Trade Reform and External Adjustment

The Experiences of Hungary, Poland, Portugal, Turkey, and Yugoslavia

Alan Roe
Jayanta Roy
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World Bank
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Foreword

This document is one of a series reporting on policy seminars organized by the Economic Development Institute of the World Bank. Policy seminars provide a forum for an informal exchange of ideas and experiences among policymakers from different countries, leading experts in development, and World Bank staff with respect to major issues of development policy.

Policy seminar reports focus on issues raised during seminars that may be of interest to a wider audience. They are not intended to be comprehensive proceedings. They seek, however, to convey the essence of the discussion that took place and to bring out any principal areas of agreement or disagreement that emerged among those participating.

Christopher R. Willoughby
Director
Economic Development Institute
of The World Bank
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Introduction

The seminar brought together Ministers and other senior officials of five middle-income countries from Eastern and Southern Europe which form a part of the World Bank’s Europe, Middle East, and North Africa (EMENA) region. These five were Hungary, Poland, Portugal, Turkey, and Yugoslavia. In addition, the resource persons attending the seminar included Dr. Garrett Fitzgerald, former Prime Minister of Ireland, who provided an in-depth assessment of the trade reform issues both in his own country and in the European Community more generally, and Mr. Chulsu Kim, Assistant Minister of Trade and Industry in South Korea, who provided detailed analysis of the evolution of Korean trade policy. The broad objective of the seminar was to provide a forum in which senior policymakers from a variety of countries could discuss both the progress of, and the constraints on their own respective trade reforms, and exchange ideas on these matters both among themselves and with officials from the World Bank in an environment of considerable informality.

The seminar was directed by Mr. Jayanta Roy of the EDI and moderated by Mr. Roger Chaufournier, a former Vice-President of the World Bank. It was introduced by Mr. Parvez Hasan, Chief Economist for EMENA, who spoke about the experiences of structural adjustment and trade liberalization in the 1980s. Thereafter it was informed by seven main presentations, namely by Messrs. O. Havrylyshyn on Approaches to Trade Liberalization in East Europe, M. Nuti on the Trade Regimes and External Adjustment Experiences of Hungary, Poland and Yugoslavia, M. Finger on recent developments with respect to the Uruguay Round, and by Dr. Fitzgerald, Mr. Kim, Mr. Silva Lopes and Mr. H. Ersal, on the evolution of trade policies in Ireland, South Korea, Portugal, and Turkey respectively.

One of the major points of interest in the seminar was to establish the sense in which centrally planned economies face a fundamentally different set of problems when trying to reform trade policies than do market economies. As the comments under several of the headings below indicate, there were many issues where participants generally saw these differences as relatively minor, and others where the problems were seen as radically different.

This summary paper attempts to synthesize the major issues which arose from the seven presentations as well as from the lively discussion from the floor of the seminar which characterized each of its sessions. This is done by reference to seven broad themes which together encapsulate much of the discussion which took place.1 On some of these such as the first theme on the Origins of the Need for Adjustment (Section 2 below) there was considerable unanimity of view across the very diverse set of countries whose experiences were recounted. On others, such as whether trade reform is a substantively different problem in socialist as compared to capitalist systems, there were a number of different perspectives which were not reconciled by discussion. The present synthesis merely attempts to capture the tone of these differences.

In the spirit of informality which characterized the seminar the paper makes no attribution of particular comments to individual participants other than those which were incorporated in the seminar papers themselves.

1. It can be noted that of the seven main presentations already referred to, five were supported by written papers. The two presentations not supported in this way were those by Dr. Fitzgerald and Mr. H. Ersal.
In his introductory remarks, Parvez Hasan noted that since 1979 the world economic environment has changed not only in the sense that growth is generally much slower, but also in the sense that greater volatility in, for example, exchange rates and commodity prices has made that environment far more uncertain. Whereas many countries adjusted to the difficulties of the mid-1970s by taking advantage of easy access to ample external capital at low interest rates, this easy option is no longer available. Furthermore, the easy availability and low price of credit in the mid-1970s had encouraged many countries to use capital extensively, in some cases to invest in major white-elephant projects, and to be generally unaware of the consequences of mistakes in investment decisions. The higher interest rates and reduced external resources of the 1980s had changed this by giving rise to a need for structural adjustment in which the focus of policy has had to be the search for more intensive use of capital and greater efficiency of resource use in general.

Two factors in particular had generated this pressure for adjustment. The first was the major reduction in the net resource transfers from abroad resulting both from the generally lower availability of funds from the banks, and from the pre-existing large debt/GDP ratios which act as a severe discouragement to new lending. In some of the East European economies such as Hungary, principal and interest payments on debt are pre-empting up to 70 percent of the countries' hard currency earnings. In the middle-income countries as a whole these sorts of pressures have resulted in a fall in the current account deficit from an annual average of $72 billion in 1980-82, to an average of only $12 billion in 1986-87.\footnote{The change in the non-interest current account deficit is larger than this, and most heavily indebted countries were running surpluses on the non-interest current account by 1986-87.}

The second factor has arisen in cases where public sector deficits, both from the general budget and public enterprises, have been a major part of the problem. Increasingly in such cases, governments have found it more difficult to extract the necessary resources by monetizing their deficits and instead have had to pay higher real interest rates to domestic as well as foreign savers in order to gain access to the necessary resources.

Participants from Yugoslavia and the other East European countries were quick to emphasize that these fundamental changes in the imperatives regarding the efficient use of capital applied with full force to their own countries. Whereas two decades ago there had been plenty of resources but no recognition of the need to adjust, now the degree of recognition was high but unfortunately was accompanied by a situation in which the resources to provide the headroom for fundamental reform were extremely limited. They also added substance to another of Hasan's propositions, namely that adjustment had been less rapid and generally less successful than had earlier been expected. In the case of Hungary, for example, it was noted that the successful stabilization of the external payments deficit from 1981 to 1984 has been "stabilization without adjustment," in that the massive fall in investment arising from that program had precluded any real prospect of strengthening productive potential in those sectors which should have responded to the new and more internationally oriented price structure. Hence the composition of Hungarian exports, and her export-dependence on imported raw materials and intermediate goods was little changed. In Hungary as in many other middle-income countries the disappointingly low growth rates of the 1980s\footnote{Though the performance in Turkey was a notable exception from this point of view among the countries at the seminar.} seemed set to continue, not least because of the decline in the investment rate (from a 26 percent average for middle-income countries as a whole in 1979 to 21 percent in 1985), which has characterized recent...
stabilization effects. In addition, external debt burdens have generally risen rather than fallen in the 1980s\(^4\) as higher real interest rates and cross currency exchange effects, notably the fall in the US dollar relative to the DM, have offset the benefits of domestic austerity and reduced deficits. It was noted that for most countries represented at the seminar these factors together mean that the burden of necessary adjustment will remain considerable; that the non-interest current account will have to remain in surplus to service debt and reduce the debt overhang; and that the pre-emption of domestic savings for this purpose will continue to restrict investment levels. Hence the continuing process of adjustment will of necessity have to give high priority to the productivity of investment, while improved import capacity will be heavily dependent on the success of exports. It is these facts of economic life in the late 1980s which together place so much importance on appropriate trade policy both as a critical source of pressure for improved investment efficiency, and as the key element in generating improved export performance.

