

## « Coping with trade liberalisation adjustment »

### POLICY BRIEF

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# Coping with trade liberalisation adjustment

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## Summary

With the prospect of further trade liberalisation the question for developing and vulnerable countries of how best to manage the adjustment process consecutive to reform needs clearer answers. This paper discusses the process of adjustment for developing countries, highlighting three motives for policy intervention during this process: equity, efficiency and political economy.

Because these motives for intervention will necessarily arise, and also because their interplay - not always negative as complementarities may arise - it is necessary to get maximum clarity about the policy objective behind any adjustment policy. It is likely that the balance of equity, efficiency and political economy motives will be different in developing countries than in more developed ones, and vary across countries, thus calling for careful consideration of the context of each reform.

The simple analysis grid suggested in this paper is discussed over the specific dimension of developing countries' characteristics. Examples of what is thought as desirable and less desirable policies are then discussed.

Keywords: adjustment; developing countries; trade policy; political economy; equity; assistance

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This is a revised version of a background paper prepared for the UNCTAD study *Coping with Trade Reforms: A Developing-Country Perspective on the WTO Industrial Tariff Negotiations*, Fernandez de Cordoba and Laird (eds.), Palgrave-McMillan, 2006.

Comments from Douglas Lippoldt and Patrick Messerlin are gratefully acknowledged.

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## 1) *Introduction*

The question of adjustment to trade liberalisation is not new and yet we still have surprisingly little answers to the challenge it presents, in particular for developing countries.

The case seems now well established that non-discriminatory and multilateral trade liberalisation should provide welfare gains to most developing countries (exceptions of course apply for instance because of negative terms of trade effects). The main challenge for policy makers and analysts is to better comprehend the process that leads from the removal of trade barriers to the realisation of these gains. Trade liberalisation changes relative prices and thus generates a reallocation of production factors across the economy. Some industries contract, others grow.

Two main facts arise from the reallocation process. First trade liberalisation unavoidably creates gainers and losers. Second, making the most of the gains arising from liberalisation will require an adjustment process in the economy's production. Moving from one sector to another is costly, and there has been some argument that these adjustment costs can outweigh the gains from liberalisation, at least in the short term. A third remark also applies: making the most of the *dynamic* gains from trade (such as economies of scale or technology transfer) also requires some specific form of adjustment process.

Studies of trade liberalisation have tended to set aside issues related to adjustment by focussing on the question of whether trade liberalisation would bring net costs or gains in the long term at country level. On the question of within country effect, most of the literature has focussed on the impact on relative wages though price changes triggered by trade liberalisation on unskilled workers, and whether they can be adversely affected by liberalisation. This focus is shared in developed and developing countries alike, albeit probably for different reasons. Empirical studies have mostly looked at developed countries, at least until recently. This is probably because of availability of data, and reflecting the fact that most of international trade occurs among rich countries.

These investigations and most of the debate on trade liberalisation thus concentrates on investigating the *net* losses arising from trade liberalisation either at the country level, or for some specific interest groups. However, studying the impact of trade liberalisation is not only about this question of net impact of trade liberalisation on some, but also of how to manage the *path* of adjustment, and therefore *gross* effects, leading to hopefully not only negative, but also *positive* outcomes. For instance, Roberts & Tybout (1997) have established the export expansion consecutive to liberalisation

principally takes place through exports realised by agents that were not previously exporting.\* This means that in order to take maximum advantage of trade liberalisation, conditions have to be created as early as possible for these agents to become exporters. It is possible that firms may achieve this status without a change in policy being required; it is, however, more likely to be the case that firms in developing countries face important transaction costs preventing them to seize new opportunities.

Policy makers are thus not only facing the choice of opting for a given policy of trade liberalisation, such as negotiating for the adoption of a certain formula in WTO, but also, and importantly, the task to manage the trade liberalisation process, *before* and while it takes place. Accompanying policies are about helping the economy to move from one state to another, and reallocating resources in the economy that become unused as a result of the adjustment process. It is important to look at the transmission channels affecting firms, government and individual behaviour.

## **2) *Understanding and perception: the three dimensions of adjustment***

The nature of the adjustment arising from trade liberalisation is relatively well identified, at least in the literature. What is known with less precision is the extent of the cost of adjustment. Finally, whether or not specific policies, and what type of policy is needed to manage the process of adjustment is also a topic left relatively unexplored.

### *a) The issue at stake: efficiency, equity, and political economy considerations*

When people talk of *adjustment* they often do not refer to the same thing. An economic definition would restrict itself to the short-term process that characterise the move from one state of the economy to another, consecutive to the liberalisation process.

However, from a political economy (and social choice) perspective policy makers will not only be concerned by short-term adjustment of factors of production but by other issues as well. It is therefore important to establish clearly *why* policy intervention is needed to adapt to trade liberalisation, as different policy motives may be justified by the need to cope with adjustment.

These motives can be classified in three categories: efficiency, equity and political economy rationales (table 1). A welfare maximising approach will generally concentrate on the efficiency gains side. However, in reality policies aiming at coping with adjustment often go beyond this definition and integrate the need to assist sectors negatively impacted by trade liberalisation. This is because they are likely to oppose the process (the political economy dimension), and because they want to compensate them with redistributive objectives in mind (the equity dimension) (Magee, 2001, discusses this in the context of the US Trade Adjustment Assistance programme).

