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FACILITATING TRADE AND STRUCTURAL ADJUSTMENT: EXPERIENCES IN NON-MEMBER ECONOMIES

OECD Trade Policy Working Paper No. 69

by Osamu Onodera

Contact: Osamu Onodera; Tel. +33-1-45248937; e-mail: osamu.onodera@oecd.org

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ABSTRACT

This paper, together with five other background studies, is a part of a broader research programme addressing trade and structural adjustment issues in non-member economies which was conducted as a follow-up to *Trade and Structural Adjustment: Embracing Globalisation* (OECD, 2005) which identified policies for successful trade-related structural adjustment. This paper revisits and elaborates on specific parts of these policy recommendations with a view to reassessing their applicability to developing countries. The five background studies; a comparison study comparing East Asia and Latin America and four country case studies (Chile, Ecuador, the Philippines and Thailand), which were conducted as a part of this project, form the basis for the analysis, supplemented by existing literature.

The report consists of 4 main sections; The first section provides an introduction and the second section provides an overview of the liberalisation experiences of the four countries. In the third section, some of the “recommendations in OECD (2005) are revisited with a greater focus on developing countries, covering such issues as i) trade and investment policies, ii) macroeconomic policy, iii) social safety nets and labour market policies, iv) policies to facilitate export response, v) institutional frameworks and regulatory and competition environment, vi) role of multilateral cooperation and regional and bilateral initiatives, and vii) broad based approach to reforms. The fourth section concludes.

Keywords: trade, structural adjustment, trade reform, developing countries, macroeconomic policy, exchange rates, social safety nets, export response, institutional frameworks, multilateral cooperation

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The Working Party of the OECD Trade Committee discussed this report and agreed to make the findings more widely available through declassification on its responsibility. The study is available on the OECD website in English and in French: http://oecd.org/trade.

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EXECUTIVE SUMMARY

The study *Trade and Structural Adjustment – Embracing Globalisation* (OECD, 2005) identified a number of policy recommendations for successful trade-related structural adjustment which were considered applicable to both developed and developing countries ("Trade and Structural Adjustment: Recommendation for Good Practice", reproduced in this paper as Annex 1). This follow-up paper revisits and elaborates on specific parts of the "recommendations" with a view to reassessing their applicability to developing countries. Five background studies, a comparison study comparing East Asia and Latin America and four country case studies (Chile, Ecuador, the Philippines and Thailand), which were conducted as a part of this project, form the basis for the analysis, supplemented by existing literature.

The four countries embarked upon trade reform after following an import substitution strategy to development which led to strong anti-export bias and misallocation of resources. Trade reform in the four countries differed in terms of content, speed and magnitude, leading to divergent results. In all cases trade reform was an ongoing process, and was taken in several steps. Trade reforms have been resilient: all four countries experienced reversals but this has not derailed them from the general path of trade reform. Trade reform has been conducted as a part of overall market-oriented reform, including reforms in macroeconomic institutions, FDI policy, foreign exchange policy, capital and labour markets, product markets among others. Experiences indicate that policies are inter-related, underlining the importance of taking a holistic view of economic reform. In all four cases, trade reform has been followed by considerable adjustment in industrial, trade and employment structure.

One of the key lessons that emerge from the four case studies is that while both imports and exports are important, an economy's export response may be crucial in the early stages of trade reform. Imports typically increase faster than exports after trade reforms, warranting specific attention to export response. Delays in export response may lead to 1) a growing trade imbalance and macroeconomic instability; 2) short to medium term increase in unemployment; 3) less resilience to external shocks; and 4) difficulties in maintaining continued support for trade reform.

We find that most points in the "recommendations" are reaffirmed, although some are not applicable to certain developing country situations or warrant further elaboration. Outlined below are the findings on specific issues on i) trade and investment policies, ii) macroeconomic policy, iii) social safety nets and labour market policies, iv) policies to facilitate export response, v) institutional frameworks and regulatory and competition environment, vi) role of multilateral cooperation and regional and bilateral initiatives, and vii) broad based approach to reforms. As noted in the original study, any recommendations about good practices need to be approached with care. An approach which has worked in one country may not work in others. Differences in the policy environment and resource constraints mean that countries will need to place priorities on different areas.

i) On ***trade and investment policy***, the study looks at the pace and content of trade reforms, FDI (foreign direct investment) policy and services, and find that the "recommendations" are fully supported.

With respect to pace, both a "big bang" approach and gradual approach have respective benefits and costs. A gradual approach may be warranted if adjustment costs are large, if there are differences in the speed at which different reforms become effective, and if there are uncertainties as to the effects of reform. Gradual reforms also allow institutions to adapt. In certain situations such as a crises and existence of serious distortions, a "big bang" approach may nevertheless be an option. In terms of content, the early elimination of quantitative restrictions (QRs) is especially important to reduce serious distortions at the outset. While a uniform tariff is superior in terms of lower administrative costs, greater transparency and less lobbying, differentiated tariffs can also work. In any case, there seems to be some convergence towards more simplified tariff structures.

The services sector, as a large and dynamic sector in all economies, can also facilitate structural adjustment through the creation of new jobs, and by contributing to productivity improvements in user industries in both agriculture and manufacturing. Some service sectors have often been an important absorber of short term unemployment, acting as an informal safety net. Advances in technology is allowing developing countries to increasingly benefit from trade opportunities in services (e.g. business process outsourcing (BPO) in the Philippines). Remittances from overseas service suppliers and tourism have been important sources of foreign exchange (e.g. Ecuador, Philippines, Thailand). Services are also important as inputs to agricultural and manufacturing production. Improvements in air transport were key to Ecuador's success in cut-flowers while weak transportation has been an impediment to growth to the food-processing sector in the Philippines. These cases underline the importance of services liberalisation as a complement to overall trade reform. The Thai telecom study on the other hand highlights the difficulty of regulatory reform in network industries.

FDI can facilitate structural adjustment as 1) a key driver of export growth (e.g. electronics and automobiles in Thailand), 2) conduit for technology transfer (e.g. copper, wine and salmon in Chile; cut-flower and processed tuna in Ecuador), and 3) a facilitator of structural change through M&As etc (e.g. cement in the Philippines, Thailand in post Asian financial crisis period). All cases support the "recommendation" to maximise opportunities for associated flows of FDI and underline the importance of having a liberal FDI policy that complements trade reform.

ii) On ***macroeconomic policies***, all cases reaffirm the "recommendation" to foster an adjustment-enabling environment through the promotion of macroeconomic stability and growth. Macroeconomic stability can contribute to smoother structural adjustment (e.g. Chile in the 1990s). Macroeconomic stability, however, does not seem to be a prerequisite for initiation of a successful trade reform programme; on the contrary trade liberalisation has often been initiated in times of crisis. Macroeconomic instability nonetheless has been the main reason for trade policy reversals.

Exchange rate policy is a crucial part of trade reform. In the initial phase of liberalisation, over-appreciation of the currency needs to be avoided to elicit a widespread export response. However, developing country governments have often been reluctant toward devaluation for various reasons. Care should be taken so that the exchange rate policy supports trade reforms initially by avoiding over-appreciation and subsequently by preventing misalignments, and large and sudden adjustments.

Trade reform and related policies can affect the fiscal balance. Tariff cuts can have a negative effect on the fiscal situation, and changes to the exchange rate in the reform process may affect government revenue and spending – especially the fiscal deficit and debt service. Care should be taken so that a deterioration of the fiscal balance does not lead to a reversal of trade reform before export response is realised. Successful trade reform has often been followed by tax reform such as the introduction of a value added tax, which indicates that good coordination between trade policy and fiscal authorities is a prerequisite for a successful trade reform effort. The elimination of non-tariff barriers and trade facilitation which facilitate both imports and exports may provide an important opportunity for increased duty collection through an increase in trade flows.

iii) On **social safety nets and labour market policies**, the study finds that formal social safety nets are much less developed in developing countries. Even where they exist, their coverage is often limited and social programmes have often been cut in the face of macroeconomic crises and fiscal deficits. The labour markets of developed and developing countries also differ in terms of the size of the informal sector. Thus, while the "recommendations" on the need for balanced employment protection policies and flexible wage setting hold, other recommendations on the issue of safety nets and other labour market policies, such as income replacement benefits, active labour market programmes etc. are less applicable to developing countries.

In some cases, fast economic growth, especially in the export sector and a large informal sector have acted as *de facto* social safety nets. Some developing countries have also put in place limited social safety net programmes, such as food subsidies, public employment programmes, credit based livelihood programmes and labour intensive civil works programmes. As developing countries develop, the pressure to put in place formal social safety nets appears to increase, as is evidenced by Thailand's introduction of unemployment benefit system in 2004.

iv) While not explicitly included in the "recommendations", ***facilitating export response*** to trade reform is an important element in adjustment to trade reform. Trade reform often leads to an increase in imports. Imports are indeed a crucial part of trade reform as it is the price signals through imports which lead to better allocation of resources and imports are an important source of technology. However, while importers respond relatively smoothly to changes in relative prices, the response of exporters has often been slow. While macroeconomic stability and appropriate exchange rates early on in the trade reform process are important elements in eliciting a strong and wide export response, governments can lend a hand through well designed policies that encourage exports. Such policies can include measures that facilitate access to competitively priced inputs and financing, and policies related to foreign market information.

Access to competitively priced inputs is essential for exporters to compete in an increasingly competitive global market, and various tariff exemptions on inputs for exports, duty drawbacks, export processing zones and other mechanisms have been used with success (e.g. Thailand's duty drawback and Philippines' export processing zones). **Access to competitively priced financing** is also important and can be promoted through capital market reforms. However, the case studies indicate capital market reform and establishment of a regulatory framework that works well have not been easy. Some other measures may be necessary in the meanwhile. **Access to information on export markets and technology** is also important. However, the cost and uncertainty related to the acquisition of information on foreign markets may deter individual exporters. Governments can play a role in gathering and making available such information, in assisting companies to reorient their activities to foreign markets, in promoting the reputation of domestic exporters, and in organising exporters so they can make a collective effort. The Chilean case provides a good example in this respect. While export subsidies can be an option, they are generally prohibited under WTO rules, are sub-optimal policies from an economic point of view and may introduce new distortions in the economy defeating the purpose of trade liberalisation.

v) On **institutional frameworks and regulatory and competition environment,** the study largely supports the recommendation that stresses the importance of an institutional and governance framework which will favour structural reform while enhancing public understanding and acceptance of reform measures and a regulatory and competition environment which permits transformation within firms as well as entry and exits across sectors. The case studies however highlight that both governments and industry have sometimes found it difficult to adjust to changes in institutions which have accompanied trade reform. The right regulatory framework and effective competition have been important in the development of many growth sectors (e.g. Chile's copper and forestry sectors).

vi) On the role of **multilateral cooperation and regional and bilateral initiatives**, the study reaffirms the point that multilateral cooperation and bilateral and regional initiatives can facilitate the structural adjustment process. In the area of trade, international commitments can act as a **trigger for economic reforms** but also can be useful **signals of a government's commitment** to trade liberalisation and enhance credibility of reforms (NAFTA in Mexico and WTO Accession in Ecuador). They can lock in reforms and enhance transparency and predictability as well as promote good practices. In the area of aid, multilateral cooperation through the World Bank and regional/bilateral cooperation have contributed to structural adjustment through financial support and capacity building.

One issue that was not quite explicitly stated in the "recommendations" is the role that multilateral trade liberalisation as well as bilateral and regional initiatives may help structural adjustment by facilitating export response through the **provision of access to markets**. The study suggests that the Doha Development Agenda (DDA), and to a lesser extent, regional and bilateral free trade initiatives can facilitate adjustment processes in developing countries through new market access opportunities, as was the case for Ecuador (ATPDEA with the U.S.) and Chile (FTAs).

vii) On the **need for a broad-based approach to reforms**, the study indeed reaffirms the point that trade reform has been implemented as a part of overall economic reform and that various policies are closely interlinked. The close linkages between trade and FDI policy, trade and exchange rate policy, trade and fiscal policy, trade and capital market policy, among others, mean that different government agencies must coordinate closely to ensure that policies are coherent and that reforms can be sequenced to bring about better results. **Credibility of reforms** is important since trade reforms will successfully induce reallocation of resources only if the private sector considers reforms will be sustained. Deeper reforms, mutually supporting and consistent policies, a track record of successful reforms, and international commitments are some ways countries have used to enhance credibility of reforms.

In conclusion, developing countries have progressively undertaken trade reforms as a part of overall economic reform sometimes as a part of multilateral/regional initiatives but quite often on a unilateral basis. Reforms in trade and other policy areas are closely interlinked, requiring close government coordination to ensure policy coherence. Analyses point to the importance of export response in the initial phase of trade reform. Developing governments moving ahead with trade reform may wish to consider a range of policies to facilitate export response. The Doha Development Agenda, and to a lesser extent various regional and bilateral free trade initiatives can contribute to structural adjustment in developing countries undertaking trade reforms, by providing the access to markets that can contribute to inducing export response and successful adjustment to areas of comparative advantage in those developing countries.

**FACILITATING TRADE AND STRUCTURAL ADJUSTMENT:
EXPERIENCES IN NON-MEMBER ECONOMIES**

1. Introduction

1. The study *Trade and Structural Adjustment – Embracing Globalisation* (OECD 2005) identified, for both developed and developing countries, policies for successful trade-related structural adjustment, i.e. policies that facilitate structural change via the reallocation of labour and capital to more efficient uses while limiting adjustment costs to individuals, communities and society as a whole. While acknowledging the difference both in nature and extent of the policy environment and adjustment challenges faced by developing countries and advanced industrialised countries, a common set of underlying principles of good practice were suggested on the basis of case studies[1] and other experience gained in the OECD peer review process. The recommendations permeated all sectors and tend to be widely applicable across countries, albeit with differing degrees of emphasis (See Annex 1 for original "Trade and Structural Adjustment: Recommendations for Good Practice").

2. It was suggested that all countries will benefit by adopting:

- Macroeconomic policies which promote stability and growth;
- Labour market policies which help develop human skills and which facilitate a smooth transfer of resources from declining to expanding activities, while providing adequate assistance to those who experience adjustment costs as a result of structural change;
- A sound regulatory and competition environment which minimises the regulatory burden on business entry, exit and transformation, and fosters competition;
- A strong institutional and governance framework that will favour structural reform, while also enhancing public understanding and acceptance of reform measures;
- Liberal trade and investment policies which support structural adjustment by contributing to growth, innovation and competitiveness and which are implemented over a period long enough to enable affected parties to adapt and short enough to avoid policy reversal.

3. The objective of this study is to shed more light on the structural adjustment process in developing countries through a more focused analysis on experience in selected developing economies and to revisit and elaborate on some elements of the "Trade and Structural Adjustment: Recommendations for Good Practice".

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1. Case studies were conducted in eight sectors; agriculture, fisheries, textiles and clothing, steel, shipbuilding, motor vehicles, health services, and international sourcing of information technology and business process services. A follow-up study (Engman et al., 2006) covering agriculture (coffee and tobacco), telecommunications and chemicals produced some additional policy implications.

4. Developing countries have undertaken significant trade liberalisation in the past 20 years. For example, in Latin America and East Asia, tariff levels have fallen from an average 15-60% to 5-20% (Figure 1). Some of the tariff cuts have been taken on a unilateral basis while others have been taken as a part of multilateral or bilateral initiatives.[2] Developing countries, as is the case with all WTO members, will be expected to make further tariff reduction commitments as a result of the Doha Development Agenda (DDA). Due to large differences among countries in the gap between bound rates and applied rates (Table 1), differences in applied tariff levels (Table 2 and Annex 2 Table A)[3], and differential treatment in obligations[4], there will be considerable country differences in the level of cuts to applied tariff rates requiring real adjustment.[5]

5. Cutting high tariffs presents an opportunity for these countries to improve resource allocation and improve welfare. However, tariff cuts that require adjustment inevitably also creates some losers. The experiences of developing countries indicate that there are differences in the policy environment related to trade and structural adjustment which pose greater challenges to developing than developed countries. Developing countries generally have higher existing levels of protection. This will mean that distortions in resource allocation are probably larger: while expected long term gains are greater, the short term adjustment costs may also be greater. A heavy reliance on tariffs for government revenue, high levels of debt in foreign currency, an illiquid foreign exchange market, and/or over-reliance on specific commodities and aid for foreign exchange complicates the task of maintaining macroeconomic stability. Lower levels of technological sophistication, inadequate infrastructure, weak property rights (including over intellectual property), restricted access to capital, and a lack of readily available market information often present challenges for developing country companies in adjusting to the new market challenges and opportunities presented by trade liberalisation. Political instability, poor governance and wide-spread corruption, as well as the absence of a social safety net, often also complicate the adjustment process in some developing countries.

6. The sustainability and effectiveness of trade reform rests on whether resources can be reallocated smoothly to more productive uses and whether society finds that the benefits outweigh their costs and lead to equitable outcomes. In other words it will be important for these countries to find an optimal sequence of trade liberalisation commitments and other reforms based on current commitments and policy environment (fiscal position, inflation rate etc) which (1) maximises technological or productivity gains from a more open economic system and (2) induces successful supply and investment responses from both domestic and foreign investors to facilitate adjustment into sectors of comparative advantage, while (3) minimising output and job losses in the transition.

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2 . World Bank (2005) states that of the tariff reductions in the period 1983-2003, 66% were autonomous, 25% were due to multilateral agreements and 10% were due to preferential trade agreements.

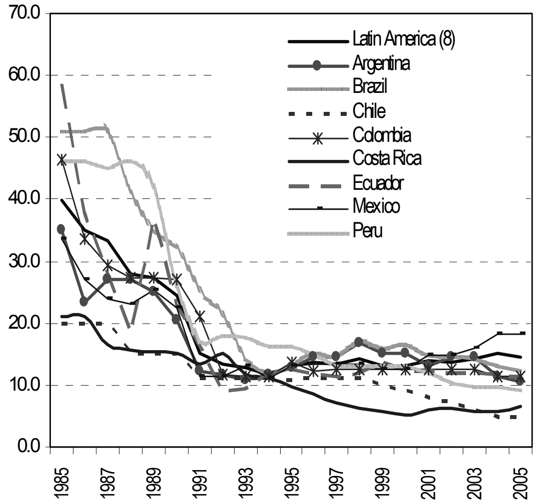
3. Looking at Table 2, although a majority of countries have tariff levels lower than 20%, 35 countries in agricultural goods and 12 countries in non-agricultural goods still have high average applied tariffs exceeding 20%. Other things being equal, countries with higher applied tariffs will more likely need to make tariff cuts that require adjustment.

