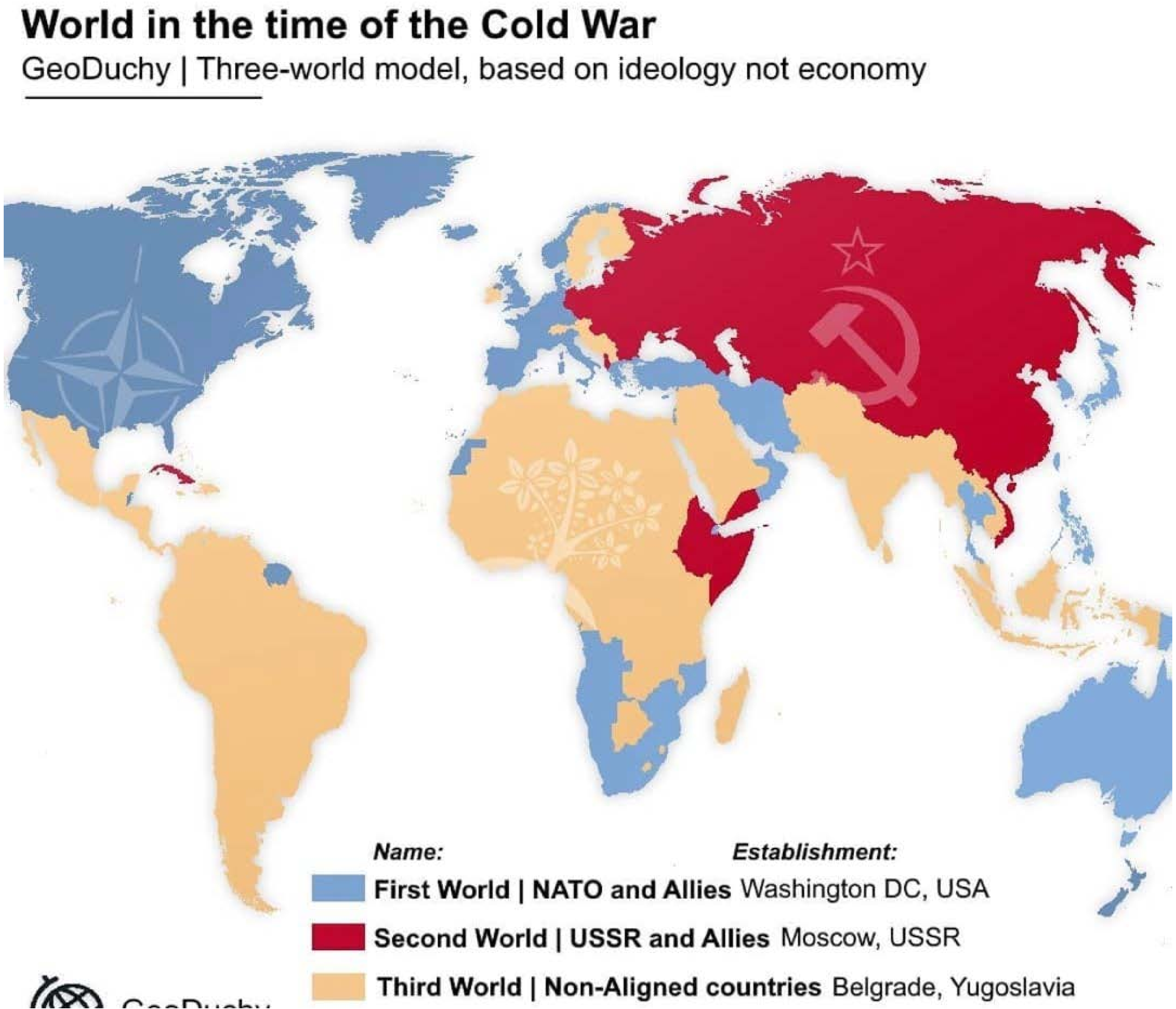
The Trade Reform Wave of 1985-1995

Douglas Irwin
Dartmouth College

1985


World in the time of the Cold War
GeoDuchy | Three-world model, based on ideology not economy
Name:
Establishment:
First World | NATO and Allies
Washington DC, USA
Second World | USSR and Allies
Moscow, USSR
Third World | Non-Aligned countries
Belgrade, Yugoslavia

1995


WTO members and observers
WTO members
Others
WTO observers

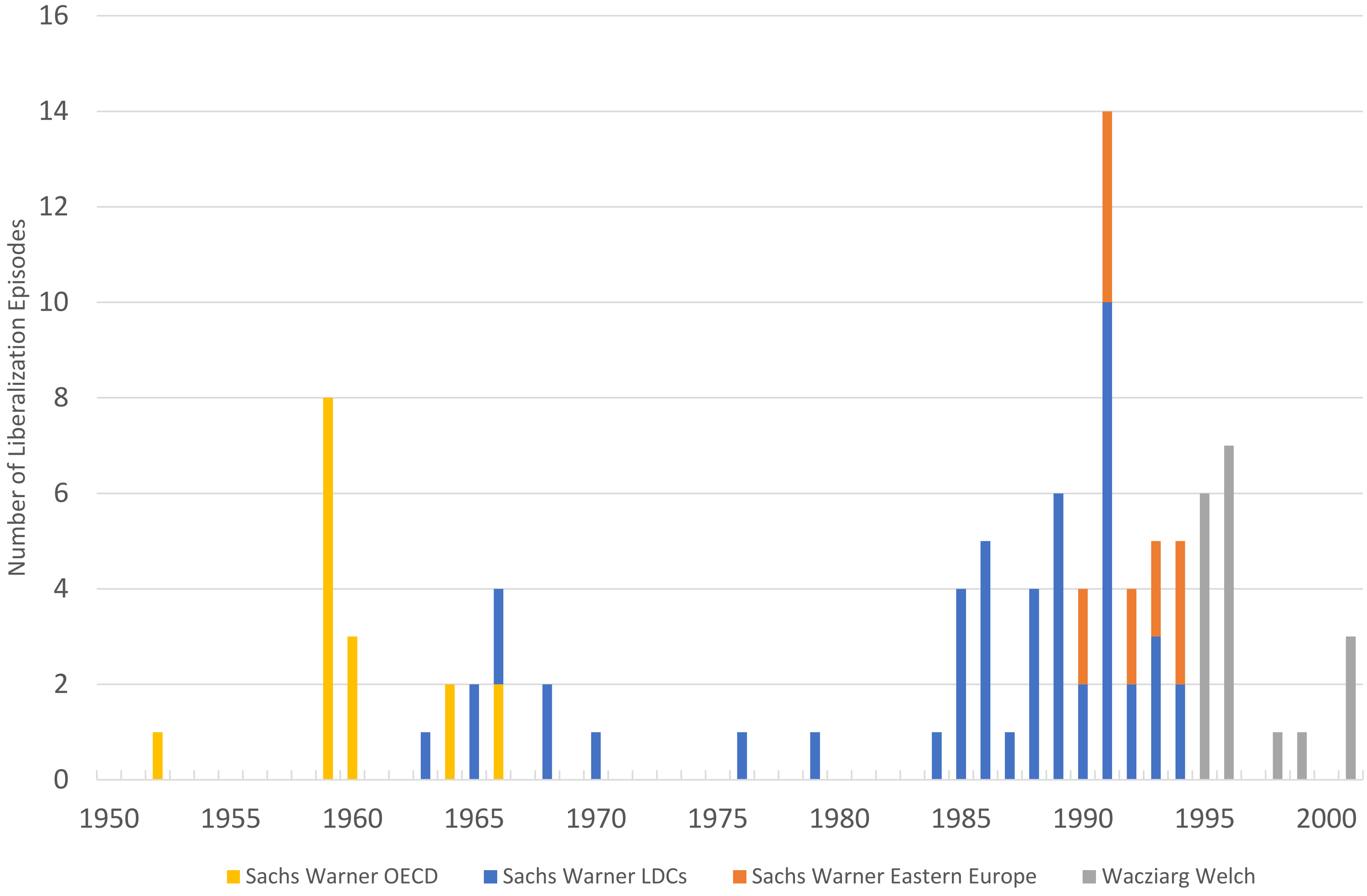
Trade reform wave of 1985-95

- Unilateral
  - Developing countries (Latin America, South Asia, Africa)
  - Eastern Europe and former Soviet Union
  - China, Vietnam