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\* As recalled in Bachetta and Jensen (2003).

*Efficiency* motives arise from the objective to maximise the social welfare by mitigating the frictional costs of the reallocation process. Such friction costs can be caused by market failures, or by other government policies that introduce additional distortions. For instance, because credit markets are weak in a given country, it might not be possible for private agents to find the capital to move into sectors that benefit from the liberalisation. In this case, there may be a role for the government to create an “adjustment friendly” environment (Bown & MacCulloch, 2005). The objectives are essentially short-term, since evidence shows that a large share of the adjustment on factor markets takes place upfront (Harrison & Revenga, 1998; Hammermesh & Pfann, 1996).<sup>†</sup>

*Political Economy* motives arise from the desire to accommodate opponents to liberalisation. Unlike efficiency seeking, the issue is here how to offset the private costs of trade liberalisation on specific sectors and agents. The most direct way to achieve this is obviously by postponing trade liberalisation itself, but this will be at the expense of the objective of efficiency gains (Bown & MacCulloch, 2005a). Both policies are not necessarily incompatible in the medium-term as compensating opponents to the liberalisation process may be the only way to implement the liberalisation policy and thus achieve efficiency.

**Table 1. Policy objectives and adjustment policies**

	Equity	Political Economy	Efficiency
<b>Horizon:</b>	<i>LT</i>	<i>ST</i>	<i>MT</i>
<b>Focus:</b>	<i>Net effects Private costs</i>	<i>Net effects Private costs</i>	<i>Gross effects Social costs</i>
<b>Objective:</b>	<i>Offset</i>	<i>Offset/Facilitate</i>	<i>Facilitate</i>
<b>Example of Policy:</b>	<i>Pro-poor Tax cum subsidy</i>	<i>Safeguard protection Sector specific exemption Consensus building</i>	<i>Training Competition policy Subsidies (ST)</i>

Source: Author

Note: ST = Short-term; LT = Long-term; Offset indicates the need to offer compensation to certain sector of the economy; Facilitate refers to policies easing adjustment.

Finally, *Equity* motives complete the equation to be solved by policy makers. The objective in this case is to guarantee that appropriate transfers are in place to redistribute more equally the gains from trade liberalisation. This is another policy set that addresses private costs. As a matter of fact, the poverty impacts of trade liberalisation are increasingly integrated in the policy debate in developing countries. The horizon of such policy is different from the other two as it focuses on redistributing the

<sup>†</sup> We may want to bear in mind the long-term objective of coping with future (not necessarily trade-related) adjustment.

long-term gains from liberalisation. However, short-term considerations will apply with respect to the poor, vulnerable in the very short-term. Redistribution motives can too run counter the efficiency objectives of trade liberalisation, and can provide added reasons for opponents to liberalisation.<sup>‡</sup> This need not be so as neutral redistributive policies, and policies achieving both objectives of better redistribution and enabling efficiency gains can be designed. As for political economy costs, equity considerations may matter to reach the objective of efficiency gains as such objectives may be seen as a political necessity (Bown & MacCulloch, 2005).

A recent supplementary argument for adjustment policy is motivated by *global goods* considerations. Fung & Staiger (1996) suggest that domestic adjustment programmes may help enforce international cooperation into reciprocal tariff concessions at the multilateral level. Thus adjustment policies help attain welfare superior objectives. Domestic adjustment in this case addresses international externalities, as by failing to liberalise a country imposes costs on its partners<sup>§</sup> (Bown & MacCulloch, 2005). This argument is important in the aid for trade debate (Page & Kleen, 2004) and a motive for an international consideration of adjustment. We focus in this paper on the domestic policies and therefore any international political economy motive for adjustment is not covered here.<sup>\*\*</sup>

### *b) Adjustment costs and adjustment shocks*

Case studies of trade liberalisation abound, although most focus on high or middle-income countries, and less is known of the process of adjustment within less developed economies. Whether the policy recommendations arising from case studies are replicable to other countries is subject to considerable caution. Another major issue in case studies is disentangling the causes of adjustment. The sources of external shock are numerous – technology changes; evolving consumer preferences; exchange rate movements; macroeconomic cycles; and trade liberalisation for instance – their effects blend in by forcing adjustment of factor markets. Trade liberalisation has often occurred along other structural adjustment policies and determining when trade liberalisation has happened is difficult (Winters, 2002). As a matter of fact, changes, and therefore adjustment happen all the time. While globalisation is often designated as the culprit, technology changes are much more important in magnitude (Bachetta & Jensen, 2003). But we must note one important characteristic of trade policy induced adjustment: it is *predictable* and therefore can be anticipated with the right set of policies. Policies

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<sup>‡</sup> Equity driven policies have served as a rationale (which may have been misguided) for the maintenance of some form of protection. For instance Indonesia introduced duties on rice in 2000 and even an import ban in 2004 to fight poverty (Hertel & Reimer, 2004).

<sup>§</sup> This is the rationale for the optimal tariff argument. Note here that trade distortions may be imposed for other political economy reasons, such as the European Common Agricultural Policy.

