Report No. 6714-MOR

S/R

Morocco: The Impact of Liberalization on Trade and Industrial Adjustment

(In Three Volumes) Volume I: Executive Summary Report

March 15, 1988

Europe, Middle East & North Africa
Country Department II
Country Operatiions Division

FOR OFFICIAL USE ONLY

Document of the World Bank

KINGDOM OF MOROCCO

CURRENCY EQUIVALENT

Currency Unit: Dirham (DH)

Official Exchange Rate: Dirham (DH) per US Dollar

1975	4.053	1981	5.172
1976	4.419	1982	6.023
1977	4.503	1983	7.111
1978	4.167	1984	8.811
1979	3.899	1985	10.062
1980	3.937	1986	9.104
		1987	8.359

FISCAL YEAR

January 1 - December 31

GLOSSARY OF ABBREVIATIONS

BNDE	=	Banque Nationale pour le Développement Economique (National Bank for Economic Development)
BTN	=	Brussels Tariff Nomenclature
CAP	=	Common Agricultural Policy
CCCN	=	Customs Cooperation Council Nomenclature
CGE	=	Computable General Equilibrium Model
CIH	=	Crédit Industriel et Hôtelier (Housing Finance)
DRC	=	Domestic Resource Cost
GATT	=	General Agreement on Tariffs and Trade
IBP	=	Corporate Income Tax
IHS	=	International Harmonized System
ITPA	=	Industrial and Trade Policy Adjustment Loan
MC	=	Domestic Market Regime
MCIT	=	Ministère du Commerce, de l'Industrie et du Tourisme (Ministry of Commerce, Industry and Trade)
MFA	=	Multifiber Arrangement
MFN	=	Most-Favored Nation
NTB	=	Non-Tariff Barrier
ONT	=	Office National du Transport
PERL	=	Public Enterprise Rationalization Loan
PMIs	=	Petites et Moyennes Entreprises (Small- and Medium-Scale Firms)
QR	=	Quantitative Restriction
SAL	=	Structural Adjustment Loan
SIT	=	Special Import Tax
TA	=	Temporary Admission Regime
TFP	=	Total Factor Productivity
TPS	=	Taxe sur les Produits et les Services (Turnover Tax)
VAT	=	Value-Added Tax
VER	=	Voluntary Export Restraint

This report was prepared by an economic mission that visited Morocco in December 1986. The mission was composed of Messrs. John Porter (Chief of Mission), Riccardo Faini (Macro-economist), Julio Nogués (Trade Economist), Carlos Basterra (Financial Analyst), Benoît Morin (Economist), Brendan Horton (Consultant) and Mmes. Orsalia Kalantzopoulos (Industrial Economist) and Aysegül Akin-Karasapan (Economist). Statistical and logistical assistance from the Moroccan Departments of Industry and Foreign Trade is gratefully acknowledged.

TABLE OF CONTENTS

Page No.

VOLUME III

I. LIST OF TECHNICAL ANNEXES

II. LIST OF STATISTICAL ANNEXES

Page No.

7231B

MOROCCO

THE IMPACT OF LIBERALIZATION ON TRADE AND INDUSTRIAL ADJUSTMENT

Volume I: Executive Summary Report

1. The origins of Morocco's economic difficulties can be traced to the phosphate boom of the mid-1970s, which coincided with rising defense expenditures and an unprecedented expansion of the public investment program, signaling the end of the conservative fiscal policies of the past. The sudden reversal in the terms of trade in the late 1970s as a result of the plunge in phosphate prices and the second oil shock, prompted Morocco to resort increasingly to external capital markets in order to maintain the higher rate of public investment. The viability and expediency of this development strategy were conditioned by the abundance of foreign financing opportunities on highly attractive terms (interest rates were negative in real terms).

2. During this period, Morocco's external debt had grown exponentially from US$1.8 billion in 1975 to US$11.3 billion in 1983, representing 85% of GDP and 290% of exports. The structure of Moroccan debt had changed, moreover, with 40% of outstanding liabilities owed to commercial banks compared to nil a decade earlier and over 60% at non-concessional rates. The declining productivity of public investment and the unfavorable external environment, viz. continued deterioration in the terms of trade compounded by a severe drought in 1980-84 which reduced agricultural and hydroelectric production, served to erode debt service capacity. The unanticipated rise in international interest rates proved more than Morocco's balance of payments could endure. Bereft of foreign exchange reserves and access to external funds, Morocco was unable to shoulder its debt service burden - the debt service ratio reached 52% in 1983 with interest payments alone accounting for 20% of exports.

