction of anti-export bias can be achieved either by
lowering effective protection rates on import substitutes or by
increasing export incentives or both. Uniform, direct subsidies for
foreign exchange value added in exports (ideally equal to a uniform
effective tariff on imports) could be a second-best solution. These,
however, could prove to be not beneficial over the long run if they were
retained too long. They might also be difficult to calculate
properly. Being visible budgetary expenditures, the export subsidies
may arouse antagonism even when fully covered by taxes on imports. 2/

Any differentials between effective protection rates for import
substitutes and exports are in effect taxes on exports. Some of these
are inadvertent; for example, import duties on imported (noncompetitive)
inputs for exports. Efficient drawback arrangements can eliminate this
tax even without major policy reforms.

Arguments can be made for selective export promotion, justified by
a "picking winners" approach, based on expected long-term comparative
advantage, or by short-term fiscal considerations that take advantage of
the less supply-elastic export industries. 3/ It is this writer's
opinion, however, that the market is usually a better predictor of long-
term benefits than bureaucrats; consequently, as a general rule it is
advisable to prevent or eliminate intra-export differentials as soon as
possible.

Intra-import differentials should also be reduced as soon as
possible. The tendency to have lower import duties on inputs and on
investment goods than on finished consumer goods creates an escalated
protective system, and by making capital relatively cheap, distorts

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1/ Lin (1987) believes that a separate export-promotion stage prior
to import liberalization explains the relative greater success in East
Asia compared with Latin America; but no such clear conclusion emerges
from the WBP, and for Korea, there was a ten-year pause between these
two stages.

2/ This aspect of export subsidization accounts for the popularity of
export retention schemes, whereby some import-quota profits are
transferred to exporters as consumer-financed subsidies, which do not
appear in government budgets. The costs of the distortions that arise
from the intra-export differentials associated with this type of
subsidization are likely to outweigh any budgetary advantages.

3/ One can justify theoretically an export tax on a specific item
facing inelastic world demand. This market power for individual
countries is not very common. For estimates of inelasticities that can
be exploited by developing countries and indications that taxes tend to
be set above optimal levels see Sanchez-Ugarte and Moti (1986).

factor prices and encourages misallocation of resources. These differentials will probably be reduced slowly; their elimination does not preclude the intentional discriminatory taxation of "luxury goods" by means of general purchase taxes, or value-added taxes, which do not discriminate in favor of domestic output.

Lowering protection rates on import substitutes, what some authors call "real" liberalization, will of course eliminate anti-export bias. But since this component of liberalization may have to be deferred, and may in any case be a drawn out process, it is not advisable to wait for this stage to remove anti-export bias. Consequently, it may be necessary to use second-best, nondiscriminatory, and temporary export promotion instruments at an early stage, thus strengthening the balance of payments, a necessary condition for the later stages of liberalization.

The reduction of protection levels may generally be gradual, but targets can be set for the medium term and dates set for specific reductions. The actual reductions can be made in several ways. A recommended system is the "concertina method," whereby there is a sequential lowering of tariff ceilings, and at each stage tariffs above the ceiling are lowered to it. This does not preclude placing a minimum tariff on items previously exempt.

4. Political support

Trade liberalization means readjustment, and inevitably involves income redistribution. Typically, the potential losers are in a better position to make their influence felt than potential gainers, even when the national net gain is clearly positive. For this reason, the strategy for successful liberalization is to minimize adjustment costs, to get quick results (often an objective contradictory to the first one), and to generate supporting factions. This raises the question of preannouncement, about which there are contradictory arguments. To minimize adjustment costs economic agents should be given the proper information to plan their adjustments. This will also generate support from potential gainers. Preannouncement may, however, make possible the mobilization of opposition, so a case can be made for a series of surprise measures. 1/ Clearly, the political circumstances of particular situations will determine which strategy is most likely to be effective.

What role can external pressures and inducements play? Greece, Israel, Spain, and Portugal had their liberalization policies strongly influenced by a desire to join or be associated with the European Community (EC). The potential benefits of such association could be pointed out as an inducement to liberalize—or similarly, the threat of isolation from Europe shown as a danger from continued protection—and used to support those forces in each country urging liberalization in

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1/ This is an inference drawn by Wolf (1986).

their conflicts with opponents. Moreover, the negotiations with the EC
have often been used to receive some benefits while in the form of
reduced tariffs on the country's exports adhering to a timetable
designed in terms of the country's own preferences.

International organizations and major creditor or trading countries
may help strengthen the advocates of liberalization by provision of
financial aid for the period of adjustment or by implied threat of
sanctions. 1/ The history of liberalization efforts by developing
countries, however, clearly indicates that success depends on
conviction: where the political regime is basically opposed to trade
liberalization, such liberalization measures will prove to be only
temporary. For liberalization to succeed, credibility of conviction and
of the process chosen is vital.

III. Identification of Trade Restrictions and Distortions

The above observations on timing and sequencing are suggestive for
general approaches and goals. Specific proposals depend on given
situations and will in all probability not be the same for any two
countries. Nonetheless, somewhat more specific approaches can be
suggested, and this is done in Section IV. Neither practical approaches
for trade liberalization nor effective monitoring can be possible, how-
ever, without prior identification and some sort of quantification of
the extent of trade restrictions and their distortive effects. Although
there is apparently no limit to human ingenuity in designing tools of
intervention, the most widely used direct instruments can be identi-
fied. These are discussed below, and some quantitative indicators could
be considered. 2/ In many cases the data available may not be
sufficient to estimate the most desirable of these quantitative
measures. In some cases very crude "guesstimates" may have to
suffice. The quantification possible will depend on the statistical
base available in each country, and the relevant indicators will depend
on the type and level of trade restrictions. In designing a liberal-
ization program, priority could be given to assembling the relevant
information. 3/

1/ Kim's study on Korea (1977) suggests that U.S. influence was
important and publicized.

2/ The indicators discussed refer to direct trade intervention;
excluded are import substitution protection and export promotion not
tied to specific quantities, that is, government investment support and
other industrial targeting strategies.

3/ Care must be taken so that the need to make proper estimates does
not lead to undue postponement of needed reforms.