<sup>\*\*</sup> Given that developing countries are expected to be recipients of such adjustment assistance, it is not foreseen that global public goods motives will alter the desirable policy prescription for these countries, but merely reinforce them and provide additional means to implement these. It may on the other hand change the policy prescription in developed countries, where policies that may be chosen for one of the three motives might be altered because of global public good motives.

designed to deal with trade adjustment may well help tackle other adjustment caused by less predictable shocks: trade policy reform should therefore be seen as an opportunity.

The general message from the empirical literature about the size of adjustment costs is mixed. Labour adjustment costs have been the most surveyed. Studies agree that estimates of these costs in the long term are low in relation to the gains from trade liberalisation. It is difficult to quote precise estimates, but higher cost estimates do not amount for more than 5% of the total benefits of liberalisation. There is, however, an important caveat to this conclusion: these figures apply to developed economies.<sup>††</sup> Surprisingly, given its relevance, the questions of adjustment costs for the other factor, capital, is less studied, certainly reflecting fewer concerns on that side. Studies indeed show quite consistently that compared to labour adjustment costs, capital adjustments costs are significantly lower. Baldwin *et al.* (1980) estimate for instance that they only amount to 10% of labour adjustment costs.<sup>‡‡</sup>

A further concern with developing countries lies in the existence of additional adjustment challenges. Because this problem is of a different nature than the costs discussed above, we will refer to it as adjustment shocks, following Charlton & Stiglitz (2006). This is not to say, however, that adjustment shocks do not raise similar issues in terms of their political economy, efficiency and equity dimensions.

Adjustment leaves countries in a very different economic environment, and one that may present new challenges: negative term of trade shocks, loss of tariff revenue or loss of preferential access rent. Two categories of adjustment shocks have caught attention in the context of the Doha round: revenue and preferences. Developing countries comparatively rely heavily on international trade taxes revenue. They account for 4% of GDP of low and middle income countries against less than 1% for high income countries (Keen & Baunsgaard, 2005). Some African countries rely on trade taxes for over 50% of their revenue. The switch from international sources of financing to a more domestic tax base is also not evenly spread in time, and the adjustment must take into account this gap, and the ensuing risks on macroeconomic stability, developing countries being already more volatile to start with. Indirect evidence, such as whether government have been able to recover the lost revenue, suggests that the trade tax loss is not without significant costs. Keen & Baunsgaard's (2005) work on 125 countries concludes that low income countries have not been able to recover the lost revenue, while middle income countries have not fared much better, managing to recover about 35% to 55% of the foregone trade tax revenues on average. This relatively stark assessment is however mitigated by success stories (OECD, 2004), but the conclusion for developing countries is that one should look at the government sector with care (see section 4 below).

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<sup>††</sup> Recent estimates by Hall (2004) even find near zero adjustment costs in the USA.

<sup>‡‡</sup> Hall (2004) finds that capital costs are consistently smaller than labour adjustment costs.

The loss of market access preferences although a concern for only a handful of mostly small countries (Hoekman & Prowse, 2005) has caught widespread attention, probably for two reasons. One is the political economy of preferences, a situation for which developed countries are accountable. It is difficult then to negotiate a development round without addressing this question. Besides, countries facing the loss of preferences have to face the challenge of loss of rents in addition to classic adjustment costs.

*c) Perception issues*

Krueger (1990) notes that private losses from the liberalisation process are much more visible than gains. They typically arise over a longer period and are diffused to the entire economy. In studies of labour adjustment private costs to persons or firms are generally found to be of big magnitude. This is likely to trigger some government response in form of equity or political economy policies. There is also evidence of long unemployment transitions period in reforming countries (Rama, 2003). Although not all this unemployment may be caused by globalisation, this may add to the perception that trade liberalisation is negative. Bown & McCulloch (2005a) recall that the *gross* losses and gains accruing to specific interest in the economy far exceed the *net* social welfare gain, and thus generate powerful political forces that affect the country's ability to achieve the potential benefits of adjustment. In other words, if trade liberalisation generates -9.5 welfare losses for the import competing industry and +10 welfare gains for the rest of the economy, policy makers will tend to look more at the first of these two numbers than the +0.5 net welfare gain and the +10 gross gain accruing to the remainder of the economy. Adding to the imbalance in perception is probably the fact that, as noted by Bown & McCulloch, the costs of adjustment will have to be borne upfront when benefits are discounted over the future. The policymaking process, which may be biased in favour of the short term,<sup>88</sup> is therefore faced first with the certainty of adjustment, such as job losses before witnessing future benefits from liberalisation, for instance job creation in a new exporting competing sector. Another perception deficit among policy makers is indeed that adjustment is about adjusting to negative outcomes, when adjustment to positive ones matters as well (Hoekman & Smarzynska-Javorcik, 2004). The significant capacity constraints faced by developing countries may help explain the over emphasis on negative outcomes. All this comes in support of the classic proposition of Olson (1965), that if benefits from liberalisation are diffused among many, while the losses affect a small number, these are more likely to organise themselves against the policy change.