3. In 1983, it became clear that the solution to Morocco's financial distress lay in a medium-term program of economic reform supported by considerable debt rescheduling. In the immediate, the Government imposed emergency, across-the-board import restrictions and effected draconian cutbacks in public expenditures. Debt service payments to official and commercial creditors were rescheduled, initiating a process that has already spanned five years and is expected to continue for some time into the future. A comprehensive set of stabilization and adjustment policies was evolved by the Government and supported by a series of IMF standby arrangements and World Bank sectoral adjustment loans. Restrictive fiscal and monetary policies were employed to contain aggregate domestic demand, while structural reforms were initiated to augment the supply response of the economy.

4. The adjustment program was initially comprised of measures in the trade and industrial sector to improve the allocative efficiency of resource use and make the economy more resilient to external shocks. The flexible management of the exchange rate was considered critical in order to maintain the competitiveness of Moroccan exports and to compensate for the reduction in barriers to external trade, thereby maintaining balance-of-payments viability. The relaxation of trade barriers through the dismantling of quantitative restrictions, the lowering of tariffs, and the freeing of domestic price controls was expected to improve industrial productivity and raise export potential by attenuating the existing bias against exports. The rationalization of the investment codes would realign factor prices in line with resource endowments, leading to the adoption of production techniques which reflect Morocco's comparative advantage.

5. Following the release of the second and final tranche of the second industrial and trade policy adjustment loan (ITPA II), a Bank economic mission visited Morocco in December 1986 to: (i) assess the reaction of the economy at the macro, sectoral, and micro levels to the program of trade and industrial liberalization and (ii) evolve a set of policy recommendations to further trade reform in the context of a proposed Structural Adjustment Loan (SAL). Although the full impact of the measures on the underlying economic structures is expected to be felt only in the medium-term, the present analysis indicates that the adjustment strategy followed by the Government since 1983 is working. Changes in trade and industrial policy instruments have led to a significant improvement in the structure of incentives. Producers have responded favorably thus far and the scope for further adjustment at the firm level is considerable. The overall macro-economic situation remains difficult, however, with too much disabsorption having occurred via reductions in investment, and debt service payments continuing to absorb a substantial share of national savings. If the progress achieved under the liberalization program is not to be undermined, the sectoral reforms must be complemented and strengthened by an array of macro policies that raises the investment rate and reduces the ratio of debt service to total savings, while reining in aggregate demand and inflation.

6. Results show that considerable progress has been achieved in liberalizing the external trade regime since 1983. Following the generalized control of imports in March 1983, quantitative restrictions have been significantly reduced and the prohibited list of imports has been officially abolished with the result that 86% of total import value is no longer subject to licensing compared to 38% at end-1983. The maximum customs duty rate has been reduced from 400% in 1983 to 45% at present and the special import tax (SIT), an across-the-board, uniform surtax, has declined from 15% to 5% over the same period. These measures lowered the unweighted average cumulative rate of trade taxes to 35.9% down from 58.4% and the maximum protective rate to 62% down from 466%. The dispersion of rates across the 8050 positions of the Moroccan tariff code was also significantly reduced. The standard deviation decreased from 40.5 to 15.4.

7. In order to promote the expansion and diversification of exporting activities, several important reforms were introduced since 1983 to eliminate export barriers, reduce existing disparities between exporting and

import-substituting activities, and simplify admininstrative procedures in the area of external trade. For example, export licensing requirements have been virtually abolished, all export taxes have been repealed, and the temporary admission (TA) scheme, maintained even during the financial crisis of 1983, has since been expanded and made more attractive. A committee for the simplification of foreign trade procedures was established in order to improve the flow of information and eliminate institutional constraints pertaining to international trade transactions. Preferential financing arrangements for exporting activities have been broadened and the fiscal incentives embodied in the existing Export Code extended.

8. Morocco's commitment to free trade was reaffirmed by its accession to the GATT on June 15, 1987. The binding of 157 tariff lines, corresponding to nearly 35% of total import value, consolidates the gains achieved thus far in liberalizing the trade regime. Membership in the GATT will confer greater stability on Moroccan trade policy, help the Government resist political pressures from special interest groups for higher protection, and enable policy makers to extract concessions from trading partners in exchange for further trade liberalization in Morocco.