The following discussion distinguishes between instruments of administrative and price intervention and considers separately measures applied directly to imports and exports.

1. Administrative restrictions on imports: types

The most widely used administrative restrictions or nontariff barriers on imports are as follows:

1. Absolute restrictions on imports: These may be based on lists of allowed imports ("positive list") or lists of disallowed imports ("negative list").

2. Quantitative restrictions: Quantities may be controlled by licensing, exchange control, or both. 1/ Distinctions should be made between specific and general licenses, discrimination among license recipients or source of supply, and whether foreign exchange is allocated automatically if import permission is granted, is bought at auction, or is tied to specific (governmental or private) sources of supply. The crucial questions are to determine how the restricted supply is allocated among competing demands, and who obtains the potential monopoly rents.

3. State trading: Governmental agencies or corporations may be given monopoly power in the importation of specific commodities.

4. Procurement regulations: In domestic purchases by public or publicly controlled institutions and corporations, domestic content requirements may be a significant form of protectionism.

5. Nongovernmental restrictions on trade: Multinational oligopolies often use "orderly market arrangements" to restrict imports in particular markets. 2/

1/ Although which of these two instruments is used is important and of great interest to organizations that are concerned with particular measures, for example, the Fund on exchange restrictions and the General Agreement on Tariffs and Trade (GATT) on other barriers, from the point of view of trade restrictions there is little to choose between them. As a matter of fact, many developing countries in recent years have eased exchange restrictions while retaining the other kinds.

2/ Dealing with these types of restriction, unless they were bilaterally negotiated at the governmental level, would probably be outside the scope of governmental liberalization programs.

2. Administrative restrictions on imports: quantification

Restrictions on imports are generally much more difficult to quantify than those employing price intervention. Some published data may be available, such as lists of prohibited or allowed imports, import plans and foreign exchange budgets, and regulations on licensing procedures, foreign exchange procurement, testing procedures, and domestic content requirements. More detailed information and analysis require the cooperative efforts of governmental departments. 1/ Attempts to assess the extent of resort to nontariff barriers on the basis of international comparisons of broad macroeconomic indicators appear to be of little use in analysis of individual developing countries. 2/

The best that can generally be hoped for are some indicators of the distortive impact of the regulatory system, not measures of the height and severity of restrictions. The following information should be solicited on the basis of published lists or consultations.

1. Lists of items subject to absolute and quantitative restrictions.

2. Classification of restricted items according to whether the product is produced domestically or not. This requires a comparable classification of restricted items, tariff items, and domestic production.

3. Lists of items subject to state trading and domestic content requirement.

This information can be used to distinguish between import restrictions that have direct protection effects and those that limit noncompetitive imports. From this information several ratios can be computed and used as indicators of changes in quantitative protection (though not levels of protection). Because the information obtained is in the form of detailed lists, it can be used to compute the following ratios, for comparison over time, separately for broad classes of goods: current consumer goods, durable consumer goods, capital goods, semiprocessed goods, and raw materials. (Special efforts may be made to try to identify restrictions on imports of inputs for export industries.)

1/ The GATT compiles some data on nontariff barriers based on members' reports, and the Fund publishes annual reports on exchange and trade restrictions.

2/ Such measures have been used imaginatively to evaluate the use of nontariff barriers by Japan, as compared with the United States. See Bergsten and Cline (1985).

1.   Percent of items subject to administrative restrictions.

2.   Ratio of value of imports subject to restrictions to value of total domestic market: output <u>minus</u> exports <u>plus</u> imports.

3.   Ratio of state-traded imports to total imports.

4.   Ratio of output subject to domestic content requirements to total domestic market.

None of the above purports to measure the height of protection. For a selected list of commodities, either not produced domestically or produced domestically but comparable to alternative imports, it may be possible to compare domestic prices with international prices, thus getting one type of estimate of distortion. 1/ This list should include representative commodities from the major economic categories.

In cases where a complex system of quantitative restrictions is applied, simple ad hoc information about the impact of regulations may be obtained. For example, how many documents must be processed and signatures be obtained in the process of receiving an import license and the foreign exchange for its financing? What is the average waiting time? Is there a measurable market fee for agents who get around the bureaucracy? 2/ What are the ratios of approvals to requests, in number of requests and value of requested imports?

3.   Taxes on imports

Governments affect the level and composition of imports by intervention in the market's price-setting procedure. A multiple exchange rate system whereby the prices for foreign exchange are differentiated by uses is a method of price intervention relatively easy to identify and quantify. More complicated are the complex systems of taxes on imports. 3/

The most common tax on imports is the tariff; however, taxes with other names that apply specifically to imports (or differentiate between imported and locally produced goods) such as excise or purchase taxes, are tariff equivalents. In addition, valuation adjustments may be applied at different stages of taxation. A commonly used cost-adding instrument is the requirement of deposits as a percentage of the value of requested imports. In the following discussion of tariff structure, all such tariff equivalents should be included in the estimates of

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1/ This is not an exact measure of the cost of protection. For a summary of the issues involved in estimating the true cost, see Corden (1985, Chapter 1).
2/ For example, this type of practice is within the Brazilian <u>jeito</u>.
3/ Subsidies on imports are also distortive, but since the major protective instrument is taxes, the discussion concentrates on them.

"tariffs"; in practice, multiplicity of agencies dealing with some
tariff equivalents may complicate estimation.

A tariff may have multiple direct effects: it provides revenue,
restricts consumption and importation, and gives protection to import-
competing domestic production. All these affect welfare and income
distribution. 1/ Frequently a particular import duty is imposed to
serve an objective associated with a specific effect; the other effects
may be incidental and not taken into account or become operational when
other changes are made. Rational tariff reform should start with an
analysis of the tariff structure.