Other factors are probably not well taken into account in studies of adjustment. People may not look forward to the prospect of finding themselves in an economic environment that is more volatile - or

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<sup>88</sup> A factor to take into account is for instance the potential constitutional bias against liberalisation in the country: when the executive term is short this may induce a focus on shorter-term issues arising during its tenure, and not after. Thank you to Patrick Messerlin for making this point.

dynamic to use Rodrik's (2000) term -, going through phases of adjustment, with loss of jobs and re-employment, even when the net outcome is positive. The timing of liberalisation also plays on perception: Gaston & Trefler (1997) found that if restrictive macroeconomic policy is pursued at the time of trade liberalisation, the false impression can be conveyed that the culprit is trade liberalisation. Krueger (1990) also notes that losers are personified. This is something that NGOs have been particularly efficient at exploiting for advocacy. Winters (2002) quotes surveys in Zambia that have shown that individual perception of liberalisation remained overall negative. At the same time improvements in poverty levels were reported in household data and individual interviews suggested that even in the winning sectors people remained dissatisfied of their working conditions even though it is likely that they had improved. Winters concludes that better collection of data and better public information can help overcoming these discrepancies. The attitude of policy makers can therefore be explained also by the representation of the relatively hostile perception of liberalisation by populations, despite evidence pointing to positive outcomes.

### **3) *Specific dimensions of adjustment in developing countries***

The question of adjustment matters particularly for developing countries for three main reasons. First, the size of adjustment is bigger as developing countries start from more protected situations (nominal tariff levels in LDCs are 15% on average). Second, the specific situation of poor countries leaves them more exposed and vulnerable to liberalisation, because of their patterns of production and trade. Developing countries' exports tend to be concentrated in the most distorted sectors, agriculture and textile, clothing and leather. Their economies are less diversified, and specialised in low-value added sectors, leaving less scope for absorbing the adjustment shocks through other sectors of the economy.\*\*\* Firms may for instance have less opportunity for diversification in new or neighbouring markets and may thus be forced to exit (Greenaway, Gullstrand & Kneller, 2005). Some small economies are also very trade dependent. Developing countries are vulnerable to shocks due to preference dependence, high revenue dependence or other reasons, and therefore need aid-for-trade to create effective markets (Charlton & Stiglitz, 2006). Third, developing countries are from an institutional point of view ill equipped to manage the adjustment path. Factor markets are less deep and efficient, coping uneasily with adjustment. Administration lacks adequate capacity to put the necessary policies in place.

Developing countries face important obstacles to realise the *efficiency* gains arising from trade liberalisation. Failing markets and regulatory constraints may, for instance, result in specialisation in the wrong sectors and trade liberalisation having immiserising effects (Bolaky & Freund, 2006).†††

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\*\*\* A related point is that intra-industry trade in developing countries is low, thus offering no prospect of moving to a neighbouring sector of trade when facing adjustment.

††† Tchenoskova (2005) offers a model where credit constraints can drive such effects.

Close attention needs to be paid in this respect to channels of transmission of trade liberalisation shocks. Winters (2002) recalls how the Maize sector collapsed in Zimbabwe, where trade liberalisation and the withdrawal of the government from the sector led to the disappearance of markets such as supply of inputs for crops. Bachetta & Jensen (2003) recall the experience of Mozambique and the liberalisation of the cashew nut sector.<sup>+++</sup> Political intervention - de-regulation but also re-regulation - is necessary.

Firms play an important role in facilitating adjustment, not only as the consumers of factors of production, including labour, but also in developing countries as providers of basic and unique services to the local economy: services such as credit, or supply of inputs, but also housing, or education (the sugar industry in Jamaica for instance). When these services disappear because of liberalisation, this is not compensated by the price rise of the output (Winters, 2002). Similarly Rama (1999) warns of the risk of “one-company-town” externalities, when liberalisation affects sectors which are large source of employment.

Firm shakedown resulting from liberalisation thus raises serious *equity* dimensions. These can also be viewed from an efficiency perspective: when large parts of the poor population depend on a sector that will not manage to compete internationally, it is conceivable that liberalisation can have an immiserising impact through deepening poverty trap effects. More likely, liberalisation may fail to have the efficiency effects foreseen because the causes of poverty have not been properly addressed beforehand. In particular, where market failures affect the poorest in developing countries, efficiency gains will not transfer into equity as poverty traps persist (Dercon, 2004).

Even small shocks can have disproportionate effects on the poor. Although unskilled people are not hindered by skill specificity, they find it harder to find jobs outside their sector of origin, as labour markets in developing countries are segmented (Winters, 2002). Limited access to information is an issue, as is lack of access to means of smoothing out consumption: ownership of assets, access to credit and future markets, or insurance policies means that they are not able to cope with downturns. This explains why farmers are often particularly vulnerable, because of a very limited ability to stock their production. Specific transmission effects also happen through consumption channels: because their share of consumption on import goods being lower, poor are also less likely to benefit from the positive effect on consumption of lower prices (Ravaillon & Loskin, 2004). It should be noted, in particular, that the effects on the poor will be essentially felt in the short-term therefore perhaps calling for specific policies of redistribution targeted at them.

Lastly, the *political economy* of trade liberalisation in developing countries may too present specific difficulties. Beyond the specific risks for poverty outlined earlier, the poverty dimension will increase

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<sup>+++</sup> See MacMillan, Rodrik and Horn Welsh (2002).

the perception that trade liberalisation is negative. Industrial concentration is higher in developing countries than developed ones (Tybout, 2000), and may favour coalitions opposing reform: “[o]n average, large firms in Africa have twice the market share of those in China, India and Morocco”.<sup>888</sup> It could also be expected that large firms’ place in the economy of developing countries is more important (this can be related to the “one-company town” phenomenon described earlier) and thus access to government (in some occasion very direct when large companies are owned by cronies) might be easier.

