Agricultural Trade Liberalization and Adjustment in Developing Countries

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Summary: Agricultural trade liberalization offers the possibility of substantial income gains and poverty reduction in the developing world. For those gains to be realized, institutional innovations and realizations of export opportunities are crucial. Adjustment policies to foster gains from trade include initiatives to compensate losers, institutional reforms to integrate into the global trading system, and policies which facilitate resource reallocations and especially enhance investment activity, both foreign and domestic. Much can be learned from experience with structural adjustment reforms, in which substantial trade liberalization by developing countries was accompanied by numerous other reforms when successful. Agriculture is important in reforms because of the size of the agricultural sector, and because poverty reduction requires that agricultural investment be part of the overall development strategy. Good governance is key, because experience has shown that the free market left to itself will not bring about the institutional innovation nor provide the public goods necessary for equitable adjustment to occur, but corrupt governments can hinder adjustment. Timing and pace of reforms is also crucial, both to insure that institutional change keeps up with market incentives, and because the macroeconomic environment is crucial to both the need for compensation and the extent of social disruption trade liberalization can bring. The role of trade relative to other development objectives must also be kept in perspective, as meeting WTO rules or compensation schemes can be extremely costly and stall other development initiatives.

KEY WORDS: agricultural trade liberalization, developing countries, structural adjustment, institutional innovation, good governance, investment

1 Introduction

Numerous CGE studies have demonstrated potentially large benefits to developing countries from agricultural trade liberalization. World Bank results included in its *2004 Global Economic Prospects* (World Bank, 2003) suggest that trade liberalization generally could yield $500 billion in annual gains to developing countries, with over $100 billion of those gains due to direct (static) improvements in resource allocations as a result of the elimination of distortionary agricultural policies. (Table 1 presents the World Bank projections of potential income gains to developing countries by 2015 from trade liberalization.) The Australian Bureau of Agricultural and Resource Economics (ABARE – Freeman et. al. 2000), and the Global Trade Analysis Project at Purdue (GTAP – Hertel and Martin, 1999) have utilized a similar methodology and come to qualitatively similar conclusions if somewhat smaller impacts. The message is that agricultural trade liberalization should bring greater economic efficiency, hence more rapidly growing income and reduction in poverty, to the developing world.

The similar methodology utilized in each of these studies is essentially a Ricardo-Viner adaptation of Heckscher-Ohlin theory that simulates long run resource reallocations in response to price changes. This approach tends to be narrowly focused on the consequences of trade policy reform, modeling the impacts of tariff changes on prices, and in turn the consequences of those price changes on supply and demand in trading countries. Facilitating the adjustments necessary for those movements along supply and demand curves, and creating the capacity to export products where prices rise, is implicit in those models. They simply do not address the institutional changes necessary for new activities to appear and expand, nor do they consider the constraints to expanding exports which have limited benefits to trade liberalization by developing countries in the past. They show potential gains, but institutional change directed by government and donor intervention is needed to realize that potential.

Several important lessons about the nature of changes necessary to realize the benefits from agricultural trade liberalization can be gleaned from these results, nevertheless. Gains are derived mostly from correcting a nation's own distortions --unilateral liberalization therefore can bring about most of the potential benefits. But protection elsewhere, especially in industrialized countries, can limit adjustments options (i.e. export opportunities). While there are significant gains to agricultural liberalization, more comprehensive liberalization involving manufactured goods is also important to developing countries, enhancing opportunities for the resources freed from agriculture. ABARE’s conclusions, unlike the World Bank results, show gains to developing countries that are greater for industrial goods liberalization than from agricultural liberalization.

The long-term impacts predicted by these models require short-term adjustments to move to new resource allocations, and those often are characterized by requiring significantly expanded exports in some sectors. Countries are highly dependent on the success of realizing export expansion somewhere. That may mean new markets, and so new institutions.