4. **Classification of tariff by ascending order of effects**

The following scheme of tariff classification sets out a method for
identifying the existence of three tariff effects: revenue, import
reduction, and protection. Actual classification can only be completed
with the aid of informed government officials.

a. **Purely formal tariffs**

Very often a published tariff schedule will include at least some
items that have no economic significance at all. These taxes are purely
nominal, since the commodities to which they apply would not be imported
at all even if no restrictions were placed on their importation. 2/ The
remaining tariffs are defined for cases where the tariffs are not
completely irrelevant.

b. **Pure revenue tariffs**

When an import duty is the only restricting device, it will have
some effect on the quantity of imports, except in the (purely
theoretical) case of a completely inelastic demand for the commodity.
However, if the commodity is subject to an effective quantity
restriction, 3/ then the tariff will merely absorb some of the quota
profit that exists unless effective price controls transfer this
potential monopoly profit to consumers. Information on effective
quantitative restrictions, discussed above, can be used to identify the
items subject to purely revenue tariffs. These should be computed
separately for competitive and noncompetitive imports.

1/ The general equilibrium effects are even more complex and depend
also on how tariff revenues are spent.

2/ This is one of three types of tariff redundancy. A second is
considered in the next paragraph. Finally, there is tariff redundancy
in the sense of "water in the tariff"; the observed domestic price is
below the international price plus the tariff.

3/ When a good is subject both to a quantitative restriction and to a
tariff, only one of these instruments is the effective one in
determining the quantity imported.

c.   Nonprotective import-reducing tariffs

When tariffs do reduce the level of importation, that is, when there are no quantitative restrictions or, if they exist, imports are less than the permitted amount, an important distinction is that between tariffs which protect domestic production and those that do not. Consequently, this category includes only tariffs on goods that are not produced domestically.

d.   Protective tariffs

These will include only tariffs on imports of goods not subject to an effective quantitative restriction, and which are also produced domestically.

The above classification is based on identifying ascending restrictive effects; obviously the nonprotective import-reducing tariffs will generate some tax revenue (unless completely prohibitive) and the protective tariff, too, has all three effects.

Once the tariffs are classified, useful statistical compilations may be constructed showing the percentage of total revenue (and for each major category of imports) derived from each type of tariff, 1/ and the percentage of actual imports subject to each type of tariff. Of extreme importance are quantifications of partial exemptions from posted tariffs.

5.   Measuring the height of tariffs

Published tariff schedules do not measure effective protection; they show only nominal protection levels. 2/ As is by now well known, most countries impose higher tariffs on final products than on inputs, thus creating a cascading structure of effective protection. 3/ Estimation of levels of effective protection is a laborious project, whether done on the basis of sample firm data or by use of input-output tables; therefore, many developing countries contemplating implementation of a trade liberalization program would probably not have reliable benchmark estimates of effective protection let alone the apparatus for time-series comparisons. 4/ Although a precise ranking of industries by level of effective protection would be extremely helpful

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1/ This is useful in identifying cases (probably not frequent) where particular duties are important sources of revenue.

2/ Even these data are difficult to obtain when tariff substitutes are not published in like manner, or when special effort is needed to translate specific duties into ad valorem terms.

3/ For a succinct summary of the theory of effective protection and its limitations, see Michaely (1977, Ch. 4).

4/ In some cases (e.g., Israel) rough estimates have been used to replace quantitative restrictions by tariffs; in others (e.g., Turkey), existing private estimates were not used in policy decisions.

in focusing attention on the major areas of distortion, the available data on nominal protection levels should be sufficient to initiate tariff policy reform and help track its implementation. Certainly, lack of detailed estimates of effective protection should not be a basis for postponement of tariff reform.

The simplest aggregative measure of the height of tariff walls is the average tariff. Unfortunately, the ideal average figure, that is, that level of tariff which if imposed uniformly would lead to the same level of total imports, cannot be estimated from the normally available data. 1/ Two complementary averages are frequently used. One is a simple arithmetic average of nominal tariffs. 2/ The average of all tariffs, and more important, the averages for specific classes of commodities, would provide rough measures of the extent and special areas of distortion, and could serve to set quantitative goals of tariff reductions. The second rough estimate of protection level is given by a weighted average, with actual base period imports used as weights. 3/ Here too, averages should be prepared for each commodity class. Average tariff levels have been frequently used in setting preannounced goals for tariff reductions.

If tariffs are classified by their effects, as suggested above, average tariffs should be computed for each of the three types: purely revenue, import-reducing but not protective, and protective. Comparison of the last two would clearly indicate the extent of intentional protective discrimination. Both types of averages are necessary because the weighted average would be biased by giving less weight to a tariff that effectively reduces imports. For the class of protective tariffs a useful additional average can be obtained (if the data are available) by weighting each individual tariff by the domestic production of the commodity.

1/ It would require estimates of demand elasticities and free trade import levels. For a presentation of the concept and measurement of average tariff levels, see Michaely (1977, Ch. 5).

2/ Preferably after exclusion of those tariffs known to have no economic effects at all.

3/ These averages are obtained by dividing total tariff revenue by total imports. Alternative estimates of average tariff heights are now relatively easy to estimate using specially designed computer programs. For example, the World Bank SINTIA-T Program (Software for Industrial, Trade and Incentives Analysis) can make these estimates, facilitate transformation between alternative commodity classifications, and using alternative elasticity estimates made for other developing countries, can show the range of changes in tariff revenues to be expected from tariff changes. The latter information may be vital for fiscal authorities in considering reducing tariffs.

Comparison of nominal tariffs on final products, intermediate goods, and raw materials can indicate the cascading extent of the tariff structure. An additional, though inexact, method for ranking industries by levels of effective protection is to use average coefficients of material imports known for similar developing countries to estimate average protection levels for a broad industrial classification. Because such an approach ignores the differences between countries in use of nontraded intermediates, it provides estimates that are clearly very rough, but the errors arising from this should not be so important as to negate the general ranking obtained. 1/

6. Measures of impact of protection

Protection, whether by quantitative or price restrictions, reduces the impact of competitive products and makes possible charging higher prices for domestic production. One measure of this impact is measured by the ratio of imports to the total domestic market for that commodity class, that is, domestic production minus exports plus imports. Of course, the base year estimate of import penetration is not a conclusive indicator of protection; for that, other measures have been suggested. But changes in import penetration ratios are important. Reduction of protection levels should increase import penetration ratios over time. In general, comparison of such ratios in different years is most useful for showing movement toward liberalization for the intermediate or longer runs, and not for short-term tracking. However, if an actual reduction in protection levels is announced, other things being equal, there should be an increase in the import penetration ratio within one year; thus, although these ratios cannot be used as reliable quantitative measures of liberalization in the short run, they can be used to indicate whether announced reductions have been implemented significantly.