- Regional
  - EEC – 1986 – expansion & single market act
  - NAFTA – 1994

- Multilateral
  - Uruguay Round (1986-94) – creates WTO 1995

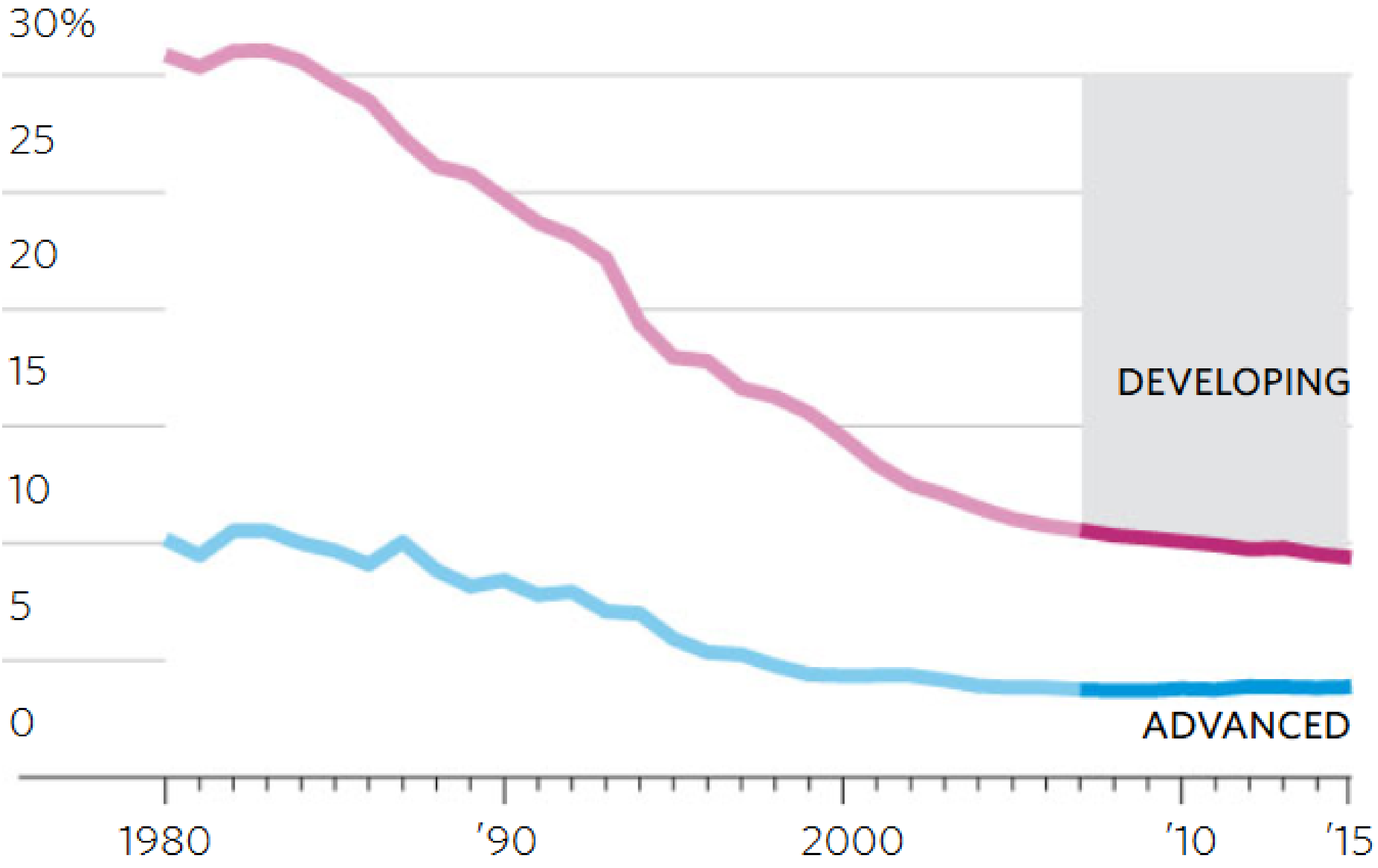
Trade openings



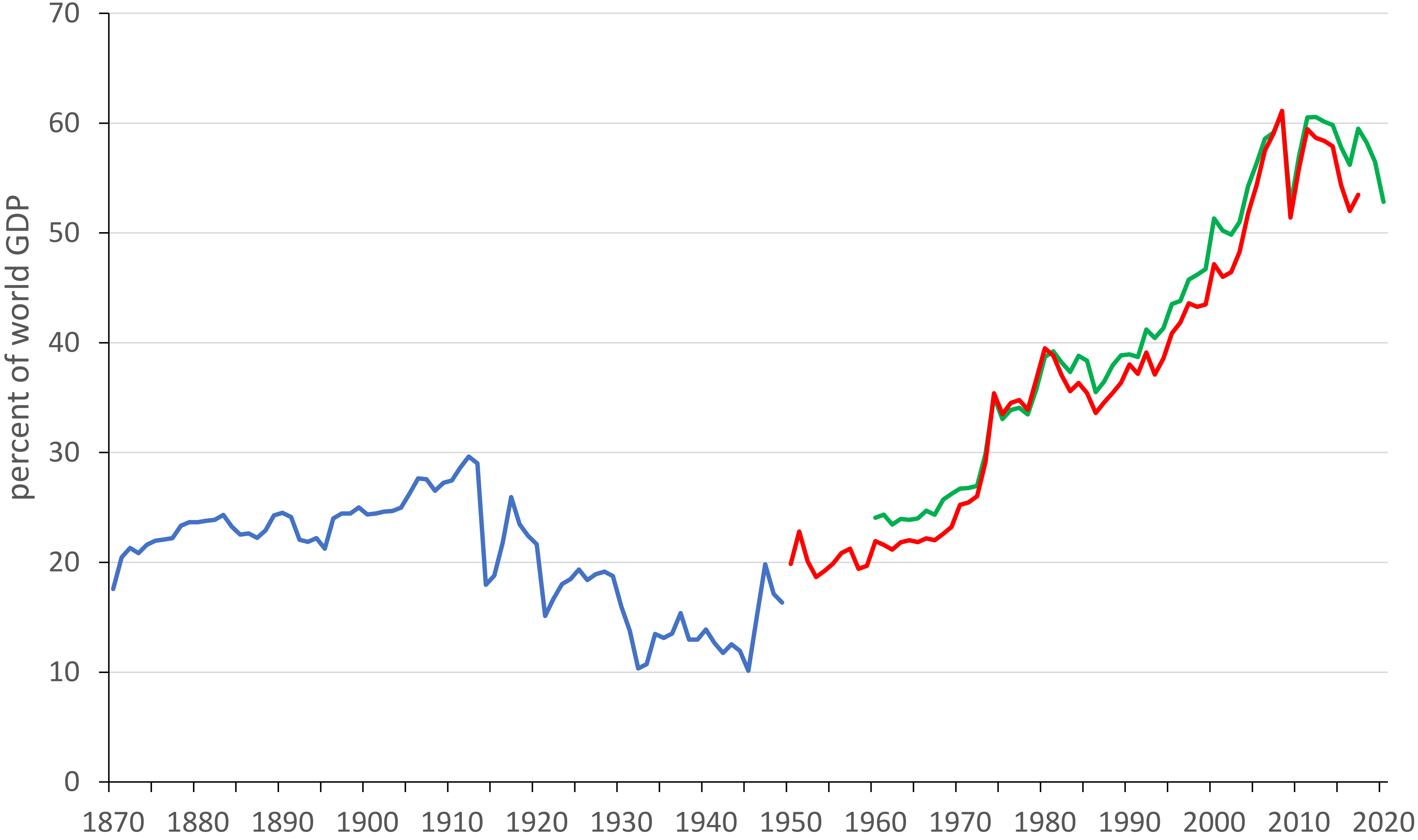
Trade/payments reform process

- Devalue overvalued currency and unify the exchange rate
- Eliminate quantitative restrictions on imports
- Reduce import tariffs

Average tariff rates, by country's level of economic development



World trade/gdp ratio



Trade reform wave of 1985-1995

- What happened?
- Why did it happen?
- Consequences? Future?

