Dani Rodrik. 1992. *The limits of trade policy reform in developing countries.* Journal of Economic Perspectives 6(1) (winter), pp. 87-105.

Why has trade liberalisation become so important in the period of macroeconomic crisis? Does crisis force radical change? Does creditors' leverage determined the direction of reform? Is the direction of reform influenced by the belief that past policies are to blame for the crisis? (pp. 87-9).

Problems with trade policy reform: can it be sustained? How does it play with macroeconomic stabilisation? How does it work under imperfect competition?

Sustainability of trade liberalisation depends on *credibility* of the policy (economic agents believe that trade liberalisation is not going to be reversed):

(i) sustainability depends on the relative bargaining and action power of forces that support and oppose reform, and in the ability of the alliance for reform to reduce opposition – the change from opposing to supporting reforms depends on credibility as well as on reducing costs of reform to losers;

(ii) credibility can be undermined if:
   a. economic agents believe that reform simple reflects creditors' leverage, not government will, and hence face asymmetric information with respect to the government's real long term commitment to reform;
   b. the government is sensitive to interest groups pressure and pragmatism;

(iii) lack of credibility (uncertainty) may induce:
   a. enlargement of current account deficit (if borrowing is available) due to inter-temporal substitution of consumption (consumption may escalate in the short term to prevent against reversal of trade liberalisation);
   b. fall in investment (if borrowing is restricted) because of re-allocation of forex to consumption, or because of a wait-and-see policy that uncertain investors may decide to pursue;
   c. resource rigidity (no reallocation) due to risk aversion and irreversible costs of investment, unless the premium of reallocation is high enough to compensate for irreversible cost if the reform is reversed.

(iv) in the presence of excess capacity – more general case in the midst of macroeconomic crisis – export boom can be engineered without reallocation and more investment, but such boom is obviously not sustainable;

(v) trade reform that lacks credibility is not sustainable because it brings macroeconomic balances under further stress and blocks the formation of new alliances in favour of reform. (pp. 90-94).

Macroeconomic (in)stability and *trade policy* are not clearly and directly linked in any way:

(i) macroeconomic stability is more often associated with the relative size and dynamics of the fiscal deficit, as well as the value of the exchange rate;

(ii) trade liberalisation may affect the degree of openness but it is unlikely to affect, on its own, the ratio of exports to imports, provided that the exchange rate is allowed to balance demand and supply in the exchange market;

(iii) because of inflation targets, the real exchange rate cannot be allowed to depreciate enough to support aggressive trade reform. Hence, trade liberalisation may well worsen the current account and the level of foreign reserves;

(iv) but trade reform is important for two reasons:
   a. it may help to break established modes of operation and vested interests;
   b. it may help fiscal balance if quotas and other quantitative restrictions are replaced by tariffs. (pp. 94-98).

Imperfect competition rules out any guarantee that *trade liberalisation* will bring domestic prices in line with world prices, even if domestic marginal costs are lower than international prices:

(i) protection allows Pd > Pw, but does not cause it. If liberalisation squeezes import-competing production, net gains are ambiguous;

(ii) liberalisation may yet increase the output of import-competing firms, since:
   a. firms may react to expected increase in the elasticity of demand due to erosion of market power;
   b. industry rationalisation may reduce the number of firms and even the aggregate output, whereas remaining firms are allowed to expand production;

(iii) trade liberalisation/protection can delay or accelerate innovation, and in so doing hinder/help productivity, investment and asset and product differentiation and quality to increase and costs to fall. Given that gains from innovation are proportional to the level of output, output squeezing trade reforms may harm innovation. (pp. 98-102)