In the process of realizing these gains and adjusting an economy there will inevitably be winners and losers. Theory shows us that that the distributions away from special interests now benefiting from policy distortions towards consumers can be an order of magnitude larger than that the gains from trade. Those net gains are on the order of only 1% of GNP in the most optimistic projections, while the impact on special interest groups can be a very significant fraction of their income. In developing countries that are highly self-sufficient in agricultural commodities, the outcome of redistributions exceeding net gains -- the Harberger triangles being small relative to changes in producer and consumer surplus -- is even greater. Much of the focus of adjustment policy is on compensating these losers so that liberalization becomes politically feasible. But the costs of compensation packages could be large, and giving them could induce further distortions.

Both the World Bank and ABARE have focused on the importance of “dynamic gains” from trade liberalization. In both sets of results dynamic gains exceed the static efficiency gains from resource reallocations. Dynamic gains include the pro-competitive effects of trade liberalization eliminating domestic monopolies as well as productivity gains that result in sectors that are more globally integrated and so realize the benefits of improved technology. But it is these dynamic gains which are most likely not simply due to price realignments, but rather to the institutional innovations that both accompany and are needed for resource adjustment of an economy.

2 Lessons from Structural Adjustment

There has already been significant trade liberalization by developing countries over the last decade, driven more by requirements of structural adjustment programs imposed by the World Bank and the IMF rather than from compliance with the 1994 WTO Uruguay Round Agreement. Structural adjustment incorporated a package of numerous additional reforms going well beyond simple trade liberalization. Experience with structural adjustment may serve as the basis for assessing both the impact of trade liberalization on developing countries and for considering the nature and influence of adjustment policies which were part of the package of reforms imposed on developing countries -- referred to as the Washington consensus.

Experience with structural adjustment has also allowed economists to estimate the impacts of openness and trade liberalization on economic growth and poverty reduction. Many economists conclude from the evidence that openness fosters growth which in turn reduces poverty (Nordstrom, Ben David and Winters, 2002; Berg and Kreuger, 2002). It is that evidence which is used to set the magnitude of dynamic gains included in the World Bank estimates of impacts from trade liberalization cited above. Others argue that econometric results demonstrating the benefits of trade liberalization are not robust, and that this conclusion derives from misinterpretation of the regression results. Rodrick (2001) argues that, in the set of developing countries where trade has been liberalized, it is also typically the case that macroeconomic policy has been significantly reformed and other measures to promote economic efficiency, including institutional reforms were pursued. After all, the structural adjustment programs that drove trade liberalization were primarily about fixing severe macroeconomic problems in the affected countries, so the solutions proposed included a number of complementary reforms beyond trade.

A middle ground may be found in the controversy on the impacts of trade liberalization. Both Rodrick and Berg and Kreuger agree that trade liberalization must be accompanied by complementary adjustment policies, particularly macroeconomic reform, in order to be effective. They disagree on the importance ascribed to trade liberalization in the reform process and as part of development policy. Kreuger's view serves as the foundation for the Integrated Framework promoted jointly by the WTO, the World Bank and the IMF to "mainstream" trade policy as part of development strategy. Rodrick, on the other hand, believes that trade policy is overemphasized, and that macroeconomic reform and institutional innovations are far more important in fostering growth. Both parties agree that trade liberalization accompanies development and that in the long run a closed economy which fails to integrate with international markets will grow more slowly. The question which remains is how to get started on the path of growth and poverty reduction, and what role trade policy plays in the package of development policies to be pursued. Unfortunately, collinearity of data due to the fact that trade liberalization, where successful, was accompanied by numerous other reforms makes sorting out to price effects from macroeconomics and institutional change difficult. The message on need for adjustment policy going well beyond trade policy seems clear from this debate, however.

The composition of structural adjustment programs offer a basis for both assessing the need for adjustment policies and examining what might be included in a package of adjustment policies to accompany agricultural trade liberalization. In the case of developing countries, if one understands that adjustment, structural adjustment, and hence development policy are nearly synonymous, the broad literature on development policy and development history also become applicable to this assessment. Much work has been done examining outcomes from application of the Washington consensus, although controversy continues on the effectiveness of that package and what needs to be added for more rapid development to be achieved.