Why?

- Standard political economy analysis → economic interests
- Import-competing producers versus exporters & consumers - Olson (1965)
- *Problem:*
  - *special interests account for status quo bias, but not why reform takes place*
- "Because of their neglect of ideas, political economy models often do a poor job of accounting for policy change" (Rodrik 2014)

Ideas about balance of payments adjustment

- Adverse shock:
  - Terms of trade, loss of aid, loss of foreign lending
  - Shortage of foreign exchange

- Adjustment:
  - deflation, depreciation, or import controls

- Early postwar view: don't devalue or change exchange rate
  - Exchange rate ineffective at maintaining external balance (elasticities condition)
  - Adverse terms of trade effect
  - Increase inflation
  - Undesirable income redistribution

- But – does nothing to increase export earnings

1950 draft

THE CASE FOR FLEXIBLE EXCHANGE RATES

Milton Friedman
University of Chicago

It is now over a quarter of a century since Keynes' Monetary Reform produced widespread recognition of the conflict between fixed exchange rates and stable domestic prices. Yet the history of international economic arrangements in the past quarter of a century is largely a reflection of the failure to resolve this basic conflict.

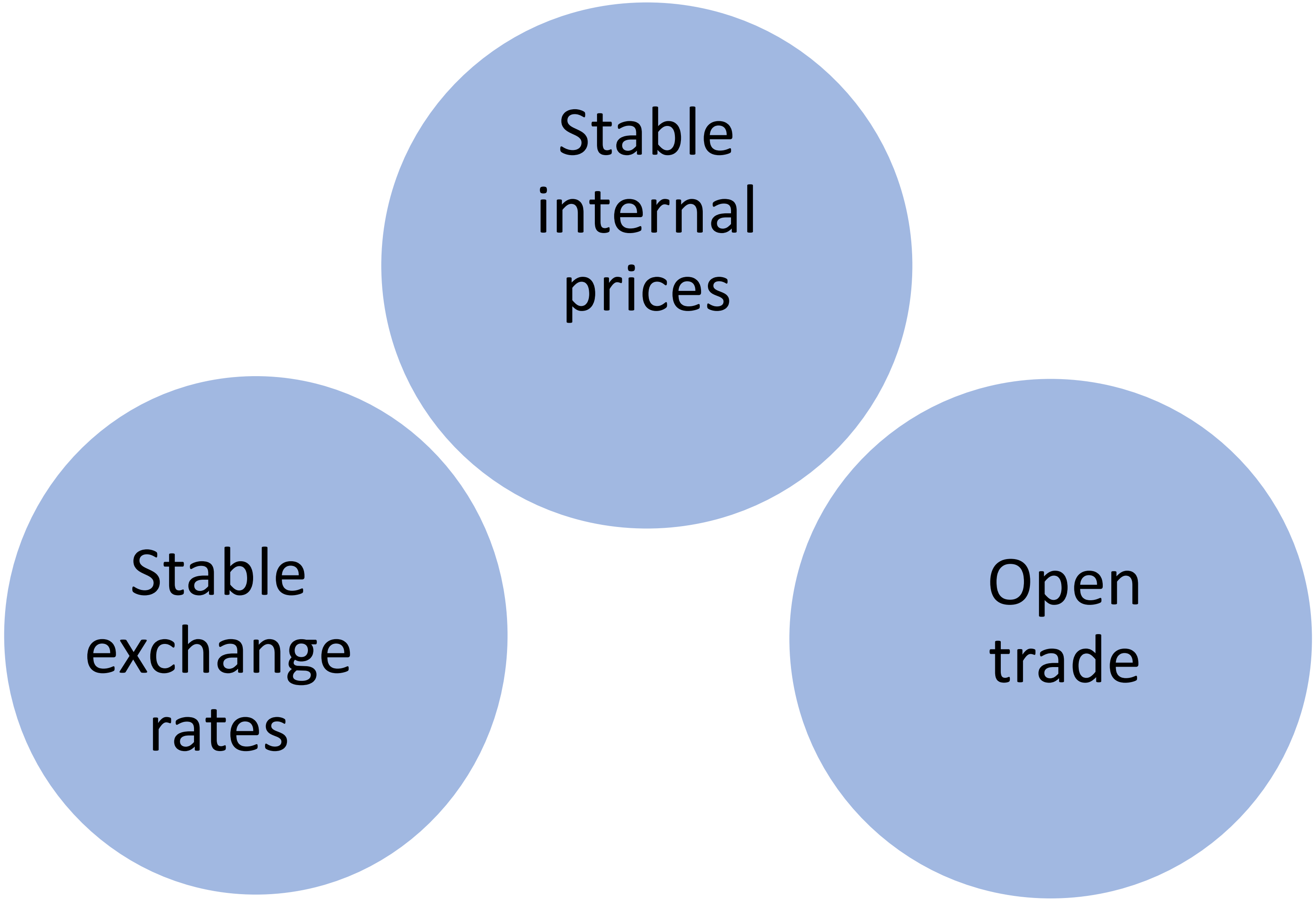
Stable exchange rates were initially the dominant explicit objective. Yet even during the 1920's, the United States, to cite one outstanding and critical example, refused in practice to allow exchange rate pressures to dominate its policies and insisted on "sterilizing" gold imports to prevent the rise in domestic prices that the old-fashioned rules of the gold standard called for.

The Great Depression was followed by a radical shift of emphasis. Full employment and stable or rising prices at home became the dominant objective and led to important departures from a system of rigidly fixed exchange rates. Nonetheless, fixed exchange rates remained an important goal of policy. And the introduction of widespread direct controls over international trade, at first in the attempt to increase employment and then as a result of wartime pressures, seemed to render this goal compatible with full employment at home.

Writing in a free trade atmosphere, Keynes had not even considered this outcome in Monetary Reform. He had taken relatively unrestricted multilateral trade for granted, and so had expounded the simple dilemma: fixed exchange rates vs. stable internal prices. This dilemma has now become a trilemma: fixed exchange rates, stable internal prices, unrestricted multilateral trade; of this trio, any pair is attainable; all three are not simultaneously attainable.

Post-war international economic policy has so far evaded this trilemma, though at every turn it shows at least partial recognition of its existence. The Bretton Woods agreements, the United Nations Charter, the abortive ITO arrange-

The Friedman Trilemma



ments are a monument to the attempt to achieve all three goals, yet give back-handed recognition to the impossibility of doing so. Fixed exchange rates are to be the rule -- but changes of less than 10 per cent are permitted without approval of the International Monetary Fund; unrestricted multilateral trade is to be the rule -- but numerous escape clauses permit exceptions; "joint and separate action" to promote "full employment" is pledged in the United Nations charter -- and here the escape clauses are least obvious, reflecting the fundamental shift that has taken place in emphasis during the past 30 years. Domestic economic stability -- interpreted generally to mean full or overfull employment -- has replaced stability of exchange rates and free trade as the overriding objective.