\(4\). For the highly indebted countries the ratio of external debt to GDP has risen from 33 percent at the end of 1982 to 55 percent at the end of 1987. Turkey, Hungary, and Poland are close to or above this average. Portugal, starting from a much higher figure a few years back, has seen a considerable improvement in her debt situation.
The Nature of the Necessary Adjustments

It was noted that at one level, adjustment is merely the accounting task of balancing a country's books. This can occur in a variety of ways and will certainly happen one way or another with or without active policy. It can, for example, be achieved in the short term merely through stabilization programs supported by various forms of disorderly adjustments such as intensified restrictions on imports. However, this form of adjustment is inherently short-term in its focus and is unlikely to provide a country with the improved efficiency in its resource-use needed to achieve long-term sustainable growth. Real adjustment is a far more complex matter which involves first of all a substantial change in the existing patterns of resource-use to eliminate inefficiencies and establish a structure of production more closely attuned to the prevailing international patterns of relative prices, interest rates, and other conditions. Thereafter it needs a sustained flexibility of policies to enable resources to be reallocated at the margin relatively rapidly in response to the evolution of international and other conditions.

In the centrally planned economies, and also in other countries, this view of an adjustment program implies that it necessarily has to be extremely broad in its scope. Its components will certainly include changes in the relative prices of energy, factors of production, foreign exchange, and other commodities to better reflect their true opportunity costs. Although relatively straightforward in concept, these changes will not be an easy matter to implement especially where the gaps between actual and scarcity prices have been allowed to become extremely large.

Yet more difficult will be those components of an adjustment program which call for far-reaching institutional reform to support and deliver the more realistic pricing of resources. Participants from each of the three East European economies noted at various stages that while the institutional reforms ideally required to facilitate adjustment in such countries needed to be pervasive, they were at the same time politically difficult to design and implement. A central question to which many of their comments related and which generated a good deal of controversy is whether it is possible to move away from the centralized planning of resource allocation which has been fundamental in socialist countries without reneging on the high priority traditionally attached to equity and distribution issues (see also section 5 below). O. Havrylyshyn in his paper argued that not only is such a separation possible but that without it and without a more liberal approach to resource allocation, the fairness principles of socialism will themselves be threatened by systematic further declines in efficiency and growth rate (see also section 5). The Yugoslav team noted that there are three fundamental questions posed by a commitment to structural adjustment, namely: who are the main agents of the adjustment — the state or individual enterprises?; what are the criteria to guide such adjustment — the maximization of output growth or the needs of the population?; and what are the mechanisms — market mechanisms or control? The Yugoslav representatives argued in relation to the third of these questions that policymakers in East Europe had already conceded the need for prices to be set in a competitive market-oriented fashion. But this was a most difficult matter in practice, not least because the interconnectedness of markets meant that liberalization at one point (e.g. imports) would soon provide a need for liberalization elsewhere (e.g. in foreign exchange allocation).

Similarly, the Hungarian participants referred to the need for their economy to become a "socialist market economy" in which goods, labor, and capital markets would become progressively more liberal, new forms of ownership would progressively provide competition for the erstwhile state monopolies, and where even managers of state enterprises would increasingly behave as though they were owners of such enterprises. This would involve a clear retrenchment of the state
not only as regards the ownership and control of productive resources, but also as regards the level of subsidies and other supports for poorer groups in society. But while accepting the need for this, they saw no guaranteed connection between its successful implementation and sustained improvement in the country's external situation or other aspects of the macroeconomic position.

In his own remarks, Parvez Hasan drew some of these ideas together by suggesting that there are basically three components of a successful adjustment effort, namely, a more liberal trade and price regime designed to reduce factor-price distortions and align domestic prices more closely to their international levels; institutional reforms to improve the effectiveness of those government interventions which remain necessary, and to ensure that price signals can help enterprises adjust more correctly and flexibly to rapidly changing conditions; and a realistic macroeconomic framework which above all will eliminate the macro-imbalance (e.g. excessive domestic demand leading to high inflation) which can compromise the success of the other components of structural reform.

On a somewhat narrower issue, Havrylyshyn linked the nature of the adjustment, which might reasonably be anticipated in particular countries, to the realities of the world economic environment discussed in the previous section. Specifically, on the basis of the figures presented in Table 1, he observed that a return to high growth rates could be achieved in a number of ways. One would involve the re-establishment of the higher investment rates of the 1970s but with efficiency rates akin to those experienced in the 1980s (i.e. Scenario 1). This seemed unlikely given the future prognosis for investment rates already explained. It would in any case produce growth rates which were only modest. An alternative would be to seek no major change in investment rates but a set of policies to extract greatly enhanced efficiency from such investment (i.e. Scenarios 2 and especially 3). If successful, as Table 1 shows, they would produce growth rates even better than those achieved in the 1970's.

Table 1. Investment, ICORS, and Growth Rate in Middle Income

<table>
<thead>
<tr>
<th>Outcomes</th>
<th>Investment GDP (percent)</th>
<th>ICOR</th>
<th>Growth Rate of GDP (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before the 1980s crisis:</td>
<td>24</td>
<td>4</td>
<td>6.0</td>
</tr>
<tr>
<td>Situation in the 1980s</td>
<td>20</td>
<td>5</td>
<td>4.0</td>
</tr>
<tr>
<td>Possible Scenarios</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1) Modest Investment Increase</td>
<td>22</td>
<td>5</td>
<td>4.4</td>
</tr>
<tr>
<td>2) Modest Efficiency Increase</td>
<td>20</td>
<td>4</td>
<td>5.0</td>
</tr>
<tr>
<td>3) High Efficiency Increase</td>
<td>20</td>
<td>3(i.e.) Asian levels</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Table 1. Investment, ICORS, and Growth Rate in Middle Income
The Role of Trade Reform in the Adjustment Process

It was of course a central purpose of the seminar to assess the role of trade policy reform as a key element in the overall adjustment program. Ideas on this were articulated by several participants but especially in the paper by O. Havrylyshyn. He noted in particular the very important role of trade liberalization as the main mechanism for disciplining local productive enterprises and transmitting the efficiency levels established internationally to domestic production. Given that the majority of the economies of East Europe are relatively small, he argued that greater liberalism in international trade may be a more effective disciplinary mechanism than the alternative often discussed by socialist reformers of forcing a break-up of concentrated and vertically integrated enterprises. It is also important to note that while trade reform may initially be introduced to improve the current account of the balance of payments, this should not be regarded as its fundamental raison d’être. The alternative idea of using it as a stimulus for productive efficiency is a radical one in the East European context where trade has normally been cast in the role as a residual to handle domestic shortages or deficits, rather than as a motive force for realizing the benefits of the comparative advantage of domestic industry.

If it is accepted that trade’s disciplining role for productive efficiency is indeed the raison d’être for greater liberalization, then it also needs to be acknowledged that the benefits will fail to be realized if sound trade policies are not allowed to transmit the correct signals from abroad because of a variety of other inappropriate policies. A variety of distorting interventions which can pervert the benefits of liberal trade were mentioned during the seminar as being important in East Europe. Four matters in particular were elaborated by Havrylyshyn.