4. For example, under the Framework Agreement in July 2004, it was agreed that least-developed country participants shall not be required to neither apply the formula nor participate in the sectoral approach, and be expected only to substantially increase their level of binding commitments.

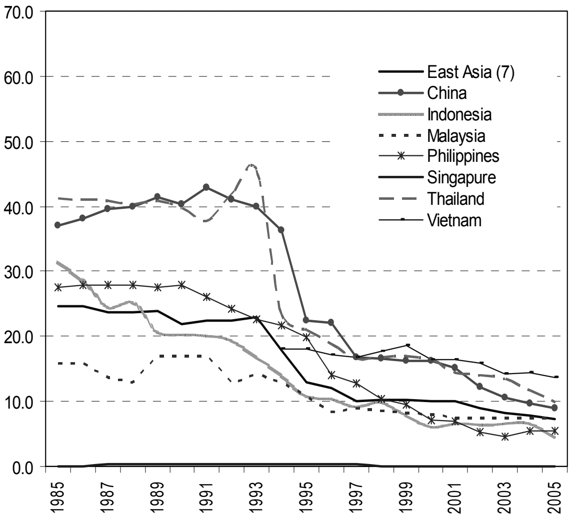
5. Note that reductions in bound tariffs that do not lead to cuts in applied tariffs would generally not lead to adjustment.

Figure 1. Average MFN applied tariffs in Latin America and East Asia

Latin America (8 countries)



East Asia (7 countries)



Note. The regional average equals the weighted average of national tariffs, using each country's imports in total regional imports as weights.

Source : Accompanying regional comparison study

Table 1. Simple tariff averages (2006)

Economies	Agricultural products		Non-agricultural products	
	Bound	Applied	Bound	Applied
OECD economies	45.2	26.7	9.5	4.2
Low and middle income economies of which:	61.2	16.4	33.1	10.4
East Asia and Pacific	46.6	15.3	27.1	8.5
Europe and Central Asia	29.0	15.6	11.6	6.3
Latin America and Caribbean	56.3	13.2	36.8	8.5
Middle East and North Africa	61.2	37.7	29.0	16.5
South Asia	89.6	21.4	33.6	14.8
Sub-Saharan Africa	73.2	14.9	38.6	11.9

Source : WTO World Tariff Profiles 2006. Numbers represent simple averages which are derived from the data of the countries for each region. For the classification of regions in low and middle income economies, the World Bank definition is used. The list of the economies that are classified in each region as follows; East Asia and Pacific (Cambodia, China, Fiji, Indonesia, Malaysia, Mongolia, Myanmar, Papua New Guinea, Philippines, Solomon Islands, Thailand and Vietnam); Europe and Central Asia (Albania, Armenia, Bulgaria, Croatia, Georgia, Kyrgyz Republic, Macedonia, Moldova, Romania and Turkey); Latin America and Caribbean (Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Uruguay and Venezuela); Middle East and North Africa (Djibouti, Egypt, Jordan, Morocco, Oman and Tunisia); South Asia (Bangladesh, India, Maldives, Nepal, Pakistan and Sri Lanka); Sub-Saharan Africa (Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Cote d'Ivoire, Gabon, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Swaziland, Tanzania, Togo, Uganda and Zambia). EC is considered as one economy when calculating OECD.

Table 2. Levels of applied tariffs of WTO Members (2005)

Simple average – MFN applied tariffs		Agricultural (No. of countries)	Non agricultural (No. of countries)
	Above 30%	12	2
	25% – 30%	3	4
	20% – 25%	20	6
	15% – 20%	26	23
	10% – 15%	41	34
	5% – 10%	31	51
	0% – 5%	10	26

Source : Secretariat using data in Tariff Profiles table II in WTO(2005)

Note. 1 Includes both developed and developing countries. Data years vary from 1998 to 2004.

2 Individual country data attached as Annex 2 Table A1

Approach and structure of this study

7. In revisiting the "Trade and Structural Adjustment: Recommendations for Good Practice" (Annex 1), this study will adopt a country-based and cross-sectoral approach in contrast to the sector specific approach taken in the original TASAP report and sectoral follow-up. While the sectoral approach is useful in order to analyse sector specific issues such as technological change, emergence of new sources of competition or shifting consumer preferences, a country-specific approach allows us to take a more holistic view to analyse the links between various policies and the inter-sectoral reallocation of resources implied by the structural adjustment process. This paper tries to tackle such issues as:

- What has been the experience of developing countries with respect to the role of trade and foreign direct investment in the overall structural adjustment process?

- In undertaking trade and investment liberalisation, to what extent is the sequencing and timing of measures important? Should there be uniform or discriminatory treatment of sectors?

- Does past country experience provide any guidance on the links between trade reforms and other economic reforms such as price controls, labour regulations and domestic regulations which impose barriers to the entry and exit of firms? Should a higher priority be given to some reform areas when considering trade policy reforms? Are they complementary or sequential?

- Transparency and predictability of policy reforms are important in order to facilitate resource reallocation by the private sector. What has the experience of developing countries been on this issue? To what extent can WTO or regional/bilateral commitments contribute?

- More generally, what roles do bilateral, regional and multilateral free trade initiatives play in the adjustment process?

8. This study consists of two parts. The present document looks at the trade liberalisation experiences of selected developing countries with a view to revisiting the "Trade and Structural Adjustment: Recommendations for Good Practice" which appeared in OECD (2005) to consider their applicability to developing countries and to elaborate on them. The document is based on analyses contained in five background studies (See Annex 3 for a brief summary of the studies) and existing literature (See Annex 2 Table B). The five background studies have been issued as separate Trade Policy Working Papers; (a comparison study reviewing the trade liberalisation experiences in Latin America and East Asia (issued as [TD/TC/WP(2007)6/PART2/A]) and four country studies (Chile, Ecuador, the Philippines and Thailand) examining the links between trade and structural adjustment (issued as [TD/TC/WP(2007)6/PART2/B] through [TD/TC/WP(2007)6/PART2/E].).

2. The trade liberalisation experiences in the four countries under study

9. Prior to trade liberalisation, all four countries under study followed an import substitution strategy to development which was characterised by high tariffs, tariff escalation, direct or indirect taxation of exports (such as agricultural products), and non-tariff-barriers which led to strong anti-export bias and misallocation of resources. All four countries undertook trade reform aiming at the removal of anti-export bias and reduction of distortions in resource allocation. These objectives have typically been realised through the elimination/reduction of quantitative restrictions, tariff liberalisation, and phase out of export taxes. Trade reform was not planned or implemented in one step; typically it was conducted as an ongoing process in several steps with, in some cases, reversals (see Table 3). The speed and magnitude of tariff liberalisation differed as did the content of reforms such as treatment of quantitative restrictions: Chile was a deep and radical reformer while Ecuador, the Philippines and Thailand adopted a gradual approach. In all cases, trade reform was conducted as a part of overall market-oriented economic reform, including reforms in FDI policy, foreign exchange policy, capital and labour markets, product markets, and privatisation programmes among others.

Table 3. Brief Summary of the Trade Liberalisation Episodes in the four countries

Country (Phase)	Years	Reason for initiation	Reversal	Reason for reversal	Reduction in QRs	Tariff Reduction	Devaluation	Pre-announce ment
Chile 1	1973-79	Crisis	Reversal in 1983-85	BOP crisis	Yes (tariffication)	100% > 10%	Yes (73-75) No (75-79)	No (1973-75) Yes(75-79)
Chile 2	1985-89	Crisis / WB Conditionality			N/A	35% > 15%	Yes	No
Chile 3	1990-05	Reduce distortions			N/A	15% > 6%	Yes	Yes
Ecuador 1	1985-88	Reduce distortions/ IMF conditionality	Reversal in 1989	Debt, BOP and social crisis	Yes	59% > 19%	Yes	No
Ecuador 2	1989-93	Andean Community			Yes	37% > 12%	No	Yes
Thailand 1	1982	Reduce distortions	Reversal in 1982-84	Fiscal deficit	N/A		Limited (84)	N/A
Thailand 2	1993-97	Shift to export oriented strategy	Reversal in 1997 due to Asian crisis	Fiscal deficit after crisis	N/A	Avg 40% > 15%	No	Yes (1990)
Thailand 3	1999-	Crisis recovery ITA and FTAs			N/A	Avg 15% > 10%	Yes (97)	Yes
Philippines 1	1981-90	Crisis / WB conditionality	Suspended in 83. Resumed in 86.	Debt and BOP crisis	Yes	Avg 43% > Avg 28%	Yes	Yes
Philippines 2	1991-94	Simplification of tariff structure	Tariff raised for QR tariffication	Fiscal deficit	Yes (tariffication)	10-50% > 3-30%	No	Yes
Philippines 3	1994-97	Reduce distortions			Yes	Avg 15% > Avg5%	No	Yes
Philippines 4	2000-	To reduce distortions	Halted in 2003	Sensitive sectors	N/A	Uniform 5%	Yes	Yes

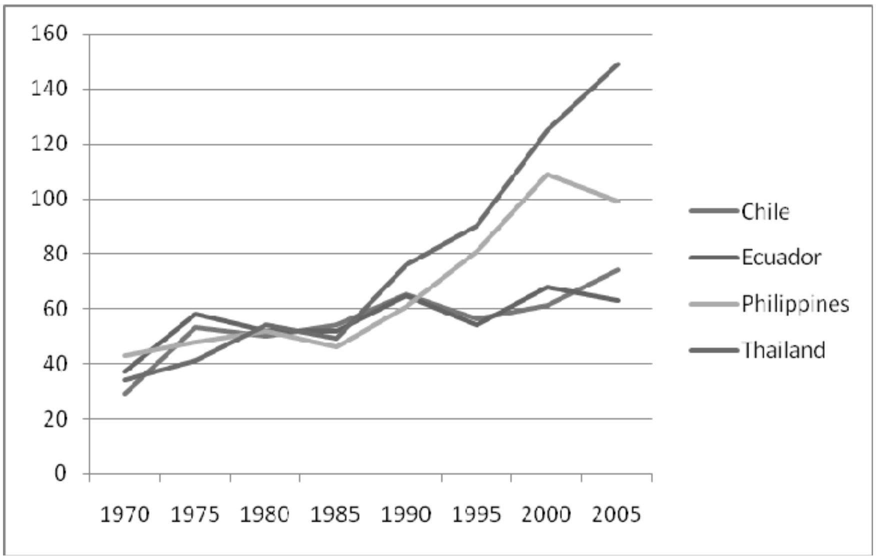
1. The definition and numbering of trade reform “phases” are quite arbitrary. For example, Papagergiou (1990) categorises Chile’s liberalisation as Chile 1(1956-61) and Chile 2 (1974-81). Numbers are only provided for ease of reference purposes only.

Source : Author based on case studies

10. There were significant differences in the content of trade reform and complementary reforms, and in achieved outcomes. In terms of GDP growth, Chile and Thailand have outperformed Ecuador and the Philippines. In most cases, trade reform was followed by an increase in both imports and exports with trade

as a proportion to GDP increasing. The speed and extent of the increases differed with imports generally increasing faster than exports (Table 4).

Figure 2. Trade/GDP of four countries



Source : author using World Bank World Development Indicators data

Table 4. Import and Export Response to Trade Reform

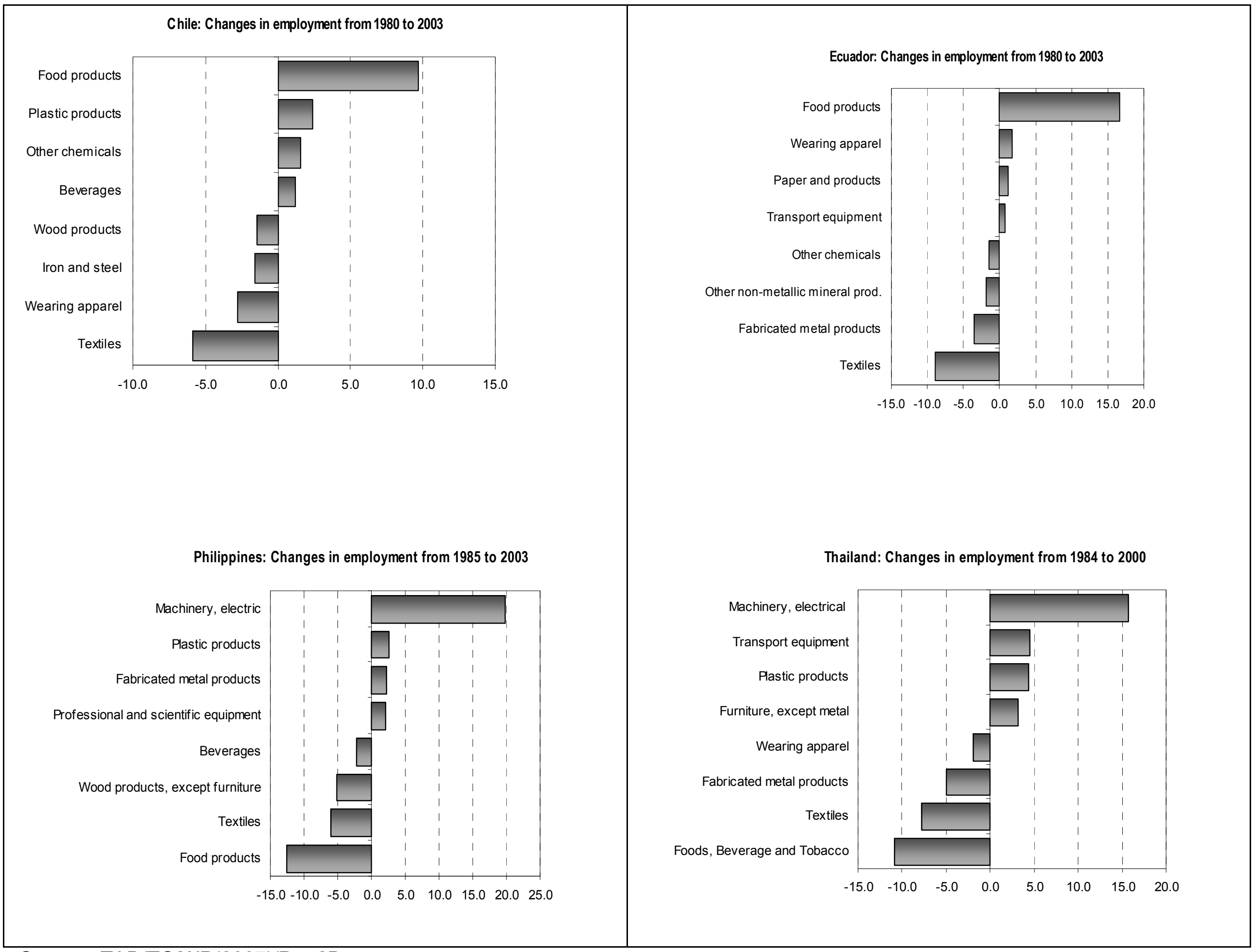
		Year 1	Year 2	Year 3	Year 4
Average	Exports	13.7%	15.7%	13.3%	16.1%
	Imports	16.9%	17.2%	10.3%	8.5%
Chile 1973	Exports	37.0%	33.0%	-0.9%	15.3%
	Imports	23.4%	20.2%	1.1%	19.0%
Chile 1985	Exports	11.1%	23.5%	26.9%	20.5%
	Imports	7.5%	20.4%	30.7%	23.4%
Chile 1990	Exports	6.5%	3.3%	9.6%	18.8%
	Imports	13.7%	14.8%	14.7%	17.0%
Ecuador 1985	Exports	-6.6%	-7.9%	2.8%	10.4%
	Imports	3.2%	-1.6%	1.3%	-1.2%
Ecuador 1989	Exports	9.2%	8.9%	3.0%	10.5%
	Imports	11.5%	11.2%	12.9%	17.1%
Philippines 1981	Exports	-2.5%	0.4%	5.1%	-0.6%
	Imports	0.3%	-6.9%	-4.7%	-11.9%
Philipines 1991	Exports	11.1%	14.6%	21.0%	22.1%
	Imports	13.4%	21.0%	22.6%	22.7%
Philippines 1994	Exports	22.1%	23.6%	19.3%	19.7%
	Imports	22.7%	19.4%	4.9%	-1.3%
Thailand 1982	Exports	-4.1%	6.6%	20.5%	30.8%
	Imports	6.1%	18.8%	-10.3%	0.6%
Thailand 1993	Exports	44.4%	46.0%	24.7%	-0.2%
	Imports	41.2%	48.4%	27.7%	-22.1%
Thailand 1999	Exports	25.8%	14.0%	4.8%	29.1%
	Imports	41.3%	23.9%	10.0%	30.1%

(Source: author using UN Comtrade data)
Note: Export and import growth figures are 3 year moving averages of trade growth calculated. Year 1 in Chile 1973 is therefore an average of growth in 1973, 1974 and 1975.

11. In all four cases, there has been considerable adjustment in industrial, trade and employment structure (Figure 3).[6] While these changes were in part due to changes in technology (e.g. textiles in all countries), and structural reforms and economic development in general (e.g. plastic products in countries except Ecuador), changing trade patterns also had a significant effect (e.g. Philippine and Thailand's electronics sector)[7]. As trade reforms have been a part of broader structural reform, it is difficult to isolate the economic effects of trade liberalisation. Nonetheless, sequencing of reforms and policy coherence seem to have affected outcomes. External factors such as global tightening of capital supply and/or volatility in commodity prices (oil, copper etc.) have also affected outcomes.