Trade policy is often used to achieve non-trade objectives and alternative policy tools may not be readily available in developing countries. A well-known example is that of taxation, when government revenues relying heavily on foreign taxes. Reform is confronted with the dual problem of implementing administratively more complex systems such as VAT, and also the politically unpalatable prospect of enlarging the tax base to domestic agents (foreigners do not vote). Likewise subsidies are not an option for cash-strapped governments and protection might be preferred.

Developing countries now benefit from numerous and varied preferential regimes, through unilateral or regional schemes. These may act as stumbling blocks to further liberalisation (Bhagwati, 1991; Limao & Olarreaga, 2006), because such preferences are received in exchange of concessions in non-trade areas, meaning that both the recipient and provider of preferences are likely to oppose their elimination in the future. Preferential regimes may also affect the nature of adjustment if they are source of large trade diversion and thus increased pressure for sector relocation.

#### **4) Policy lessons for measures to accompany adjustment**

##### *a) Gradualism and sequencing*

Arguments against rapid opening essentially pertain to the risk of impact, and potential disorganisation effect (Blanchard & Kremer, 1997) on the overall economic environment and the macroeconomic imbalances that such a process would involve. It is also widely accepted that introducing trade reforms in times of economic downturns is not desirable. This is why the WTO offers safeguard mechanisms.

On the other hand, opting for a gradual process means bearing the cost of protectionism for longer, and might create wrong incentives to invest in the non competing sector during the transition period (when, for instance, staggered liberalisation increases temporarily rates of effective protection).

Winters (2002) also notes that once introduced, trade policy reforms have often been implemented

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<sup>888</sup> Gobind Nankani, *Enhancing Africa’s Development Through an ‘Export Push’: Prospects and Challenges*, speech delivered at Woodrow Wilson International Center for Scholars, 14 September 2005.  
<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/0,,contentMDK:20654339~menuPK:258660~pagePK:146736~piPK:146830~theSitePK:258644.00.html> (accessed 10/05/06).

ahead of schedule, such as in the Philippines (Clarete, 2006), reflecting perhaps the desire of the private sector to shorten the adjustment phase. This suggests in turn that transition periods, during which trade barriers removal is deferred, should be accompanied by other measures. The lessons of the missed opportunities during the ATC phase out (both from the perspective of developed and developing countries) should therefore be learned since gradual implementation resulted in politicians back-loading adjustment policies (Francois & Woerz, 2005).

Beyond the need for public commitment to reform, private agents need also to perceive the right incentives. If economic agents do not believe in the policy change they are witnessing they will not start to adjust. One way to reinforce the credibility of trade induced reform is signing up to international agreement and committing to liberalisation. It is also, we believe, having governments undertake complementary reforms (such as assistance programmes), which can signal strong commitment to reform in the eyes of the private sector.

Sequencing of different reforms is the other aspect of the dynamic dimension of policy making. It is difficult to assess whether trade liberalisation should precede, be concomitant with, or follow complementary policies such as provision of adequate infrastructure, education, and institutional support. Sequencing issues are perhaps clearer in the context of budgetary issues when loss of trade taxes is foreseen: prior implementation of reduction of expenditure or switch to alternative sources of revenue is warranted.

### Offsetting trade policies

The first answer to adjustment spurred by trade liberalisation might be the temptation not to engage in the full liberalisation process, and instead opt for partial implementation of trade reform, or rely on contingent protection *post* liberalisation. This is often what is observed. While very few countries have not subscribed to the idea that trade liberalisation brings benefits, partial implementation remain the norm. Schematically this can either be achieved by exempting specific sectors from the liberalisation process, taking a gradual approach on the pace of implementation, or resorting to safeguard mechanisms such as high levels of tariff bindings and contingent protection.

Sectoral exemptions seem generally motivated by political economy motives, so as to preserve the *status quo* in favour of liberalisation in other sectors. Such policies are very appealing, because the cost for governments of implementing them is almost zero, though this does not mean that these policies are cost-free for the economy.

The case for such exemptions to generate efficiencies (such as in the infant industry argument) is weak. Governments are not very good at picking winners and often end up by protecting inefficient producers. By definition, the infant industry nature of an industry is temporary, while exemptions and

exceptions to liberalisation are unlikely to be time-bound. Irwin (1998) estimates that infant industry protection actually slowed down adjustment, retarding the emergence of the US tinplate industry by a decade in the late nineteenth century. In addition these policies do not seem to be well suited to poverty reduction, as trade protection generates rents paid by the consumers and captured by narrow interests group without being redistributed. An example of such rent is the European Common Agricultural Policy, which benefits primarily big farmers (Messerlin, 2003).

Subsequent to liberalisation contingent protection tools, such as anti-dumping and safeguard mechanisms may be used to provide temporary (or not so temporary) relief. There is relatively persuasive theoretical and empirical evidence that such tools do not achieve the expected outcomes of shielding the industry from decline, and often end-up filling the pockets of vested interests (Bown & McCulloch, 2005a). Limited examples of successful safeguard of an industry exist (OECD, 2004) reports the story of Harley Davidson in the US) but the cost of success is often not known.