Given this shift in objectives, the half-measures so far taken have not succeeded and cannot succeed. The Economic Cooperation Administration has used its not inconsiderable influence consistently to promote "liberalization" of trade among O.E.E.C. countries. This pressure produced a facade of brave resolutions and impressive agreements; it has produced little or no effective liberalization of trade. Despite the European Payments Union and all the rest, Western Germany, the country that went farthest in the desired direction of liberalizing trade, was forced to retreat by the exchange crisis in the fall of 1950 because of unwillingness to let the exchange rate for the mark go free. This experience is almost a classroom example of the incompatibility of fixed exchange rates, unrestricted trade, and a domestic full-employment policy.

The Western nations seem committed to a system of fixed and rigid exchange rates. Yet, in the current economic and political environment, a system of flexible exchange rates is absolutely essential for the achievement, and, even more, the maintenance of a world community engaging in unrestricted multilateral trade. There is scarcely a facet of international economic policy for which the implicit acceptance of a system of rigid exchange rates does not create serious and unnecessary difficulties. Promotion of rearmament, liberalization of trade, avoidance

*The Case for Flexible Exchange Rates**

THE Western nations seem committed to a system of international payments based on exchange rates between their national currencies fixed by governments and maintained rigid except for occasional changes to new levels. This system is embodied in the statutes of the International Monetary Fund, which provides for changes in exchange rates of less than 10 per cent by individual governments without approval of the Fund and for larger changes only with approval; it is implicit in the European Payments Union; and it is taken for granted in almost all discussions of international economic policy.

Whatever may have been the merits of this system for another day, it is ill suited to current economic and political conditions. These conditions make a system of flexible or floating exchange rates—exchange rates freely determined in an open market primarily by private dealings and, like other market prices, varying from day to day—absolutely essential for the fulfilment of our basic economic objective: the achievement and maintenance of a free and prosperous world community engaging in unrestricted multilateral trade. There is scarcely a facet of international economic policy for which the implicit acceptance of a system of rigid exchange rates does not create serious and unnecessary difficulties. Promotion of rearmament, liberalization of trade, avoidance of allocations and other direct controls both internal and external, harmonization of internal monetary and fiscal policies—all these problems take on a different cast and become far easier

* This paper had its origin in a memorandum written in the fall of 1950 when I was a consultant to the Finance and Trade Division of the Office of Special Representative for Europe, United States Economic Cooperation Administration. Needless to say, the views it expresses are entirely my own. I am grateful to Joel Bernstein and Maxwell Obst for criticism of the original memorandum and to Earl J. Hamilton and Lloyd A. Metzler for criticism of a subsequent draft. The paper owes much, also, to extensive discussion of the general problem with a number of friends, particularly Aaron Director, James Meade, Lloyd Mints, and Lionel Robbins. Unfortunately, these discussions failed to produce sufficient agreement to make a disclaimer of their responsibility unnecessary.

Balance of payments shock

Terms of trade deterioration

Loss of foreign aid

Loss of foreign lending

Balance of payments shock

Terms of trade deterioration

Loss of foreign aid

Loss of foreign lending

Import repression

Maintain exchange rate

Ration foreign exchange

QRs on imports

Resistance to devaluation

8 **Devaluation Controversies in the Developing Countries: Lessons from the Bretton Woods Era**

Sebastian Edwards and Julio A. Santaella

In 1973, the international monetary system forged in Bretton Woods experienced a final collapse, as the industrial nations abandoned all efforts to sustain a fixed exchange rate regime and decided to adopt freely floating exchange rates. In spite of this significant change in the international financial system, throughout the 1970s most of the developing countries continued to rely heavily on fixed exchange rates, mainly pegging to specific countries within the spirit of an optimum currency area. For example, the December 1979 issue of *International Financial Statistics* (*IFS*) reports that 85% of the developing countries had some sort of fixed exchange rate system at that time.

guay, and Guatemala. Many countries rapidly adapted to their new circumstances. The exchange rate ceased to be a sacrosanct variable linked to the nationalistic destinies of countries; during the late 1980s, a large number of economies had become increasingly comfortable with managed exchange rate regimes.

Recently, however, a number of observers and experts—including prominent members of the IMF Executive Board—have argued that the enthusiasm for devaluation and an active exchange rate policy has gone too far. It has been pointed out that, by relying too heavily on exchange rate adjustments, and by allowing developing countries to adopt administered systems characterized by frequent small devaluations, Fund programs have become excessively inflationary. According to this view, exchange rate policy in the developing countries should move toward greater rigidity—and even complete fixity—as a way to induce financial discipline and reduce inflation. This position, which is steadily gaining new supporters, has largely been influenced by current macroeconomic views that emphasize the role of expectations, credibility, and institutional constraints (see, e.g., Aghevli, Khan, and Montiel 1991; Agenor and Montiel, 1991; and Burton and Gilman, 1991).

It would be illusory, however, to think that a return to greater exchange rate fixity will completely eliminate situations of "fundamental disequilibrium." In fact, most supporters of nominal exchange rate anchors concede that, under conditions of severe exchange rate misalignment, it is generally advisable to implement adjustment packages that combine fiscal and credit restraint with a discrete nominal devaluation (see Burton and Gilman 1991). What is perhaps paradoxical is that precisely this type of pegged arrangement, where the currency may be occasionally devalued by a large amount, was extremely controversial during the Bretton Woods period. In fact, the "devaluation issue" was often at the forefront of conflict between national authorities and the staff of the International Monetary Fund. Even under conditions of obvious "fundamental disequilibrium," the economic authorities in the developing countries tended to resist devaluing their currencies. Instead, they often imposed trade and exchange controls in an effort to avoid a balance of payments crisis.[1] This historical resistance to devaluations had its roots in a deep skepticism about the effectiveness of exchange rate adjustment. In fact, it has been commonplace in the developing world to argue that large and discrete devaluations—and especially devaluations implemented within the context of IMF programs—have no effect on the external sector, result in output contractions, and worsen income distribution. (see Denoon 1986; Buira 1983; and SELA 1986).

An important question in the current debate regarding the desirability of a

1. There has traditionally been a sense among some observers that LDCs have been forced by third parties—and in particular by the IMF—to devalue their currencies (see, e.g., Denoon 1986).