Figure 3. Structural changes in employment in manufacturing from the 1980s to recent years

(Absolute % change in sectoral share)



Source : TAD/TC/WP(2007)/Part2B

6. The numbers in Figure 3 show changes in the share of an industry in total manufacturing employment. For example, between 1980 and 2003, the food products industry in Chile increased its share in manufacturing employment by 10% while textiles lost its share by about 5%. See also the accompanying regional study and case studies for further information on changes in production, trade and employment structure.

7 . Other examples where exports have contributed to structure in the economy is Chile and Ecuador's food product sector, and Thailand's transport equipment sector. On the other hand, wearing and apparel and iron products in Chile, food products in the Philippines are examples where increase in imports contributed to a decrease in employment.

12. One of the key lessons that emerge from the four case studies is that while both imports and exports are important, an economy's export response is crucial to facilitate adjustment to trade reform. Of the four studies, in the two successful cases Chile and Thailand, there was an increase and diversification of exports early on in the trade reform process. In contrast, in the two less successful cases Ecuador and the Philippines, the increase and diversification of exports was either delayed or was lacking.[8] This is because exports are subject to greater short term supply constraints than imports.[9] A combination of fast growth of imports and delays in the response of exporting industries may impede trade reforms by leading to (1) a growing trade imbalance which may lead to macroeconomic instability; (2) short to medium term increase in unemployment; (3) less resilience to external shocks[10]; and (4) difficulties in maintaining continued support for trade reform.[11] Exports are thus important as a critical means to other important ends, i.e., deeper import liberalisation and more robust overall economic growth (Hachete, 1991).

3. Building on "Trade and Structural Adjustment: Good Practices"

13. In the following sections, we revisit some of the "recommendations" in OECD (2005) and elaborate on them with a greater focus on developing countries. We have placed specific emphasis on the macroeconomic and political economy aspects that a country should keep in mind when engaging in trade reform. We find that while most of the "recommendations" are reaffirmed, some are not applicable to certain developing country situations or warrant elaboration. As noted in the original study, any recommendations about good practice need to be approached with care. An approach which has worked in one country may not necessarily work elsewhere. It should also be recognised that these findings are based in large part on the four case studies, although supplemented by references to other existing studies.

1) Trade and investment policies

14. On the issue of trade liberalisation, the "recommendations" state that countries should adopt liberal trade policies that support structural adjustment, foster competitiveness and innovation, improve access to essential imports and encourage synergies between countries with different areas of comparative advantage. Liberal trade policies support structural adjustment by facilitating access to competitive inputs, facilitating access to foreign markets and by cutting the price distortions caused by high tariffs and other barriers to trade. While safeguards and other trade remedies can be used to ease adjustment pressures, such trade barriers have rarely been effective in obviating the need for adjustment in the long run.

15. Here we look at several aspects of trade and investment policies and their impact on the adjustment process in order to draw some policy implications concerning; a) the pace of trade liberalisation

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8. Some recent studies have found that in general imports grow faster than exports after trade liberalisation, with exports picking up only after a time lag (Santos-Paulino and Thirlwall, 2004 and Parikh, 2002). This seems to have been the case in the four countries studied although with some exceptions. For example, when the domestic economy is in a down turn, imports may not increase despite substantial liberalisation. On the other hand, exports may increase immediately after trade liberalisation if there is excess production capacity. An example of the former is Ecuador in the late 1980s and an example of the latter is Chile in the 1970s.

9. While importers may face constraints in financing, transportation and/or remaining non-tariff barriers, they have sufficient knowledge of markets and do not face supply constraints as they can source imports globally. Exporters may not have sufficient information on export markets and face greater supply constraints in the short term as they would need to reorganise production.

10. Dependence on a small number of export items such as oil and commodities for foreign currency, make the economy more susceptible to changes in commodity prices.

11. When there are a number of import-competing industries who have been hurt by trade reform, a critical mass of exporters is necessary in order to maintain support for trade reforms.

– big bang or gradual approach; b) quantitative restrictions; c) benefits of uniform vs differentiated tariffs; d) services and e) investment policies.

a) Pace of trade liberalisation – "big bang approach" vs "gradual approach"

16. On the issue of pace of trade liberalisation, the "good practices" state that liberal trade policies should be implemented over a time period long enough to enable affected parties to adjust but short enough to avoid back-tracking. Economic theory predicts that without adjustment costs, immediate and complete liberalisation or a "big bang approach" is desirable as the benefits of reform are realised more quickly, [12] and there will be no intermediate adjustments.[13] Some political economy arguments also support a "big bang approach".[14] On the other hand, many countries have taken a more gradual approach in practice. In the existence of adjustment costs, adjustment costs may be minimised by modulating change.[15] There are also some political economy arguments which support a gradual approach.[16]

17. The four countries under this study showed varying experiences. In a crisis situation, governments can gain political support for a "big bang approach", and they have sometimes (but not always) made use of this.[17] The Chilean reforms in the 1970s, the Philippines' reforms in the 1980s and the Thai trade reforms after the Asian crisis in 1997 were examples of this.[18] In the case of the Chilean reforms in the 1970s, the large anti-export bias and significant levels of unused capacity meant that the reduction of large distortions early in the process led to a fast export response by existing industries. On the other hand, in the Philippines, relatively large tariff cuts initially did not lead to an immediate export response because

12. In so far as future benefits will be discounted using some form of interest rate, the sooner benefits are achieved, the greater the present value of benefits.

13. To the extent that economic players make intermediate adjustments, a gradual approach may entail higher costs. For example a country cutting protection on tariffs in the clothing sector may decide to cut tariffs of 50% in 10% increments over a period of 4 years to 10%. Even if the clothing sector is not profitable at a 10% tariff rate, companies may decide to make interim investments to maintain production. This effect would be augmented if the sector had doubts on the credibility of future tariff reductions.

14. For example, a big bang approach with deeper reforms is often considered to be more credible; baby steps in reform may be considered as a sign of indecision on the part of policy makers. Rodrik (1989a) shows, using an econometric model, how policy overshooting may allow a genuinely reform minded government to distinguish itself from its more equivocal counterparts. A gradual approach may also give time for opposition against reform to organise themselves and thus invite a more formidable resistance (Krueger, 1993)

15. Mussa (1986) provides an argument on the merits of a gradual approach when some resources employed in protected industries are industry specific. If resources are industry specific, they may become unemployed as a result of a reduction in protection levels. If adjustment can occur primarily through depreciation and attrition, little may be gained in terms of increased efficiency by pushing liberalisation more rapidly than the rate required to prevent new capital from being invested and new workers from training for jobs in declining industries.

16. By gradually implementing reforms, it may be possible to nurture increasing support for reform efforts (although as stated above there is an equal possibility that opponents may regroup).

17. A crisis situation may provide a "honeymoon" period for reformers which open up possibilities which are not politically possible at normal times (Haggard and Webb, 1994). Cross-country empirical analysis in OECD (2007a) finds that deep economic downturns are typically associated with increased intensity of reform.

18. It should be noted that the reforms in Chile were introduced under military rule. Trade reforms in the Philippines were initially introduced under authoritarian rule and resumed by a new regime instituted by the "People Power Revolution" in 1986.

of continuing non-tariff barriers and appreciated exchange rate among other factors. In the case of Thailand, a large depreciation of the exchange rate triggered by a currency crisis presented a unique opportunity for trade liberalisation rendering most trade barriers redundant while facilitating export response.

18. However, some of these reforms pushed through in times of crisis have led to policy reversals (Chile in the 1970s, Ecuador in the 1980s, Philippines in the early 1980s). The costs of such reforms have also been considered to be quite high. This may be considered as evidence that a "big bang approach" is undesirable. It should be noted however that even when there have been reversals, the general thrust of reform has been maintained and a second effort made with success.[19]

19. On the other hand, the Thai case shows that gradualism can work. Thailand's trade reforms have been cautious and slow, sometimes involving the use of unorthodox measures. This has enabled Thailand to move forward with trade liberalisation while making sure that the negative effects on government finances were minimal, and allowing its institutions to adapt. Chile's tariff reduction from 11% to 6% in the 1990s was pre-announced and gradual, which seems to have led to much smaller adjustment costs. On the other hand, the most recent trade reform in the Philippines which was pre-announced has been suspended, providing evidence that a pre-announcement of trade reforms does not always work.

20. There have been successes and failures in both approaches[20] – which approach is most suitable appears to depend on the circumstances of the individual case. A gradual approach may be warranted if adjustment costs are large, if there are differences in the speed at which different reforms become effective, and if there are uncertainties as to the effects of reform. Gradual reforms may also allow institutions to adapt. There is also evidence that if there are less distortions in the economy, gradual reform may lead to lower costs (Thailand, Chile in the 1990s). However, in certain situations such as a crises and existence of serious distortions, a "big bang" approach may nevertheless be a viable option for political economy reasons and economic reasons. In economies with high distortions, an initial step of reforms which removes the most serious distortions may well lead to high costs in the short term (e.g. Chile in the 1970s). However, delaying reform or taking a gradual approach does not necessarily lead to smaller costs (e.g. the Philippines).

b) Quantitative restrictions

21. Although the issue of quantitative restrictions (QRs) is not specifically mentioned in the "recommendations", reduction/elimination of QRs is an important part of trade reform. This is because QRs undermine trade and economic efficiency more than tariffs because resources are allocated administratively by the state rather than through price mechanisms (Czaga, 2005). Quotas also allow

19. Looking at other experiences, the Eastern Europeans and Peru carried successful stabilisation programs at the same time when they were lowering barriers to trade and implementing many other reforms (Nash and Takacs, 1998). In these countries the big bang has generally been considered a success. Some have stated that the big bang approach was more successful in Central and Eastern Europe than Russia as there was sufficient cultural and institutional similarity to allow institutions to be imported from Europe. Others point to partial reform as the reason for Russia's failure (Kramer, 1999).

20. It should also be noted that the distinction between "big bang approach" and gradual approach is not clear cut. For example, looking at the initial trade reform by Chile in the 1970s, one could refer to it as a "Big Bang" approach as it reduced tariffs from over 100% to 10% over a short period of 5 years and accompanied complementary reforms such as privatisation, labour market reform, financial liberalisation etc. One can also argue that it was gradual as reforms were not complete and not all reforms were implemented at the same time. It should also be noted that a large cut in tariffs (e.g. from 200% to 30%) may have little effect while a relatively modest cut (e.g. 15% to 5%) can have a large effect depending on the slope of the demand and supply curves.

importers to realise “quota rent” or higher profit owing to the higher prices they can obtain for the products, which can form the basis for corruption.

22. The trade reforms of the four countries present very different experiences and verify the importance of eliminating QRs early on in the trade reform process. Thailand is a case where QRs only played a minor role historically. Chile provides a model case where QRs were dismantled and replaced with tariffs at the initial phase of trade liberalisation. The absence of QRs in the case of Thailand and their early elimination in Chile greatly facilitated trade and simplified the trade liberalisation process. The Philippines presents a case where QRs were reduced only gradually, i.e. over a period exceeding 15 years. It is interesting to note that growth in trade after the trade reforms in the early 1980s was slow and only picked up after tariff reforms were resumed with greater emphasis placed on the elimination of QRs after 1986. Both in the case of Chile and the Philippines, import quotas had been replaced by tariffs, which had led to enhanced transparency and reduced lobbying for import licences and rent seeking.

23. Ecuador provides a case where the elimination of QRs has been slow and partial (i.e. tariff quotas) with remaining distortions in price signals. The lack of trade response to tariff reductions may be partly due to the existence of untransparent QRs. It also shows how these measures are difficult to dismantle later on in the process. Remaining QRs have sometimes been difficult to abolish because of their convenience; they provide a government greater predictability in terms of levels of trade, provides domestic industry with protection and gives a substantial amount of rent to quota-holding importers. All existing studies state that the reduction of QRs is key in the initial stage of trade reform: Papageorgiu et al. (1990) goes as far as to refer to this finding as “one of the study’s clearest findings”. The four country case studies support such evidence.

c) Benefits of a uniform or flat tariff vs differentiated tariffs

24. Although the issue of uniform or flat tariffs vs differentiated tariffs is not specifically mentioned in the “good practices”, it nonetheless may affect the adjustment process. The case for uniform tariffs lies in the fact that they generally result in lower levels of distortion and that they have a number of administrative[21] and political economy benefits. [22] The case for differentiated tariffs lies more in the value that governments perceive in policy flexibility (e.g. intentionally distorting prices to promote certain industries; income redistribution by taxing luxury goods).

25. The countries studied had quite different experiences in this area. The case of Chile illustrated how a uniform tariff rate can work quite effectively by leading to less lobbying. Both the export and non-tradable sectors have been supportive of trade liberalisation even on a unilateral basis as lower tariffs mean cheaper inputs. Uniform tariffs were one of the reasons that the tariff increase to 35% in the 1980s was subsequently reversed as many industries (export industries and non-tradable industries) using imported inputs lobbied for reinstating of lower tariffs.

26. The other three countries (Ecuador, the Philippines and Thailand) had a differentiated tariff structure which was characterised by tariff escalation (higher tariffs on consumption goods and lower

21. The administrative argument supporting a uniform tariff goes as follows. Since there is no question as to the applied tariff rate, customs authorities do not need to check classification of goods as thoroughly. Delays in clearing goods should be reduced and potential investors will have less need to invest resources in understanding complex tariff structures (Panagariya, 1990).

22. One of the main arguments for a uniform tariff lies in the political economy arguments that there will be less lobbying because of potential free riding. This is because the cost of lobbying is borne by those few who lobby while the resulting high tariffs will be shared by all industries regardless of whether they lobbied or not.

tariffs for intermediate products and capital goods). All three countries found that such a tariff structure led to large effective rates of protection for import substituting industries, leading to over-investment in inefficient import substituting industries and underinvestment in industries where countries had a comparative advantage. They all embarked upon tariff reform.

27. Thailand initially maintained its import substitution policy with its high and escalated tariff structure while correcting some of its anti-export bias through various tariff exemptions and duty drawbacks. Judging from results in the 1970s and early 1980s, it was largely successful in achieving both objectives. Even so, it should be noted that in the medium term, Thailand found its complex tariff structure and web of exemptions/duty drawbacks to be increasingly inefficient and costly for small and medium enterprises and cut its tariffs across the board. The tariff structures of both the Philippines and Ecuador have also been more simplified as general tariff levels have come down. Thus while uniform tariffs do have significant benefits, one cannot conclude that uniform tariffs are necessarily better than differentiated tariffs. In any case, there has been some convergence towards simplification of tariff structures as trade levels have increased.

d) Services

28. The “recommendations” state that countries should adopt liberal trade policies that maximise the particular welfare and flow-on benefits which arise from the liberalisation of trade in services. OECD (2005a) goes on to state that liberalisation of trade in services is likely to result in significant benefits for three reasons. First, potential welfare gains can be much greater from services liberalisation than for goods liberalisation as services constitutes a large part of many economies. Second, given the dynamism of the services sector, the adjustment strains of liberalisation are likely to be more easily accommodated than those associated with goods liberalisation. Third, the liberalisation of services inputs to agricultural and manufacturing production is likely to ease any adjustment strains which those sectors may face.

29. While analysis on the effect of services in this study was limited, the services sector constituted around 50% of GDP in the countries studied (Chile (48%), Ecuador (48%), Philippines (53%) and Thailand (46%) in 2005, WDI Indicators). As described below in the section on safety nets, the informal sector, much of which is in the services sector, has absorbed some of the short term unemployment in the adjustment process.

30. Developments in telecommunication technology are enabling some developing countries to capitalise on its abundance of labour and opportunities for outsourcing. The rapid growth of the business process outsourcing and IT services (BPO-ITS) sector in the Philippines is a case in point.[23] In Ecuador and the Philippines, remittances[24] have contributed significantly to macroeconomic stability as foreign financing for the country’s deficit has dried up. In 1999 after the Asian crisis, overseas Filipino remittances through the banking system amounted to 10.7 billion USD which was larger than the trade deficit of 7.5 billion USD. Moreover the remittances are becoming a greater source of capital for financing small scale entrepreneurial activities which have tended to cluster around micro-services such as retail (mini convenience store), transportation (public utility vehicles) and personal services (barbershops, salons, etc.). In Ecuador, remittances of overseas workers also grew at high rates, amounting to 7% of GDP in 2006, and

23 . See also Engman (2007).

24. It should be noted that remittances are not an ideal match for estimating mode 4 activity because it overstates mode 4 services trade by including international payments that are (1) related to agriculture, mining or manufacturing employment abroad and (2) related to transfers associated with a rather long term presence abroad not envisaged in the GATS, while understating such trade by (3) covering less than full earnings. Despite shortcomings, worker’s remittances are judged to be of interest as indicators of the value of mode 4 trade (OECD, 2007b).

have become more important as a source of foreign currency than foreign direct investment. In Thailand, receipts from tourism and remittances grew to 69.2 billion baht and 21.1 billion baht in 1989 from negligible figures in the 1970s which were equivalent to 57% and 17% of the trade deficit in that year.[25]

31. The cases also illustrated the importance of services as inputs in production and delivery of goods and services.[26] In Thailand, monopoly/oligopoly, poorly designed regulations and ineffective competition have resulted in higher telecommunication costs which may be 80-90% higher than otherwise (Dee, 2004) imposing costs on the export sector. The case also highlights the difficult task of regulatory reform in network services industries.[27] In the Philippines, the relatively weak transportation infrastructure was one of the key impediments faced by the food-processing sector: government estimates indicate that about 30 to 40% of agricultural production ends up as post-harvest losses and total costs to export a standard container from the Philippines may be over 1.5 times more expensive compared to Thailand. On the other hand, the deregulation of the telecommunication sector was considered critical for the development of the BPO-ITS sector in the Philippines. In Ecuador, improvements in air transport were a key element of its success in cut-flowers. The case studies indicate that further liberalisation in services trade could facilitate structural adjustment both through the creation of new jobs and by contributing to productivity improvements in user industries in both agriculture and manufacturing.

e) Foreign direct investment policy (FDI policy)

32. On the issue of investment policy, the "recommendations" state that countries should maximise opportunities for associated flows of foreign direct investment in adopting liberal trade policies. Export orientation can help to attract foreign direct investment (FDI), and FDI in turn can contribute to export competitiveness (OECD, 2004a).