First, by contrast with the situation in recent years in both Turkey and Portugal, the use of nominal exchange rate adjustments in the East European context has often been hesitant. With the exchange rate also being looked upon as a major instrument to restrain inflation, nominal devaluations in countries such as Hungary have often been insufficient to prevent a real appreciation of the exchange rate. In the first five years of the 1980s, for example, the Hungarian real exchange rate appreciated by 11 percent while that of Poland appreciated by 30 percent. Over the same period the Yugoslavian currency showed a major real depreciation. The result was that Hungary and Poland’s share of total imports into industrial countries remained extremely small and sharply lower than the historical highs achieved by those countries in the 1970s. An associated point is that real devaluation will not work well if other factors causing an anti-export bias such as import restrictions, price controls, and administrative allocation of raw materials and foreign exchange, are perpetuated in such a way as to inhibit increased exports and reduced imports. While the general pessimism in some parts of East Europe about the benefits of exchange rate policy partly stems from these other factors which limit its effects, the fact remains that trade policy reform cannot play its disciplinary role without reasonably active exchange rate policy and the abandonment of other anti-export policies.

Second, it is a tendency in East European economies to use compensatory administrative intervention to encourage exports as an alternative to a more liberal trade stance which would give incentives to exporters more directly through a non-discretionary system. Countries such as Turkey and South Korea, which have enjoyed some successes in adjustment, have continued to pursue policies of compensatory export-support. But Havrylyshyn argued that in both these cases export...
compensation policies were pursued simultaneously with reduced import restrictions and real devaluations, and were gradually phased-down as import liberalization made them progressively less necessary. In East Europe, by contrast, the use of compensatory export-supports as a primary tool of trade reform is a poor second best since it leaves too much influence with the administrative authorities, for example, to restrict imports it often encourages an underlying selectivity in export-supports which are themselves distorting; and it greatly complicates the achievement of a central objective of trade reform, namely the establishment of equalized incentives as between products for exports and those for the home market.

The third difficulty in the way of making liberal trade an effective transmitter of the general changes in international standards of efficiency, is the so-called “soft-budget problem.” In a nutshell, what this amounts to is that there is little point in providing enterprise with the “carrot” of positive incentives to resource reallocation and improved efficiency via more open trade, if the “stick” to punish inefficient firms is not available or is insufficiently used. If the sanction against inefficiency is not enforced then the incentive for enterprises to be efficient and work hard to find the best profit-making opportunities will be seriously diluted, and inertia and complacency will continue to thrive whatever trade regime is in place. A quote from the Wall Street Journal about Israel and cited by Havrylyshyn makes the point very clearly, “...It appears that the best business strategy is to get into as much debt as possible and threaten to dismiss as many workers as possible. If you reach that happy state, members from every party will line up for the right to use taxpayers’ money to keep you artificially alive.” (Wall Street Journal, April 1986)

The presentation by Jose da Silva Lopes on Portugal emphasized that the soft-budget problem is not only a East European phenomenon, and in recent years has certainly been of significance in Portugal and Turkey as well. In general, if a problem of financial failure at the enterprise level is not addressed by the closure or restructuring of the enterprise, some burden will be imposed somewhere in the economic system and this is certain to have distortionary effects. If the burden is passed to the Central Bank, distortionary effects will arise if the Bank is able and willing to use inflationary methods to finance the cost of it. If it is left with commercial banks, as in Portugal, by relaxing the normal banking sanctions against enterprises failing to service loans, then the capital of the banks and their own financial viability is threatened. This in turn damages and distorts their ability to properly discharge their resource-allocating function.

If the banks, again as in Portugal and in Turkey, pass the problem on to other clients through higher margins between lending and borrowing rates, then efficient units in the productive system are effectively taxed to finance the failure of the inefficient. Ultimately if the decision is made to allow the survival of failed firms in order to protect jobs or for other good social reasons, then the only sound approach is to reflect the cost in the government budget and finance it through general taxation. But governments are generally loathe to see their own deficits rise and have not infrequently sought a variety of ways to avoid the transparent treatment of the “social losses” in normal budgets. Silva Lopes and Havrylyshyn both developed this point into an extremely important set of propositions about the interconnectedness between trade liberalization, fiscal deficits, and inflation.

In brief, large fiscal deficits and external deficits go hand in hand, especially in planned economies where the large public investment projects characteristic of the 1970s have directly boosted both expenditures and imports. While it is often argued by the critics of trade reform that liberalizing trade in the face of large external deficits is dangerous because of a likely surge of imports, this view is far from unassailable even by reference to conventional arguments. But in the context of the argument that trade reform is a disciplinary mechanism, it misses a further crucial point.
Trade reform will show up the failures of domestic investment in a way that could not happen in a protected administered scheme.\textsuperscript{6} If the soft-budget constraint is simultaneously allowed to harden as protection is removed, the subsidies and support for weak enterprises will be partly reduced and so too will the magnitude of the government's financing/borrowing requirement. The benefits of this lower deficit can then be appropriated either in the form of reduced foreign borrowing by the government which will imply a reduced current account or external deficit or in the form of a lower rate of monetization of the deficit and lower inflation. Some weighted average of a lower external deficit and lower inflation is an obvious third possibility. But the main conclusion is clear: trade liberalization combined with a willingness to allow the soft-budget constraint to harden, enables countries to avoid the trade-off between an improved current account and worsened inflation which applies when the size of the public sector deficit is fixed.\textsuperscript{7} The fourth difficulty which potentially obscures the signals from trade reform was identified as the administrative setting of prices in the East European economies and the typical failure of such approaches, even where they attempt to do so, to replicate the price signals which would emerge in a less controlled system. This point is dealt with further in the next section.

In general, and by way of summary, participants in the seminar did not have any fundamental difficulties with the concept of trade liberalization as a powerful disciplinary force. There were however a variety of critical comments about the practicality of exploiting the benefits of such a discipline especially in the somewhat complex institutional trading situations found in East Europe. Most of these comments are taken up in the next sections.

\textsuperscript{6} Most mistakes in investment decisions in Portugal according to Silva Lopes occurred when there was high protection of the industries concerned.

\textsuperscript{7} The explanation of this trade-off is set out very clearly in a recent discussion paper which was made available to all participants. See M. Corden, "Macroeconomic Adjustment in Developing Countries," IMF Working Paper, WP/99/13, February 1988.
What Are the Special Trade Reform Problems in Socialist Countries?

It would indeed be convenient to assume that a recipe for trade reform that had been shown to be successful in market or mixed economies could be applied without major adaptation to socialist planned economies. The seminar discussion on this issue however demonstrated a considerable gulf between convenience and reality and also that there were considerable divergences of view among participants on this matter. The debate essentially occurred at two levels. The first was concerned with the underlying philosophy of the socialist form of organization and, in particular, with those components of the socialist model which might reasonably be dispensed within the interests of greater efficiency of investment and resource-use, more generally. The second related to practical issues associated with the special trading ties of the East European economies into the CMEA area and the constraints on liberalization as normally understood which these ties are likely to cause.