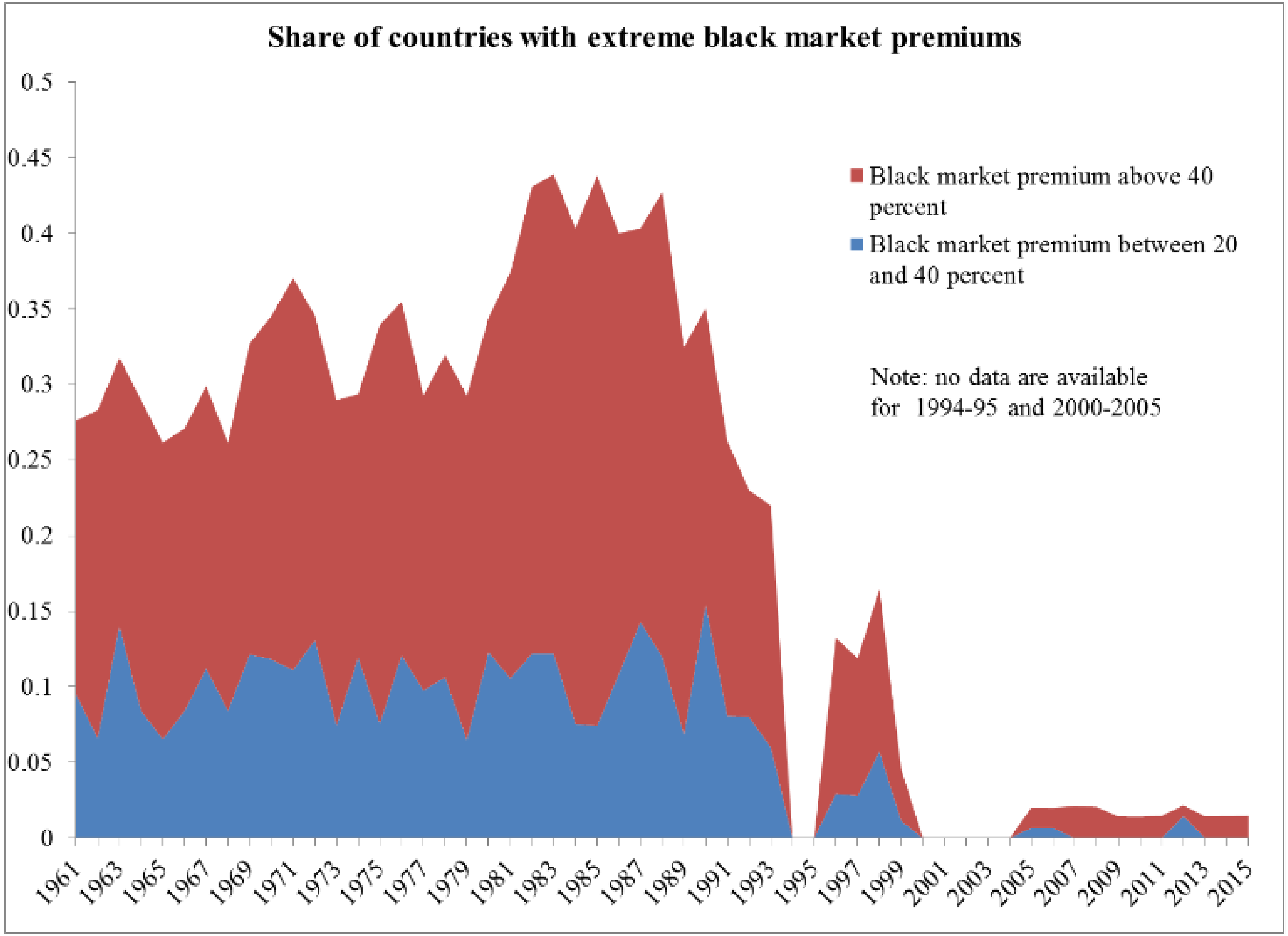


Figure 2a: Share of countries within each range of black market premium

Open economies review, **7**: 437–468 (1996)

Why Clashes Between Internal and External Stability Goals End in Currency Crises, 1797–1994

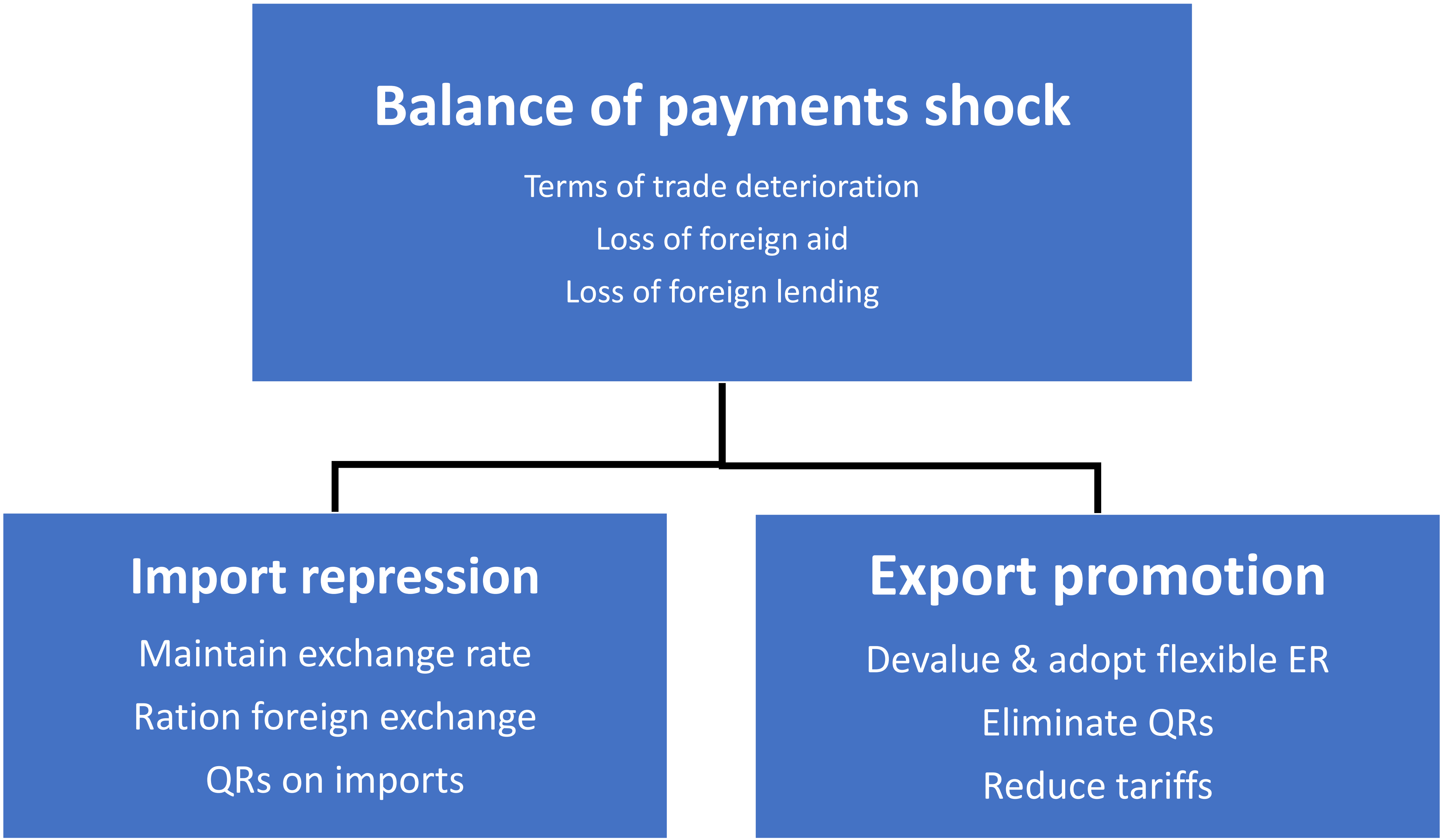
MICHAEL D. BORDO
Rutgers University, U.S.A., National Bureau of Economic Research, U.S.A.

ANNA J. SCHWARTZ
National Bureau of Economic Research, U.S.A.

Key words: fundamentals, self-fulfilling prophecies, currency crises

Abstract

We argue that recent currency crises reflect clashes between fundamentals and pegged exchange rates, just as did crises in the past. We reject the view that crises reflect self-fulfilling prophecies that are not closely related to measured fundamentals. Doubts about the timing of a market attack on a currency are less important than the fact that it is bound to happen if a government's policies are inconsistent with pegged exchange rates. We base these conclusions on a review of currency crises in the historical record under metallic monetary regimes and of crises post-World War II under Bretton Woods, and since, in European and Latin American pegged exchange rate regimes.