Another useful indicator is a comparison of domestic prices to international prices, that is, to the c.i.f. price of a comparable imported commodity, converted to domestic currency price at the official exchange rate. These types of comparison are often difficult to obtain: quality differences complicate the identification of "comparable" commodities. Nonetheless, sample commodities can be examined, and even when exact comparison cannot be justified, narrow ranges of price differentials may be obtained. In addition to indicating the height of exploited effective protection--for commodities protected by quantitative restrictions direct price comparisons are the only way to measure this--comparison of domestic prices with the

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1/ Comparisons of estimates of effective protective method using the "Balassa method" for dealing with nontraded intermediaries with those using the conceptually desirable (but technically more difficult to obtain) "Corden method" show that the two methods, though arriving at different figures, do not usually show a markedly different ranking of industries.

international price plus the relevant tariff show the extent to which
there is redundant protection, "water in the tariff."

7.   Export intervention

Restrictions on exports may be in the form of quantitative
restrictions or taxes. Taxes may take the form of producer prices being
set, by official agencies or semi-independent export marketing boards,
below the internationally obtained price. In addition, there may be
"voluntary export restraints" imposed by pressure from trading
partners. Assessment of the existence and significance of these
restraints can be based on many of the same types of measures and
sources of information enumerated above in the discussion of restraints
on imports; consequently, it is not necessary to give details here.

Export subsidization does, however, deserve some elaboration. The
methods used to subsidize exports directly are varied. They include
multiple exchange rates, direct subsidies on export sales, subsidies by
means of covering specific costs (e.g., port charges), or, more
commonly, by provision of subsidized credit, indirect fiscal subsidies
by means of tax rebates, and indirect subsidization via the domestic
market by means of export earnings retention schemes and officially
sanctioned cartel arrangements. In attempting to quantify and assess
the extent of export subsidization, and more important, in identifying
sources of distortion, it is important to make two distinctions. The
first is between subsidies that are real net subsidies to exporters and
those that are merely adjustments for taxes on exports (e.g., tariff
drawback arrangements). The other is between subsidies that create
intra-export distortions and those that reduce such dispersions.

The quantification of export subsidies is usually problematic.
Some types are more transparent than others: multiple exchange rates
and specifically budgeted direct subsidies may be subject to reliable
computation, but estimation of complex governmental subsidies,
frequently administered by different departments, will require full
governmental coordination; quantification of market-financed subsidies
may not be possible at all or subject to only rough guesses.

Ideally for all subsidies and, more realistically, available only
for direct subsidies, estimates should be made for net subsidies per
unit of foreign exchange value added rather than for gross export
receipts, and separately for industrial branches. These should indicate
average effective rates for different export groups and rate dispersion.

8.   Measures of inward- or outward-looking bias

A major objective of trade liberalization is to eliminate, or at least reduce, anti-export bias, 1/ that is, shifting from an inward-looking to an outward-oriented growth policy. Two measures are of use in estimating the extent of anti-export bias; if possible both should be computed as total averages and for individual industries.

The first is the ratio of the average effective exchange rate for exports to the relevant average exchange rate for imports: EERX/EERM. The effective exchange rate includes not only the official rate, but also all additional tax payments specific to imports and additional net subsidies (i.e., subtracting taxes) to exports. 2/ Unfortunately, such estimates are rarely available. If the data on tariffs and similar taxes and export subsidies are available, these ratios can be easily computed. National account estimates usually have data to permit computation of average effective exchange rates, but include only budgeted taxes and subsidies on traded goods. It is more difficult to estimate sector averages. This, however, is a measure of nominal protection ratios; a more relevant ratio is the effective protective (exchange) rate for export value added (EPRX) to the effective protective rate for value added in import substitutes (EPRM). 3/ Unfortunately, such estimates are rarely available. Consequently, the effective exchange rate ratios are more common and are useful as indicators of desirable changes and the extent of their attainment.

1/   There have been cases of pro-export bias. For example, Kim (1987) uses reductions in pro-export bias as one of his indicators of liberalization. However, this is not a common phenomenon for developing countries, the extent of pro-export bias measured is rarely large, and in other cases where this has been found, the distortionary effects of pro-export bias have been much less damaging than anti-export bias. (Bhagwati and Krueger (1971)).

2/   In recent years the term "effective exchange rate" has been used in another sense, referring to an average rate in terms of a basket of currencies. Here, the older meaning is the relevant one.

3/   A simple example may make the distinction between these measures clearer. Assume: an exchange rate of 1; a tariff of 100 percent on all final goods and 50 percent on imported inputs; all production uses only imported inputs, and the import component is 50 percent; exports receive a 20 percent subsidy per unit of foreign exchange; 50 percent of all imports are inputs. From this: EERX = 1.2; EERM = 1.75 (=0.5x2+0.5x1.5); the ratio of EERX/EERM is about 0.66. The effective protection rates are: EPRX = 0.9 (=(1.20-0.75)/0.5); EPRM (for final import substitutes) = 2.5 (=(2-0.75)/0.5), and the true anti-export bias is measured by EPRX/EPRM = 0.36. The effective exchange rates for value added are simply the nominal rate times an index of effective protection, e.g., the effective tariff plus one.

IV. Approaches to Implementing and Monitoring
Trade Liberalization

The experience with trade liberalization suggests that the attainment of completely free trade is not a practical goal. 1/ More realistic goals should include elimination of anti-export bias, low nondiscriminating and transparent protection levels, and a minimum of exceptions. The discussion of Section II above leads to the conclusions that (1) a far-reaching transformation from a highly restrictive to a liberal trade regime could be accomplished within a few years; and (2) the time path will differ among countries, because of varying economic conditions and trade regimes as well as abilities to carry out the reforms, and to implement necessary exchange rate and macroeconomic policies. 2/ Consequently, approaches to successful reform should set as objectives the adoption of substantial liberalization as a goal and a time path that will best assure sustainability of implemented measures and continuity of progress.