9. Analysis of the change in the structure of incentives as a result of liberalization-induced policy reforms reveals that a growing proportion of local industry is being subjected to increased competition from abroad. Nearly one-quarter of total industrial production has been completely liberalized. According to a production-weighted index of protection, the share of domestic manufacturing subject to QRs during the period 1983 to 1986 has declined from 60% to 40% and from 45% to 15% as a function of tariff line and import value respectively. The proportion of license requests approved has increased steadily, reaching 84% in 1986, and the time necessary to process license applications has declined significantly, indicating that the licensing regime is being managed more flexibly.

10. Reductions in trade tax rates have led to a fall in the import-weighted mean tariff net of wheat and oil from 29.4% to 20.7% and in the production-weighted tariff index from 66.4% in 1983 to 38.7% in 1986. Although not calculated explicitly, effective protection has fallen inferentially by at least 11% across-the-board on products which are not subject to licensing. The compression of the tariff structure from above has dramatically limited the potential for effective protection. In 1983, effective protection could have ranged from negative to over 1500% compared to a range of 180% in 1986 under the same conditions.

11. Analysis of Moroccan trade and industrial performance since 1983 clearly indicates that the economy is reacting positively to the more efficient incentive structure. Buoyant export growth has sustained a relatively higher level of imports, leading to an increase in the ratio of external trade flows to GDP from 42.7% in 1983 to 54.7% in 1986-87. Econometric analysis shows that the depreciation of the exchange rate (22.1% in real terms since May 1983) was a determinant factor underlying the 14% average annual export growth of finished manufactures during the period 1983-87. This trend led, in turn, to an increase in market shares abroad.

After stagnating at 1.5% during the period 1982-84, Moroccan manufacturing exports as a percentage of EEC imports rose to 1.9% in 1986. The strong export performance of Moroccan manufactures, moreover, stood the economy in better stead to absorb the sharp decline in external phosphate demand which occurred in 1985-86.

12. Judicious exchange rate management and appropriate macro policies initially served to contain import demand at sustainable levels following the dismantling of external trade barriers. Temporary admission imports increased their share in total imports from 9.1% in 1983 to 14.2% in 1986, reflecting the improved functioning of the TA regime and the growth in manufactured exports. Consumption imports have risen by 17.4% in real terms since the beginning of the liberalization program.

13. The supply-side effects of the adjustment program are manifest at the micro level. Recent evidence reveals that outward-oriented industries grew at relatively higher rates than import-substituting firms, induced by the policy changes which have occurred since 1983. Whereas some of these industries have previously exported a relatively high share of production, others have undergone a significant shift in orientation towards external markets. Analysis of export performance at both the sectoral and firm level as a function of relative factor intensities of production techniques reveals that industries characterized by high export-output ratios are also the most labor-intensive. Typical of this category are goods produced through subcontracting arrangements, exports of which have risen by 82% in real terms from 1983 to 1985, thus increasing their share in total merchandise export value from 3.4% to 6.9% between 1983 and 1985. The recent expansion of labor-intensive exports can be attributed, in part, to the narrowing of certain fiscal incentives and the adoption of a more realistic interest rate policy. This served to attenuate, if not eliminate, the previous bias against labor. The realignment of factor prices in line with the prevailing conditions of supply and demand has tended to reorient investment decisions away from the relatively capital-intensive technologies that were advantaged in the past.

14. The analysis of changes in total factor productivity (TFP) and sources of industrial growth provides further evidence of the reform's positive impact. Nearly all industrial subsectors exhibited higher capital and labor productivity growth following the onset of the adjustment program. These trends were confirmed by the findings of an industrial survey carried out by the mission which revealed increasing cost-consciousness and concern with efficiency as a result of greater competition from abroad induced by liberalization. Many firms sought to economize on labor costs by substituting seasonal for permanent employment, while others began to retool as a means of improving product quality. The realignment of the wage-rental ratio in keeping with market forces was an important factor underlying the labor and capital productivity gains which have taken place in Moroccan manufacturing to date.