Balance of payments shock
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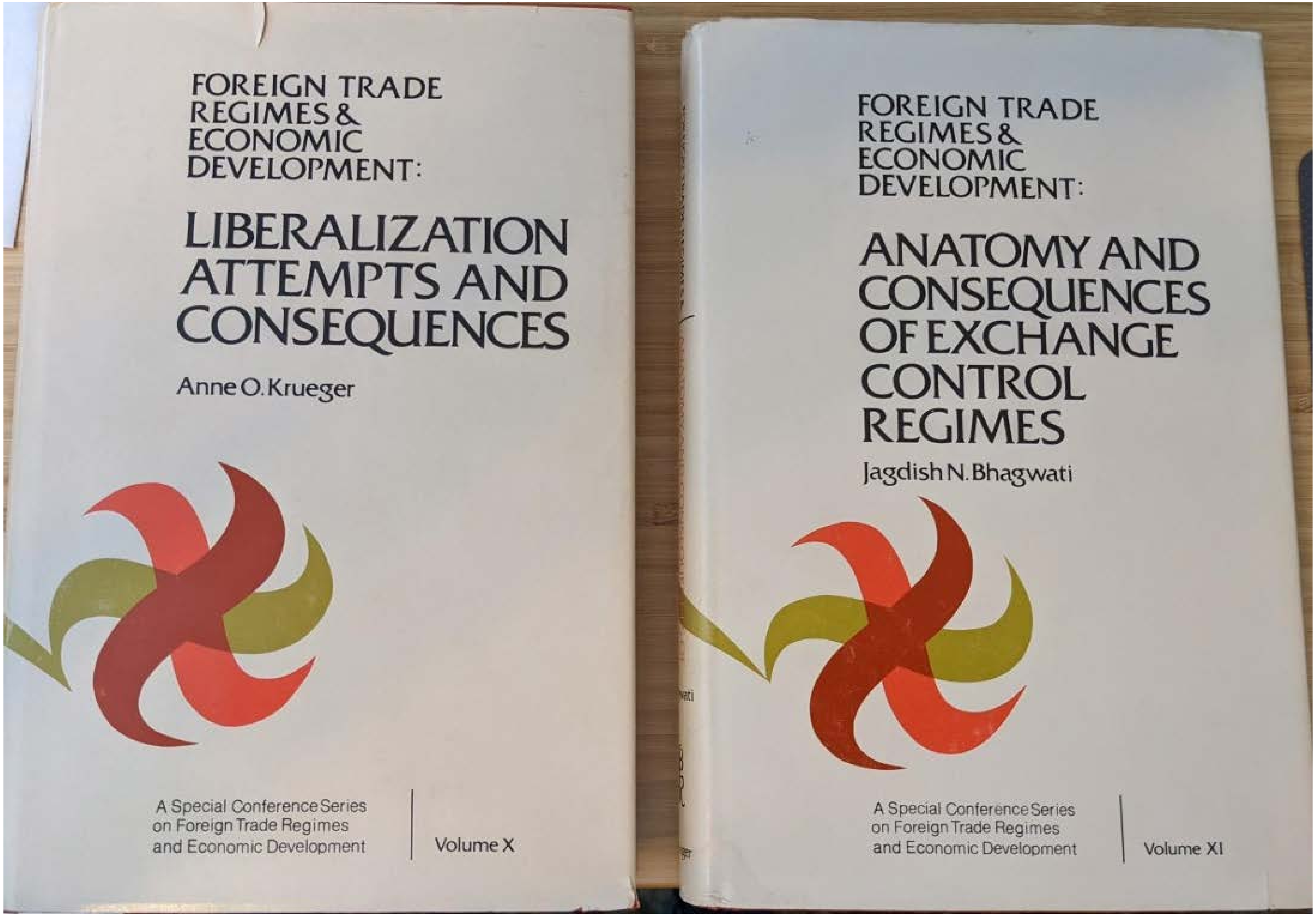
FOREIGN TRADE REGIMES & ECONOMIC DEVELOPMENT:
LIBERALIZATION ATTEMPTS AND CONSEQUENCES
Anne O. Krueger
A Special Conference Series on Foreign Trade Regimes and Economic Development
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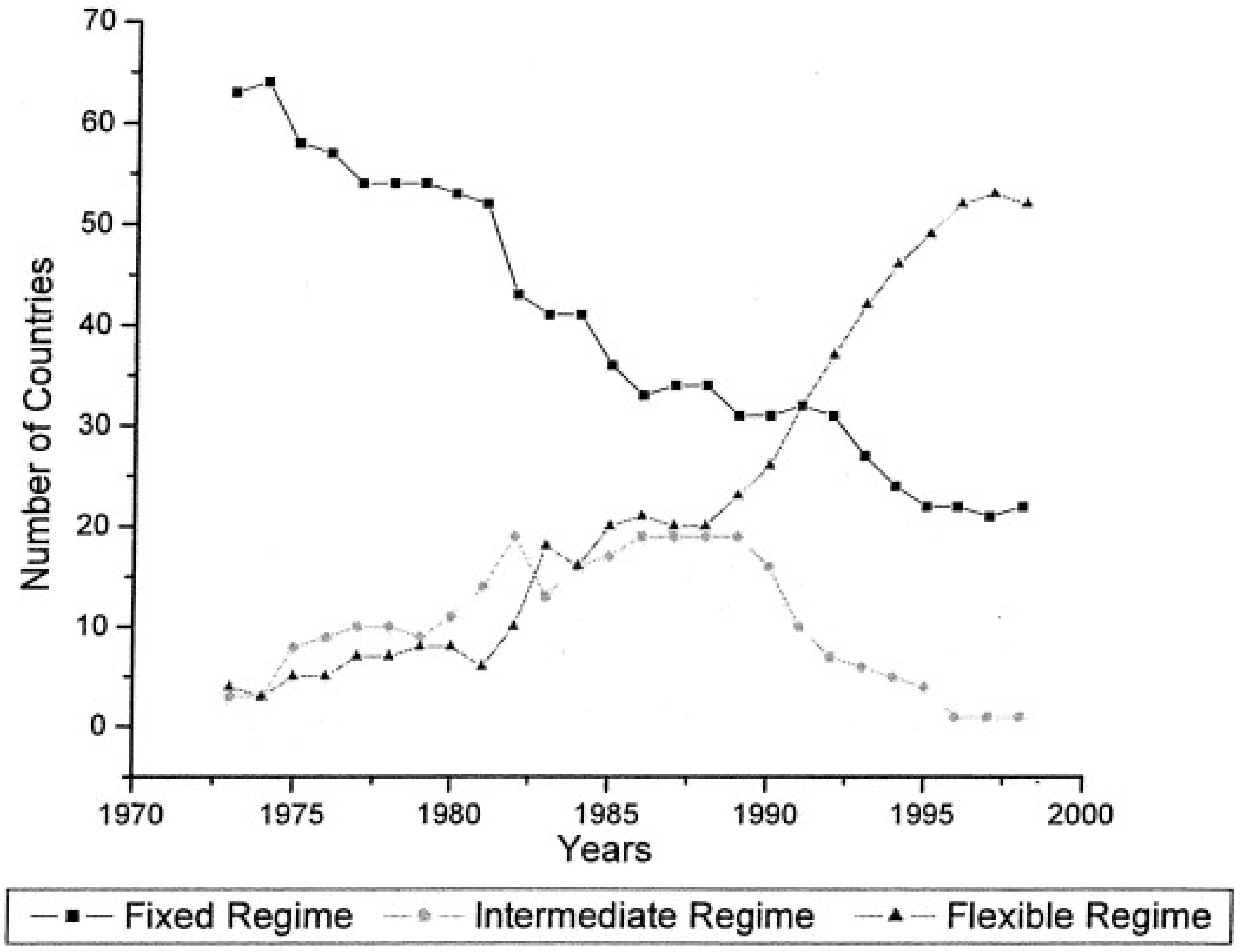
- The heart of liberalization is the conversion from using trade policy for payments balance to using the exchange rate.” – Paul Collier