Specific approaches, in the sense of what exactly a particular country should do, and when, must of course be tailored to the specific conditions. Knowledge of the economic conditions and political-economic possibilities are essential, as is the minimal data and information on the trade restriction system--as discussed in Section III above--to identify the features most needing immediate attention and to set indicators that specify the goals and serve as monitoring devices. Nonetheless, on the basis of conceptual considerations and country experience, it is possible to identify some broad approaches, focusing on critical areas, including a reasonable time period for implementation, and which may be indicators for setting specific policy goals and monitoring their implementation. 3/ It should be stressed, however, that these approaches should be recognized for what they are and not be viewed as authoritative prescriptions.

Some liberalization measures, such as the removal of impediments to exports, can be implemented quickly and independently of other policy measures. Many, however, are closely related to exchange rate policy. The role of exchange rate adjustments in facilitating trade liberalization is most obvious where quantitative restrictions used as substitutes for exchange rate adjustment are subsequently eased when devaluation takes place (e.g., many Latin American countries in the last decade). Dramatic reductions in quantitative restrictions have taken place when a change was made from a fixed to a flexible exchange rate system (e.g., in The Gambia, Guinea, and the Philippines in recent years). The extent and speed of exchange rate adjustment accompanying liberalization would presumably need to be greater where restrictions

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1/ Pure free trade cannot be justified theoretically either.

2/ The ability to implement policy is as much a political as an economic problem.

3/ Monitoring refers to tracking the implementation of policy, not the longer term economic effects.

are maintained mainly for balance of payments reasons rather than as instruments of protection.

Combining liberalization with devaluation is an example of what may be, in most circumstances, a first-choice solution. But first-choice solutions are not always possible: even where possible, they are rarely sufficient. The historic evidence for the need to compromise is overwhelming. Second-best solutions must often be considered. In such cases, it must be considered carefully whether an intentional additional intervention would be justified to correct an existing distortion, or whether it would lead to prolonging that distortion and therefore not lead to a net advantage.

Two general considerations are relevant in any plan to implement a liberalization program. The first concerns prior information; it is desirable to assemble the information and as many of the quantitative indicators (listed in Section III above) as possible, both to pinpoint problems and to set quantitative goals. 1/ The second concerns effective implementation: this requires high-level coordination; for example, if done by a committee, it should be responsible to the most powerful economics minister.

The following more detailed description of approaches begins from the assumption that the initial trade regime is highly restrictive; obviously, many countries will already be somewhere along the path to a more liberal regime. The order of approaches is based on type of distortion to be reduced, keeping in mind the sequencing aspects discussed earlier (in Section II) and the fact that parallel actions on a broad front may also be desirable and practical in many cases. The relevance of policy measures and the time needed for their adoption and implementation will, of course, vary from case to case, but it will be helpful to think of countries in terms of two distinguishing elements: ability to employ effective exchange rate policy, and extent of industrialization developed as a result of protracted protection.

1. Reduction of impediments to exports

Because of the crucial importance of the balance of payments for the liberalization process and of course as an objective in its own right, it would be desirable to eliminate or at least sharply reduce the impediments to exports. 2/ The reforms would affect quantitative restrictions on exports, and quantitative restrictions and taxes on imported inputs and on exports.

1/ But as already mentioned, lack of some time-consuming estimates (e.g., effective protection rates) should not be a basis for delay.
2/ This is not to suggest that liberalization be delayed until after a stage of export promotion.

a. Quantitative restrictions on exports

The justification for quantitative restriction on normal commercial exports is typically to ensure some minimum domestic requirements of supplies, for goods of strategic importance or in cases where the market may not guarantee the socially desirable allocation. For this purpose, very limited lists of prohibited or restricted exports could be published, and regarded as exceptional cases, and subject to annual reviews. 1/

b. Restrictions on imports for exports

Inputs for exports should be imported with ease, without import licenses (or subject to open general import licenses) and preferably not taxed. In some cases--inputs specific to an export subsector--the elimination of quantitative restrictions on imported inputs can be done at once, without combined tariff changes. But, in most cases imported inputs will be used for production destined to the domestic as well as to the export market, and it may not be feasible--for revenue reasons-- to eliminate all duties. Consequently, as long as tariffs are applied on imported inputs it may be appropriate to use a tariff drawback system for exports. An efficient system would try to minimize the interest cost on prepaid (and post-returned) tariffs, 2/ especially by decreasing the delays in repayment of taxes.

Where a drawback system already exists, the implementation of this liberalization can be virtually immediate; where a drawback system does not exist, several months may be necessary for its creation. If there is hesitancy about sudden switching in the system, a schedule could usefully be adopted and announced, specifying when and what goods will be moved from restricted to unrestricted lists. It would be also useful to set quantitative goals, for example, percent of base-year imports.

c. Financing of imports for exports

The freeing of importation of inputs for export would not be complete if restrictions apply to their financing, and it would be helpful if allocation of foreign exchange were automatic. If official allocations are unavoidable, export retention deposits usable for imports of inputs may be useful as an interim solution, particularly if administered by banks. 3/ These arrangements can be set up very

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1/ For example, Mexico reduced the number of items on which it had export controls from 729 to 249 between 1976 and 1983. Although hailed as a major change, it appears to have been unnecessarily prolonged.

2/ If tariffs on inputs are expected to be permanent, it may be useful to explore the use of bonded warehouses and tax-free export zones. This is, however, a proposition for the medium term.

