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Adjustment Issues and Transitional Arrangements

Improvements in market access generally lead to potential for trade expansion. In turn, trade expansion results in changes in the allocation and utilisation of society's factors of production and results in trade expansion. In a smoothly functioning economic system, with markets which clear quickly, resource reallocation occurs smoothly and with little by way of transitional adjustment costs. In practice, however, rigidities and distortions may frustrate the process of adjustment, with consequential losses in real output. In such circumstances adjustment policies may be called for.

5.1 Trade Expansion and Adjustment Pressures

Trade liberalisation works by changing relative prices. Specifically the price of importables is lowered relative to exportables. This directs resources from areas in which an economy experiences a comparative disadvantage, to areas in which it enjoys a comparative advantage. In a smoothly functioning system, these resource transfers occur relatively smoothly and at minimal cost.

Typically, in the real world the transition from a protection-distorted equilibrium to a freer trade equilibrium involves the loss of some real output. Often this takes the form of some factors of production being unemployed, or underemployed for some period of time. Why might this occur? The most obvious reason is the presence of some barrier or barriers to factor mobility which prevents factors from transferring smoothly from one sector to another. One common problem is a mis-match in the factor requirements between expanding and contracting sectors. Industries may use capital and labour in different combinations, so that the import substitute sector releases labour and capital in the 'wrong' proportions. This would require some change in capital:labour ratios to accommodate the factors released. This in turn may take some time. Even if, in aggregate terms, the capital:labour ratios across sectors appear to be similar, the mix of labour skills across activities may be different. In this case, one could only sustain full employment with appropriate retraining. This of course takes time and real resources.

Another common source of adjustment frictions is geographical mis-matches in terms of labour requirements. The expanding sector(s) may be concentrated in one region, the contracting sector in another. Relocation may not be straightforward, again requiring time and resources.

5.2 The Case for Adjustment Policy

It must be said that non-intervention is a policy option, though it is rarely characterised as such. The case for non-intervention runs as follows: markets deliver the appropriate relative price signals to direct resource reallocations. Agents, left to their own devices, will react to those price signals. Where factor mis-matches occur, agents will take the appropriate action, either voluntarily leaving the labour market, or withdrawing physical capital from production, or investing as appropriate in retraining/retooling. This may result in some temporary loss of output. However, this should not be viewed as a cost in itself but, rather, it should be seen as investment and offset against the long-run benefits associated with the higher output which the retrained labour/re-equipped capital will produce. Thought of in this way, adjustment costs are simply the price which society pays for change.

This is a cogent argument. There are, however, economic, political economy and socio-political arguments which can be used to counter it. The first point to raise is one of time: how long does it actually take for factors to relocate from one sector to another? This is partly driven by socio-political factors: the US is a much more mobile society than the EU, or even the UK, despite the enormous differences in size. There is a large body of evidence to support the view that hysteresis can take hold in labour markets: in other words the skills of unemployed labour depreciate through time; this reduces the probability of re-employment, which results in further depreciation and so on. As a consequence the economy can get stuck in an under-employment 'equilibrium' for quite a long period of time. The transitional loss of output could therefore be very high.

This leads to the political economy point. In general, agents resist change. There are important asymmetries in the political market for trade policy formulation. Typically, those who benefit from tariff liberalisation (primarily consumers) are not well organised and cannot articulate their case effectively. Those who perceive themselves as bearing costs (producers) are typically well organised and politically effective. The longer it takes to transfer resources from one sector to another, the more persuasive the case that can be made to the effect that trade liberalisation 'causes' unemployment and therefore the stronger the pressures against trade reforms. Since the evidence strongly suggests that liberal trade reforms confer net benefits on society, it is unfortunate if transitional costs frustrate the reform process.

Finally, although it is a non-economic issue, it must be noted that there are social costs associated with factors of production, especially labour, being tied up in unemployment/under-employment for long periods (especially in the absence of safety nets in low per capita income countries).