2.1 Washington Consensus

The Washington consensus is a term attributed to Williamson (2003) which identifies the components of structural adjustment reforms applied particularly during the 1990s to developing countries. Those components, in addition to *trade liberalization*, are:

Fiscal discipline -- government budget deficits were to be reduced, public expenditure was to be reprioritized, and tax structures were reformed.

Financial market liberalization -- *lower interest rates* were to be set and subsidies on interest rates were to be eliminated. Financial markets were deregulated (capital controls eliminated).

Exchange rate devaluation -- is a key component of the Washington consensus since international debt and trade deficits were at the heart of problems leading to structural adjustment programs, believed to be due in part to overvaluation of exchange rates.

Foreign direct investment (FDI) -- was assumed necessary to increase the rate of the investment in developing countries and bring resources which would otherwise be unavailable for economic growth

Privatization and deregulation -- were introduced to reduce the role of inefficient and corrupt governments, based on the belief the less government was almost always better.

Property rights -- needed to be clearly established in legal frameworks so that the incentives under structural adjustment program could be pursued.

Since structural adjustment programs were often imposed on developing countries governments rather than being advanced by national governments themselves, and since they imposed substantial hardship on populations, these programs were not always embraced by governments nor pursued fully. Incomplete adoption of the Washington consensus has led to some controversy concerning its effectiveness. Proponents of the consensus argued that the failure of structural adjustment to work in many countries was due to too little reform. Others argue that too much reform, too soon, and the wrong sorts of reforms, were pursued by the IMF, the World Bank, and USAID (Stiglitz, Williamson). This approach became quite unpopular in countries where these policies were pursued, and many, particularly in developing countries, believe that this was a flawed approach to development. Williamson argues that there is a misunderstanding as to what the Washington consensus entails, since many simply equate it with neoliberalism -- eliminating government and leaving everything to free markets. Williamson argues that such a view was never a correct characterization of the Washington consensus. He goes further to argue, however, that we can now identify four critical missing components to the approach taken under the Washington consensus which must be added to the approach to adjustment now to be taken in developing countries.

Policies of the IMF and the World Bank following the Asian financial crisis came under severe criticism because of the impacts they appeared to have on *income distribution*. Since then both the IMF and the World Bank have identified poverty reduction as a key goal of their strategies. Policies now needs to be chosen taking into account impacts on income distribution and the extent to which they reduce poverty. While growth may be necessary to reduce poverty, some policies which lead to growth will improve the distribution of income while others make it worse.

Stiglitz argues that an important failure also evident from application of structural adjustment policies following the Asian financial crisis, and a root cause of the crisis itself, was lack of *financial market regulation*. While FDI and international capital may be important to filling the “resource gap” of the famous Chenery-Strout two gap model (which still serves as the justification for most foreign aid initiatives – Easterly, 2003), poorly regulated capital markets and the volatility of foreign investment may bring more harm than good. Resources may not be directed to the most productive investments. While long-term investment is key to rapid economic development, the problem of intermediation of short-term money from foreign capital markets needs to be carried out by a sophisticated and carefully regulated banking sector which is unlikely to exist in early stages of development.

Rodrick has emphasized that *institutions* are crucial to both the success of structural adjustment programs and to economic development. Legal and regulatory frameworks must be established and new market structures are needed. These institutions are unlikely to arise (and have not arisen) simply as a result of incentives being put in place in a free market. Governments are needed to ensure appropriate institutions are put in place. Moreover, he notes that in the course of their development, these institutions evolved during (not before or after) the course of economic development in industrial countries.

The view on the need for extreme privatization and deregulation has also been tempered. It is now recognized that there is an *appropriate role for government intervention*, such as provision of public goods and fostering institutional reform. Financial as well as good and factor market regulation is necessary. Institutions needed for activities will not arise without the support of government. Good governance is necessary even for privatization to work – but corrupt governments will give rise to corrupt privatization, as Stiglitz shows for the Soviet Union.