33. This point is certainly supported by all four of the country case studies, with FDI playing significant roles in all four countries under study although to different degrees. FDI played the largest role in Thailand where FDI has been the driver of export growth in sectors such as electronics and automobiles. FDI also helped Thailand's recovery after the Asian financial crisis through debt restructuring. In the Philippines, the relative delay in the deregulation of FDI restrictions together with the unstable political situation proved costly as it was unable to benefit from the initial FDI inflows to the Asian region in the early to mid 1980s. Nonetheless, FDI is playing a larger role since the country opened up to FDI, as evidenced in the electronics sector. The cement sector in the Philippines, once a fragmented and inefficient industry, has also been restructured into larger, more efficient groups through FDI. In Chile, domestic investment was dominant in terms of quantity especially up to the early 1990s. FDI nonetheless has played a secondary but important role as a provider of know-how and technology in specific sectors (e.g. copper, wine, and salmon). In Ecuador, the role of FDI was more limited but nonetheless important in the growth of the cut-flower and processed tuna industries. Thus all cases point to the importance of linking trade reforms to reforms in the regulatory framework for FDI.

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25 . Geloso Grosso et al. (2007) highlights the crucial role that tourism can play as a source of forign exchange for developing countries and points out that services trade liberalisation may contribute to tourism development.

26 . Lesher and Nordas (2007 forthcoming) looks at the relationship between openness to trade in services and trade performance in manufacturing and find that an increase in the FDI restrictiveness index in certain services such as business services, financial services and water transport had a significant negative effect on the export share of gross output in manufacturing on average.

27 . Geloso Grosso (2006) reviews key issues in liberalising network infrastructure services including telecommunications, postal/courier, energy, water and sewage and finds that while services liberalisation can contribute to development when appropriately designed, liberalisation is no easy task and requires sound regulation and effective institutions to address market failures and ensure public policy objectives.

34. While FDI can be beneficial, care is needed to ensure FDI promotion measures (if any) are not excessive. In many cases, domestic investment continues to be the mainstay of investment. While some countries have provided incentives to target export-oriented FDI in sectors with potentially high productivity gains and backward/forward linkages with domestic firms, and an economic argument can be made based on scale economies and dynamic gains of trade, it is doubtful whether large investment incentives are warranted. Large incentives provided to FDI are done so at the expense of others, notably domestic investment. Large incentives create additional distortions and put at risk the efficiency improving aspect of FDI. As it is generally believed that the general business environment such as political stability, macroeconomic stability, and good infrastructure are more important investment determinants, it is more effective to concentrate on providing a business friendly environment for all investors.[28]

2) Macroeconomic policy

35. On the issue of macroeconomic policy, the "recommendations" state that countries should foster an adjustment enabling environment through the promotion of macroeconomic stability and growth, which supports the effective functioning of labour markets and the economy in general, and which, particularly in the case of developing countries, complements the process of trade liberalisation by (1) removing anti-export bias and maintaining appropriate exchange rate policies and (2) encouraging tax reforms to offset declines in government revenue resulting from tariff reductions. In this section we first look at the issue of macroeconomic stability, then exchange rates and fiscal impacts in turn.

36. All four of the case studies show the importance of macroeconomic stability in the adjustment process while pointing to some difficulties that developing countries face (See Boxes 1 and 2). In the case of Chile since the 1990s and Thailand before the Asian financial crisis, macroeconomic stability clearly facilitated the structural adjustment process, while in Ecuador and the Philippines, macroeconomic instability blocked smooth structural adjustment of industry for extended periods of time. Thus macroeconomic stability is clearly desirable. One useful question to ask is whether macroeconomic stability has been a prerequisite for successful trade reform. Looking at the four country case studies, this has not been the case. Trade reform programmes have often been initiated in times of crisis and macroeconomic instability.[29]

37. One of the reasons trade reform is launched in times of crisis is because it is often included in prescriptions presented by IMF and the World Bank (Chile in the early 1980s, the Philippines in the 1980s, and Thailand after the Asian crisis).[30] However, this has not always been the case: trade reforms have been launched in times of crisis without such outside intervention (Chile in the 1970s and Philippines in the 1990s). There is both an economic and political economy reason for this. The economic reason is that trade distortions created by high tariffs were often the main cause of the crises making their elimination one of the first priorities in economic reform. A large depreciation of the exchange rate triggered by a currency crisis may also present an opportunity for trade liberalisation rendering most trade barriers redundant

28 . For a more detailed discussion on FDI, refer to the *Policy Framework for Investment* (OECD, 2006).

29. Economists' discussion on whether trade liberalisation contributes to or hinders macroeconomic stability has not been conclusive. See Papagiorgiou et al (1990), Nash and Takacs (1998), Goldsbrough et al (1996) among others.

30. In such cases one could say that the governments did not have a choice on whether to delay trade reform until macroeconomic stability had been achieved.

(Thailand after the Asian crisis). The political economy reason is that crisis situations tend to provide a new government with a unique opportunity for reform which may not be supported otherwise.[31]

38. Although macroeconomic stability is not a prerequisite for initiation of reform,[32] macroeconomic stability is nonetheless necessary for trade reform to be sustainable in the long run.[33] Chile's reform in the 1980s, Ecuador in the mid-1980s and Philippines in the 1980s were examples where reforms were reversed due to debt/balance of payment crises which were in part related to the dwindling of international financing and/or drop in commodity prices, as well as some inconsistencies in complementary policies. However, these reversals have not been permanent. The four countries we studied all resumed trade reforms, with greater success.[34] While a history of failure may undermine the credibility of reform, policy reversals do not necessarily lead to a loss of policy credibility.

Box 1. Difficulties faced in maintaining macroeconomic stability - capital market liberalisation

The four case studies show that there is a need for caution in moving ahead with capital market reforms even though they are an important part of overall economic reform. Access to capital at competitive prices is essential for development and accelerated growth. However, opening of the capital account can lead to a surge of inflow of capital if there is a relative over supply of global capital, regardless of the capital needs of a country.

For example, capital account liberalisation in a country with high tariffs may lead to over investment in capital intensive and inefficient import substitution sectors (e.g. the Philippines in the 1970s, Chile in the 1980s, etc.). Exchange rate appreciation from capital inflows would further accelerate such movement of capital to non-tradeables such as real estate, the exact opposite to the original objectives behind trade liberalisation (Chile in the 1980s and Thailand before the Asian crisis). Without sufficient prudential regulations and a regulatory framework, such movement of capital may well lead to a financial crisis as the environment changes (changes in the global supply of capital, changes in exchange rate, etc.).

Box 2. Macroeconomic challenges in resource rich countries – Chile and Ecuador

Chile and Ecuador are two cases on how countries dealt with terms of trade shocks at the macroeconomic level. As both of these countries rely on commodities for both exports and government revenues, they have found it difficult to manage the booms and busts, and avoid the stop-go cycles of structural reforms and backtracking. The reliance on specific commodities made them susceptible to what is commonly referred to as "Dutch disease". Rises in commodity

31. Cross-country empirical analysis confirms that deep economic downturns are typically associated with increased intensity of reform. Specific examples in OECD countries include the United Kingdom at the end of the 1970s, the Netherlands and New Zealand in the 1980s and Italy in the early 1990s (OECD, 2007a).

32 . On the issue of whether stabilisation and trade reform can be undertaken simultaneously or whether a particular order is more advisable, Edwards (1989) states that the answer would depend greatly to the extent of the initial macroeconomic disequilibrium.

33. Michaely et al (1990) cites macroeconomic instability as the single largest reason for policy reversals. A number of trade liberalisation efforts have been reversed when macroeconomic problems have arisen or worsened. Rajapatirana(1997) states that trade tightening in Brazil (1973-74) and Costa Rica (1974) were related to the first oil shock, while tightening in Argentina (1982), Brazil (1981-84) and Colombia (1982) were precipitated by the second oil shock. The debt shock unleashed trade restrictions in Brazil (1981084), Costa Rica (1982-84) and Mexico (1980-82).

34. Papageorgiou (1990) noted that of thirteen countries they studied whose first trade liberalisation episodes collapsed or was only partially sustained, eleven made further efforts at reform. Five of the second attempts at trade reform (Chile, Indonesia, New Zealand, Sri Lanka, and Turkey) were sustained, five (Colombia, Pakistan, the Philippines, Portugal, and Spain) were partially sustained and the second attempt collapsed only in the case of Argentina. Four of the five of the above mentioned successful second attempts were strong while five of the six partially sustained/collapsed attempts were weak.

prices may lead to appreciation of the currency as demand for domestic currency increases with the increase in commodity exports. Such appreciation of the currency has been detrimental to export diversification. Windfalls in government revenue also led to overspending in boom periods and subsequently to high fiscal deficits in bust periods.

Chile has progressively been able to increase its ability to manage the copper cycle by establishing fiscal rules that insulate government spending from windfalls and downturns and by putting in place a cautious exchange rate policy which aims to avoid misalignment of the real exchange rate, learning from the shortcomings in macroeconomic and exchange rate policies in the late 1970s and early 80s which led to the banking and debt crisis in 1983. This has led to an increasingly diversified export structure.

Ecuador is an example of a country which has been less successful. From the 1980s to 2000, Ecuador experienced a stop-and-go process with spells of tight fiscal policy overtaken by uncontrolled increases in public spending resulting in major deficits and spiraling debt burdens, leading to several defaults or temporary suspension of payments. In 2002, a fiscal responsibility law (FRL) was adopted which among other issues, capped real expenditure growth of the central government and created an off-budget oil fund (FEIREP) with revenues from sales of heavy crude. The resources of the fund were to be used for debt buybacks, revenue stabilization and social spending. The FRL was met only once, in 2003 and revised in 2005. In 2005, the FEIRIP was incorporated into the budget and corresponding revenues were redirected towards social spending, economic reactivation and other projects. While targets to reduce the non-oil deficit and public debt have been respected in 2005, export diversification remains a considerable challenge.

a) Exchange rate policy

39. The "recommendations" underline the importance of removing anti-export bias and maintaining appropriate exchange rate policies. As Corden (1997) noted, trade liberalisation is likely to require real exchange rate (RER) depreciation[35] if the current account balance is to stay constant. RER appreciation may impede adjustment as export supply response will be muted and importers will have a greater incentive to import goods. This will result in a deterioration of the current account[36] and could lead to an increase in unemployment.[37] Undervaluation may also make up for institutional/contractual weaknesses and market failures which lead to suboptimal allocation of resources to the tradable sector (Rodrik, 2007).[38] Thus it is important in the initial phase of trade liberalisation to have a depreciation of the exchange rate which offsets the existing anti-export bias.[39]

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35 . If the nominal exchange rate is held constant while domestic inflation is higher than foreign inflation, the real exchange rate (RER) will appreciate. Thus a real exchange rate depreciation would be often realised with a nominal exchange rate depreciation.

36 . A deterioration of the current account in and of itself should not be interpreted in a negative light. As the current account balance is identically equal to the excess of private saving over private investment plus the fiscal surplus, and there may well be situations where excess private investment and/or fiscal deficits are warranted, the desirable current account balance is not necessarily zero. See for example, Pitchford (1992).

37. This effect may be larger in developing countries with smaller domestic economies which are more dependent on trade.

38. Rodrik (2007) argues that developing countries tend to have weaker institutions and market failures which disproportionately affect tradables compared to non-tradables. A barber relies on little more than a few tools, a chair and his ingenuity to sell his services. A manufacturing firm needs the cooperation of multitudes of suppliers and customers with which he has numerous market transactions all of which rely on reliable institutions, and a well functioning market. While the introduction of reliable institutions and removal of market failures is the first best solution, undervaluation may serve as a second best solution to make up for the existing market failures.

39. A couple of caveats need to be made. First, the exchange rate is not a policy variable per se. However, countries have a number of policies which can affect the exchange rate and a depreciated real exchange rate can be maintained by having higher saving relative to investment, or lower expenditures relative to

40. Looking at country experiences even within the four countries, countries have not necessarily coupled trade liberalisation with a depreciation of the currency. This may partly be due to policy implementation problems but also because many developing economy governments have been reluctant towards devaluation for a number of reasons; e.g. (1) use of the nominal exchange rate as an inflationary anchor (See Box 3); (2) a general view that a weak currency is a policy failure on the part of the government (See Box 4); (3) effect on government debt and revenue (See Box 5); and (4) a belief that devaluation would increase the prices of imported inputs for import substitution industries which may lead to unemployment. These considerations often pose a policy dilemma which must be considered on a case by case basis; an exchange rate which supports macroeconomic stability from an inflation and fiscal perspective may undermine macroeconomic stability by hurting the economy's exports.

Box 3. Chile: the exchange rate as nominal anchor

Chile used the nominal exchange rate as an anti-inflationary anchor.[40] By delaying the adjustment of the nominal exchange rate to domestic inflation, it tried to change expectations towards future rates of inflation.[41] While this policy enjoyed some success, as inflation rates started to come down, this policy started to raise other problems. The Chilean government had in place a policy of wage indexation whereby minimum wages were indexed to domestic inflation rates to protect workers. The problem was that the exchange rate as an inflation anchor and wage indexation[42] sent conflicting signals. While the fixed exchange rate sent a signal that inflation rates should be lower, wage indexation was based on the premise that inflation will be maintained. Moreover, such an exchange rate policy resulted in RER appreciation which "provided assurances to potential exporters that, whatever the real return in local currency to exporting might be today, it will be less so in the future" (Krueger 1997). In a situation where investment in the export sector is risky to start with, such an assurance of less profitability went against a shifting of resources. This experience shows that care is needed in using the exchange rate as a nominal anchor.

Box 4. Philippines and Thailand: the exchange rate as a sign of government competence

In some developing country economies with a fixed exchange rate, governments have had a tendency to avoid currency devaluation as it could be considered as a sign of incompetence. However, such tendencies can have a negative effect on adjustment. The real exchange rate appreciation between 1987 and 1997 in the Philippines had a negative impact on the structural adjustment of industry. In Thailand, RER appreciation was a part of the reason for the mis-allocation of resources into the non-tradable sector leading up to the Asian financial crisis. Thus while government may wish to avoid depreciation for political reasons, it is necessary to keep in mind that this may have negative effects on the real economy.

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income. This can be achieved by a number of means such as fiscal policy (a large structural surplus, savings policy (compulsory saving schemes), currency intervention (building up of foreign reserves) among others (Rodrik, 2007). Second, it is notoriously difficult to define an "appropriate" exchange rate. Thus what a government (or central bank) can do at best is to keep in mind the effects of exchange rate policy on exports. Third, although an initial exchange rate depreciation may be a necessary part of trade reform, in successive years the exchange rate may well appreciate as a result of economic growth and productivity improvement (the so called Balassa-Samuelson effect). While it is important to avoid over-appreciation of the currency, an effort to maintain a misaligned exchange rate may also prove costly.

40. In a country with a fixed exchange rate, the nominal exchange rate would need to be changed in line with differences in domestic and international inflation. When the exchange rate is used as a nominal anchor, the nominal exchange rate adjustment would lag the differences in domestic and international inflation. Examples include Argentina, Chile and Uruguay in the 1970s and Mexico starting in 1987 (Krueger 1997).

41. Such an approach may be more effective as exchange rates may be much more visible than other intermediate targets to attain inflation objectives (money supply etc).

42. Wage indexation is often used in chronic inflation countries to shield workers from the effects of inflation. Wage indexation in an economy where inflation is slowing down would tend to drive up real wages.

Box 5. The exchange rate and effects on government debt

Many developing country governments have high levels of debt, often in foreign currency.[43] In such a situation, devaluation will have the effect of increasing the level of debt and debt servicing when converted into local currency. Depending on the revenue and expense structure of the country, this may make governments cautious towards devaluation. The cases of Thailand illustrated how an appreciated currency and sudden depreciation can lead to a financial crisis when there is a large mismatch between the debt (in dollars) and future revenue streams (in local currency). In such cases governments may be required to assume private debt as public debt in order to maintain integrity of the financial system as was the case in Chile. This implies that governments need to keep an eye on not only government debt levels but also on debt levels in the private sector.

b) Fiscal impacts of trade reform

41. The "recommendations" do not refer to fiscal issues other than to point out the importance of macroeconomic stability and the need to implement tax reforms to offset declines in government revenue resulting from tariff reductions. Because fiscal deficits can become the root cause of macroeconomic problems, the potential effects of trade reform and other reforms on the fiscal situation need to be considered carefully. Trade reform may affect the fiscal balance in several ways: (1) potential decrease of tariff revenues (See Box 6), (2) effect of any exchange rate changes related to trade liberalisation on existing debt and debt services (See Box 5) and (3) potential increases in government spending to help companies and workers adjust, among others. While shortfalls in the fiscal balance can be financed through government debt and/or foreign aid, such a response is most likely unsustainable in the long term and may jeopardise the credibility of trade reform.

42. While this issue was not studied in depth in the case studies, some points emerge. First, fiscal problems have indeed been among the stated reasons for reversals (Thailand in the 1980s and the Philippines in 1983). Secondly, subsequent trade reform has been closely followed by tax reform such as the introduction of a value added tax (VAT) as was the case of Chile in 1975, the Philippines in 1988 and Thailand in 1992. In the case of Thailand, despite an understanding of the need for tariff reform, tariff cuts were made only when the fiscal situation improved. The case study thus seems to indicate that careful consideration of the fiscal impact of trade reform is indeed necessary and that good coordination between trade policy and fiscal authorities is a prerequisite for a successful trade reform effort.