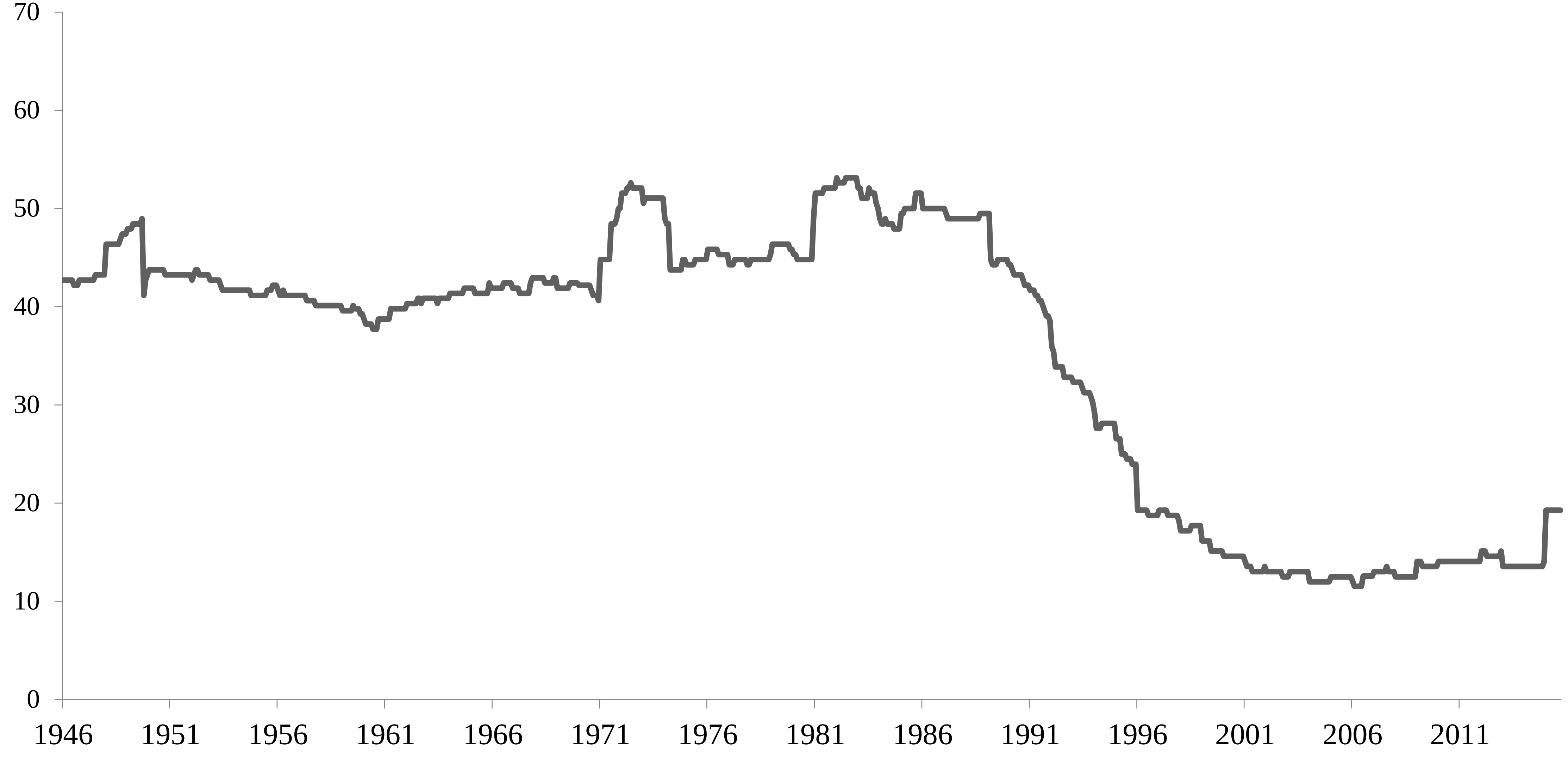
- Why no reform in 1970s?
  - “foreign exchange reserves kill the will to reform”

- Why reform in 1980s?
  - Era of scarce foreign exchange – all three BOP shocks
  - Goal: increase foreign exchange earnings by increasing exports!
  - Learning from experience – cost of import controls, benefit of exports



Notes: The Exchange Rate Regime Classification is based on Ghosh et al (1997).

Share of countries with multiple exchange rates



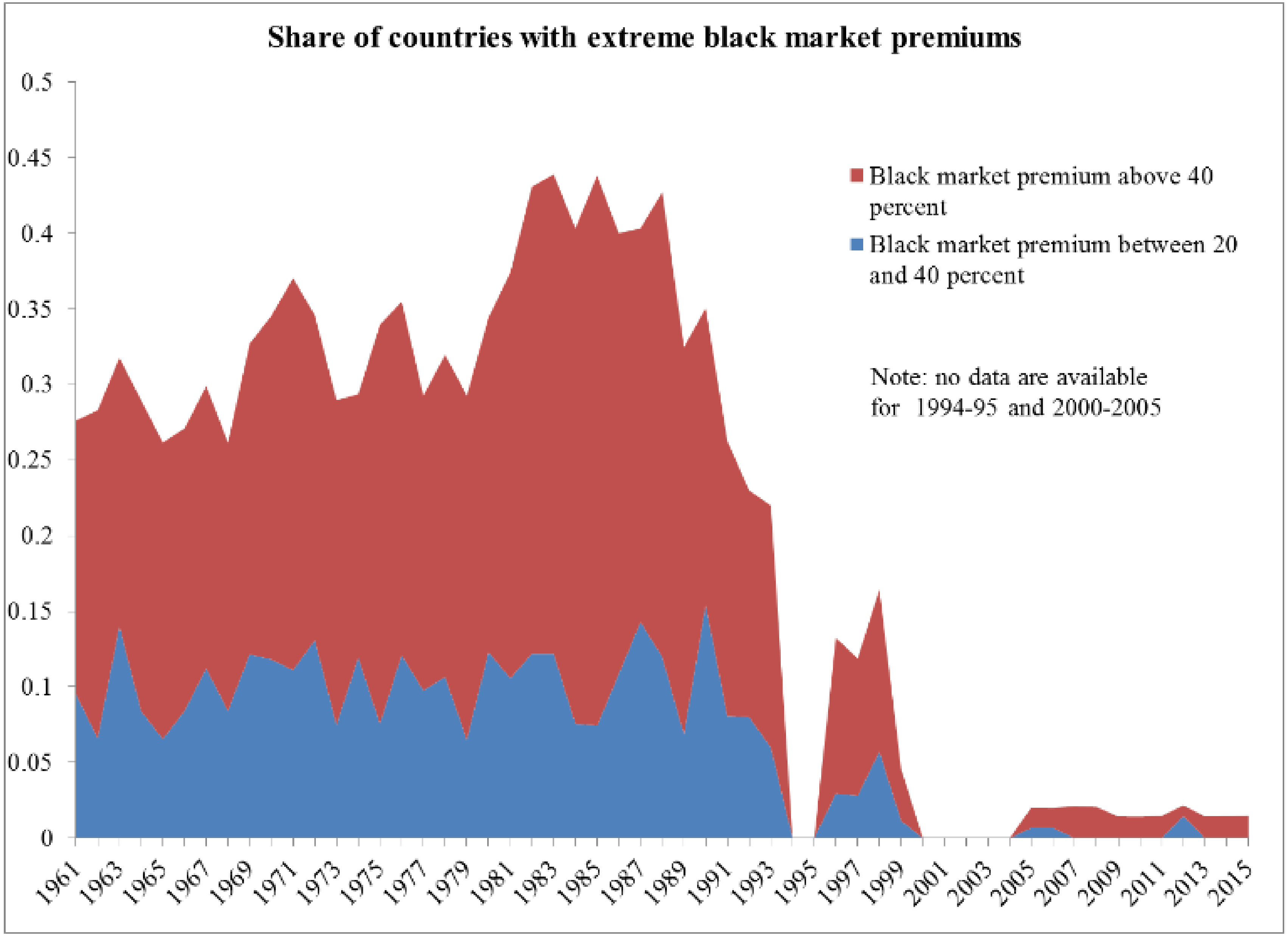


Figure 2a: Share of countries within each range of black market premium

Drivers of reform

- Shift from import repression to export promotion to overcome foreign exchange shortage
- Not special interests, but economists in central banks & finance ministries
- Idea
    - import controls are costly and don't promote exports
    - Exchange rate adjustment promotes exports and saves on imports