On the first of these issues, the presentation by Havrylyshyn observed that planned socialism had proved to be a relatively effective system from the viewpoint of mobilizing resources (e.g. investment/GDP ratios were typically high), but relatively poor in terms of resource efficiency. It is poor performance in this second area which is the basic source of most of the contemporary pressures for reform. Furthermore, philosophically and historically, socialist thinking has been far more concerned with distributional issues, and with forms of asset ownership that precluded excessive concentration of ownership in the hands of a limited set of individuals, than with planning in the sense of tight centralized control over resource-use. Planning can be regarded more as a means to an end and to the extent that it has not served the function well, it can be dispensed with, in his view, without destroying the fundamental basis of a socialist state.

Judged by the experiences of a number of East European economies it appeared that the attempts to set prices administratively in a manner which simulated free markets had not been very successful and that this was not the way to achieve improved resource allocation. Reform therefore needed to be more fundamental and to allow markets to be established and function largely free of administrative guidance. From their point of view the similarities between the necessary reforms in socialist and market economies were greater than the differences. The solution to the adjustment problem in both cases involves greater discipline at both the government and the enterprise level, greater use of the exchange rates to stimulate trade, more flexibility of price signals and, above all, more open and central trade policy. The partial nature of reforms to date—partial above all because of a misguided effort to retain central control of resource-use—had generated only limited success because they had not provided an adequate mechanism of carrot and stick incentives, equivalent to that found in most capitalist systems.

Although these propositions were not extensively debated, there was considerable documentation in Nuti’s paper about the extent to which price and market systems in Hungary, Poland, and Yugoslavia had deviated from the model of liberalization advocated by Havrylyshyn. One undercurrent of concern was the extent to which it was technically possible to establish effective markets without substantially giving up on social control of the means of production. Nuti’s presentation suggested that continued social control of assets was not necessarily inconsistent with the delegation of a great deal of power to decentralized markets. However, the practical issues involved in this were not developed.

On the narrower issue of the institutional trading arrangements in East Europe, several points were made. The Polish participants noted that in the 1940s, Poland had to re-orient politically and
economically, and a high degree of dependence on trading links within the Eastern CMEA trading system was unavoidable. Some 60 percent of Poland’s trade still took place within this trading block, which has very specific arrangements which are fundamentally alien to the idea of liberal trade in its normal sense. The major factor militating against moves to diversify trade and establish a greater interaction with Western trading partners was the uncertainty about external relations and the very real risks attached to revamping not only the direction of trade but also, by implication, the institutional arrangements which such a change would imply. Hungarian participants made similar points and stressed, in particular, the inherent difficulties of buying in the CMEA area and selling in OECD markets. What was needed was some built-in assurance about the stability of possible new trading relationships to reduce the risks of liberalizing to establish those new patterns.

By way of partial denial of the significance of these problems, it was observed that the German Democratic Republic functions quite well as a socialist economy but is also integrated into trade with the European Community. However, it was quickly pointed out that East Germany is a very special case, having access to the EEC through West Germany and being in a fundamentally different situation because of the common language and industrial standards than that of other Eastern bloc countries. It is almost the 13th member of the EEC from many viewpoints. The Hungarian participants, for example, pointed out that by contrast with East Germany, there is no sector where Hungary is exporting to the EEC which is free from restrictions such as voluntary export restraints, and the protection levels and restrictions of the Common Agricultural Policy. East European participants left the seminar in no doubt that the particular institutional circumstances which the Eastern bloc countries face in Western trade certainly do reduce the benefits and so the enthusiasm for trade liberalization (see also Section 8 below).

Nuti’s presentation elaborated on this line of discussion by noting that not only are the East European countries subject to trade restrictions in the EEC, but they do not even enjoy free access for their products into East Europe. Since in part this is due to the absence of a convertible currency unit in the Eastern bloc—not even the so-called “transferable rouble” was really convertible—there was a desperate need to create such a unit. This was technically quite feasible and would certainly stimulate a considerable expansion of trade within East Europe. While a necessary condition for its success would be an enhanced degree of policy coordination within the CMEA area, this need not amount to a full coordination of all policies, but it would need reasonably convergent rates of inflation. In this context, the Hungarian participants noted along with others that the role of monetary policy had been underestimated in the East European economies generally, but that such policies now needed to be used not only actively but in a coordinated manner to enhance the prospects for improved trade integration.

Finally, on this subject of the institutional differences of the East European countries, it was noted that prices within the trading baskets of the CMEA system are negotiated values not much influenced by any of the conventional pressures of supply and demand. The negotiations are conducted largely to preserve the overall terms of trade between the different trading partners. But this necessarily makes individual prices somewhat arbitrary and so blurs the efficiency performance of individual exporters and slows down adjustments, where a need in other systems is signaled by changes in individual prices.

In summary, the discussion of these matters largely confirmed that, notwithstanding recent reforms in individual countries and the proposed reforms of the CMEA system itself, the institutional factors conditioning the basis of trade in the East European countries were sharply different from those generally encountered in the West. In the absence of major changes in such institutional arrangements, the market economy model of trade liberalization did not guarantee equivalent results in the East.
The Policy Content of Adjustment and the Role of Devaluation

The seminar discussed a variety of policy changes which together would constitute an effective program for trade adjustment. Discussion earlier in this paper has already focused on the need to inject greater financial discipline so that the stimulus to efficiency coming from trade reform would be effective at the enterprise level. Subsequent discussion also noted that this would involve removing the barriers to the exit/closure of individual firms since this has been largely untouched by Eastern bloc reforms up till now. In addition, World Bank participants noted that explicit programs would be needed to aid the restructuring of key enterprises and sectors to enable them to respond to new circumstances. It was worth noting that in few market economies did markets work well enough to generate such restructuring without some intervention. These programs would need to facilitate the entry of new, and especially smaller firms, both to create alternative jobs to replace those lost in declining industries, but also to improve the system’s overall capacity to respond to technological and market changes. This would also require a range of functional supports to industry including measures to broaden access to new technologies and to ensure that the relatively high R and D spending of the socialist economies was translated into effective gains in technological capacity across a broad range of industries. All such policies raised a variety of questions, the answers to which were not immediately apparent and where discussion in the seminar was relatively limited. In particular, how can a socialist system based on extensive public ownership incorporate some of the characteristics of “owner interest” in such enterprises, and is it necessary to do so in order to gain improved performance? Similarly, in relation to technological upgrading, can the socialist systems make the necessary progress when their access to international technology is severely restricted by arrangements such as that of the CoCom—the co-ordinating committee to control technology transfer?  