43. Bearing in mind that reform of the general tax system (use of income, sales or value added taxes in order to maintain government revenues) requires considerable planning, a careful assessment of the effects of trade reform on the budget needs to be made. It should be noted that non-tariff-barriers such as burdensome customs procedures may become an important issue from the fiscal perspective. If customs procedures are overly burdensome, tariff cuts may not lead to an increase in imports even if the price elasticity of consumption is quite high. This implies that the negative effect of tariff cuts on government revenue would tend to be larger in a country with burdensome customs procedures. Thus, the reduction of non-tariff barriers and trade facilitation may be an important opportunity for increasing duty collection through an increase in trade flows.[44]

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43. Since the Asian crisis, there has been a significant improvement in the macroeconomic performance of many emerging market countries. Many emerging markets have significantly reduced their reliance on foreign exchange debt since the late 1990s. The largest reduction in the share of foreign exchange debt (over 1996-2004) has occurred in Thailand (62 percentage points), Mexico (42 percentage points), Venezuela (22 percentage points), and Hungary (20 percentage points). However, Russia increased its share of foreign debt (by 42 percentage points) along with Chile (29 percentage points) and the Philippines (28 percentage points). (IMF, 2006)

44. "Several conference participants confirmed the revenue enhancing effects of tariff and customs reform, and emphasized the importance of improvements in customs administration. Fritz du Bois of Peru noted that

Box 6. Potential effect on tariff revenues

As noted in OECD (2005), one of the most commonly made arguments by developing countries for not cutting tariffs is the fiscal consequences of tariff reduction. Many developing countries depend on import duties for a significant proportion of total government revenue (See Figure 4). In general, the effect of trade liberalisation on government revenues is uncertain – the fiscal situation may either improve or worsen with trade liberalisation. Government revenues from tariffs will increase if quotas and other quantitative restrictions are being replaced by tariff equivalents and/or if tariff exemptions are being withdrawn.[45] If tariff rates are reduced, tariff revenues may either decrease or increase depending on the price elasticity of imports (the rate at which import quantity increases as price decreases). Lower tariffs may decrease the incentives towards smuggling and lead to an increase of “legal trade” which may also contribute to higher tariff revenues.

Kowalski (2005) finds that the literature makes a strong economic case for a non-discriminatory tariff reform that, where necessary, should be accompanied by a reform of the tax system. Tariff reform would often need to be accompanied by a comprehensive tax reform in order to maintain government revenue. From an economic point of view, the case for trade reform seems strong as the welfare gains of trade reform tend to be quite large and permanent while the costs associated with the design and implementation of a less-distorting tax are more short term. It was noted that developing countries that currently tend to maintain higher and more dispersed tariff barriers are particularly well positioned to benefit from a tariff reform as welfare gains were significantly positive even taking into account possible tax revenue losses, but were also more vulnerable to the associated tariff revenue loss. Simulation results indicated considerable cross-country differences in trade, welfare and revenue impacts.

Baunsgaard and Keen (2005) finds through a study of 111 countries over 25 years that low income countries may have more trouble recovering lost tariff revenues through trade liberalisation while high income countries fully recovered lost tariff revenues through non-tariff revenues and middle income countries recovered between 45-60% of lost revenues. Glenday (2006) provides similar findings and argues that VAT as a revenue substitute for trade tax revenue may have been overrated as the informal sector in many developing countries make VAT administration difficult. Di John (2006) using the case of Uganda states that gradual liberalisation “proved crucial to maintaining fiscal revenues until the political and administrative problems of introducing VAT could be overcome”. Pelzman (2004) looking at Jamaica found that increase in domestic taxes have yielded diminishing returns and that informal market activities have increased as a result. These recent studies support the view that careful assessment of the fiscal effect of trade reforms and planning of tax reforms is required.

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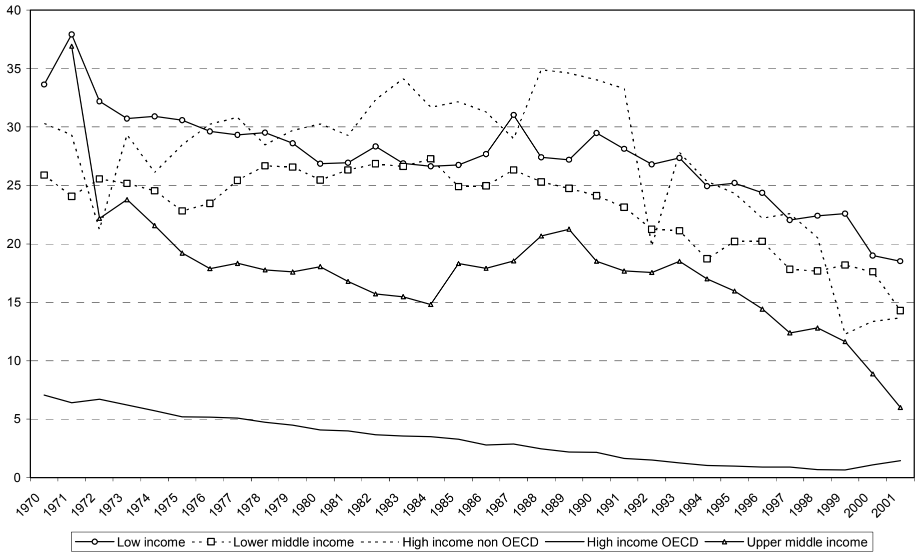
customs revenue soared from $6 million in the early 1990s to nearly $2 billion in 1994 following the country’s sharp tariff reduction, elimination of quantitative restrictions, and customs reform. Emmanuel Tumusiime Mutebile attributed a large part of the increase in revenues after Uganda’s trade reform program to improvements in customs administration”. (Nash and Takacs (1998) pp9)

45. This would primarily be through the direct effect of withdrawal of exemptions. There may also be indirect tax effects if tariff exemptions had inhibited economic activity in areas that could be taxed at higher rates.

Figure 4. Countries' dependence on import duties as a source of tax revenue

(% of tax revenue)



Source : Figure 2 in Kowalski (2005)

3) Social safety nets and labour market policies

44. On the issue of social safety nets, the "recommendations" state that countries should rely, wherever possible, on generally available adjustment measures, including through the social security and tax system, and to ensure that if targeted adjustment measures are taken for political economy reasons that they should be time-bound with a clear exit strategy, decoupled from production, aimed at re-integrating displaced workers into the workforce, compatible with general safety net arrangements, cost effective, and transparent and accountable. On the issue of labour market policies, the "recommendations" state that governments should adopt sound labour market policies which facilitate the reallocation of workers towards higher productivity employment which encompass income replacement benefits, active labour market programmes, balanced employment protection policies, flexible wage setting systems, and appropriate education and training systems. All of these recommendations are consistent with the OECD's policy guidelines for employment policy, the Restated OECD Jobs Strategy (OECD, 2006), while providing more detailed guidance concerning best practices for coping with structural adjustment pressures due to trade liberalisation. In this section we look at these two inter-related issues.

a) Social safety nets

45. In OECD countries, social safety nets are an important part of the reform process as lack thereof will lead to decreasing support for reforms. A priori, this consideration could be even more pertinent for developing countries, as in many cases their political situation is more unstable than in many developed countries. Looking at the experiences of the four countries however, one finds that in most cases, formal social safety nets are much less developed than in developed countries. Even where they exist, they cover only a small part of the population, i.e. the public sector and large companies, and do not cover the informal sector and agriculture sectors. Moreover, in the face of macroeconomic instability and the need to cut fiscal deficits, social programmes have often been cut, sometimes quite drastically, as was the case in Chile in the 1970s.

46. This, however, does not mean that these developing countries did not have such considerations. For example in Thailand, the government introduced labour intensive civil works programmes in

construction and infrastructure rehabilitation in the wake of the Asian crisis. In the case of the Philippines, the government undertook a number of safety net programmes such as food subsidies, public employment programmes and credit-based livelihood programmes which were intended to mitigate the effects of economic reform on the poor.[46]

47. Some developing countries have adjusted relatively smoothly despite deficiencies in formal social safety nets. The Thai case study indicates that economic growth led by a growing export sector, a large informal sector and flexible labour regulations largely compensated for the lack of a formal social safety net. This case also shows, however, that as developing countries develop, the pressures to put in place formal social safety nets increase. The Thai government introduced an unemployment benefits system in 2004 and put in place a scheme to support adjustment for businesses affected by trade liberalisation in 2006. The Philippines case study indicates that growth in the services sector together with the increased role of overseas Filipino workers and their remittances to the Philippine economy have served as informal social safety nets. Whether such a policy of letting market-driven responses address the adverse distributional effects of reform can work largely depends on: (1) the growth rate of export industries; and (2) the ability of the informal and agricultural sectors to play the role of a social safety net.

b) Labour market policies

48. The four case studies show that the labour markets in developed and developing countries are very different. The informal sector, which is not covered by work place regulations or formal social safety nets (even when they are present), is much larger in many developing economies than in developed ones.[47] Some economies lack unemployment benefit systems and, even where they exist, they do not cover the entire working population. Similarly, public job training programmes and other types of active labour programmes are either very limited or totally absent. As such, the recommendations regarding income replacement benefits, active labour market programmes, and appropriate education and training systems are less relevant or do not apply to developing countries.

49. The recommendations on flexible wage setting systems and balanced employment protection policies, however, do hold in the case of developing countries, particularly in the formal sector. In Thailand, economic growth and a relatively flexible labour market has historically kept unemployment at low levels and has contributed to Thailand's successful transformation. On the other hand, wage indexation and other relatively stringent labour policies were one of the reasons behind Chile's costly adjustment experience in the late 1970s and early 1980s. Subsequent labour reforms contributed to labour expansion in the latter half of the 1980s.[48] Ecuador's stringent labour laws were also an impediment to adjustment.

46 . ILO and WTO (2007) refers to local self-help initiatives to provide insurance against illness and loss of income; active labour market policies such as employment guarantee schemes based on labour-intensive rural and urban public work programmes; and various forms of micro-credit programmes to promote productive self-employment.

47. Schneider (2004) estimates the informal economy in % of GNP in 1999/2000 as follows: Chile (19.8), Ecuador (34.4), Philippines (43.4), Thailand (52.6). This is much higher compared to France (15.2), Germany (16.0), Japan (11.3) and the United States (8.7). Perry et al. (2007) state that informal employment is 37.0 - 38.8% (2003) in Chile and 55.7 - 56.5% (2003) in Ecuador citing Gasparini and Tornarolli (2006) and ILO (2006).

48. While Harrison et al (1998) did not find that minimum wage legislation hampered adjustment, Edwards (1982) found that minimum wages, especially indexing of wages to inflation may have hampered adjustment through wages in the case of Chile and estimates that "the combination of tariff reductions and minimum wages can explain at the most, less than one third of the unemployment of the late 1970's. Alternative possible explanations of the high unemployment are the stabilisation policy and the reduction of the public sector."

50. A key issue in developing countries is the possibility of workers being driven from the formal sector to the informal sector. ILO and WTO (2007) find that the existing empirical evidence on the relationship between trade and the informal economy is still limited and inconclusive.[49] The informal economy can be interpreted in a positive way as it permits individuals to escape from poverty (OECD, 2004b), and a higher percentage of employment in agriculture and in informal labour markets which are very flexible may imply lower adjustment costs (Matusz and Tarr (1999)). An excessively large informal sector, however, can become a growth constraint, if it leads to higher taxes rates for the formal sector, low spending capacity of governments, inability to effectively target and manage social protection, unfair competition for formal activities, incentives for unproductive activities, and inefficiencies in production (OECD, 2004b). Lower productivity in a large informal economy compared to the smaller formal economy may also lead to increased disparities in income. The biggest barriers to incorporating firms operating in the informal sector into the formal sector are the tax and regulatory costs associated with registering as a formal enterprise. Domestic regulatory reform to streamline various government procedures and cut down the costs of integration into the formal sector thus becomes an essential part of complementary reforms to trade liberalisation.

51. Many studies have discussed the relationship between trade liberalisation and labour markets.[50][51] There may be some short term effects and long term effects. On unemployment, in terms of short term effects, if trade reform leads to contraction of an import substitution industry this may lead to a decrease in employment if new jobs are not created in the exportable sector. Employment may increase even in the short term, however, if the export response is robust.[52] In terms of medium to long term effects, if exportable industries are relatively labour intensive compared to import substitution industries, trade reform may lead to an increase in employment as was the case in the Philippines.[53]

4) Policies to facilitate the export response to trade reform

52. The “recommendations” do not explicitly refer to “export response” although they do refer to the importance of removing anti-export bias in macroeconomic policy and the need to improve access to essential imports. However, as stated before, ensuring a strong export response early on in the trade liberalisation process is extremely important as it can affect macroeconomic stability and employment levels in the short term, and will be important in maintaining continued support for trade reform.

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49 . See also Perry et al. (2007) for extensive discussions on the merits and costs of informal employment.

50 . ILO and WTO (2007) provide a more in depth review of the literature on trade and employment issues. Trade liberalisation may affect income levels, unemployment and inequality.

51. There is some evidence that liberalisation in product markets is followed by liberalisation in labour markets. One reason may be that increased product market competition reduces the ability of firms to appropriate excess profits, which in turn undermines labour market institutions that make it easier for workers to share in such excess profits. Another may be that product market reform boosts demand, employment opportunities and real wages, making it easier to undertake labour market reform (OECD, 2007a).

52. Papagerorgiu *et al.* (1990), comparing employment in manufacturing before and after reform in 13 episodes (9 countries), state that the evidence suggests that the effects of trade liberalisation on unemployment have been small, and that trade liberalisation did not generally result in decreased employment even in the short run in these developing countries.

53. Krueger (1983) states that trade reform should lead to employment increases in developing countries because the labour force would shift from the capital intensive import substitution sector toward the labour-intensive tradables sector. Harrison et al (1998), looking at time series data for Costa Rica, Czechoslovakia, Peru, Poland, Romania and Uruguay found that aggregate employment increased after trade reform in all countries except those economies in transition and noted that Guatemala. Morocco, Mongolia, Uganda and Vietnam reveal the same general pattern.

53. Export response to trade liberalisation however has sometimes been slow for several reasons; e.g. continued distortion in price signals; lack of policy credibility; and various constraints faced by exporters such as lack of access to competitively priced inputs and technology, human resources, financing, infrastructure, and information. As discussed earlier, macroeconomic stability is important in order to avoid distortion in price signals and a relatively depreciated exchange rate early on in the trade reform process is one way to solicit a stronger export response. Policy credibility can be enhanced through the various methods discussed later in the section on the need for a broad base approach to reforms. Development of human resources, and infrastructure are also key to development.[54] Here we discuss some of the other mechanisms put into place to increase/diversify exports such as access to competitively priced inputs, access to financing, access to information on export markets and technology, and export promotion.

Access to competitively priced inputs

54. In an increasingly competitive global market, imported inputs are often required as no developing country has the full breadth of industries which provides inputs on a competitive basis. Export processing zones, tariff exemptions on inputs for exports, duty drawback mechanisms and bonded warehouses are but some of the mechanisms used to reduce or exempt tariffs on inputs for exports.

55. The experiences of Thailand and to a lesser extent the Philippines indicate that these countries used these schemes extensively and quite effectively. However, it should also be noted that Thailand found that such mechanisms entailed high administrative costs and were often less friendly to small and medium sized enterprises. As time elapsed, it found it necessary to refine such mechanisms indicating that these mechanisms merely served as an interim solution towards more general trade liberalisation.

56. Another option that is often considered is tariff reduction on inputs and capital equipment. While this may be an option, such an approach leads to tariff escalation and an increase in the effective rate of protection on finished goods as evidenced in many imports-substitution policy regimes. As the measure benefits not only exporters who use such inputs but also other companies that use such inputs for consumer goods and non-tradables destined for the domestic market, it may lead to anti-export bias. Assembly operations which simply import semi-manufactured components and put them together for sale to the domestic market may increase. Such a tendency will be greater where general tariff levels are higher as was the case in the Philippines in the 1980s before trade reform. Thus care is needed to make sure that the tariff structure does not result in such unintended inefficiencies.

57. Another important option to consider is regulatory reform in the area of domestic input generating industries as discussed in the section on services. Services and other domestic inputs constitute an important cost component. As such, regulatory reform which enhances competition and efficiencies in these areas can contribute to export competitiveness. There is evidence that external product market environment such as tariffs can affect reform in domestic product markets by increasing competitive pressures on domestic enterprises (OECD, 2007a).[55] This was clearly the case in the Philippines and Thailand where increasing competition in export markets is becoming a driving force for reform in services

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54 . Bhattacharya (1988) refers to infrastructure and institutional support in such areas as utilities, transport, ports and customs handling as contributing significantly to lowering the cost of exporting. Government support through training, technical assistance and marketing was considered lower order of priority.

55 . OECD estimates suggests that the external product market environment (labour and product market policies in other countries, tariff barriers, participation in international organisations etc.) can explain a significant part of observed liberalisations in OECD telecommunication markets over the past two decades. Liberalisation abroad may serve as a source of inspiration. Together with domestic trade liberalisation, it may increase competitive pressures on domestic enterprises and thereby strengthen pro-reform constituencies (OECD, 2007a).

industries such as telecommunications and transport. Trade facilitation and reduction of non-tariff barriers may also facilitate access to competitively priced inputs.

Access to competitively priced financing

58. Access to competitively priced financing is necessary for export industries to make the necessary investments to grow. Substantial benefits can be gained from the ability to source capital from global markets at lower interest rates, the potential for domestic asset holders to diversify their portfolio by investing in foreign assets which may yield higher returns, and improvements in resource allocation through increased competition. Capital account liberalisation is thus an essential part of economic reform in the long term. If a country has an inefficient financial market, trade liberalisation runs the risk of making domestic companies compete on an uneven playing field. Therefore in some cases such as in Chile's first reforms in the 1970s to the 1980s and Thailand's reforms before the Asian financial crisis, trade liberalisation has been accompanied by capital account liberalisation.

59. However, as the four case studies all indicate, capital market liberalisation without a sufficient regulatory framework entails considerable risk. As Chile and Thailand's case pointed out, capital market liberalisation may lead to a rapid inflow of foreign capital, and investment in non-productive areas if price signals are distorted (See Box 1). Thus, a case could be made for delaying capital market liberalisation.[56] However, it should be underlined that this should not lead to delays in domestic financial market reform as the underlying problem of insufficient capital remains unsolved. If capital account liberalisation is delayed, some other measures may be necessary to provide viable domestic companies with access to loans at reasonable rates.[57]

Access to information on export markets and technology

60. There are sometimes important constraints to swift and strong supply response by the private sector which are more of an informational nature. Domestic producers often do not have adequate information about (1) technologies for producing goods or services that will sell in foreign markets or that will help them to compete with foreign producers at home; (2) marketing and distribution channels in overseas markets; (3) consumer tastes or producer needs in potential markets; or (4) standards, and sanitary and phytosanitary requirements in overseas markets. This tendency is augmented in a country which has a strong dependency on a limited number of commodities.