5.3 Adjustment Policy

Broadly speaking, interventionist adjustment policy can be defensive or positive. The former tends to be responsive, ad hoc. From society's standpoint it is also sub-optimal since its function is generally to resist adjustment pressures. By contrast, positive adjustment policies tend to be aimed at promoting change by addressing the rigidities which are slowing the adjustment process.

Defensive adjustment measures have been extensively deployed by DMEs in the face of competitive pressures from NICs and other LDCs. GATT sanctions defensive adjustment under Article XIX: the safeguards clause. When faced with a sudden upsurge in imports and where this upsurge can be linked to 'serious injury', a Contracting Party can introduce temporary protective measures. However, one of the problems with Article XIX is that it has not been widely used. If CPs have recourse to this device it should be non-discriminatory and the parties affected have a right to negotiate compensation. As an alternative, many CPs have relied on unilateral measures like VERs or anti-dumping action. Not only are these discriminatory, they are very difficult to remove once they are introduced. The panoply of restraints which have regulated North-South trade in textiles and clothing for over thirty years is testimony to this. Through time these restraints have become more extensive in both their product and country coverage. There is little by way of evidence to indicate that they have promoted adjustment in textile and garment sectors in DMEs; quite a lot of evidence to suggest that they have frustrated to a degree the process of specialisation in LDCs.

By contrast, positive adjustment policies are market-augmenting: they are intended to smooth the process of resource transfers. Such policies can take the form of labour retraining schemes directed at changing the skill mix of labour displaced from the import substitute sector. It can also take the form of mobility grants aimed at encouraging labour to move from one part of the country to another. The actual form of the intervention depends upon the perceived nature of the rigidities frustrating adjustment. Likewise the institutional arrangements for managing the policy will vary from one economy to another. We will return to the implications of this for adjustment policy in CDCs in the section below.

5.4 Transitional Arrangements in the Uruguay Round and Post-Uruguay Adjustment Policy

There are a number of aspects of the Round which have a bearing on these matters. Table 10 sets out those components which explicitly allow for a transitional implementation. These are of two forms: those which aim to slow adjustment in DMEs; and those which aim to slow adjustment in LDCs. Good examples of the former are the ten-year phase-out period for the MFA and the six-year phase-in period for reductions in agricultural support. These are essential provisions in that an agreement would never have been reached in their absence. However, they are also defensive. Not only will they slow up the process of adjustment in DMEs, they will also slow the pace at which LDCs can benefit from the arrangements. The key issue here for CDCs is to keep a watchful eye on implementation to ensure that the transitional arrangements are not abused. In the case of MFA phase-out, the Textiles Surveillance Board has been put in place as a watchdog and this should certainly be helpful. No such monitoring body exists for agriculture, however.

CDCs will also benefit from transitional arrangements which are essentially defensive. For example, the phase-out period for TRIMs and phase-in period for agricultural reforms are longer than those permitted for DMEs. From a political economy standpoint this is important.

The GATT's key adjustment provision (Article XIX) has been revised in two rather crucial ways. First, discriminatory intervention will henceforth be permitted if a convincing case can be made which links a sudden increase in imports, from a particular source, to domestic injury. Developing countries are rightly concerned at this change and see it as an explicit threat. They see themselves as being targeted for discriminatory action. It is certainly true that the potential for abuse exists and the GATT Secretariat is aware of this. Accordingly the revision also includes far tighter constraints on the use of Article XIX, designed to ensure that action is genuinely based on a clear causal connection between an upsurge in imports and domestic injury. More importantly, the new provisions are designed to ensure that intervention is temporary. If they are deployed as a substitute for unilateral action via VERs and the like, this will be of obvious benefit to LDCs.

What of post-Uruguay Round positive adjustment policies? There is a growing recognition in many DMEs, especially in Western Europe, that labour market rigidities need to be dealt with constructively. Accordingly, far greater emphasis in public policy is being given to retraining and up-grading of skills. Moreover, more by way of public funding is being devoted to support such initiatives. Although it will take time, it is to be hoped that such measures will ameliorate some of the pressures for defensive adjustment policies.