2.2 Integrated Framework

In addition to structural adjustment, the World Bank and the IMF also collaborated with the WTO, the United Nations (UNCTAD, UNDP) and other international organizations (ITC) to assist developing countries in implementing commitments arising from the 1994 Uruguay Round Agreement and necessary for trade liberalization initiatives to advance. The Integrated Framework was one such effort which began in 1997, but according to WTO (2001) evaluation it never “took off’. The

Integrated Framework was designed to help developing countries *comply with WTO rules*, *enhance their negotiating capacity* in future WTO rounds, *establish national policy and regulatory frameworks* required as a consequence of trade liberalization, and increase *export "readiness*". The World Bank has estimated that this compliance can be extremely costly, and few developing countries committed the resources necessary to make the Integrated Framework succeed. A second Integrated Framework began in 2000 to "mainstream" trade in the development process. It seeks to insure that trade chapters are incorporated in the Poverty Reduction Strategy Papers now used by the World Bank to guide development policy. It is too early to see significant results from this second effort, and evidence of increased export readiness where the Integrated Framework has been applied is not yet evident. This effort, more so than earlier structural adjustment programs, recognized the need for institutional reform to complement trade liberalization.

2.3 Second Generation Reforms/ New Enlightened Standard View

Based on their evaluations of structural adjustment, the Integrated Framework, and foreign aid initiatives generally, both critics (Rodrick, Stighlitz) and those closer to the World Bank and IMF (Williamson, Easterly) see some convergence on a new paradigm to replace the Washington Consensus. Rodrick describes a "New Standard Enlightened View" which is similar to the "Second Generation Reforms" described by Williamson. New components of adjustment packages would now include both the need for enhanced market access in industrialized countries and a much greater role for institutional reforms in developing countries. The need for market access in industrialized countries highlights the need for a good result for developing countries from the Doha Round so that export opportunities exist. The two aspects of institutional reform typically highlighted are legal and administrative changes, including financial regulation, anti-corruption initiatives and policies to insure good governance, and safety nets through poverty reduction efforts and more flexible labor markets.

Williamson argues that second generation reforms really must generally precede the first generation reforms of the Washington consensus – legal and administrative frameworks as well as safety nets must be in place before competitive markets can function properly. Rodrick cautions that market and financial institutions in developed countries evolved gradually, and may need to adapt in developing countries to local conditions, histories and existing institutions. Successful developing countries have also not always taken institutions directly from those found in industrial countries, where variety in institutions can be observed. He also cautions that approaches such as the Integrated Framework may overemphasize trade and trade policy. He states that development, not trade should be "mainstream," since trade is a means to the end of more rapid development, not an end in itself.

3 Adjustment Policies

The experience with structural adjustment, the Integrated Framework, and development more generally suggest three indistinct (sometimes overlapping) categories of adjustment policies:

Helping losers – through compensation schemes, retraining and education, and support activities to assist in expansion of alternative activities, such as extension and research services so important to agriculture.

Complying with WTO rules – by improving the transparency and efficiency of customs procedures, by establishing necessary legal and administrative frameworks, and in agriculture by developing the capacity to meet requirements of the SPS and TBT agreements and to insure safe food exports.

Fostering resource reallocations – by facilitating investment, by creating a sound macroeconomic environment, by providing infrastructure and institutions, and through good governance to establish property rights and foster new institutional arrangements.

3.1 Helping Losers

Much of the debate on developed country agricultural trade liberalization has focused on compensation schemes. The justification for these is usually to make liberalization politically feasible rather than to increase efficiency, and decoupled payments are put forward as the least distorting way of making such payments. If taxation is distortionary, as is often assumed in public finance literature (where the deadweight loss of taxation may be 30% of the taxes raised – see Alston, Carter and Smith, (1993) for an application to agricultural trade policy), and if as noted earlier losses to special interests may be an order of magnitude larger than the gains from trade, these compensation schemes risk inducing greater distortions than the trade distortions created even if decoupled.