61. Such information is both costly and in the nature of a public good (non-exclusive, non-rival).[58] The acquisition of such information is an investment as returns are uncertain. Smaller companies and entrepreneurs are often undercapitalised and are ill equipped to make such investments. Social returns may often be far superior to private returns, which would tend to lead to its under-supply from a societal point

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56. Such a case cannot be made for FDI. As Johnston et al (1997) notes, while liberalisation of portfolio capital have tended to be coordinated with domestic financial sector liberalisation and reforms, liberalisation of direct investment inflows have often gone hand in hand with reforms aimed at strengthening the real sector and export potential of the economy.

57 . Bhattacharya (1988) studies East Asian countries and finds for example that some of them introduced some financing support for exporters, most commonly a pre-shipment short-term credit, discounted by the central bank at preferential market rates.

58. Information is a non-excludable good so it is difficult to keep others from using it. It is a non-rival good in the sense that its consumption by one agent does not necessarily reduce its value to another. A company may find as a result of considerable research (and maybe trial and error) that it is profitable to produce apples in Chile and export them to the United States. A second exporter would easily be able to free ride on the research efforts of the first company.

of view. This may give governments an important role in (a) subsidising the gathering of information on technologies, foreign markets, and foreign tastes; (b) subsidising the establishment of reputation for domestic producers; and (c) assisting existing firms to retool, reorienting their activities towards foreign markets and becoming better able to compete in domestic markets with foreign producers (Agosin, 2002).

62. The Chilean case provides a good example of how governments can promote exports by facilitating access to information. ProChile, the government's trade promotion office supported and continues to support export growth and diversification by supplying information on foreign markets and customers, promoting Chilean exports through generic publicity and targeted missions and working to resolve the administrative problems faced by exports. By providing services only to trade organisations or groups of companies, it encourages the formation of exporter organisations. Exporters can cooperate by sharing the costs of information collection and otherwise making a collective effort to tackling foreign markets, while continuing to compete in the market itself. The Ecuadorian case study also shows that Corpei, the (private) national export promotion body in Ecuador has played a key role in the growth of the cut-flower industry. A recent study at the World Bank has found that export promotion agencies on average have a strong and statistically significant impact on exports estimated to be a $300 increase in exports for each $1of export promotion for the median export promotion agency (World Bank 2006a).[59]

The dubious case for export subsidies

63. One way to encourage exports may be through export promotion schemes. Some of these export promotion schemes may be characterised as export subsidies which are generally prohibited under WTO rules,[60] and therefore must be made WTO consistent. Some exceptions however have been granted to developing countries in recognition of the role subsidies may play in economic development.

64. Export promotion schemes have often failed to live up to expectations and can be a waste of scarce government resources. Looking at the four country case studies, Chile's simplified drawback system[61] pointed out that modest, well-administered incentives can be effective. The simplified drawback was a form of export subsidy where exporters were given a rebate of a fixed percentage of export value to "compensate" for duties paid for inputs. The rebate was cut off when exports for a certain item reached a certain level. According to Agosin (2002), this kind of incentive is close to economic optimality considering the aforementioned characteristics of information: the first or second entrants into the market

59. The study finds that there is significant heterogeneity across regions and countries. For every $1 in the export promotion agency (EPA) budget, on average there is an additional $490 of exports in the Latin American and Caribbean, $227 in Asia, $160 in the OECD, $137 in Sub-Saharan Africa and $96 in the Middle East and North Africa. The study also states that there are strong diminishing returns, suggesting that a simple increase in funding is not necessarily cost-effective. The study also suggests that (1) EPAs should have a large share of the executive board in the hands of the private sector, but they should have a large share of public funding, (2) a single and strong EPA is preferred to the sometimes proliferation of agencies within countries, (3) EPAs should focus on non-traditional exports or have some broad sector orientation, and (4) they should also focus on large firms that are not yet exporters (although this point is statistically weak). For developing countries, EPAs should cover investment promotion and export financing, and focus their expenditure on on-shore export support activities rather than on country image or marketing and market research activities (World Bank, 2006a).

60. A subsidy is defined as a "financial contribution by a government or any public body which thereby confers a benefit" in article 1 of the WTO Agreement on Subsidies and Countervailing Measures and subsidies contingent on export performance are prohibited by Article 3.1(a). Article 27 provides for the special and differential treatment of developing country measures. (See Engman et al. 2007 Part 3 for further discussion)

61. This system has since been modified as it was not considered to be WTO consistent.

are rewarded, allowing these companies to recoup start-up costs related to information gathering of and compensate for initial risks. As exports grow (and externalities related to information disappears), the rebates will be cut off. This automatic phase out characteristic is also important as these measures are extremely difficult to get rid of once put into place.

65. The Export Processing Zones in the Philippines and Thailand also were examples of export promotion measures which have contributed to development.[62] While these experiences may show that some export promotion policy may have a role to play,[63] it should be reemphasised that export subsidies are a suboptimal policy from an economic point of view[64] and exports are not an end in themselves. Providing strong export incentives defeats the objectives of trade liberalisation – to reduce distortions in the economy. Thus, any export promotion policy should be limited to the extent that market failures exist, must comply with existing WTO rules that prohibit export subsidies, and be phased out when such a need diminishes (i.e. when the market failure no longer exists and/or exports have reached a certain level).

5) Institutional frameworks and regulatory and competition environment

66. On the issue of institutional and governance frameworks, the "recommendations" stress the importance of an institutional and governance framework which will favour structural reform, while also enhancing public understanding and acceptance of reform measures via effective review and evaluation, a well functioning consultative process, and sound public institutions. On the issue of the regulatory and competition environment, the "recommendations" state that governments should foster a sound regulatory and competition environment which permits transformation within firms as well as entry and exit across sectors by facilitating mergers and shifts in corporate culture, keeping regulatory barriers on enterprises to the necessary minimum and reducing the trade-distortive effects of domestic regulation. The four country experiences largely support the above points. In this section we look at (a) sound public institutions, (b) well functioning consultative process, and (c) competition environment.

a) Sound institutions and regulatory environment

67. Sound institutions and the right regulatory environment facilitate all forms of economic exchange by minimising the risks that are inherent in economic transactions.[6566] Institutions, such as property rights[67]

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62 See Engman et al. (2007) for more detailed discussions on the pros and cons of EPZs as a development tool.

63. Rodrik (2007) argues that developing countries tend to have weaker institutions and market failures which disproportionately affect tradables compared to non-tradables. While the introduction of reliable institutions and removal of market failures is the first best solution, undervaluation or export subsidies may serve as a second best solution to make up for existing failures.

64. Fine tuning subsidies to where the perceived distortions are would amount to a highly intricate form of industrial policy with all the attendant informational and rent-seeking difficulties.

65. For example, when selling a good or services to another company, the company may not pay. When buying a good, the good may not be of the quality stated.

66. Rodrik (1999) states that it is useful to consider institutions as "a set of humanly devised behavioural rules that govern and shape the interactions of human beings, in part by helping them to form expectations of what other people will do (Lin and Nugent, 1995) ." He goes on to discuss five types of market supporting institutions: property rights; regulatory institutions; institutions for macroeconomic stabilisation; institutions for social insurance; and institutions of conflict management. Institutions can be both formal and informal.

67. Property rights have several effects: (1) fixing the economic potential of assets and allowing property to be used as collateral greatly enhancing capacity to invest; (2) integrating dispersed information into one system (price) creating new opportunities to create surplus value through transactions; (3) increasing

and contract enforcement thus allow firms and individuals to initiate economic transactions even with firms and individuals with which they have not had previous contact. This fact highlights the importance of institutions in a period of structural adjustment where firms and individuals are required to cultivate new business relationships and enter new areas of activity.[68] All four cases showed how institutions and the right regulatory framework were important for providing the predictability necessary for investment. The Ecuador and Philippines case showed how frequent changes in government and policies and resulting uncertainties in the institutional framework have not been conducive to adjustment. The Thai case on the other hand showed an interesting case where stability in the general institutional framework[69] has led to sustained growth despite apparent political instability. The Thai case study further showed how the strengthening of formal institutions such as the central bank, the budget bureau and the economic planning agency have been a key factor in the development of Thailand. The four case studies all showed (1) how the strengthening of the independence of the central bank has been important in restoring and maintaining macroeconomic stability and (2) that while capital market liberalisation is extremely important, it is critical to set up an effective financial supervision mechanism and prudential regulation before liberalising the capital account.

68. The importance of institutions and the right regulatory framework also came out in some of the sectoral analyses. A clear and stable regulatory framework allowing both domestic and foreign private investors to invest through mining concessions was extremely important for FDI and the development of the copper sector in Chile. In a similar manner, the legal framework related to the forestry sector including a declaration that privately planted land used in the forestry sector could not be expropriated, was crucial for development of the forestry sector. On the other hand, continued concern related to land reform in the Philippines has been a deterrent to investment in the agriculture sector. The Thai telecom sector case study showed how a poorly designed regulatory regime can delay the development of a sector.

69. The experiences related to capital market liberalisation in the four countries highlighted the difficulties related to changes in the institutional and regulatory framework. Successful institutional arrangements usually take into account a countries' history and are typically developed over time. The opening up of capital markets requires extensive changes in government institutions, the regulatory framework and changes in behaviour on the part of the private sector. However, as evidenced in the country case studies, all four countries have experienced considerable difficulties. This seems to provide evidence of the difficulties in changing the institutional framework, and a case for gradualism in reforms. The Philippines case study on cement provided a similar example. The Philippines government, despite a history of considerable involvement in the industry and a number of bail outs in the past decided to cease intervention in the sector. However, companies found it difficult to change their behaviour and expectations towards government. When there was a temporary boom in the construction sector, they invested aggressively in capacity assuming that they will be bailed out as in the past. A downturn in the economy and the government's decision not to intervene, led to many company failures. This case shows how industry may need time to adjust to changing institutional and regulatory frameworks.

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accountability and cutting down transaction costs; (4) making assets fungible and divisible; (5) networking people and improving the flow of communications about assets and their potential; and (6) protecting transactions (De Soto(2000)).

68. Rodrik (2007) argues that bad institutions may affect tradables more than non-tradables since production systems tend to be more "complex" and round-about in tradables, placing greater premium on contractability and reliable third-party enforcement.

69. Major parties' shared acceptance of the importance of preserving Thai traditions and institutions, strong loyalty to the present monarch and a large degree of independence of Thai bureaucracy from political control are the reasons for such stability in the general institutional framework. The institutional framework is thus a combination of formal and informal institutions.

b) Well functioning consultative process

70. A well functioning consultative process can improve the adjustment process by alleviating some of the information asymmetries between the government, industry and the public. Through the consultative process, governments can gain more information on how future reforms could affect different stakeholders while stakeholders may also gain a better understanding on which way reforms are headed, why such reforms are needed and how future reforms may affect their livelihoods.[70] The Chile case study showed that limited consultations with industry likely led to a systematic underestimation of the negative effect of its initial major economic reforms. A well functioning consultative process in the second and third phases led to more pragmatism on the part of policy makers and better outcomes by facilitating adjustment. A well functioning consultative mechanism may also allow governments to identify the constraints that exportable industries face (e.g. human resources, infrastructure, financing, information, etc.) and to respond more effectively. As pointed out in the Thai case study, the lack of transparency and broad based participation[71] in the reform process has been one reason for the increasing lack of popular support for trade liberalisation and privatisation in Thailand.

c) Competition environment

71. The competition environment has been an extremely important factor in structural adjustment. Effective competition provides the incentives for firms to increase efficiency and to reallocate resources to more efficient firms. There are synergies between trade, investment and competition policies in the sense that gains emerging from one policy area are enhanced by reforms made in the other two areas. Trade liberalisation generates higher gains when markets are competitive and the movement of capital is free (Bartok and Miroudot, 2007). While the studies did not go into this issue in depth, and some countries such as Thailand only put into place a competition law in 1999, this point did come out in some of the sectoral case studies. One of the reasons that government intervention in the automotive and auto-parts sector was relatively successful in Thailand was because the relatively large domestic market and large number of foreign entrants to the market led to effective competition. Chile's copper corporation (CODELCO) and the national mining company (ENAMI) have been relatively efficient despite public ownership partly because of effective competition from the private sector. The Thai telecom sector, on the other hand, provides a counter-example where limited competition has led to inefficiencies.

6) Role of multilateral cooperation and regional and bilateral initiatives

72. On the issue of multilateral cooperation and bilateral and regional initiatives, the "recommendations" state that multilateral cooperation should be fostered in the areas of trade and finance, by avoiding trade policy retaliation, helping lock in domestic reform, while addressing in particular adjustment related concerns of developing countries, and other interlinked areas of capacity building and corporate responsibility and core labour standards. The "recommendations" state that bilateral and regional initiatives should be fostered where regulatory cooperation can foster opportunities through trade or ease adjustment strains in particular sectors.

70. See also Engman et al.(2006). Policy dialogues between the government and industry in the Japanese chemical industry and the U.S. tobacco industry are provided as examples of policy dialogue assisting in the acceptance of reform.

71 . It should be noted that closed consultative mechanisms may lead to regulatory capture and in some cases corruption.

73. As stated above, multilateral, regional and bilateral initiatives can be useful signals of a government's commitment to trade liberalisation, enhance credibility of reforms,[72] and act as a trigger for economic reforms and structural adjustment. While developing countries often have undertaken trade reforms unilaterally to achieve domestic policy objectives,[73] commitments at the multilateral level can serve to lock in earlier unilateral liberalisation (Engman et al, 2006) and to provide an upper limit to any backtracking. The Chilean case illustrated this point well. When the initial trade reforms in the 1970s and 80s were reversed due to a balance-of-payments and financial crisis, tariffs were raised to 35%, which was Chile's bound rate in the GATT. FTAs in Chile have contributed not only to better access to export markets but also to institution building by locking in various reforms under the FTA commitments.

74. As developing countries' bound tariff rates under the WTO are often significantly higher than applied levels, the current Doha Development Agenda negotiations will result in an increase in bindings and a reduction in the levels of bound tariffs, which will lead to greater predictability. However, it will not lead to new market opening unless applied tariffs are also reduced. Regional and bilateral commitments currently play a noticeable role in pushing toward greater liberalisation in the absence of progress in multilateral fora. Rule making at the multilateral, regional or bilateral levels may also be used to promote good practices (e.g. the Reference Paper in the Basic Telecom Negotiations).[74]

75. One issue that was not quite explicit in the "recommendations" was that multilateral trade liberalisation as well as bilateral and regional initiatives may help structural adjustment by facilitating export response through the provision of access to markets. The example of Ecuador presented the clearest example in this regard. The Andean Trade Preference Act (ATP) and the Andean Trade Preferences and Drug Eradication Act (ATPDEA) provided access to US markets which have been essential for the growth of non-traditional export sectors such as cut flowers and tuna processing in Ecuador. The case study suggests that re-imposition of MFN tariffs on Ecuadorian exports may jeopardise the competitiveness of these industries. Market access provided through the multi-fibre agreement was key in the initial development of Thailand's textile and clothing sector. The Andean Community, the Asean Free Trade Agreement and the multiple RTAs by Chile also provide examples where bilateral and regional initiatives have facilitated adjustment through access to export markets. The studies suggest that the provision of access to export markets both in developed country and developing country markets through progress in the DDA may facilitate adjustment processes in developing countries.[75]

76. While this study did not focus on the issue of multilateral assistance for capacity building, the cases indicate that multilateral assistance in the form of aid has been important in the growth of some industries. Thailand, in the wake of the Asian financial crisis introduced temporary labour intensive civil works programmes with financial support from the World Bank and the Japanese government. The cut-flower sector in Ecuador benefited from subsidised loans in part from the IADB and World Bank as well as technical assistance by the United States. Ecuador's tuna processing sector benefitted from official development aid from the United Kingdom. These cases indicate that multilateral cooperation in capacity building will continue to be important for structural adjustment in developing countries.

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72. The accession process to the European Union acted as a trigger for trade reforms in Eastern Europe as well as making the reforms credible and facilitating resource reallocation.

73. This has been the case for the countries studied in this project except for Ecuador.

74. The Reference Paper provides policy makers with guidance on how to introduce sustainable competition in telecommunication markets. It includes regulatory disciplines such as commitments on competitive safeguards, interconnection, independent regulation, transparent licencing procedures and non-discrimination (Engman et al., 2006).

75 . Kowalski and Shepherd (2006) and Dihel et al. (2006) points to the growing importance of South-South trade in goods and services.

7) Need for a broad-based approach to reforms and credibility

77. The "recommendations" state that governments should "undertake reforms across different policy areas in a complementary, broad based way, in order to maximise cross-policy synergies and to reduce resistance to structural change, by helping ensure that those adversely affected by one reform may benefit from another. The "recommendations" do not specifically mention the issue of credibility of reforms.

78. The four case studies indeed show that trade reform has been implemented as a part of overall economic reform and that various policies in the area of trade policy, FDI policy, macroeconomic policy, exchange rate policy, fiscal policy and labour and capital market policy among others are all closely interlinked. As documented in the sections above, the close links between trade policy and respective policy areas mean that government agencies must coordinate closely to ensure that policies are coherent and that reforms can be sequenced to bring about better results. Other areas of reform such as public sector reform and pension reform may also contribute to better results in other areas such as capital market reforms. In the case of Chile, public sector reform led to an increase in the companies traded on the stock exchange and pension reform contributed to the increase of investment in the capital market.

79. Credibility of reforms is important because the private sector will reallocate resources in response to trade reforms only if they consider reforms will be sustained (Rodrik 1989b). When a future reversal of liberalisation is anticipated, the private sector will often take a wait and see attitude. Producers competing with imports will not invest resources to look for new export opportunities; even worse they may intensify their lobbying efforts. Some consumers may even front-load their imports in order to import cheaper goods before high tariffs are re-instated. Loss- making firms may go into debt in order to remain in operation while waiting for a reversal of policy (Edwards, 1986). There may even be a perverse incentive for some companies to refrain from making a true effort to adjust to the changing environment: a worse situation may allow it to receive more protection when reforms are reversed. Thus in proceeding with trade reform, governments need to consider ways to enhance credibility of their reforms. Credibility can be gained by several means; (1) deeper reforms;[76] (2) mutually supporting and consistent policies;[77] (3) creation of a track record over time; and (4) use of international commitments.