3/ It is assumed that the tariff system has been charged with controlling inputs for domestic uses; the export retention scheme should not be used as an export subsidy.

quickly, but should be adopted only if they are formulated as temporary measures, with provisions announced for their replacement by an efficient exchange purchase system. 1/

    d.   Export taxes

        As a general principle, export taxes are not desirable, but they may be justified in two cases, almost exclusively applicable to exports of primary products; in some countries, such taxes are implicit in the policies and operation of export marketing boards which frequently can be inefficient. 2/ The first is for prevention of negative terms of trade effects. The second case is when the tax administration is not up to the complexities of efficiently administering income tax collection, especially from the agricultural sector. Both cases are usually less applicable the higher the level of income per capita and the greater the diversity in exports. 3/ The goal could be to reduce export taxes, replacing them with alternative fiscal measures. Because the total elimination of some export taxes may not be feasible in even the medium term, especially for countries where they are a major source of income, there is the issue of trade-offs. Even in these cases, it would be helpful to set a schedule for attaining the specifically determined (minimal) difference between producer prices and border prices. 4/

2.   Simplification of quantitative restrictions on imports

        Serious consideration could be given to eliminating quantitative restrictions on imports (additional to those on inputs, discussed above). The process may take several steps, depending on the initial situation, though it may be advisable to minimize the time for the entire process and, if possible, to skip steps. Quantitative restrictions can be simplified and made more efficient even before their reduction. First, where absolute prohibition exists, positive lists could be replaced by negative lists. Second, the negative lists could be converted from absolute prohibition to import quotas. 5/ These could be auctioned to prevent creation of quota profits. 6/ Setting up such a

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    1/ Zaïre, for example, adopted an export retention scheme in 1980, which was utilized as an export subsidy, and abolished most of the export retention arrangements in 1983.
    2/ The way to streamline marketing boards is beyond the scope of this paper.
    3/ Inability to collect income tax is not a problem restricted to low-income, agricultural economies. In many middle-income countries the difference between tax rates and tax collection for nonagricultural incomes is often enormous.
    4/ Such a program was adopted by Ghana as regards cocoa prices.
    5/ Both those actions were undertaken by Turkey in 1984.
    6/ Such a Dutch auction "second window" has recently been used by Ghana.

system could require several months. 1/ The transfer of items from the negative list to the quota list may usefully be scheduled, with goals set in terms of number of items still on the prohibited list. (At a later period, general licenses and price instruments would replace the quota system.) Little time should be necessary to simplify procedures for licensing and exchange allocation.

In some countries the import system is inefficient because much of it is in the hands of state monopolies. Reform of this system, introducing competition into import trade, is an important step which may be taken quickly. For example, Guinea in 1984 adopted the goal of dismantling the pervasive system of state import monopolies.

3. Removal of quantitative restrictions on noncompetitive imports

Quantitative restrictions on noncompetitive imports are clearly for balance of payments purposes and not for protection. Their removal needs to be accompanied by other instruments to prevent a flood of imports. The main price instrument for external transactions is the exchange rate. Devaluation can be a substitute for quantitative restrictions and, if accompanied by sufficiently restrictive demand policy to supplement the expenditure-reducing effect of devaluation, may be all that is necessary to permit elimination of quantitative restrictions on most noncompetitive imports. In some cases, it may be necessary to raise (or impose) tariff supplemental to devaluation.

When no nominal exchange rate adjustment is feasible for institutional reasons--though the restriction of imports by means of quantitative restrictions is a priori indication of excess demand for foreign exchange and suggests that such adjustment is desirable--quantitative restrictions on noncompetitive imports could be replaced by purchase taxes, or as a decidedly second best alternative, by tariffs. 2/ The absorption of quota profits should be popular with revenue bureaus and has no effect on output or prices.

The time required to replace quantitative restrictions by price instruments will depend first of all on whether this is being done as part of a package, including exchange rate and demand-management policies. If the additional measures can prevent import flooding, most, if not all, quantitative restrictions can be eliminated immediately, and certainly all those affecting capital formation. If tariff reform must be coordinated with removal of quantitative restrictions, time would be needed to determine the correct height of the tariff. Too low a tariff will allow too many imports; too high a tariff may have an inflationary impact. Immediate action could be taken when available estimates of demand conditions suggest that a mistaken average tariff rate would not

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1/ A less desirable alternative would be to add high customs duties, designated in Section III as pure revenue duties.

2/ "Revenue tariffs" on noncompetitive imports would become "import-reducing tariffs".

have important consequences. In cases of doubt, it may be useful to impose or raise the tariff prior to eliminating the quota, but with some enlargement of the quota. Several months may then be sufficient to determine whether the quota is still effective or whether it can be eliminated. For items where data are available to make at least a close estimate of the difference between the domestic and the international price of goods, an appropriate tariff could replace the quota immediately, but that would necessitate differential tariffs.

Should the tariffs vary to suit the individual demand situations? From the point of view of efficient consumption patterns, a uniform ad valorem tariff would be ideal. 1/ But, in all probability, developing countries with balance of payments problems would rely on higher taxes on consumer goods. In this case, the best combination could be a uniform tariff and a purchase tax on "luxury goods" or--second best--a higher tariff on consumer goods than on capital goods, 2/ but as a temporary measure until replaced by a purchase tax.

In all cases of delayed or staggered replacement of quantitative restrictions, preannounced goals and schedules could usefully be set, in terms of both the percent of items and the percent of base-year imports still subject to quantitative restrictions. The entire process of replacement of quantitative restrictions on noncompetitive imports might not require more than two years, and could well be done sooner.

4. Replacing protective quantitative restrictions

The most insidious aspect of administrative protection of domestic production--one which endears it to its advocates--is that the extent of protection is not visible. The most important reason for replacing these quantitative restrictions by price instruments is to achieve transparency. A second important reason is to replace unlimited protection by a ceiling, which can be raised or, hopefully, lowered as a matter of deliberate policy.

The importance attached to protective quantitative restrictions depends on the political strength of the sectors developed as a result of extended protection. Thus, vested interests opposing liberalization will be more vehement the larger the affected industrial sector and the greater the disparity between domestic and international prices. It is here argued that these factors are somewhat less relevant in replacing the form of protection than in lowering protection levels. For both these aspects of liberalization the exchange rate is the major instrument. In some cases, where the extent of effective protection is not high, that is, where the differential between domestic and international

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1/ Tariff reform could replace specific duties with ad valorem duties; although the former are often imposed to hide true tariff levels, lack of transparency causes internal distortions.

2/ Since these goods were, till now, restricted by quotas, the differential tariff will not lead to inefficient domestic production.

prices is not large, real devaluation may be sufficient to replace all
or most of the quantitative restrictions, with little or no need for
additional tariff protection.