The case of Morocco as it negotiates a free trade agreement with the US illustrates the difficult problems faced by a developing country contemplating compensating losers from trade liberalization (Abbott, Abdelkhalek and Salinger, 2000). The major concession sought by the U.S. is that Morocco reduce its tariffs on wheat, which have recently been as high as 100% when world prices are low. Morocco's political economy dilemma is not unlike, but possibly more severe, than the problems typically found in an industrial country. Large land owners supply the majority of Morocco's wheat, and are a politically powerful interest group who has successfully obtained high tariff protection. But many small, poor farmers also produce wheat – some are net wheat buyers who would benefit from liberalization but others are net sellers and derive much of their very low income from wheat. Compensation may be needed to buy off the large land owners, but is also required to prevent poverty from becoming worse for the vulnerable small farmers. A better alternative than compensation is rural development, but options to accomplish that have proven elusive so far.

Morocco has been exploring alternative compensation schemes, and is being directed to WTO green box compatible direct payments. But the administrative infrastructure necessary to implement direct payment schemes simply does not exist. Morocco has been able to identify ways of influencing market outcomes to achieve compensation – indeed their current tariff policy does that. After several years of investigation mechanisms to implement direct payments have yet to be identified. And criticism of past compensation – particularly of livestock producers when drought severely limited barley production – have been criticized as having poorly targeted affected groups. Imports of barley went to villages near ports more so that distant villages, and within villages equal amounts were distributed per capita, irrespective of livestock herd size.

Past compensation and protection in Morocco have also varied with domestic production shortfalls and world price variations. As in the U.S., compensation needs to play a role as a safety net, to stabilize farm income somehow. The Moroccans had early in the Uruguay Round determined that variables levies would be optimal, but that form of safety net is now illegal under the URAA. Stockpiling has consistently been shown to be more costly than trade as a stabilization tool, yet food security stocks remain WTO legal. The WTO debate seems too focused on static gains from trade, losing sight of variability, as is seen in the lack of content to address food security concerns of developing countries in the current Doha round positions. Given the limited administrative infrastructure, border protection again appears to be a more efficient means of maintaining stability.

U.S. experience with compensation schemes also not only reflects the concern with safety nets, but also highlights the difficulty of buying out losers from trade liberalization with term limited payment schemes.

Morocco has been directed to the Mexican experience with Pro Campo as a model of how decoupled payment schemes might work in a developing country. But evaluation of Pro Campo (World Bank, 2002), the emergence of additional compensation schemes in Mexico targeting poverty, and the discontent of Mexican grain producers as the next round of NAFTA implementation is about to occur all point to problems with this compensation scheme effectively targeting losers, and serving as an effective political tool to enable trade liberalization.

The World Bank has been working on introducing other stabilization tools, particularly risk management via futures market activity or crop insurance schemes. But most developing countries offer markets too thin to support their own commodity exchanges, and transactions costs make trading on futures markets prohibitively costly for small farmers. Insurance schemes, like compensation schemes, require administrative infrastructure not typically found in developing countries.

Helping losers also involves identifying alternative activities. In the case of Morocco there have been several donor funded projects to enhance rural development. But the adjustments predicted in our models are typically unrealistic options. In Morocco's case, agricultural land is to be shifted from wheat to tomatoes. But tomatoes are now grown hundreds of miles from wheat production, where climate and especially water availability is better. Land is simply not the homogeneous resource assumed in our models, and land heterogeneity plays an important role in determining existing and potential crop mixes. In Morocco, wheat land may be better suited to other cereals which now receive less protection, but is much less likely to be suitable for export crops.

Retraining in the industrial country context probably translates to education in developing countries, and education appropriately receives high priority in foreign aid. Some adjustments proposed for developing countries are quite unrealistic given existing education levels, however. For example, in the recent African cotton initiative, the U.S. response was that Africa should shift from cotton production to labor intensive textiles and clothing. But rural peasants are not trained nor located near enough to work in factories, which would require investment capital from somewhere to be built to international market standards. Education of peasant farmers is similarly a problem if radical crop mix changes are envisioned.