80. The four countries under study show different experiences with respect to credibility of trade reforms. After an earlier failed attempt at trade reform, Ecuador enhanced credibility of its second round of reforms in the late 1980s using the Andean Community and WTO accession. While Chile's initial trade reform in the 1970s and early 1980s led to a reversal, it enhanced credibility of its second reforms in the late 1980s through greater emphasis on involvement of the private sector in policy formulation and policy coherence, putting into place more mutually supporting policies which promoted exports. Interestingly, in the case of Chile, its withdrawal from the Andean Community may have served as a signal for the Chilean government's commitment to trade and investment reform. [78] World Bank and IMF programmes have also been used to signal credibility and commitment as was the case in Thailand's post crisis reforms and Chile's second reforms.[79] However, one needs to be careful not to overuse outside forces as it may

76. See section on pace of trade liberalisation and footnote 14 on how deeper reforms can signal credibility.

77. This is because mutually complementary policies increase the cost of reversing one single part of the policy package.

78. Chile withdrew from the Andean Community because Chile failed in persuading other Andean Community Members to lower the high common tariffs of the Community.

79 . Rajapatirana et al. (1997) states that the conditionality attached to relevant loans was rather mild compared to the liberalisation the countries undertook and that in fact, the strongest liberalisations like those of Argentina (1991). Chile (1974) and Colombia (1991) were not associated with World Bank Structural Adjustment Loans for trade or broader reforms.

undermine the domestic legitimacy of reforms (Engman *et al*., 2006). Reforms when considered to have been imposed by outside forces could be more susceptible to policy reversals.

4. Conclusions

81. In conclusion, developing countries have progressively undertaken trade reforms as a part of overall economic reform. Trade reforms have differed in terms of content, speed and magnitude leading to different results. Sequencing and timing of reforms as well as their content are important. While a gradual approach is often warranted to allow for institutions, government bodies and industries to adjust, a more radical approach may be considered in some cases. QRs and the most serious distortions to trade should be removed in the initial phase of reforms.

82. Trade reforms and other reform areas such as FDI policy, macroeconomic policy, exchange rate policy, fiscal policy and labour and capital market policy among others are all closely interlinked. The close links between trade policy and respective policy areas mean that government agencies must coordinate closely to ensure that policies are coherent and that reforms can be sequenced to bring about better results. For example, trade reforms should be closely linked with FDI policy which enhances the associated flows of FDI. On the other hand, a more cautious attitude may be necessary towards capital market liberalisation to make sure that the financial regulatory framework and the financial community can cope with the institutional changes. Trade reforms may also need to be accompanied by labour market reforms which allow for flexible wage setting arrangements and balanced employment protection. Trade reforms may also need to accompany tax reform such as the introduction of a Value Added Tax. While developing country governments may not have sufficient resources to put formal social safety nets in place, economic growth, flexible labour markets, and a large informal economy can act as a substitute, supplemented by some focused social safety net programmes.

83. One point developing country governments may wish to consider is the importance of export response in the initial phase of trade reform. From this point of view, exchange rate policy as well as other policies to facilitate exporters in terms of inputs, financing, and market information may be important.

84. Transparency and predictability of reforms have been an important factor which has facilitated structural adjustment, while lack thereof has retarded adjustment. From this point of view political stability, macroeconomic stability as well as policy consistency are important factors. Multilateral, regional and bilateral initiatives can contribute to transparency and predictability, as can better institutional frameworks and consultative mechanisms.

85. More importantly, the Doha Development Agenda, and to a lesser extent the various regional and bilateral free trade initiatives can contribute to structural adjustment in developing countries that are undertaking trade reforms by providing the access to markets that can contribute to inducing export response and successful adjustment to areas of comparative advantage in those developing countries.

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ANNEX 1: TRADE AND STRUCTURAL ADJUSTMENT: RECOMMENDATIONS FOR GOOD PRACTICE[80]

On the basis of the cases examined in this study and other experience gained in the OECD peer preview process, government, in both developed and developing countries, are recommended to:

1. *Rely, wherever possible, on* ***generally available adjustment measures****, including through the social security and tax system, in order to help improve the benefits from openness while reducing adjustment costs.*

2. *Ensure that targeted adjustment measures, should these be considered necessary for reasons of political economy, are:*

   2.1 *time-bound, with a clear exit strategy*

   2.2 *decoupled from production*

   2.3 *aimed at re-integrating displaced workers into the workforce*

   2.4 *compatible with general safety net arrangements*

   2.5 *cost effective*

   2.6 *transparent and accountable*

3. *Foster an adjustment-enabling environment, through the promotion of* ***macroeconomic stability*** *and growth, which supports the effective functioning of labour markets and the economy in general, and which, particularly in the case of developing countries, complements the process of trade liberalisation by:*

   3.1. *removing anti-export bias and maintaining appropriate exchange rate policies*

   3.2. *encouraging tax reforms to offset declines in government revenue resulting from tariff reductions.*

4. *Adopt sound* ***labour market policies*** *which facilitate the reallocation of workers towards higher productivity employment and so help economies - and their citizens - reap the gains from trade, and which encompass:*

   4.1 *income-replacement benefits which provide adequate income security for displaced workers while fostering their reintegration into employment. Thus, welfare benefits should*

80. Reproduced from OECD (2005a).

support work incentives and not be used as a way to withdraw displaced workers from the labour force (as has often been the case with early retirement and disability schemes);

4.2 active labour market programmes – including job-search assistance, counselling, training, moving allowances and proactive measures in anticipation of mass layoff – which entail:

4.2.1 active tripartite cooperation between management, workers' representatives and government, where consistent with national practices

4.2.2 realistic assessment of workers' labour market opportunities and adjustment assistance needs

4.2.3 use of external specialists in the case of large-scale layoffs

4.2.4 programmes that are of sufficient duration to provide real support while also discouraging complacency

4.2.5 complementary support via income-replacement benefits

4.3 employment protection policies which find a balance between lessening adjustment costs while not restricting business dynamism

4.4 flexible wage setting systems, pension portability and fluid housing markets

4.5 education and training systems that foster the development of human capital and help ensure that labour skills meet evolving labour market needs.

5. Foster a sound ***regulatory and competition environment*** *which permits transformation within firms as well as entry and exit across sectors by facilitating mergers and shifts in corporate culture, keeping regulatory barriers on enterprises to the necessary minimum and reducing the trade-distortive effects of domestic regulation through the reinforcement of:*

5.1 transparency

5.2 non-discrimination

5.3 avoidance of unnecessary trade restrictiveness

5.4 international harmonisation of standards

5.5 streamlined conformity assessment

5.6 vigorous application of competition principles

6. Foster a strong ***institutional and governance framework*** *that will favour structural reform, while also enhancing public understanding and acceptance of reform measures, via:*

6.1 effective ex-ante policy evaluation, including analysis of whether proposed structural reform is in the overall interests of the community

6.2 independent review processes to ensure that benefits will outweigh costs while avoiding conflicts of interest

6.3 mid-term and ex-post evaluation to help ensure that policies will be modified if necessary in light of actual experiences as well as any unanticipated difficulties

6.4 a well functioning consultative process between the government and civil society, including the private business sector

6.5 sound public institutions for managing the services and incentives provided to investors, importers and exporters.

7. *Adopt **liberal trade policies**, which support structural adjustment by contributing to economic growth, fostering competitiveness and innovation, improving access to essential imports and encouraging synergies between countries with different areas of comparative advantage, and which:*

   7.1 *maximise the particular welfare and flow-on benefits which arise from the liberalisation of trade in services;*

   7.2 *are implemented over a time period long enough to enable affected parties to adjust but short enough to avoid back-tracking;*

   7.3 *rely sparingly on the use of safeguards and with a careful assessment of their potential benefits in providing breathing space for – and greater public acceptance of – structural adjustment justifies the cost they entail;*

   7.4 *maximise opportunities for associated flows of foreign direct investment.*

8. *Undertake reforms across different policy areas in a complementary, **broad-based** way, in order to maximise cross-policy synergies and to reduce resistance to structural change, by helping ensure that those adversely affected by one reform may benefit from another.*

9. *Foster bilateral and regional initiatives, where regulatory cooperation can foster opportunities through trade or ease adjustment strains in particular sectors, and where trade--related adjustment and opening can be undertaken among bilateral or regional partners as a transition, or complement, to wider multilateral commitments.*

10. *Foster multilateral cooperation in the adjustment-related and interlinked areas of:*

    10.1 ***Trade and finance**, by avoiding mutually destructive trade policy retaliation, helping lock in domestic reform, while addressing in particular adjustment- related concerns of developing countries, via:*

    10.1.1 *a sustained commitment to the trade-liberalising and rules-strengthening objectives of the Doha Development Agenda*

    10.1.2 *the effective application of special and differential treatment for developing countries*

    10.1.3 *strengthened disciplines on the provision of officially supported export credits*

    10.1.4 *enhanced cooperation between the WTO, the World Bank and the IMF to ensure greater coherence in global economic policy making*

    10.2 ***Capacity building**, via:*

    10.2.1 *effective coordination between the WTO, IMF, World Bank, bilateral donors and other multilateral agencies to help reinforce developing country institutional and supply-side capacities*

    10.2.2 *co-ordination of donor activities*

    10.3 ***Corporate responsibility and core labour standards**, via:*

    10.3.1 *ongoing efforts to enhance the effectiveness, transparency and timeliness of the implementation of the OECD Guidelines for Multinational Enterprises*

    10.3.2 *ongoing application of the OECD guidelines relating to corporate social governance in the provision of official support for export credits*

10.3.3 ongoing application of core labour standards, notably through continued enforcement of the ILO Declaration on Fundamental Principles and Rights at Work

ANNEX 2:

Table A. Levels of applied tariffs of WTO Members

MFN APPLIED TARIFF RATES (%)*	AGRICULTURAL GOODS	NON-AGRICULTURAL GOODS
above 30	Bhutan (41.2), Burundi (33), India (37.4), Iran (32.3), Korea (41.6), Morocco (48.6), Nigeria (50.4), Seychelles (38.4), Solomon Islands (34.0), Sudan (34.6), Tunisia (66.5), Turkey (42.3)	Bahamas (31.5), Djibouti (32.6)
25-30	Barbados (29.3), Thailand (29.6), Zimbabwe (25.7)	India (27.9), Morocco (21.5), Nigeria (25.8), Seychelles (26.8)
20-25	Algeria (23), Bahamas (24.3), Bangladesh (20.6), Cameroon (22.0), Central African Republic (22.0), Chad (22.0), Congo (22.0), Djibouti (20.5), Egypt (22.5), Equatorial Guinea (22.0), Ethiopia (21.7), Gabon (22.0), Kenya (23.6), Libya (22.4), Mexico (24.5), Guyana (20.1), Romania (24.4), Sri Lanka (22.5), Syria (20.6), Viet Nam (24.5)	Burundi (22.0), Iran (20.5), Maldives (20.5), Solomon Islands (20.5), Sudan (22.9), Tunisia (22.4),
15-20	Belize (17.6), Bulgaria (18.4), Cambodia (19.5), China (16.2), Colombia (16.1), Dominica (19.6), Ghana (17.3), Grenada (17.0), Israel (15.9), Jamaica (15.7), Jordan (19.6), Lao People's Democratic Republic (18.9), Malawi (15.1), Maldives (18.3), Mauritius (19.4), Mozambique (16.6), Pakistan (18.7), St. Vincent and the Grenadines (15.6), Serbia Montenegro (15.9), Sierra Leone (16.4), Chinese Taipei (16.3), Tanzania (18.1), Trinidad and Tobago (15.8), Vanuatu (15.5), Yemen (15.0), Zambia (18.7),	Algeria (18.1), Bangladesh (18.3), Bermuda (18.8, Bhutan (19.2), Cambodia (15.9), Cameroon (17.5), Central African Republic (17.4), Chad (17.4), Congo (17.4), Equatorial Guinea (17.4), Ethiopia (18.4), Egypt (19.5), Gabon (17.4), Kenya (15.7), Libya (16.3),Mauritius (17.3), Mexico (17.1), Pakistan (16.2), Romania (15.8), Rwanda (18.0), Syria (19.5), Viet Nam (15.7), Zimbabwe (15.2)

MFN APPLIED TARIFF RATES (%)*	AGRICULTURAL GOODS	NON-AGRICULTURAL GOODS
10-15	Antigua and Barbuda (14.6), Argentina (12.0), Azerbaijan (12.7), Benin (14.3), Bolivia (10.0), Brazil (10.3), Burkina Faso (14.0), Costa Rica (12.2), Cuba (10.9), Cote d'Ivoire (14.3), Democratic Republic of the Congo (13.0), Dominican Republic (13.0), Ecuador (14.7), El Salvador (11.7), Eritrea (10.0), FY Republic of Macedonia (12.7), Gambia (14.9), Georgia (11.7), Guatemala (10.0), Guinea-Bissau (14.3), Lebanon (14.7), Mali (14.3), Mauritania (12.4), Moldova (10.2), Nepal (13.5), Niger (14.3), Oman (10.2), Panama (14.8), Papua New Guinea (14.7), Paraguay (10.1), Peru (13.6), Rwanda (13.5), St Kitts and Nevis (13.1), St Lucia (14.8), Senegal (14.3), Togo (14.3), Turkmenistan (13.2), Uganda (12.0), Uruguay (12.0), Uzbekistan (10.5), Venezuela (14.8)	Argentina (12.0), Barbados (11.2), Belarus (10.1), Benin (11.6), Brazil (12.7), Burkina Faso ((11.7), Colombia (11.6), Cuba (10.9), Cote d'Ivoire (11.6),Democratic Republic of the Congo (11.9), Ecuador (11.5), Gambia (12.5), Ghana (12.5), Guinea-Bissau (11.6), Jordan (12.1), Malawi (12.9), Mali (11.6), Mauritania (10.3), Morocco (11.7), Nepal (13.7), Niger (11.6), Paraguay (10.9), Russia (10.1), Senegal (11.6), Sierra Leone (13.3), Tanzania (12.9), Thailand (13.3), Togo (11.6), Uruguay (13.5), Uzbekistan (11.1), Vanuatu (13.6), Venezuela (12.4), Yemen (12.5), Zambia (13.2)
5-10	Albania (9.0), Angola (9.4), Armenia (6.6), Bolivia (6.8), Belarus (9.0), Bermuda (8.0), Botswana (9.1), Chile (6.0), Croatia (9.3), European Communities (5.9), Fiji (8.4), Guinea (6.6), Honduras (9.8), Iceland (6.5), Indonesia (8.2), Japan (7.3), Kazakhstan (8.8), Kyrgyz Republic (7.0), Lesotho (8.8), Madagascar (5.7), Mongolia (5.1), Myanmar (8.5), Namibia (9.1), Nicaragua (9.5), Philippines (9.5), Qatar (6.3), Russia (8.9), Saudi Arabia (6.8), South Africa (9.1), Swaziland (9.1), Tajikistan (9.4)	Oman (5.0), Panama (7.4), Philippines (5.8), St Kitts and Nevis (8.8), St Lucia (8.0), St Vincent and the Grenadines (8.9), Saudi Arabia (6.0), Serbia Montenegro (8.4), South Africa (5.3), Sri Lanka (8.3), Swaziland (5.3), Chinese Taipei (5.5), Tajikistan (8.1), Albania (7.2), Angola (8.7), Antigua and Barbuda (8.9), Azerbaijan (8.3), Belize (9.5), Bolivia (9.3), Bosnia Herzegovina (6.2), Botswana (5.3), Bulgaria (8.8), Chile (9.5), Dominica (8.4), Dominican republic (7.8), El Salvador (6.6), Eritrea (7.6), Fiji (7.2), FY Republic of Macedonia (8.7), Georgia (6.9), Grenada (9.4), Guatemala (5.7), Guinea (6.4), Guyana (9.6), Honduras (5.3), Indonesia (6.7), Jamaica (5.9), Kazakhstan (9.5), Korea (6.7), Lao People's Democratic Republic (8.2), Lesotho (7.9), Madagascar (5.1), Malaysia (9.1), Myanmar (5.0), Namibia (5.3), Trinidad and Tobago (6.6), Turkey (5.3), Uganda (7.2), Ukraine (6.9), Peru (9.7)
0-5	Australia (1.2), Bosnia Herzegovina (4.8), Brunei Darussalam (0), Canada (3), Hong Kong China (0), Kuwait (1.7), Macao China (0), Malaysia (3.3), New-Zealand (1.7), Norway (x), Singapore (0), Suriname (x), Switzerland (x), United States (x)	Armenia (2.3), Australia (4.6), Bahrain (4.9), Brunei (3.0), Canada (4.0), Costa Rica (4.9), Croatia (4.1), European Communities (4.0), Hong Kong China (0), Iceland (2.4), Israel (4.0), Japan (2.5), Kuwait (3.9), Kyrgyz Republic (4.8), Lebanon (4.0), Macao (0), Moldova (4.1), Mongolia (4.9), New-Zealand (3.4), Nicaragua (4.0), Norway (0.6), Papua New Guinea (4.7), Qatar (4.9), Singapore (0), Suriname (x), Switzerland (x), Turkmenistan (3.9), United States (3.3)

Source: WTO (2005): World Trade Report, p. 307-311

Table B. Existing Studies in Trade Reforms and Adjustment Experiences

Title and Author	Main feature / Countries studied	Main Lessons
Trade and Employment in Developing Countries by A. Krueger (1981)	- Study comparing the effects of import substitution and export promotion on employment. - Case studies on Brazil, Chile, Colombia, Indonesia, Ivory Coast, Pakistan, Korea, Thailand, Tunisia, Uruguay	- Export oriented policies have often been more successful in expanding employment than import substitution polices as they are more labour intensive. - Extent of potential gain very much depends on whether factor markets function appropriately.
Export Orientated Development Strategies by Corbo, V., A. Krueger, and F. Ossa (eds. 1985)	- Study looking at export oriented growth strategies. - Case studies on Chinese Taipei, Rep. of Korea, Singapore, Hong Kong and Chile.	- Stable macroeconomic framework - Level of the real exchange rate has to be appropriate and stable over time. An appropriate real exchange rate is one that, given the expansion in expenditures, generates a commensurate trade balance that is sustainable in the medium term. - Exporters should operate under a regime very close to free trade. Both traded raw materials and non-tradable services should be competitively priced. - Financial markets should supply financing at domestically competitive rates. - Any discriminations against savings should be lifted.
Economic Liberalization in Developing Countries, by Choksi et al (eds.) (1986)	- Study looking at various Issues - A single case study on Chile	- Studies timing and sequencing issues, adjustment process, compensation issues, and order of liberalization of the capital and current accounts.
Liberalising Foreign Trade in Developing Countries: The Lessons of Experience, by Papagiorgiou et al (1990)	- Comprehensive World Bank study studying 36 episodes of trade reform in 19 countries including Argentina, Brazil, Chile, Korea, Peru, Philippines, Singapore, Sri Lanka, Turkey	- Programs which started boldly were more durable. - Reduction of quantitative restrictions are key. - Most successful programs began with depreciation of the exchange rate - Prudent macroeconomic policy is key. - Proper sequencing (trade liberalisation before capital liberalisation) important - Transitional cost of liberalisation smaller than commonly feared (trade liberalisation did not, as a rule, raise unemployment)
Best Practices in Trade Policy Reform, by Thomas and Nash (1991)	- World Bank Study based on case studies in Bangladesh, Columbia, Ghana, Jamaica, Madagascar, Mauritius, Pakistan, Chile, Korea, Panama, Philippines, Thailand, Turkey, Ivory Coast, Guyana, Malawi, Senegal, Togo, Yugoslavia, Zambia, Zimbabwe	- Initial priority should be reduction of QRs. - Strong action is necessary to reduce import protection. - Relatively low and relatively uniform tariffs are preferable for efficiency reasons. - Cost Benefit studies are useful for improving acceptability of trade policy reform. - Capacity for monitoring and evaluation needs to be enhanced. - If reforms cannot be carried out simultaneously, careful sequencing is necessary. - On macroeconomic stability, the fiscal effects of trade reform should be considered. When inflation is very high, stabilisation efforts can precede other reforms. - Greater emphasis on complementary policies, investments and institutional reforms will improve the payoff of trade reform.