When devaluation is not enough, or if real devaluation is not
implementable, it may be useful to rely on tariffs to replace quanti-
tative restrictions. The issues subject to controversy are speed of
replacement and tariff height. The two are related and depend in part
on the political influence of the affected subsectors. Ideally, a
uniform ceiling could be set, and all quantitative restrictions
replaced, immediately or at a not-too-distant, preannounced date. The
initial ceiling would be high enough to protect all, or all but the most
inefficient, subsectors, giving redundant protection to the more
efficient ones. This may be possible where the protected subsectors are
very small. In cases where protracted protection has built up extensive
inefficient import-substitution industries, pressure groups could press
for item-by-item action and individually setting of tariff necessary to
replace fully the existing effective protection. This is slow because
it requires detailed estimates of effective protection and negotiations
about each item. If compromise is needed, the process may be speeded up
by dealing with broad subsectors rather than individual items, making
rough estimates of average effective protection, and setting a uniform
protective tariff a little above the average. It may also be necessary
to set aside the most problematic subsectors for more detailed
treatment.

In some countries, the process of replacing quantitative restric-
tions has been drawn out over a too lengthy period. 1/ Nonetheless, it
may be practical to complete the process in less than two years.
Specific time schedules can be set in terms of percent of tariff
items, and better, in terms of the percent of base-year domestic output
moved from quantitative restriction to tariff protection. 2/

Because domestic content requirements on certain (usually public)
purchases give the same type of protection as quantitative restrictions,
it would be logical that they should also be eliminated or reduced
subject to a time schedule specifying the percent of items and market
value liberalized.

5.   Lowering effective protection on import substitutes

The real long-term benefits from liberalization derive from opening
up the tradable goods sector to foreign competition. This is especially

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1/ When Israel announced this type of liberalization in 1962, it was
believed that replacement of quantitative restrictions would be quick;
in fact, the process took over seven years.
    2/ In recent years, Korea announced two years in advance the items to
be liberalized.

true for small developing countries, where domestic production is usually concentrated in monopolistic or oligopolistic structures. Here, too, the speed of implementation depends on the economic and political influence of the affected subsectors. Agriculture, for example, has succeeded in retaining protection long after most manufacturing was opened up to foreign competition in high-income countries and some NICs. But, for most developing countries, trade liberalization refers to the manufacturing sector.

For future benefits, the quicker and the more substantially protection levels are lowered the better, regardless of the relative size of the manufacturing sector: where it is large, distortions are large and important; where it is small, it is important to set future industrial development on a competitive track. 1/ Moreover, the process of lowering protection levels itself, for example on domestically produced inputs, may create new distortions in protection rates. It may be easier, however, to lower protection levels where the manufacturing sector is still small (not more than 8-12 percent of GNP); the possible adjustment costs in terms of extent and length of temporary unemployment could be low. Where the manufacturing sector is relatively large, economic influence and political considerations would probably force a slower pace of adjustment, and the length of the process will differ in specific cases. 2/

In all cases, it would be desirable to prepare preannounced time schedules, specifying the tariff ceiling, the items on which tariffs will be lowered and the new levels, and the lower bound. 3/ A useful system is to lower higher tariffs first, and impose a minimum tariff, at the announced lower bound on everything--including all intermediates. Even the rough estimates of effective protection will show where distortions are greatest. Quantitative goals could be set in terms of the number of tariff items to be achieved, with their computation using

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1/ Obviously, the lowering of tariff protection cannot be pursued without reference to general industrial policy; however, the existence of active industrial policy does not imply that a discriminatory protection system need be regained.

2/ Zimbabwe is an example of a country with a large industrial sector ready to be liberalized.

3/ Ideally, the lower bound should be zero. But, most developing countries will insist on some minimum protection. This should be kept to not more than 10-20 percent. Countries will insist on special treatment for particular items for infant industry or other reasons; for those, upper bounds and time schedules for their reduction would be very desirable. Korea is an example of recent successful use of pre-announced tariff reductions. Uruguay (1979) targeted consolidation and lowering of tariff rates, but in the implementation since 1983 use of reference prices for "dumped" goods virtually negated much of the lowering of protection.

two types of weights, percent of base-year imports and percent of base-year output. Tariff reductions cannot usually be done more frequently than in annual steps.

6. Reduction of anti-export bias

Decreasing anti-export bias should be one of the objectives of trade liberalization, even though the various measures affecting this may extend over a long period. The system is likely to be full of anti-export bias only if there is a uniform effective protection of import substitutes and exports. 1/ As long as nonuniform import duties exist there will be dispersion in effective protection rates for import substitutes, and probably anti-export bias.

The first objective would be to strive for a uniform effective exchange rate, which includes direct taxes and subsidies. The more and the longer the nominal formal exchange rate is overvalued, the more use has to be made of the informal components of the exchange rate, though they can rarely be adequate substitutes. Consequently, adjustment of the exchange rate may be the best means to equalize effective rates for exports and imports.

In the absence of more relevant data, goals can be set and checked in terms of equalizing the average effective exchange rate for exports and imports, and for major categories. 2/ As long as imports are taxed, there may be a case for export subsidization, yet the latter is always viewed more critically than the former. Fiscal considerations may make it difficult to use subsidies as a complete equalizer.

Export subsidies, if necessary, should be nondiscriminatory, giving the same additional domestic value per unit of foreign exchange. Thus, the ideal subsidy is a uniform subsidy per unit of value added in foreign exchange, which implies nonuniform subsidies per unit of gross foreign exchange earnings. 3/ Even when information is lacking for

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1/ Exports would still, of course, be in an inferior position vis-à-vis import substitutes because of the "natural protection" offered by transportation costs.

2/ Equalizing nominal, though not effective, protection.