3.2 Complying with WTO Rules

Complying with WTO rules is a second costly adjustment that developing countries need to address to more fully integrate into global markets. As noted earlier, the elements of this category of adjustment activities include customs improvements, legislative and administrative reforms to meet requirements of SPS, TBT and TRIPS agreements, and accompanying domestic legal reforms. Bringing to modern standards the customs valuation and bureaucratic procedures, which can be quite antiquated in developing countries, is expensive and requires new, unfamiliar information technology. Meeting SPS requirements not only requires better practices by local food processors, but also regulatory frameworks to insure that exported products meet international standards. Compliance with the TRIPS agreement can also involve substantial new legislation for developing countries. The World Bank has noted that substantial investments are needed to implement these activities. Finger and Schuler (1999) estimate that in many developing countries investments to comply with WTO rules could cost a country its entire annual development budget. It is unlikely that such costs are always highest priority uses of scarce development funds, so it should not be surprising that the Integrated Framework has not been fully implemented by most developing countries.

3.3 Facilitating Investment

The first two categories of adjustment policies deal with political incentives and rules required to meet international standards and business practices. To developing countries, the third category, facilitating internal resource reallocations, is probably both more important and more problematic. Trade liberalization, per se, is about putting incentives in place to drive such reallocations. Adjustment policies here must be about how those incentives lead to implementation, and in practice result in investments to expand export capacity.

An often cited problem of preferential trade initiatives, such as in the EU's Everything but Arms (EBA) program, is that beneficiaries of preferences lack the capacity to export. In our models capital moves to permit supply expansion where returns are highest, and capital markets in developing countries need to accomplish that end, or as seems to have been the recent experience with EBA few new exports emerge.

Skripnicheko and Abbott (2003) document greater success for clothing exports under the Caribbean Basin Initiative (CBI). But they find that investments have followed with a substantial lag incentives from preference margins (reduced tariffs), taking up to five years for steady state to be reestablished. Capacity constraints and excess profits appear to persist. Riskiness of investment in developing countries generally, and uncertainty concerning upcoming elimination of MFA quotas and potential supply reallocations also contribute to investment lags as well as observed high returns (risk premiums) to capital. Uncertainty about implementation of WTO commitments as well as the adjustment periods built into implementation surely encourages firms to go slowly in pursuing new export ventures.

Evidence on CBI textile and clothing trade also highlights the importance of Foreign Direct investment (FDI). Most of the capacity to export clothing under this initiative belongs to U.S. multinationals, who also receive the returns to capital. High wage jobs benefit host country exporters. Structural adjustment recognized the importance of foreign investment to expand resources available to developing countries and to realize export opportunities. Evidence suggests technological spillovers, a potential benefit to local firms of developing countries, is not common, however. The term deep integration has referred to the actions taken by developing countries to become more attractive hosts of foreign investment. Limitations on repatriation of returns to capital are an important area where reforms have brought greater investment, but which also limit the benefits realized from foreign investment to developing country citizens.

Loper, Abbott and Foster (2003) show that structural change dominates the impact of tariff changes in explaining success of some agricultural exports from CBI countries, highlighting the importance of deep integration. This effect means gains to trade liberalization may well be greater than model predictions, but are due more to the other elements of agreements bringing institutional reform rather than tariff reductions.

The importance of capital and investment also shows up in problems observed in credit markets following liberalization and deregulation. Lack of credit is one of the biggest problems to plague cocoa trade in West Africa following structural adjustment deregulation (Sigley, 2002). Government parastatals no longer provided credit to farmers, nor made investments to advance technology and production capacity (e.g. improved tree stock). Cooperatives failed to repay loans, corruption was sometimes evident, and local traders are accused of exercising market power over farmers via credit ties. Evidence from Stiglitz' examination of the Asian financial crisis also point to the need for better organized institutions to allocate credit in developing countries.

3.4 Institutional and Infrastructure Development

The history with cocoa sector liberalization in West Africa not only highlights concerns with credit as an institutional failure following liberalization, but also exhibits a number of other problems where continued government involvement is needed (yet is still discouraged by donors) (Abbott, 2002). The credit case is but one example where potential abuse of market power by intermediaries is a problem. For example, a few large multinationals took over exporting cocoa when the West African parastatals were eliminated, and some believe they are capturing rents. Competition policy is needed to insure that oligopolistic agents do not replace the government under privatization initiatives or deregulation.