15. Despite the considerable progress achieved in liberalizing the trade and industrial regime, there exist constraints which may impede the adjustment process in the future. At the macro level, the narrowing of the fiscal deficit from 12.2% of GDP in 1983 to 6.0% of GDP in 1987 has been achieved, in

large part, at the expense of public investment. Chronic budgetary imbalances and exchange rate disequilibria are presently evident in the virtual depletion of official reserves, the buildup of external arrears, and the protracted delays in obtaining foreign exchange. Acute foreign exchange shortages have induced producers to hold higher inventories of imported inputs than would otherwise be necessary in order to avoid disruptions in operations, obtain costly letters of credit, face additional foreign exchange risk, and incur penalties for late payments. Firms have also suffered from declining creditworthiness abroad, as well as foregone interest earnings on non-remunerated prior import deposits introduced by the Central Bank in an attempt to control the availability of credit to the economy. The increased operating costs translated into a financial deterioration of material productivity, which constrained overall TFP growth.

16. Greater recourse to non-monetary domestic financing in order to contain inflationary pressures has contributed to a 19.5 percentage point increase in real interest rates since the mid-1970s. This, along with other macro-financial indicators, indicates an increasing danger of crowding-out. The reliance by the Treasury on forced savings in the form of domestic arrears from the public enterprise and private sectors, representing 7.7% of GDP at end-1987, has caused liquidity problems for some firms and underscores the unsustainability of the budget deficit. A windfall tax on petroleum levied by the Treasury to capture the benefit of the decline in oil prices has raised production costs and eroded the competitiveness of energy-intensive manufactures without addressing the structural weaknesses of the fiscal system.

17. The past financing strategy, which helped lower inflation from 12.5% in 1983 to 2.4% in 1987 by depleting net foreign assets and building up arrears, is no longer sustainable. An analysis of the structural fiscal deficit reveals that additional monetary financing will be required in the future leading, in turn, to significantly higher rates of inflation than those recorded in the past. In order to alleviate these repressed inflationary pressures and halt the rise in real interest rates, the budget deficit should be narrowed further[1/]. In view of the foreign borrowing constraint, disquilibria in the foreign exchange markets should be addressed by a flexible exchange rate policy. This will serve to maintain the international competitiveness of Moroccan exports in the short run[2/] and to compensate for the elimination of the remaining quantitative restrictions and the reduction in tariffs.

18. Although considerable progress has been achieved in reducing both the level and dispersion of effective protection, the present structure exhibits certain characteristics which indicate the need for further reform. An

---

1/ Recommendations for improving domestic resource mobilization and increasing public savings are adduced in Morocco: Public Finance and Economic Growth, World Bank Mimeo, March 1986.

2/ This recommendation takes on added significance in view of the active exchange rate policy which has been adopted by close competitors of Morocco since 1983.

analysis of QR and tariff coverage by end-use shows that final goods are more highly protected by both instruments than are inputs, resulting in a cascading structure which reinforces rates of effective protection. For example, 67.5% of all consumer goods are subject to QRs, compared to 9.5% of intermediates and 17.5% of capital goods. Similarly, intermediates, capital goods, and consumer items had mean tax rates of 27.9%, 31.7%, and 50.1%, respectively, on an unweighted basis in 1986 and 20.4%, 21.2%, and 26.5% when weighted by import value.

19. The mutually reinforcing cascading of tariffs and QRs has exacerbated, moreover, the dispersion of effective protection across sectors. An analysis of sectoral disparities reveals mining as having the lowest mean trade tax rate (19.9%) in 1986, followed by agriculture (32.6%) and manufacturing (36.5%). When weighted by import value, all means are significantly reduced with manufacturing continuing to exhibit the highest rate (21.6%), followed by mining (9.2%) and agriculture (3.6%).

20. An international comparison of Morocco's trade tax structure with those of immediate competitors and comparable economies underscores the need for further simplification. Most of the tariff reforms implemented to date have focused on the reduction of rates; however, the Moroccan tariff nomenclature remains unduly detailed, reflecting historical attempts to "fine-tune" protection on a tailor-made, firm-specific basis. This is particularly evident in the case of such consumer goods as food, beverages, tobacco, and textiles. The intricacy of the Moroccan tariff structure seems hardly justified in view of the fact that other countries manage more complex foreign trade structures with fewer codes.

21. In order to correct these irregularities and induce greater efficiency in the allocation of productive resources, it is recommended to rationalize the existing structure of protection by eliminating the remaining quantitative restrictions over the next eighteen months and replacing them by tariffs. A generalized reform of the trade tax structure should be initiated in order to simplify the customs nomenclature and attenuate the cascading of rates by product end-use. The various trade taxes should be collapsed into a single levy, namely the customs duty, even if a temporary suspension of the maximum nominal rate is warranted so as not to lose revenues. All exemptions of customs duties should be abrogated except those granted under the temporary admission regime. It is recommended, moreover, that every product category at the four-digit level be taxed at a uniform rate. While awaiting the ratification of the International Harmonized System (IHS), the authorities should prepare a provisional target tariff structure that is consistent with the objective of establishing a 25% maximum level of protection. These reforms will serve to increase the transparency of the tariff structure, reduce dispersion among rates, limit the potential for relatively high rates of effective protection, and help ward off pressures from special interest groups.