Pure gradual, across-the-board, liberalisation by not being sector specific suffers less the risk of rent capture by specific interests. Bachetta & Jensen (2003) believe that gradual approaches can help developing countries to build a capital base to compensate for lack of access to credit; achieve credibility of the reform process; mitigate the size of the shock which is likely to be important when trade liberalisation affects strategic industries.

Gradual liberalisation creates the opportunity cost of foregone gains from trade liberalisation and does not tackle the source of the problem. It is also important that gradual implementation does not send the wrong signals to economic agents and generate incentives to lobby for more protection. Therefore a credible commitment towards full and timely liberalisation is essential. International commitments in the WTO or in regional trade agreements are commonly thought to provide such a credibility anchor. It should also be noted that trade protection is relatively inefficient on the longer term, as it tends not to reduce imports as much as hoped, therefore not generating as much gain as expected for the protected sector. Protection policies will induce switching to substitute products (e.g. sweeteners for sugar): the sector that benefits from monopoly rents nevertheless shrinks.

These arguments suggest strongly that gradual implementation should be over a limited period of time, and that it is evenly spread across time and goods, so as to avoid back-loading of reform and raising effective rates of protection (Matusz & Tarr, 1999). Also, since the objective of the gradual process in this case will either be to ensure that efficiency gains are maximised, or that the adverse effects on poverty of the liberalisation shock are diminished, it is necessary to ensure that complementary policies aiming at achieving these objectives are in place.

*b) Complementary domestic measures*

The second important dimension of adjustment policy is to promote an environment in which economic agents will adopt optimal behaviour. The economic environment matters. Macroeconomic stability, good quality of institutions (Rodrik, Subramanian and Trebbi, 2004)<sup>\*\*\*\*</sup> and good governance will provide an enabling environment for agents to go through the adjustment process. Research also suggests that trade liberalization can reduce growth rates in the presence of over-regulation, in part because policy-induced distortions create incentives for the wrong kind of adjustment, away from exporting what is in a country's comparative advantage (Bolaky & Freund, 2004). We focus in the remainder of this paper on policies that directly affect agents' incentives to adjust. From the literature, two sectors seem to warrant the most attention: firms and labour.

Policies directed at firms

For firms, Hoekman & Smarzynska-Javorcik (2004) advocate for policies supporting competitive firm conduct. This involves for instance policies removing barriers to entry *and* exit from markets. The necessity to provide contestability to markets is well accepted, with competition policies, import competition, and the facilitation of the starting-up of new businesses. On the other hand the significance of policies permitting exit of inefficient firms, and transfer of the assets of failing ventures, such as bankruptcy laws remains neglected. The importance of exit is underlined by recent findings that in the UK it contributed to 50% of overall productivity growth (Criscuolo, Haskel & Martin, 2004). However, Tybout's (2000) conclusion that in many cases the manufacturing sector problems are not because of lack of competition and inhibited entry and exist questions the need to prioritise such policies. Tybout suggests instead that the uncertainty created by the economic environment such as poor rule of law and corruption are the source of the problem.<sup>††††</sup>

Secondly access to technology and know-how is crucial, since technical change is largely recognised as the main driver of growth. Government intervention is necessary in knowledge market, due to the abundance of market failure. Government actions can be numerous: this ranges from active subsidisation of R&D to policies inciting FDI and the transfer of knowledge to the economy, and regulatory institutions guaranteeing the appropriability of knowledge such as intellectual property rights or government sponsored research. This point is also emphasized in the findings of the case studies conducted by OECD (2004b), in which successful adjustment is associated to smart policies of technology transfer.

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\*\*\*\* Actually Rodrik et al. find that good institutions trump trade openness as a positive factor for growth. They find that trade has a negligible direct influence on growth levels, although it is a positive factor in good quality institutions.

†††† He also says that barriers to trade should be removed if still existing.

Third, Hoekman & Smarzynska-Javorcik (2004) suggest enabling foreign market access in order to foster spillovers from trade. This is a difficult challenge for firms, especially small ones, in particular as informational barriers in developed markets are high. Firms must also compete with well-established and entrenched competitors and overcome uncertainty. Government intervention can help mitigate many of these barriers to entry with export promotion strategies (tax exemption, provision of market information, etc.), although the track record of similar policies is not all positive.

Government intervention in this sector should, however, beware of not subsidising inefficient producers or giving the wrong incentives to become inefficient. Policies of direct assistance to industry or firms do not have a good track record (Hoekman & Smarzynska-Javorcik, 2004). Therefore horizontal-type policies that aim primarily at addressing market failure instead of industry or firm failure and not coupled to specific sector performance are preferable.

The case for economy-wide, industry-wide or firm-specific protection will depend on the type of market failure that is addressed. Given the laws of comparative advantage, there may be a case for helping declining industries for which there is no comparative advantage, and growing industries where there is, to adjust faster with targeted help. An example of industry-targeted adjustment policy is the United States Trade Adjustment Assistance programme (albeit motivated by political economy reasons). Such programmes are difficult to implement and it is possible that general-purpose policies may address the market failures that prevent desirable adjustment. Rodrik (2004) also argues for policies ensuring the provision of public goods to the private sector, such as information, sanitary and phytosanitary standards, and sound institutions<sup>\*\*\*\*</sup>, and also for policies whose focus is not on outcome, but on making policy processes work, thus suggesting a large degree of broad-based intervention.