Governments must also provide public goods. In the case of cocoa, research extension and market information systems all deteriorated with elimination of parastatals. The private sector simply did not take up these activities. Unfortunately, governments have also been slow to provide these goods under new institutional frameworks. Infrastructure, particularly roads in rural areas, is also crucial to agriculture. Port facilities often incorporate public goods elements and require government support. Inadequate port facilities, contributing to high transportation costs, lead to serious limitations on export opportunities of developing countries.

Legal and administrative frameworks and regulatory procedures must also exist in some form, and likely need to be quite different under private trade versus parastatal trade. Those frameworks need to establish property rights and standards as well as codes of conduct. In the case of cocoa, lack of land titles makes establishing collateral for credit difficult for farmers, and lack of a warehouse receipt system limits trading of cocoa within Africa. Quality deterioration is attributed in part to the lack of control systems, including grades and standards, following cocoa liberalization. Ghana, the only major coca exporter yet to liberalize, commands significant quality premiums on international markets because it is the only country which has maintained an adequate quality control system.

While government must be involved in institutional development, some of the new institutions which need to evolve are private, and a challenge is to find the right mix of public and private sector involvement. Quality is a clear example, since international standards will dominate local requirements for exports, and since private traders must participate in quality control systems. If new products are to be exported, the trading networks, and possibly commodity exchanges need to arise and function in an orderly manner. Many of the new institutions which have evolved incorporate either contracting or direct partnerships between multinationals and developing country firms to resolve institutional issues. Private contracting mechanisms need to arise, with an adequate legal system under which parties to contracts can protect their rights.

4 Conditions for Successful Adjustment

In order for trade liberalization to be effective, and to facilitate investment in new activities including new export opportunities, it is necessary to have a sound macroeconomic environment in place, and for effective government policy to encourage supportive institutional change. Trade liberalization can occur only at a pace consistent with what is happening in the macroeconomic environment and the extent of institutional evolution.

4.1 Macroeconomic Environment

Macroeconomic variables have often been seen to be highly correlated with trade liberalization when that liberalization leads to faster economic growth, prompting Rodrick and others to question whether macroeconomics or trade is more important, and Berg and Kreuger to argue that openness leads to faster growth only when accompanying policies, such as macroeconomic reform, are in place. The primacy of macroeconomic problems prior to structural adjustment reforms is clear, and shows up both in deficits (trade and government budget), which in turn determine resources available for investment, and in overvalued exchange rates. Macroeconomics sets the incentives to saving and investment, and determines interest rates in an economy. It also determines attractiveness of a country to foreign investment. Overvalued exchange rates result in disincentives to exports by biasing real exchange rates. The further bias against agriculture due to overvalued exchange rates, sometimes exceeding the effects of distortions from agricultural policy, has been well documented by Schiff and Valdes (2002).

Macroeconomics is also about the state of unemployment, which conditions the social costs of trade liberalization, since it is likely that at least in the short run trade liberalization will exacerbate unemployment. Safety nets are needed to cope with this potential increase in unemployment. Moreover, it has historically been easier to implement reform during periods of economic expansion, rather than during recession when the social costs of reform are likely to be greater. Stiglitz argues from a Keynesian perspective that several of the elements of the Washington consensus are precisely the wrong thing to do during a recession, and so the timing of reform needs to be based on the state of the economy. Recession inducing activities such as trade liberalization are unlikely to be the best starting points for reform. Much of Stiglitz' discussion on timing and pace of reform is about the macroeconomic implications of reforms relative to needs for macroeconomic stabilization policy.

4.2 Good Governance

Recently the World Bank (2003) has highlighted good governance as a key determinant of rapid development. The first element of good governance is the role the government plays in implementing macroeconomic stabilization policy. Problems in developing countries prior to structural adjustment were evident as a consequence of macroeconomic mismanagement, and successful reforms occurred where macroeconomic policy improved.