Not surprisingly in a seminar focused on trade reform, a policy issue receiving central attention was the role of exchange rate devaluation in the reform process. At an early stage of the seminar, one of the Hungarian participants asked whether the successes of the Turkish adjustment really supported the view that devaluation, which has been systematically used in the Turkish case, is a decisive element in reform or merely one element among many. This question received a variety of answers from several quarters during the course of subsequent discussions. Dr. Fitzgerald, for example, in commenting on recent Irish experiences, observed that for economies such as Ireland which export capital-intensive and high technology products, the benefits of devaluation in terms of a possible lowering of real wage costs were not particularly important. Similarly, for any products which have managed to gain a quasi-monopoly position internationally because of a high reputation for quality (e.g. German cars), the systematic use of devaluation to safeguard continuous price competitiveness is not crucial. In these cases, the exchange rate can certainly be given more prominence as an anti-inflationary weapon. Even in Portugal, which still exports a wide range of products which do need to compete on price, there were reservations from the Portuguese participants about giving industrialists a long-term guarantee of ongoing devaluation to protect their competitiveness. Their concern was that such guarantees necessarily reduced the emphasis on the need to improve productivity, which was an equally good way to defend competitiveness.

Nuti’s presentation directed a good deal of attention to the effectiveness of exchange rate devaluations in a centrally planned system, and to the contention frequently advanced that these are ineffective and inflationary because of the low elasticities of relevant supplies and demands. He

8. The membership of which is broadly co-terminous with the membership of NATO.
noted that the residual nature of exports in the planned economies means that improved export performance is conditioned more by measures to restrict absorption to make room for exports, than by the degree of competitiveness which in principle at least is capable of being amended by devaluation. Thus it is in circumstances where demand is deficient that the issue of an appropriate exchange rate mostly arises.

Further, while it is true that devaluation in the planned economies can lower real demand and so imports by raising prices, this effect could equally well be achieved, if it was thought to be politically acceptable, through more direct measures to restrict domestic demand. It does not necessarily need devaluation. He went on to suggest that the critical elasticities governing the success or otherwise of devaluation in these economies are probably the elasticity of demand for imports and the elasticity of supply of exports (their sum must exceed unity for devaluation to succeed). A low export supply elasticity could for example be caused by an excessively high level of domestic absorption. Thus in various ways policies to reduce absorption would be a critical complement to devaluation and a major factor determining its success.

A more specific problem, however, arises in the case of Yugoslavia because of its system of labor-managed firms. The theoretical literature suggests that price increases in such a system, including those brought about by devaluation, may lead to perverse results because the maxima and in the case of labor-managed firms (namely output per man rather than profit), is achieved by lowering output, employment, and exports in response to price increases, rather than by raising them. The Yugoslav participants noted that, notwithstanding the theory, their own studies had suggested some positive effects of devaluation on the balance of payments implying that, in the medium-term, the supply elasticity will be sufficiently positive. They also noted, however, that in the case of Yugoslavia, export growth was now also a matter of quality/design changes which, if achieved, would enable some switch of export supply to the EEC markets.

In summary, the conclusions from this part of the discussion were largely to the effect that devaluation could achieve some of the results traditionally ascribed to it but that this would only happen if the policy was supported by other complementary measures. Nuti laid considerable emphasis on the need to accompany devaluation by measures of domestic demand restraint to reduce absorption and argued that the pessimism about the effects of devaluation in East Europe were often disguised political statements about the political feasibility of austere economic policies. Havrylyshyn, as already noted, argued that the effects of devaluation would be at best muted if devaluation was applied in the face of other pervasive anti-export policies which gave strong incentives to production for the home market. Silva Lopes and other Portuguese participants drew attention to Portuguese industry’s rapid response to real devaluations during the main stabilization episodes of 1977 and 1983. He pointed out that these successes owed a good deal both to the simultaneous enactment of contractionary domestic policies, and to the supportive role of incomes policies and associated real wage flexibility. This last point was also of considerable importance in that incomes policies had helped confine the effects of devaluation to price and wage levels and had helped avoid major declines in employment levels.

But other comments were made which emphasized the costs and the risks of a sustained policy of real devaluation as practiced, for example, in Turkey since 1980. In particular, continuing nominal devaluations in excess of a country’s inflation differential may succeed in boosting growth and exports but, for a given real interest rate and non-interest current account deficit, it will also boost the foreign debt burden as reflected in the ratio of debt/GDP. Turkey in the 1980s, for example, has achieved very high growth rates of exports and a decline in the debt/export ratio. However, the debt/GDP ratio has risen rapidly to a current level of 58 percent, which is regarded by

9. This point is explained fully in a paper which was distributed to seminar participants. See Sweder van Wijnbergen, "External Debt Inflation and the Public Sector: Towards Fiscal Policy for Sustained Growth," World Bank (mimeo), March 1988.
Turkish officials as close to the limit of what is acceptable. The implication is that future export growth must rely much more on quality and on product upgrading and not on selling price alone. Nominal devaluation to compensate for inflationary differentials will continue to be used but support policies to encourage product upgrading, and better quality and design will be needed to take the place of further real devaluations.
Sequencing and the Characteristics of Successful Trade Liberalization

The presentations on Ireland, Portugal, Turkey, and South Korea were all of considerable interest in demonstrating the importance of some of the historical policy foundations which ultimately helped to ensure a successful liberalization of trade. In the case of Portugal, Silva Lopes noted that Portugal's EFTA membership from 1958 and association with the EEC from 1973, had given the country a relatively long period during which industry had been encouraged to look outwards for its markets. Equally, with the notable exception of agriculture, the country has had a relatively long tradition of low protection and limited anti-export bias in trade policies. In the 1960s and early 1970s the policies of relatively free trade were successful in that exports were able to expand at a rate of 11 percent per annum which was substantially higher even than the then high rates of growth in industrialized countries generally. This had not only helped sustain very rapid growth of overall GDP but it also led to the rapid development of the supply capacity of industries such as textiles, clothing, electronic products, wood pulp, and tomato paste. On the other side of the account, the relaxation of controls against EFTA country products certainly led to a diversion of imports from other sources and to a relatively fast growth of imports in total. However, import competition did not create major difficulties for Portuguese industry since there was not much industry at the time and many of those industries which were emerging were explicitly export-focused.

By contrast, the years after 1974 were traumatic for Portugal characterized as they were not only by the oil-price shock—which itself caused a 6 percent loss of GDP—but also by decolonization, the loss of major preferential markets, and the return of several hundred thousand colonists from Mozambique and Angola. The initial responses to these problems were characterized by a strongly protectionist policy involving import surcharges, a serious overvaluation of the escudo and a major emphasis on building up heavy public sector industries behind high protective barriers. However, when recovery began in 1976 and 1977 it was driven once again by policies which removed many protective barriers and gave central prominence to active use of exchange rate policy, and the general reduction of the anti-export bias. Similarly, after a further period of inappropriate policies in the early 1980s, a stabilization program which gave a central role to real depreciation again generated a rapid recovery of exports. Thus in spite of all the difficulties in the 1970s and early 1980s, Portugal still managed to achieve a growth rate of exports in the period 1973 to 1986 which, at 6.5 percent per annum, was still superior to the average in the industrialized countries as a whole.