3/ Ironically, the economically desirable uniform effective exchange rate requires what is technically "multiple" nominal rates. Israel, for example, moved from a highly distortive system of retention-scheme market subsidies to a reasonably efficient value-added subsidy in the late 1950s, eliminated in 1962 when devaluation made possible (at least temporarily) a uniform rate for exports. Colombia (1986) in effect employed a nonuniform system of value-added subsidization by use of marketable tax credits.

detailed estimates of foreign value added, exports can be classified by groups of roughly equivalent value added, and a subsidy given per unit of gross foreign exchange that will equate the subsidy for value added in each group. The advantage of this system is that it does not discriminate between exports (beyond that due to miscalculation) and can be used to minimize anti-export bias. Such a system could be set up in several months, and the subsidies could be quickly reduced when exchange rate adjustments are made.

Equating the effective exchange rate for export value added to the effective exchange rate for import substitutes, however, is not a complete solution, and retains anti-export bias as long as the nominal protection rate for imports is less than the effective one. It would be desirable to minimize as much as possible the difference between the effective protection rates for import substitutes and for exports. For this some knowledge is needed to make at least crude estimates of effective protection rate for imports as well; when available, they may be used both to reduce dispersions in the effective protection rate for imports and to equate a uniform effective protection rate for exports with the average effective protection rate for imports.

Export subsidies are clearly a second-best and transitory solution, because subsidies may be misused and retained for too long. They also lead to postponement of more desirable methods for eliminating anti-export bias. But this can be said about all intervention instruments designed as second-best measures to correct for distortions. In practice, as long as first-best measures cannot be applied, reducing anti-export bias may well be so important for healthy growth that it warrants this intervention. 1/ Ideally, use of this system should be accompanied by announcement of their temporary nature, and, if possible, posting of time schedules for their elimination.

7. Summary of approaches

The above approaches are summarized in the following table, which suggests illustrative time dimensions for preparing and implementing liberalization, and certain indicators that may be useful in setting quantifiable goals and monitoring measures. In some areas the time dimensions would vary for countries with different levels of industrialization and protection histories and this is so indicated in the table. Asterisks are used to denote where exchange rate adjustment can significantly speed up the process of trade liberalization. Although the table is organized by problem areas, a number of problems can be dealt with simultaneously. For example, simplification of import regulations and removal of impediments to exports could be done at the same time. Similarly, exchange rate adjustment could be exploited for

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1/ As effective protective levels are reduced for import substitutes, the effective protection rate for export value added should be reduced accordingly.

switching from administrative to price variables, reducing anti-export
bias, and decreasing interproduct rate differentials. It is the
desirability to move simultaneously on several fronts that makes
coordination of policies especially important.

Table 1. Summary of Approaches to Trade Liberalization

| Problem Area | Policy Recommendations | Time Frame | | Indicators 1/ |
		Implementation	Review	
I. Impediments to exports	1. Reduction of quantitative restrictions on exports			
	(a) Post limited negative list	A	Annual	Number of items restricted
	(b) Specify quantity quotas for domestic retention	A	Annual	Number of items affected Percent of output
	2. Removal of quantitative restrictions on imports of inputs for exports			
	(a) For pure export industries: no quantiative restrictions (open general licenses)	A	...	Number of items restricted; Percent of base year imports
	(b) For mixed industries: replacement of quantitative restrictions by tariff, with drawback	B	Semi-annual	Number of items; Percent of imports
	3. Financing of imports for exports			
	(a) Automatic exchange allocation	A	...	Number of items; Percent of imports
	(b) Export retention scheme, deposits administered by banks	A	To be removed when (a) can be used	Number of items; Percent of imports
	4. Reduction of taxes on exports			
	(a) For major primary exports: marketing board may be needed	C	Annual	Data on differentials between producer and international prices
	(b) Replacement with alternative taxes	I: C II: B	Annual Annual	Percent of tax revenue

Summary of Approaches to Trade Liberalization (underline)(continued)(/underline)

| Problem Area | Policy Recommendations | Time Frame | | Indicators 1/ |
		Implementation	Review	
II. Cumbersome administration of quantitative restrictions on imports	1. Conversion from positive to negative lists	B	Semi-annual	Lists of items Percent of items
	2. Shifting from absolute prohibition to quotas			
	(a) Auction of licenses	B	Semi-annual	Percent of items and
	(b) High tariffs or purchase tax 2/	B	Semi-annual	Percent of imports
	3. Eliminate state monopolies	C	Annual	
III. Quotas on imports	1. Replacement of quantitative restrictions by tariffs on noncompetitive imports 2/	C*	Annual	Percent of items Percent of imports Average tariff rates
	2. Replacement of quantitative restrictions by tariffs on competitive imports			
	(a) Setting upper ceiling tariff for all but exceptional industries	I: A II: B	... Annual	Percent of items. Percent of domestic product; average tariffs
	(b) Settling ceilings for subsectors	I: B II: C	Annual	List of items. Percent of product; average tariffs
	3. Removal of domestic content requirements	C	Annual	List of items

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Summary of Approaches to Trade Liberalization (concluded)

| Problem Area | Policy Recommendations | Time Frame | | Indicators 1/ |
		Implementation	Review	
IV. Tariff protection	1. Lowering of protection levels 3/	I: C* II: D*	Annual Annual	Average tariffs; percent of imports for which tariffs reduced; percent of tariff revenues by tariff class
V. Anti-export bias	1. Equalizing average effective exchange rates—by devaluation, 2/ tariff reductions, and subsidies	C*	Annual	EERX 4/ and EERM 5/
	2. Equalizing effective protection rates—by devaluation, 2/ tariff reductions, and subsidies 3/	I: C* II: D*	Annual Annual	EPRX 6/ and EPRM 7/, or rough estimates
	3. Reduction of intersectoral differentials	B for exports C for import substitutes	Semi-annual Annual	EPRX and EPRM, or rough estimates

Country code: I = mainly primary producer, low level of import substitution industries.
      : II = more industrial, extensive reliance on protection
Time code   : A = up to several months
       B = up to one year
       C = up to two or three years
       D = prolonged period
  * Time period shorter if exchange adjustment employed.
1/ Suitable for setting quantitatively defined goals and monitoring implementation.
2/ Preferred solution.
3/ Pre-announcement of fiscal and annual targets desirable.
4/ Effective Exchange Rate for Exports.
5/ Effective Exchange Rate for Imports.
6/ Effective Protection Rate for Export value added.
7/ Effective Protection Rate for Imports.

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