This examination of adjustment has also focused on institutional innovations, and on the need for government intervention to foster and support that innovation. Legal institutions, regulatory systems, safety nets, and investment in public goods are all activities which require active involvement of an effective government. Private institutions also need to emerge and evolve, and most likely need guidance from government for that to happen in a timely and effective manner.

One element of the Washington consensus, and especially the neoliberal take on that package, was an extreme view on the need for privatization and deregulation. Less government was generally seen as better. While the socialist structures of the 1970s may have gotten the role of government wrong and introduced inefficiencies, the 1990s seems to have erred on the other side, excessively reducing the role of government. More importantly, corrupt governments failed even at privatization, by inappropriately conferring property rights on those who would strip assets of public enterprises rather than efficiently provide goods and services. Even if in many developing countries a greater degree of privatization needs to be achieved, good governance is needed to insure that competitive private firms emerge in a properly regulated environment, and that property rights are equitably allocated. Often corrupt or ineffective governments would create private monopolies in place of parastatals, and fail to gain the benefits of competition.

Governments set the timing and pace of reform. Macroeconomic stabilization policy must be set cognizant of the state of the economy, including the extent of unemployment and recession. They must insure that safety nets are in place. They also insure that legal and regulatory frameworks, administrative procedures, and infrastructure are improved in a timely manner. Private market institutions must also evolve with the encouragement of government policy. These “second generation reforms” must precede at an appropriate pace the first generation reforms of the Washington consensus.

5 Concluding Comments

Trade liberalization is but one component of development policy, and needs to be conducted at a pace so that accompanying reforms are in place, that institutional change keeps up, and that it is not a drain on overall development goals. Both compensation schemes to help losers from trade liberalization and the investment costs to comply with WTO rules and to integrate into the global economy come at the expense of meeting other development priorities. Adjustment policies also need to insure that the macroeconomic environment is sound, legal administrative and regulatory frameworks are in place, and the new private institutions evolve to meet the needs of new market activities that trade liberalization puts incentives in place to foster.

Agriculture is a key component of adjustment policy in developing economies. Because of its size relative to GNP and its role as the major employer in low income countries, investment in agriculture should not be ignored in development policy. Mellor (1999) has argued that it may be the case that countries can accelerate growth while failing to invest in agriculture, but countries who have grown without agricultural growth have seen their income distributions worsen, so poverty increases. More of the poor live in rural areas, so urban enclave development is less likely to benefit the poor. Therefore, adjustment policies must also focus on rural areas and insure that institutions to foster development improve there, as well.

Key elements of adjustment policy identified here are policies that *facilitate investment*, since that is the vehicle through which resource reallocations and supply changes are brought about. Experience with structural adjustment reforms highlights the need for *export opportunities* to arise – it is not sufficient to simply reduce a country's import bill, but the freed up resources must move to viable alternatives to earn foreign exchange. *Good governance* is crucial, because experience has shown that the free market left to itself will not bring about the *institutional innovations* nor provide the *public goods* necessary for equitable adjustment to occur, but corrupt governments can hinder adjustment. *Macroeconomic conditions* are among the most important factors conditioning the success of trade liberalization, since exchange rates are determined by that policy as well as incentives for savings and investment. *Timing and pace of reforms* is important, both to insure that institutional change keeps up with market incentives, and because the macroeconomic environment is crucial to both the need for compensation and the extent of social disruption trade liberalization can bring.

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Table 1. Real Income Gains to Developing Countries from Trade Liberalization: World Bank Estimates

Sector:	Liberalizing DCs	Region: ICs	All Countries
Agriculture			
Static gains	80	20	101
Dynamic gains	167	75	240
All trade			
Static gains	114	44	159
Dynamic gains	265	85	349

* Static and dynamic real income gains in 2015 relative to baseline in $1997 billion.
Developing country GNP in 1997 was $6,124 billion

Source: World Bank, *Global Economic Prospects 2004*