Silva Lopes' comments and subsequent discussion identified several key elements of Portugal's relatively successful record of stabilization and adjustment. Some of these indicate some further difficulties for the reform programs in East Europe while others suggest certain possible lessons for the East. First, as one of the Hungarian participants noted, Portugal chose to undergo her major liberalization in the 1960s when world market conditions were much better than now and international prices were far less distorted. Second, Portugal's development of export industries has undoubtedly benefited critically from the easy access to EFTA markets after 1958 and the EEC which severely limits the scope for the development of Hungarian and other East European export industries (see also Section 8 below). Third, the rapid responsiveness of exports to the major

10. The Portuguese export growth rate during the period 1959 to 1973 was 11 percent per annum as against 8.9 percent per annum for the industrialized countries.
Hungary, Poland, Portugal, Turkey, and Yugoslavia

stabilization programs in both 1977 and in 1982 owed a great deal to the fact that industries were already quite well diversified by these dates with managements well-attuned to the requirements of international marketing. Therefore the foundations of the 1960s were important to the success of the trade reform of the late 1970s and 1980s. Fourth, building on the comments of Nuti discussed earlier, a number of complementary policies were extremely important to the success of the exchange rate and other trade policy reform. In particular, in both the 1977 and the 1982 episodes, the external policies were accompanied by contractionary policies to restrict domestic absorption and incomes policies to bring about relatively large falls in real wages. Trade unions in Portugal have shown themselves to be more concerned to protect jobs than the levels of real wages, and significant falls in real wages have been possible and have been a vital element in preserving Portuguese competitiveness in spite of a labor market which in other ways is very rigid. Finally, in spite of considerable external borrowing in the late 1970s which encouraged, as in other countries, a variety of very poor investment decisions, Portugal has managed to avoid an external debt problem. Possibly, the major factor here was the 50 years of very conservative policies which preceded the 1974 Revolution, and the fact that the reserves accumulated during this time were held mainly in gold, which governments of all political colors had been very anxious, albeit irrationally, to hold on to, rather than to spend.

In the case of Ireland, circumstances were somewhat different in that after the formation of the state in 1927, the economic war with Britain and an aspiration for self-sufficiency had generated a general move towards autarky in trade policies which became particularly marked in the 1930s. Although there were obvious problems caused by this approach, the fact remained that it did establish the basis for an Irish industrial sector. Indeed, although the industries which made up this sector were relatively unspecialized, inefficient and highly dependent upon imports, they did give the country rapid industrial growth for a number of years. The situation changed in the 1950s when, largely as a consequence of cheap food policies in the U.K., Irish agricultural trade suffered very badly and the economy as a whole stagnated. Beginning in the late 1950s, this was partly responsible for stimulating a fundamental change in its industrial policies. More specifically, the country was opened up to what turned out to be massive foreign direct investment, which was encouraged by generous incentives including the extremely favorable taxation of profits on exports. These policies resulted not only in a major expansion in exports but also to a situation where the formerly heavy dependence on the U.K. market has been replaced by a situation where today two-thirds of exports go to non-U.K. destinations. The rapid growth of direct foreign investment now also means that 45 per cent of the jobs in Ireland’s manufacturing sector are attributable to foreign-owned firms. They have been attracted not only by the generous incentives but also, in Fitzgerald’s view, by Ireland’s extremely good and cost-effective educational system. In relation to the points about the disciplinary effects on trade made by Havrylyshyn, he noted that Ireland, in advance of her entry into the EEC in 1973, had decided to establish free trade with the U.K.—her major import trading partner in order to expose industry to the “stick” of free trade before getting the “carrot and stick” effects of EEC membership. Although this had created difficulties for some parts of domestic industry, the situation was broadly similar to that in Portugal in that the foundations of industry established many years before, were such as to generate a generally good response. Ireland’s more recent problems stem back to the euphoria of 1976 and the massively inflated spending by the government initiated at that time. By contrast with Portugal, these problems have mainly needed to be addressed by policies to hold back domestic absorption. The low labor-intensity of much of Irish industry has meant that the real devaluations and lower real wages policies practiced by the Portuguese, have not been a realistic approach in the Irish case.

11. Ireland has an agreement with the EEC to hold the tax rates on corporate profits on exports to only 10 percent until the year 2000.
In the case of Turkey, Mr. Ersel drew attention to the very successful stabilization program of 1980 and the subsequent rapid growth of exports which almost quadrupled by 1987. A number of factors were suggested by way of partial explanation of Turkey's successful trade performance. The first was the progressive evolution of an incentive system which unwound import protection, refined the explicit incentives for exports, and above all offered exporters sustained real devaluations to boost their competitiveness. This did not receive much in-depth discussion during the seminar. However, it is discussed and analyzed at length in a paper circulated to participants. The second were certain developments in Middle Eastern markets which favored Turkey and especially the Iraq-Iran war. The third was the permissive factor that Turkey's earlier industrialization efforts superimposed on the macroeconomic difficulties of the late 1970s, which meant that there was considerable excess capacity available in industry at the moment when the reform program began.

One Bank participant noted that to encourage the conversion of this excess capacity for export-use required both a continued limitation on domestic demand as well as a sufficient degree of credibility about the longevity of outward-looking policies to persuade industrialists to develop the new markets. Turkish policy had succeeded in establishing credibility in this respect by a relatively high degree of consistency both of government pronouncements and action about the permanence of the export support. By contrast, he noted that Poland's hesitancy in these directions, for example in 1982 and also early in 1988, had lacked conviction and consequently had failed to gain credibility. One reason why the apparently strong incentives for exports in Poland had not resulted in good export performance was that production for the domestic market continued to be helped in various ways and not least through the operation of the soft-budget option.

The final point about Turkey was that its program had been extremely comprehensive and had required a great deal of external assistance: specifically $1.6 billion of SAL and project lending. It had also been very important to the overall sustainability of the program for the governments to be able to show some early successes. This had been possible because of the strategic decision to build an incentive structure for exports and good export growth performance in advance of a fully fledged liberalization of imports. This probably had lessons for other countries and Silva Lopes and others wondered whether it might be possible to develop programs to replicate this sequencing elsewhere. In particular, would it be possible for revenues from continued import protection to be partially assigned to the promotion of exports? Above all though the Turkish experience demonstrated the willingness and ability of the World Bank, and the aid community more generally, to sustain large resource transfers and long-term commitment to a country when that country's own commitment to major reform is unambiguous and itself sustained.

Mr. Kim in his paper and presentation about trade policies in South Korea provided a detailed description and assessment about the evolution of policies. This gave rise to a varied range of questions and discussion of which the following points were among the most important. First, the Polish participants noted that many of the instruments used by South Korea in her import-substitution phase in the 1960s such as import controls, sector-specific guidelines, and heavy export subsidies, are interventions generally frowned upon by the World Bank and the GATT. They wondered how the World Bank would evaluate a program incorporating such elements if it were to be invoked today in the Polish or other country contexts. Second, a number of questions arose as to the role which the Import Substitution Industrialization program and the subsequent heavy-industry program in the 1970s had played in South Korea's ultimate emergence as a powerful industrial nation—were they essential or were they now perceived as a mistake? Kim responded by noting that the limited economic base of the country at the end of the 1950s had meant that there really was little alternative for the Import Substitution Industrialization emphasis of the 1960s and so this had been well justified.

essential for ultimate success. As regards the later focus on heavy-industry the situation was different because there was still considerable controversy within the country about that phase of policy. Undoubtedly there were some major mistakes and the costs of these had been high, but in his view the policy had been correct on balance: many of the industrial success stories of the 1980s, such as automobiles, would have been much harder to achieve without the heavy-industry push in the 1970's. Equally that push would itself have been more difficult to achieve in the 1980s.