For policies providing direct support, the more targeted the intervention, the more likely are the risks of private capture. Another consideration is that what is effective at one level may not be at another: for instance industry protection may keep an industry size constant, but not diminish the rate of firm turnover in the industry (Bown & McCulloch, 2005).

### Credit markets and services

Credit markets help to cope with inter-temporal adjustment. Addressing the reasons for lack of depth of credit market and credit availability should therefore help the adjustment process. Policies impeding the development of efficient credit markets are common in developing countries, ranging from restrictions over entry, over-regulation of interest rates, and inadequate regulations of the financial

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\*\*\*\* Rodrik's argument is about industrial policies and therefore the scope of some interventions goes beyond the sole question of adjustment, such as the need for R&D policies.

sector in general, to crowding out of the private sector by (inefficient) public sector borrowing. Unavailability of information in the form of standardised accounting systems and credit record is also a factor hampering credit lending. Evidence shows quite clearly that small operators are the most vulnerable to this lack of access to credit (Bachetta & Jensen, 2003) and therefore suggests that policies should be directed at them in particular. Subvention of credit schemes has been tried out, but confronted to the difficulty of access to information and selection of valid investment plans. An element of training of private sector agents is therefore part of the policy (as for instance in micro-credit schemes).

Horizontal infrastructure services providers play a central role in the economy and to the process of adjustment (OECD, 2001). The spillovers of efficiency gains in these sectors accrue to the economy as a whole. Collier & Dollar (1999) demonstrate how the lack of transport, communication, or electricity impacts on the manufacturing sector. Also, policies aimed at developing trade-related services such as access to communication matter a great deal. Fink, Mattoo, & Neagu (2002) for instance demonstrated that access to good telecommunication services has a significant impact on trade.

### Labour and welfare policies

Partly because changes in the labour market are among the most important channel of transmission of trade liberalisation shock, but certainly too because they have disproportionate political relevance, policies directed at the labour market have been the subject of numerous designs.

Discussion about so-called adjustment policies directed at labour markets often does not distinguish between efficiency, equity and political economy objectives. <sup>\$\$\$\$</sup> For instance, concerns about employment levels pertain to the equity and political economy debate. We do not review here in detail the voluminous literature on labour adjustment. It is useful to distinguish between policies aiming at favouring labour mobility and compensation policies, noting that most policies are generally designed with compensation in mind. This is probably because policies trying to achieve efficiency and favour mobility are more difficult to design. In this respect, as pointed out by Rama (2003) the most important policies are probably *out of the labour market*, focused on enabling economic agents to adopt optimal behaviour. This does not mean, however, that labour policies are not needed to mitigate the impact of job losses.

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<sup>\$\$\$\$</sup> It is worth recalling here Krugman (1993): "The level of employment is a macroeconomic issue, depending in the short run on aggregate demand and depending in the long run on the natural rate of unemployment, with microeconomic policies like tariffs having little net effect. Trade policy should be debated in terms of its impact on efficiency, not in terms of phoney numbers about jobs created or lost" (quoted by Oslington, 2005). Krugman is merely trying to point to where policy should focus its attention: costs arise from market imperfections, not from trade liberalization.

Training schemes have proven to be of limited utility, notably because overestimation of the effectiveness of classroom training as compared to on-the-job learning. There are also incentive-compatibility issues. Finally such schemes rely on the assumption that skill upgrading is a condition of re-employment, which is not necessarily the case, as other sectors may need to employ low skill labour, or already highly skilled people may not need such training. Other job-search support programmes include employment services, offering placement information, and counselling. Such programmes can be very efficient in developing countries where markets are segmented and information about other geographical or sectoral markets may not be available to the poorest. In particular, participatory approaches should be advised as a means to improve information sharing (OECD, 2004b).

Unemployment insurance, income support programmes (Argentina), mandatory saving schemes, minimum wage, and compulsory severance payments (Peru) could possibly generate efficiencies, enabling individuals to maintain their wages and letting them afford to look for new jobs in a more secure environment. A common criticism of unemployment insurance is, however, that when too generous, it generates perverse incentives to stay out of job longer; compulsory severance payments give firm an incentive to hire less. Minimum wages combine both drawbacks. \*\*\*\* Finally the efficacy of income support programmes is not proven (Rama, 2003), while compulsory saving does not address the problem of the poorest. Overall, the efficiency effects of these policies to help re-employment are not entirely clear, and it seems rather that compensation motives drive them.

Subsidies to mobility have been suggested, along with tax on commodities, before being adopted in some countries, notably in the shape of wage-insurance schemes (Kletzer, 2004). This works on the premise that when displaced workers find a new job, part of the wage gap with their previous job is subsidised for some time after. The mechanism is also compensatory, but with a built-in incentive to adjust rapidly by finding a new job. Mobility can also be impaired by the cost of exiting a job. Bachetta & Jensen (2003) draw the attention on the portability of fringe benefits, for instance nonexistent in Mexico.