Table B. Existing Studies in Trade Reforms and Adjustment Experiences (continued)

Title and Author	Main feature / Countries studied	Main Lessons
Trade Policy Reform: Lessons and Implications, by Nash and Takacs (1998)	Lessons from World Bank Trade Expansion Programmes in seventeen countries (Kenya, Madagascar, Mali, Mauritius, Morocco, Uganda, Zimbabwe, Costa Rica, Guatemala, Peru, Uruguay, Czechoslovakia, Georgia, Poland, Rumania, Mongolia and Vietnam).	- Macroeconomic stability facilitates trade reform. Trade reform need not wait for macroeconomic stability. - Trade reform will only work with a working mechanism for allocating foreign exchange - Trade reforms will only induce adjustment if the reforms are credible - Fiscal impact of trade reform must be carefully considered; other taxes and expenditures may have to be adjusted. - In most developing countries trade reform benefits agriculture. -Measures for special protection should be avoided. -Producers access to inputs at world market prices are crucial for export expansion - Liberalisation of factor markets complements trade reform; trade reform affects factor markets
Harrison et al (1998)	Chapter in Nash and Takacs (1998) which is focused on employment issues which analyses data from 16 countries	- In all countries other than the transitional economies, trade reforms were followed by increases in aggregate employment.
Reinvigorating Growth in developing Countries – Lessons from Adjustment Policies in Eight Economies by Goldsbrough et al (1996)	IMF study which looks at adjustment policy experiences in Bangladesh, Chile, Ghana, India, Mexico, Morocco, Senegal, Thailand	- Trade reforms should (1) begin with a substantial initial effort; (2) involve rapid dismantling of quantitative restrictions; (3) be accompanied with consistent exchange rate; (4) be accompanied by liberalisation of domestic markets and price controls. - On average the export response was strongly positive and typically realised within one or two years after the initiation of trade reforms. - Policy inconsistencies (e.g. between exchange rate, fiscal and wage policies) weakened supply response and sometimes led to policy reversals.
Trade Shocks in Developing Countries, by Collier and Gunning (1999)	- Study looking at trade shocks in various developing countries such as commodity booms in coffee, cocoa, oil, sugar, copper, diamond, and uranium. - Case studies on Kenya, Ghana, Ivory Coast, Malawi, Mauritius, Senegal, Zambia, Botswana, Niger, Cameroon, Nigeria, Egypt, Colombia, Costa Rica, Bolivia, Venezuela, Mexico, Thailand, Sri Lanka, Philippines, Bangladesh, Malaysia, Indonesia	- Commodity booms have often led to increased government expenditure leading to a crisis after price falls. - Commodity booms have also led to Dutch disease and construction booms.

Table B. Existing Studies in Trade Reforms and Adjustment Experiences (continued)

Title and Author	Main feature / Countries studied	Main Lessons
Adjusting to trade liberalisation: The Role of Policy Institutions and WTO Disciplines by Baccheta and Jansen (2003)	- Study looks at adjustment process following a change in trade policy. - No case studies.	- Trade liberalisation is not main agent of a country's overall production structure. - Adjustment costs are typically smaller than gains from trade. - Governments can develop policies to target individuals and groups that suffer from adjustment. - Adjustment costs can be reduced if trade policies are underpinned by international commitments. - The pace of reforms can have a beneficial impact on adjustment costs. - Gradual reform can lessen opposition buts there are risks of undermining reforms. - In many cases effective adjustment to trade liberalisation requires the expansion of a country's export sector. - WTO agreements provide space for governments to tackle adjustment problems.
Coping with Trade Reforms: A Developing Country Perspective on the WTO Industrial Tariff Negotiations, by Cordoba and Laird (2006)	- Study looking at trade reform experiences with a view to gaining policy conclusions towards the DDA negotiations. - Case studies on Bangladesh, Brazil, Bulgaria, India, Jamaica, Malawi, Philippines, Zambia	- One size does not fit all and design of programmes must take into account level of development, quality of institutions, resource endowments and availability of resources to support reforms. - Import liberalisation initially led to more rapid growth of imports than exports and had negative effects on domestic production and employment. - Macroeconomic environment, political stability, good institutions, labour supply, infrastructure important in several cases. - Real effective exchange rate important. - Countries that opened up first to investment obtained significant FDI flows and a boost to economic growth. - Functioning of capital markets important especially for SMEs (e.g. Brazil's development bank BNDES or something similar). - Labour market rigidities tend to encourage growth of informal sector - WTO, EU accession process, RTAs, World Bank/IMF programmes have been important in countries to varying degrees.
Assessing World Bank Support for Trade, 1987-2004 – An IEG Evaluation, by World Bank (2006) Appendix B1	Literature Review	- Macroeconomic stability is a necessity - The real exchange rate is extremely important. - Compensatory measures designed to offset any inherent anti-export bias and additional incentives to address specific problems of exports important for export promotion - Design, sequence and duration of trade policy reform[2] is important. Whether trade reform should be sudden or moderate and gradual remains in dispute. - External constraints such as access to industrial country markets also important. - Complementary and mitigating measures may be necessary to reduce adjustment costs.

Title and Author	Main feature / Countries studied	Main Lessons
World Bank (2006) Chapter 4 – Case Studies	India, Indonesia, Morocco, Mozambique, Senegal and Zambia	- Crises can precipitate reform but broad ownership sustains it. - In some cases sequencing of macroeconomic policies was suboptimal (e.g. trade liberalization and currency over-valuation) - Need for complementary policies (e.g. industrial deregulation in India, supply side issues in Indonesia) were often underestimated. - Institutions matter and underpin sustainability (e.g. ministry of commerce and industry, port authority, customs administration, private sector associations) - External factors were largely understudied (overlapping RTAs, global value chains) - Distributional outcomes get too little attention.

2. The typical trade policy reform package consists on the export side, of elimination of quantitative restriction on exports; measures to offset anti-export bias, especially access of exporters to imported inputs at world market prices; export incentives; and trade facilitation including customs administration. On the import side, the reform package usually includes elimination of quantitative restrictions, reduction of tariff dispersion, lowering of average tariffs, and moves to achieve uniform tariff rates.

Source : Compiled by Author

ANNEX 3: OVERVIEW OF OTHER STUDIES

1) "Trade Liberalisation and Economic Performance: East Asia versus Latin America, 1970-2006", (Duran Lima et al, 2008)

86. East Asia and Latin America provide interesting comparisons in trade liberalisation and structural adjustment experiences. Both regions shared common features around 1980: exports were concentrated in natural resources and related products (roughly 80% in both regions) and trade policies were import-substitution oriented. Both regions subsequently shifted to a more market-oriented regime, undertaking considerable unilateral tariff liberalisation, complemented by multilateral and regional initiatives. East Asia experienced higher and less volatile economic growth, had higher volumes of trade as a proportion of GDP, and had significantly higher contribution of exports and net-exports to GDP growth. East-Asia has created new dynamic comparative advantages and diversified its export structure while Latin America has remained specialised in commodities and related manufactures. Structural change in manufacturing was also more pronounced in East-Asia than Latin America.

87. The relative success of East Asian countries is a reflection of their success in eliciting **stronger and wider export response**. While numerous factors such as better institutions, human capital, infrastructure, differences in labour policy, capital market policy, differences in the extent of services liberalisation, among others contributed, some possible reasons for overall more successful adjustment of East Asia are 1) the differences in sequencing and content of trade reform; 2) macroeconomic stability; 3)avoidance of over-appreciated exchange rates; and 4) the effective role played by foreign direct investment (FDI) and production networks.

88. On **trade reforms**, most Latin American countries cut tariffs rapidly in the mid-1980s to early 1990s while most East Asian countries took a more gradual approach. Many East Asian countries first used such schemes as tariff exemptions for exports, duty drawbacks, export processing zones to reduce anti-export bias, and reduced tariffs in the mid- to late-1990s. On the other hand, East Asian countries reduced non-tariff barriers relatively early while many Latin American countries maintained NTBs into the early 1990s. Two lessons learnt are 1) to **conduct trade reforms at a pace and in a manner which facilitates export response** and 2) to **reduce NTBs such as quantitative restrictions early**.

89. On **macroeconomic stability**, economic growth in East-Asian countries was much less volatile than in Latin American countries with relatively low inflation and interest rates. Latin America experienced recurring crises in the 1980s and also in the 1990s while East Asia has been more stable except for one crisis in the late 1990s. Crises have often triggered trade reforms, sometimes with World Bank/IMF involvement with varying degrees of success. Trade reforms have at times been initiated even without crises with generally greater success. While **macroeconomic stability has not been a prerequisite for trade reform**, macroeconomic instability has sometimes led to temporary reversals in trade reforms, showing that **stability is important for sustainability of trade reform.**

90. **Avoidance of an over-appreciated real exchange rate** is a key for successful trade reform. While in East Asia, generally appropriate real exchange rates effectively reduced anti-export bias, in Latin

America the real exchange rate was overvalued for extended periods, mitigating the potential effects of trade reform. Appropriate exchange rates and macroeconomic stability has led to **a deeper and wider export response** and **export diversification**. On the **role played by FDI,** while both regions received comparable levels of inward FDI, East-Asia has been more successful in attracting **FDI to the manufacturing sector**. East Asian countries, together with Costa Rica and Mexico, were more successful in becoming a part of global production networks, which contributed to the upgrading of their exports.

2) Overview of country case studies

a) Chile (Bartok and Onodera, 2007)

91. Chile is considered as a showcase example of a country that has successfully followed an outward-economy oriented development path. Chile had taken an import substitution policy and was characterised by a large public sector, high inflation, severe financial repression, extended price distortions and isolation from international goods and financial markets. From the early 1970s, it underwent radical reform. The initial trade and economic reform eliminated quantitative restrictions and brought tariffs down to a uniform level of 10% in a little over 5 years. Uniform tariffs have created a sense of equity, minimised lobbying efforts and enhanced support for trade liberalisation. Use of the exchange rate as an inflation anchor, capital account liberalisation without sufficient financial market reform and introduction of sufficient regulatory oversight, together with continued indexation of wages to inflation led to a balance of payment and financial crisis in the 1980s and a reversal of liberalisation. There are some signs that inappropriate complementary policies may have led to increased short term adjustment costs and interestingly Chile was sometimes referred to as a failure at this point in time. Trade reform was resumed in 1985 and an increased emphasis on complementary policies such as exchange rate policy, export promotion etc has led to successful export led growth and allowed Chile to reap the benefits of trade liberalisation. Trade reforms have been continued under a democratic government after 1990 with more emphasis on social policy. Recently Chile has moved from a unilateral liberalisation policy to a policy based on RTAs which seems to have paid off in terms of diversification of trade.

92. Some key lessons learnt from this case study include (1) importance of a stable macroeconomic environment; (2) importance of eliminating quantitative restrictions early on; (3) benefits of a flat or uniform tariff; (4) importance of a coherent exchange rate policy to solicit export response; (5) risks of financial liberalisation under weak supervision; (6) importance of a sound institutional framework, clear regulations and rule of law to promote investment (e.g. example of the forestry and copper sectors); (7) benefits of multilateral commitments in limiting policy reversals (GATT bound level of 35%); (8) useful role of export promotion; and (9) benefits of FDI.

b) Ecuador (Duran Lima and Mulder, 2008)

93. Ecuador's experience with trade liberalisation and other structural reforms has been mixed. On the one hand, the country has succeeded in integrating itself into the world economy, and, while exports remain heavily dependent on oil, non-traditional products have also gained space. On the other hand, economic growth and poverty reduction have been abysmal due to incomplete reforms and erratic economic policies linked to political instability and weak institutions. In terms of sectoral dynamics, some industries (e.g. flowers, fish processing) managed to increase production and exports, but others (e.g. cereals, textiles) have contracted in response to trade liberalisation. The recent recovery of economic growth and exports, in the context of high oil prices and increased stability imposed by dollarisation, provides hope for the near future although this is conditioned by prudent macroeconomic policies and the extension of a preferential access agreement by the United States being Ecuador's main trading partner beyond February 2008.

94. Some key lessons learnt from this case study include (1) difficulties related to an unstable macroeconomic environment; (2) necessity of continuing reforms for sustained growth; (3) the costs of maintaining tariff escalation and non-tariff barriers; (4) risks of financial liberalisation under weak supervision; (5) benefits of FDI (cut-flowers, tuna); (6) the facilitating role that international institutions can play in adjustment through provision of credit, technical assistance etc., (7) benefits of multilateral commitments in triggering reforms and limiting policy reversals (WTO Accession); and (8) benefits of enhanced market access through multilateral/bilateral trade initiatives (e.g. ATPDEA with U.S.).

c) Philippines (Antonio and Onodera, 2007)

95. The Philippines' experience with trade liberalisation is also mixed. The Philippines has pursued structural reforms aggressively since the mid 1980s and its average MFN tariff rates have been less than 10% since 1999. Relatively large misallocation of resources in the 1970s and early 80s, political instability, a relatively appreciated real exchange rate, delays in establishing an investment friendly environment and relatively weak institutions have been some of the reasons for the relatively disappointing performance of the economy in the 1980s. However there are some signs as the Philippines seems to be on a more stable growth track. Take off of the electronics industry, increase in remittances by overseas Filipinos and growth in the outsourcing industry are some new promising trends and economic growth is becoming more stable. However, some areas of higher potential growth such as food processing remain untapped and the extent of export diversification has been more limited. It would be necessary to maintain the right investment incentives for the private sector through macroeconomic stability (prudent fiscal management), political stability, ensuring of property rights, and better infrastructure.

96. Some key lessons learnt from this case study include (1) difficulties related to an unstable macroeconomic and political environment; (2) costs of a strong bias against the use of exchange rates as a means to correct trade imbalances; (3) costs of misallocation of capital in an environment where price signals are distorted; (4) costs of late elimination of quantitative restrictions; (5) role of the informal economy and remittances as informal social safety nets; (6) costs related to delays in deregulation on FDI restrictions; (7) important role played by services as inputs (e.g. telecommunications services in business process outsourcing, and infrastructure services in food processing); (8) possible benefits of export processing zones in providing streamlined bureaucracy and good infrastructure; and (9) challenges in the transition from a regulated economy to a market based economy (e.g. cement sector)

d) Thailand (Tangitvanich and Onodera, 2007)

97. Judging from its stellar economic growth, Thailand is one of the most successful developing countries in the world. Macroeconomic stability and strong institutions have been key elements behind the impressive growth record but Thailand presents a puzzle when linking trade liberalisation and growth. Thailand is commonly thought of as an open country: it did not have strong foreign exchange restrictions and quantitative restrictions were few; its trade to GDP ratio increased from 35% in 1970 to 72% in 1990 and 136% in 2005. However, when comparing tariffs, Thailand had maintained higher-tariffs compared to other countries with similar income levels and it was as late as the 1990s that tariffs really started to come down. The main reason for this seeming paradox is that Thailand initially relied upon tariff exemptions and duty drawbacks to correct the distortions in the economy based on import-substitution. Such measures offset anti-export bias of the trade regime, especially by providing exporters access to imported inputs at world market prices. In the medium term, the costs of such a strategy became apparent especially for small and medium enterprises and Thailand switched to a more comprehensive tariff reduction strategy since the early 1990s.

98. Some key lessons learnt from this case study include (1) importance of a sound macroeconomic environment, sustainable public finances, a relatively stable political and economic environment, flexible

labour market and reliable infrastructure in growth; (2) benefits of openness to international trade and foreign investment and the diverse ways in which a country can achieve such ends; (3) benefits and costs of an interventionist industrial policy; (4) need for properly designed and sequenced reforms; (5) importance of transparency and broad-based participation in reforms to maintain popular support. 0