22. Recourse to non-tariff barriers to trade, such as floor and reference prices, should be eschewed, except to counter unfair trading practices from abroad. Institutional capacity should be reinforced so as to permit the evaluation of dumping claims in a framework which is transparent,

non-discretionary, and less subject to potential abuse. An official independent commission representing the national interest should be established in Morocco and empowered to rule on allegations of unfair trading practices from abroad and requests for exceptional protection. Compensatory measures which are transparent and comply with GATT regulations should be identified for use only in proven cases of dumping or other practices which contravene international agreements. Customs valuation should be guided by considerations of tax fraud rather than protection. In this vein, it is recommended that the law giving effect to the Customs Valuation Commission be promulgated forthwith.

23. One of the major challenges of Moroccan trade strategy in the future should be the diversification of export markets. Continued reliance by Morocco on the EEC as its primary trading partner could prove costly for two reasons. First, Morocco's preferential tariff treatment in the EEC may suffer as a result of the upcoming round of multilateral trade talks. The preferential tariff margins enjoyed by Morocco could be eroded by a general reduction in tariff rates agreed in the context of the Uruguay round of trade negotiations, thereby weakening the export opportunities of Moroccan products in the future. Second, quotas on certain categories of Moroccan exports to the EEC will not be forever negotiable upwards, particularly in view of the Community's recent enlargement. In contrast, the United States is a relatively unrestricted market with enormous potential for Moroccan exports. Despite the rapid expansion of its labor-intensive exports and the relatively low import barriers applied to these products, Morocco's share of the US market is negligible. It is therefore recommended that studies be undertaken to identify ways to diversify export markets. Greater penetration of North American markets is clearly warranted and should constitute an integral part of Morocco's trade strategy in the future.

24. The extensive reforms implemented since 1983 have initiated a significant transformation of Morocco's underlying economic structure without straining the social fabric. The growing importance of foreign trade and further diversification of the export base should, in time, improve the country's capacity to manage its debt and balance of payments, as well as withstand exogenous shocks, such as the recent decline in the demand for phosphates. The positive employment effect in manufacturing which resulted from the reduction in the anti-labor bias offsets to some extent the fall in real wages and should contribute to absorbing the growing labor force in the future. The careful consideration given to the political economy of policy reform by the Government has marshaled the requisite support of the various constituent groups for the objectives of the adjustment program.

25. In conclusion, the results of liberalization have been impressive, particularly in view of the relatively limited share of non-traditional manufactures in total exports which prevailed at the onset of the program. The considerable debt burden, the relatively high level of defense expenditures, and the inherently protracted nature of structural change in general will require sustained adjustment of the economy for some time into the future. The temptation to reverse the reforms achieved thus far in the interest of short-term stabilization should be resisted as a facile expedient. Such a solution will provide only momentary relief from underlying

macro-economic disequilibria while mortgaging the economic future of the country from a structural point of view. Rather, structural reforms should be extended to address existing macro-economic constraints and the momentum of liberalization should be maintained.

26. Distributing the burden of adjustment in an equitable fashion both domestically and vis-à-vis external creditors is a final consideration which will condition the sustainability and outcome of Morocco's economic program. Expanding the scope of the liberalization program to include sectors such as agriculture, mining, transportation and banking will alleviate concerns among industrialists and ministry officials alike that industry is bearing the brunt of adjustment. The rate of current account adjustment mandated by Morocco's debt service obligations in the absence of further relief may be too rapid to permit the orderly reallocation of resources from contracting to expanding activities which constitutes the basis of structural change. Financing for new investment and working capital is necessary, moreover, to further the structural transformation of the economy, particularly in exporting sectors where capacity constraints are increasingly being reached. The political acceptability of continued adjustment and the improvement of Morocco's creditworthiness will depend on the future rate of economic growth, and therefore, on the availability of external funds to help finance productive investment. In view of these considerations and the considerable progress achieved to date, Morocco's adjustment efforts merit the full support of the entire international financial community.

8811B