Third, the Yugoslav participants asked what the mechanisms had been for the abandonment of specific policies such as preferential interest rates and multiple exchange rates, which at one stage had been key elements of policy. Kim had no specific answer to this but did note that policies in South Korea were constantly reviewed at the highest level, and there was no fundamental difficulty in abandoning policies when they had ceased to serve the central objectives of sound resource allocation and strong export performance.

Fourth, a number of participants enquired about the significance of the planning process in the Korean system. Kim noted that successive development plans had been extremely important in setting the policy priorities of the country until the 1980s. However, as the economy had become progressively more sophisticated, the role of planning had changed and had become far more indicative in nature and more concerned with social issues as opposed to resource allocation per se. But even in the early periods of the country's development it was noted that plans had been extremely flexible and targets had been revised: often as frequently as every 12-18 months. In particular, planners had consistently underestimated export growth performance with the result that certain investments which had been planned largely for the purposes of import substitution materialized ex post as significant export earners. When the Korean steel industry was set up, for example, it was competitive enough to export about half its output from the beginning and Korean engineering companies were never pressured to buy local steel. Again the key to the country's ability to use the same capacity to serve different markets in this way lay in the explicit neutrality of the trade regime as between export and domestic markets.

Finally, there was a certain amount of discussion about South Korea's policies towards technological upgrading of industry and its attitude towards the support of newer and less labor-intensive industries. Kim noted that the pressures on real wages and the emerging industrial relations problems in the country made it certain that the relative importance of labor-intensive production would decline and that some less automated plants in, say, the textile sector would need to close. Whereas Korea's tradition in relation to the technological upgrading of industry had been heavily based on imported technology, that was now changing. The current development plan, for example, envisaged a major increase in domestic R and D spending and was targeting a rise in the ratio of R and D expenditure to GDP of from 1.6 percent to 2.5 percent by 1990. The need for this switch of emphasis to higher quality products which this reflects was being intensified by the strong external trading position of the country and the growing pressures from trading partners of Korea to forgo the aggressive use of exchange rate policy to bolster her international competitiveness. Indeed, the currency had been subject to an 8.7 percent real appreciation in 1987 and seemed set to experience a further appreciation of that magnitude in 1988. Although in the past Korea had certainly provided selective support to particular industries, there was no longer serious effort to "pick the winners" in this sense. And it was now categorically not the case that Korea subsidizes her industries either selectively or in general. In general, it was moving toward a relationship between government and industry far closer to that existing in the West and away from the more interventionist model of a few years ago.
The International Environment for Trade Reform

As was noted in the earlier sections, several participants from the East European countries expressed concern about the international institutional background against which trade reform was being considered. These comments emerged most systematically in the discussion of the paper by Michael Finger on Prospects for the Uruguay Round of Trade Reform. There were essentially four main issues which emerged, namely the adequacy of the overall growth rate of world trade; the implications of the more recent developments in GATT for liberal trade in general; the specific problems of the East European countries in relation to international trade restrictions, and the relevance of the evolving policies of the European Community especially as regards the prospective single European market by 1992.

As regards the first of these, there was general agreement that the 1980s was not such a favorable time for liberalizing as were the previous two decades. However, Parvez Hasan argued that the apparently unfavorable world trade environment should not cause developing countries to turn away from an export-led strategy. It was certainly true that the growth of manufactured exports from developing countries had slowed down in the 1980s (to 8.4 percent, 1980-86) but this still remained nearly three times the growth rate of incomes in industrial countries. It was also the case that the share of developing countries in total industrial country consumption of manufacturers was only about 2 percent, while the prospects for intra-developing country trade remained good. The sound policies of a number of liberalizing countries, including Turkey and Portugal in Europe, had been rewarded by the achievement of extremely high rates of export growth in the 1980s as indeed had the policies of several non-European countries such as South Korea, Taiwan, Thailand, Malaysia and China. China had achieved a growth rate of exports averaging 11 percent during the 1980-86 period and although the sheer size of that country precluded the possibility of exports being a major engine of growth, the leadership there clearly did see expanded foreign trade as a way of providing better market signals for domestic industry and for transmitting new ideas about production techniques and products. It was worth noting that the East Asian economies already accounted for manufactured imports of almost half the level of the U.S., and three times the level achieved by Japan. Thus their further growth would ensure a healthy growing market for other developing countries whatever happened to trade prospects in other regions.

In his presentation about the Uruguay Round of GATT negotiations, Mr. Finger provided a discussion of progress in the six negotiating groups of most relevance to developing countries. These are the groups concerned with tariffs with non-tariff barriers; with natural-resource based products; with tropical products; with safeguards; and with the functioning of the GATT system itself. In relation to non-tariff barriers he noted that the relative inexperience of GATT parties in negotiating on these matters has encouraged an approach based on getting things going and the submission of bilateral or multilateral proposals or offers. This in turn has generated considerable divergence of approach and not least on the question of how far tariff and non-tariff concessions should be linked in formal negotiations. In relation to agricultural trade, he noted that the Uruguay Round seemed set to achieve greater liberalization than had the previous Tokyo Round of the 1970s. In particular, several of the national proposals had argued for the elimination of agricultural subsidies, and especially export subsidies, and measures to improve market access for imports. Particularly encouraging was the fact that although different, there was significant overlap in the proposals emanating from the U.S., the EEC, and from other European countries.

His comments on GATT procedures stimulated considerable interest in the seminar because these emphasized the potentially wide gulf between reduced protectionism in GATT terms and the
aspirations in IMF and World Bank terms, for genuinely freer trade. In particular, he noted that GATT negotiations and procedures were concerned to define controls on the limits to trade restriction and not to ban them. Provided governments used only approved instruments of trade restriction, applied to them in a non-discriminatory manner, and subjected all existing protection to a long-term process of binding obligations, then its GATT obligations were satisfied. Unfortunately, the trade remedies which GATT allows, when they are embodied in national laws, have proven perfectly capable of generating a proliferation rather than a reduction of measures designed to restrict trade. The multifold expansion of anti-dumping cases (1,288 in the year 1980-86), following the definition of the GATT anti-dumping code, is a very clear example. The general message which participants were encouraged to draw was that, although important, they should not rely on the GATT system alone as a source of international pressure to moderate the restrictions most obviously inhibiting to their own export expansion.

This proposition led on rapidly to an extended discussion of the third issue, namely the disadvantaged position of state-trading countries in relation to protectionist policies in the West. The Hungarians, in particular, asserted that they were treated extremely inequitably, especially by the EEC. Some 15 years ago the EEC had made a commitment through GATT to progressively reduce quantitative protection against Hungary but only 5 percent of such protection had been dismantled in that time. A small country such as Hungary, which M. Nuti noted accounts for only a fraction of one percent of total EEC trade, has argued that they have no economic muscle and had to rely on legal processes through the GATT and other organizations. These are presently not working in a manner which is conducive to a freer-trading approach in the country, especially since, together with the other East European economies, Hungary does not enjoy free trade access into Western Europe. Dr. Fitzgerald agreed with several other commentators in noting that there were severe weaknesses in the manner in which the EEC dealt with the East European countries. In particular, the EEC was not facing up to the consequences of the East European economies moving to a freer trade system. In logic this should eliminate the main reason for the Community’s applying differential protection against state-trading countries but this has not happened in practice. Furthermore, the EEC as an organization has no official position on external debt. This means that arguments of the type emerging at the seminar about the need for more liberal trade, as an element in the correction of difficult debt situations, cut little ice in Brussels. The EEC countries need education about this at a political level and this is probably the only way to move decisionmaking itself to a higher level within the system.