Although the scheme is rare, specific trade-related compensation is another possibility, as in the US Trade Adjustment Assistance programme. Bhagwati (2003) argues against adjustment specific assistance policy, because of the wrong incentives they generate, noting also that the causes of adjustment are besides numerous. There is no rationale for singling out a specific policy for adjustment assistance: why provide assistance when an industry faces import competition but not when it faces domestic competition? This approach also leaves each policy change captive to compensation claims. Finally, identifying who is affected is fraught with difficulties and scope for

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\*\*\*\* This of course depends on the level of the minimum wage, which are fairly widespread in developing countries (see Bachetta and Jensen, 2003).

discretionary application. The TAA is widely viewed as motivated by political economy consideration, compensating losers from liberalisation (Bown & MacCulloch, 2005a).

### Policies directed at the poor

Should trade adjustment labour policies focus specifically on poverty? For poverty reduction, labour issues matter, in particular in relation to employment of unskilled workers (Winters, 2002). Harrison & Revenga (1998) find that employment in the manufacturing sector rises again in half of episodes of liberalisation they study. In other cases where employment did not recover as well, stark conditions prevailed beyond mere trade liberalisation. They conclude that trade shocks should not pose a problem in most case as workers were already very poorly paid before liberalisation. There are however three situations where poor workers might be significantly at risk: huge shocks (“one company town”); high prior protection; specificity of factors. These conditions are unfortunately not uncommon and policy intervention should be devised in such cases.

We actually many not need to answer the above question. There are several ways in which redistribution policies can be integrated into an adjustment strategy. Equity objectives can involve adding a non distorting mechanism of welfare compensation. <sup>†††††</sup> Efficiency *cum* equity is a superior policy objective. Secondly, some policies favouring efficiency gains are also promoting more equitable distribution of gains. Supporting factor mobility helps the diffusion of the gains and losses from trade liberalisation throughout the economy. <sup>†††††</sup> Thirdly, some argue that redistribution policies generate political economy benefits, by insuring against economic insecurity and creating long-term support for reforms (Rodrik, 2000, quotes Argentina reforms in the 1980s as an example of failure in this domain).

Sectors which provide universal services (telecoms, water, electricity, mail, banking) should play a central role in the provision of efficiency *cum* equity. The practice in developing countries indicates that such services do not always play their redistributive function, and that liberalisation, though it generates efficiency, has often had a negative impact on the poor, with more benefits going to urban affluent parts of the population. Sometimes, as we mentioned earlier, the provision of “public” services is assured by non-traditional services providers (such as large farm estates in rural areas). Government intervention in the context of adjustment policy should therefore protect the provision of these services to the poor.

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<sup>†††††</sup> A review of the arguments is provided by Facchini and Willmann (2001).

<sup>†††††</sup> Winters (2002) finds in the surveys of trade liberalisation he reviews that the impact of it is unequally shared. This is probably explained by the segmentation of labour markets in these countries: displaced workers find it difficult to find jobs in other sectors other than those closely related to their original one. A generalisation from this argument is that poverty arises essentially from failing to access markets, and therefore from inefficiencies.

## Government revenue

Policies to manage government revenue along with trade liberalisation require two main components: revenue-efficient tariff reduction and domestic tax reform. OECD (2004) offers a review of these policies in the context of the NAMA negotiations. Switching from trade taxes to domestic ones is generally viewed as efficient, as the former apply to a narrow tax base and distort consumption *and* production decisions. Many developing countries have already started applying this prescription and moving away from trade taxes. Indirect taxes on consumption are viewed as superior to direct taxes on factors of production (capital and labour): less costly to maintain (than direct taxes, but more expensive than international trade taxes) and incentive-compatible. However, they also present specific difficulties for developing countries. First, there is debate on the capacity of low-income country to implement some of the reforms that developed countries have made, such as VAT taxation. This could mean that when confronted to potentially large adjustment efforts, as discussed above, developing countries may also have less policy options at hand when switching from trade taxes to domestic ones. Secondly, indirect taxation tends to be biased against lower incomes, which tend to consume a higher share of their disposable income, which would go against poverty reduction objectives.

The preference for uniform and non-discriminatory tariff reduction seems well established (Matusz & Tarr, 1999). This includes neutrality between taxes on imported and domestically produced goods (OECD, 2004).

## **5) Conclusions**

This review of adjustment challenges has put in evidence three drivers – efficiency, equity, and political economy – behind adjustment policies. There is a clear risk that under the guise of adjustment policy different objectives are sought, including some that would not necessarily benefit the economy as a whole. There is also a risk that legitimate policy objectives motivated by different factors end up undoing one another.

This, however, need not be so as there are complementarities among these objectives: what is required is careful design. First, policy objectives have to be clearly stated, with a focus on efficiency first. Second, implementation requires coherence, and the inclusion of adjustment policies in a comprehensive development strategy, as much as trade liberalisation and integration into world markets should be.

Many of the policies enumerated above are not specific to trade-adjustment, and trade liberalisation is only one cause of adjustment among others. However, trade liberalisation is predictable, and therefore can act as a catalyst for other reforms, which will facilitate adjustment beyond mere response to tariff and quota reductions. This is basically the rationale behind recent calls for Aid for Trade.

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