As regards the effects of the further development of the EEC market, Dr. Fitzgerald made several points. On the general issue of protectionism he noted that the EEC system was certainly not a market system and that it unquestionably operated in a way that made access to third countries extremely difficult. As the Yugoslavian participants were quick to confirm, the problems of access were most severe in relation to agricultural products, where West Germany, for example, currently enjoyed protection equivalent to at least a 20 percent tariff. Although the agricultural pricing system, instituted mainly to support high cost products in West Germany, was well-known to encourage massive surpluses, rapid downward adjustments of prices to remedy their situation was not potentially feasible. However, the alternative arrangement of production quotas, as applied, for example, in the case of milk, was an obvious encouragement to inefficiency. Thus problems in this area were likely to persist.

As regards the establishment of the single European market by 1992, Fitzgerald noted that for 20 years the severe nontariff barriers to trade in the Community—such things as frontier controls, national industrial standards, limits on capital movements—had not received serious attention. Now there was an extremely serious effort to address these matters. While it was going on, the EEC would probably be rather too preoccupied to deal with matters of external relationships including those with East Europe. However, if it was possible that the integration of the market led to faster
overall growth, then this would be a factor likely to reduce the need for protectionism against these countries. However, this was by no means certain to occur. The Yugoslav participants noted their conviction that countries on the periphery of the EEC would have little bargaining power in the new single market and would need to adapt to it. Yugoslavia was already preparing for the changes and strongly encouraging its industry to adopt EEC standards. There was some argument over Fitzgerald's suggestion that quotas against third country exports might usefully be reformed from a national to a Community basis. In short, the Community as a whole would seek to keep out a specified volume of goods rather than leaving decisions on this to national governments. He felt that this would result in generally lower protection against East Europe but this was disputed by the Hungarian and other participants who thought that, if anything, protection would rise as a result of that reform. In general, there was a perception that 1992 might well involve leveling external barriers up to the level of the most highly protected members of the EEC rather than down to the level of the lowest protected.

A critical element in the proposed integration of the market was the proposed liberalization of capital movements. Fitzgerald noted that with free trade, free capital movements, and a fixed exchange rate in each member state, the scope for independent fiscal and monetary policy in any one country was removed. This opens up the obvious danger that growth could concentrate on the strong central countries of the market at the expense of periphery countries such as Greece and Portugal. The proposed doubling of the EEC structural funds represented a possible offset to this concentration of economic activity. However, even with this increase, the volume of structural fund transfers would remain really quite small, certainly less small than the volumes found in most full political federations. Once again the problems arising from this would be smaller if the Community as a whole was able to achieve relatively rapid overall growth.

Finally, on the subject of the possible enlargement of the Community, two substantive points were made. First, in relation to the 1986 enlargement to include Portugal and Spain, it was noted that membership had had a strongly beneficial effect in providing for greater stability in policies in Portugal than had been the case in the preceding 12 years. The major residual problem found by Portugal was the continuing large public sector deficit and the difficulties this posed for accepting any real fixity of the exchange rate in the context of the European Monetary System. Second, in relation to Turkey, Dr. Fitzgerald noted that this possible enlargement would put the interface between the economic and defense roles of the Community on the agenda more squarely than ever before.
The Leading Issues

The complexity and diversity of the issues discussed at the seminar makes the presentation of a concise summary extremely difficult. However, a number of key issues certainly did emerge during the course of the two days and it is useful to highlight a few of these by way of conclusion.

First and foremost, the discussion illustrated a clear recognition on the part of participants from all countries of the analytically sound case for freer trade as a vital element in encouraging more efficient use of scarce investment and other resources. Less well recognized at the outset but clearly communicated during the discussion was the vital importance of complementary policy reforms to ensure that the disciplining signals from freer trade were fully communicated down to the enterprise level. There was some willingness as well to accept that policies to harden the “soft-budget option” were particularly important in this regard to ensure that enterprise inefficiency was properly penalized. Clearly the soundness of the transitional policies—not much discussed at the seminar—would also be extremely relevant to ensuring the credibility of this type of reform. Underlying this was an acceptance on the part of many participants that properly functioning markets would increasingly be needed to set prices and allocate resources, and that the administrative simulation of such processes rarely worked well.

However, the reasonably broad-based agreement about the analytical correctness of the case for free trade and the reasonably clear implications it logically generated about supporting policies contrasted markedly with the relative untidiness and the significant disagreements associated with the practical consequences of adopting such policies in East Europe. While there was little dispute that South Korea, Turkey, Portugal, and Ireland had all benefited significantly from the ultimately liberal trading postures which they had adopted, there were serious doubts expressed about the replicability of these successes in the East European context. These doubts have two main aspects.

The first concerns the philosophical basis of the socialist economic system and its ability to absorb a free-trading stance in its external policies. The implications of such a reform would run through the system as a whole and, in particular, would inevitably undermine any attempts to continue to centrally control the allocation of resources. The unanimous agreement among participants that tight central control of resources had not been successful in achieving efficiency of resource-use, did not seem to translate into an equal degree of unanimity about the feasibility and desirability of the wholesale replacement of such a system. The reasons for this are complex and difficult to untangle but probably relate in part to doubts about whether the pre-eminent distributional and ownership concerns of a socialist system could really be maintained if control over resource allocation were to be delegated to free markets. Certainly some participants were in little doubt that some deterioration in the relatively egalitarian income distribution which East European economics have achieved would be an unavoidable consequence of more liberal market arrangements.

The second aspect concerns the high degree of skepticism expressed about the present international trading environment and the unique position of the East European countries within it. The point was made in several ways that a freer trading posture would be easier to achieve for many countries if trade arrangements within the CMEA area itself could be reformed to provide a more market-oriented environment. In particular, several participants argued for an enhanced degree of currency convertibility within the CMEA area and for a greater role for prices and efficiency in determining trade flows. As regards trade with the West, the seminar discussion suggested several reforms which are required to encourage the East European economies to bite the bullet of freer trade.
The first would be for the EEC, to honor existing commitments on the removal of trade restrictions. A second and more general reform would be for the EEC, in particular, to recognize the logic of its own trading policies and agree to unwind its discriminatory restrictions against the Eastern bloc as the East European countries progressively moved in the direction of greater liberalism. Finally and most important, the Eastern bloc countries as a whole require credible international assurances that if they make the difficult effort to re-orient trade along Western lines, they will find the long-term access to markets which would justify the economic and political costs of this major readjustment. The analytical economic merits of the case are unlikely to win the day in the absence of international political commitment along these lines.
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