POLITICAL ECONOMY OF POLICY REFORM: IS THERE A SECOND BEST?[†]

Secrets of Success: A Handful of Heroes

By ARNOLD C. HARBERGER*

This paper has its origins in my long-standing conviction that successful economic policy in developing countries is very far from being the product of pure forces of history—something that happens when it happens because its time has come. Far from it, in every case about which I have close knowledge, the policy would in all likelihood have failed (or never got started) but for the efforts of a key group of individuals, and within that group, one or two outstanding leaders.

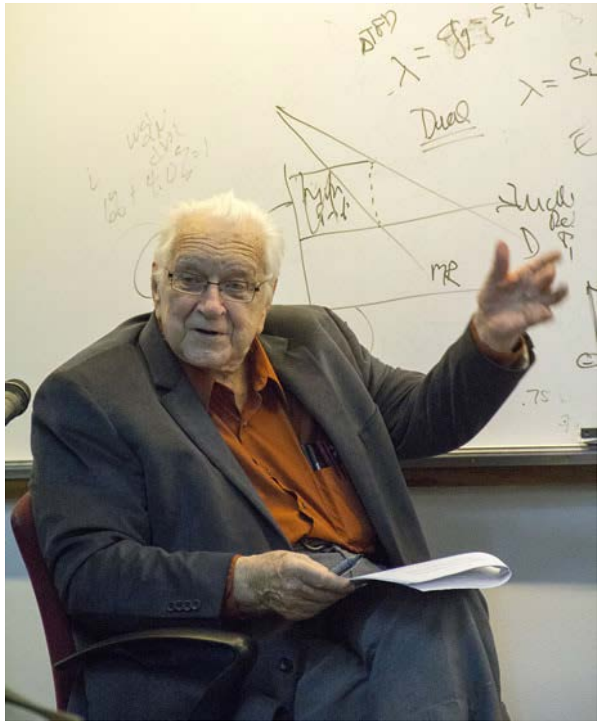
In this paper I want to do two things: 1) pay tribute to a small number of such leaders, to each of whom his country owes an enormous debt, and 2) help readers see the process of reform from a different, perhaps more intimate perspective than our literature typically provides. I draw my stories from Latin America, not because this region particularly calls to be singled out, but rather because this is the area I know most about. I wish I had the background information to tell you similar stories about Taiwan, Korea, Singapore, Hong Kong, and Malaysia at the very least, all of which represent economic miracles that Latin America has yet to match. But since I don't, I won't.

It is often the case in economic policy that the field is plowed by one team and the harvest reaped by another. Such was the case in Brazil in the mid-1960's. There is today a substantial consensus that much of the credit for the so-called "Brazilian Miracle," an average growth rate of some 10 percent per annum from 1968 through 1974, belongs to Roberto Campos, whose term as planning minister ended before the miracle started. Og Leme, one of Campos's collaborators, affirms that his actions were guided by conviction, courage, and determination and were carried out in spite of adverse circumstances and at high personal cost. Inheriting an economy on the brink of chaos in April 1964, Campos set in motion a series of reforms, all of them needed under the circumstances, but each one adding another group that was out for his head (this, in spite of his successfully reducing the rate of inflation by one-third in each successive year and restoring the economy to a path of economic growth).

Leme describes Campos's prescriptions as consisting of medicine, diets, and surgery; things that he says nobody likes to take, and certainly not the Brazilian public. Campos cut public expenditures sharply, turning other ministers plus governors and mayors against him. He raised public-utility rates, together with the ire of those who had to pay them. He raised fiscal revenues, particularly through more effective tax administration, to the dismay of taxpayers. He ended rent controls on offices, shops, and dwelling units, making yet another set of enemies. And so the story goes on. A new wage policy, a new policy of severance pay, adoption of a system of monetary correction for tax and other purposes, a devaluation of the currency to achieve an appropriate equilibrium real exchange rate, a thorough reduction of tariffs and other trade restrictions, a major reorganization of Brazil's

[†]*Discussants:* Rudiger Dornbusch, Massachusetts Institute of Technology; Deepak Lal, University of California–Los Angeles; Stephan Haggard, University of California–San Diego.

*Professor of Economics, University of California, Los Angeles, CA 90024-1477. I am grateful to all those who helped assemble information for this report, especially Juan Andrés Fontaine, Cristián Larroulet, Og Francisco Leme, Armando Pérez-Gea, Francisco Rosende, Carlos Vegh and Juan Antonio Zapata. Needless to say, full responsibility for facts and interpretations rests with me.



Cases

- Taiwan (1958) – S. C. Tsiang
- Korea (1964) - USAID
- Chile (1975) – Sergio de Castro & the Chicago Boys
- Sri Lanka (1977) – J. R. Jayawardene
- Turkey (1983) – Turgot Ozal
- Mexico (1985) – Manuel Mancera
- Vietnam (1989) - IMF
- India (1991) – Manmohan Singh
- China (1994) – Zhu Rongji

Mexico

- 1982: debt & BOP crisis → import repression
- 1985: still in crisis → shift to freer trade
- What changed?   The economic team

IVE

The New York Times

SUNDAY, OCTOBER 24, 1982

Mexico's Cambridge Connection

Ajit Singh, a Cambridge economist advising Mexico

The New York Times / Robin Laurance

The country's new policies reflect radical thinking of faraway gurus.

By STEVEN RATTNER

CAMBRIDGE, England

STRICT controls on imports. Foreign exchange curbs. Big budget deficits. Nationalization of the banks. Vast foreign borrowings. They are all part of a radical economic experiment under way in Mexico, an experiment put into place by Mexicans but one that reflects the startling ideas of a group of economists here at Cambridge University.

In part, the experiment is pragmatic — brought on by economic crisis. But as Mexico negotiates with the International Monetary Fund over $4 billion in new loans to ease its financial bind, the country has attracted widespread attention for its insistence on maintaining its interventionist policies and its drive for growth.

That intractability is being cheered on by the Cambridge economists, who have in recent years commuted tirelessly between the university on the Cam River and government offices in Mexico. The Cantabrigians vehemently object to the I.M.F.'s devotion to the free-market and to restrictive fiscal and monetary strategies. The Mexican experiment, as long as it lasts, represents the most broadly based test so far of their radical theories.

To the Cambridge group there can be no substitute for heavy government intervention in economic matters, such as Mexico is pursuing. They espouse a form of nationalism that emphasizes industrial growth, which for developing countries, they say, requires protectionism and expansionary economic policies.

Indeed, the Cambridge economists see themselves as spiritual descendants of another Cambridge intellectual, John Maynard Keynes, whose controversial ideas of the 1930's helped spark an earlier wave of government intervention.

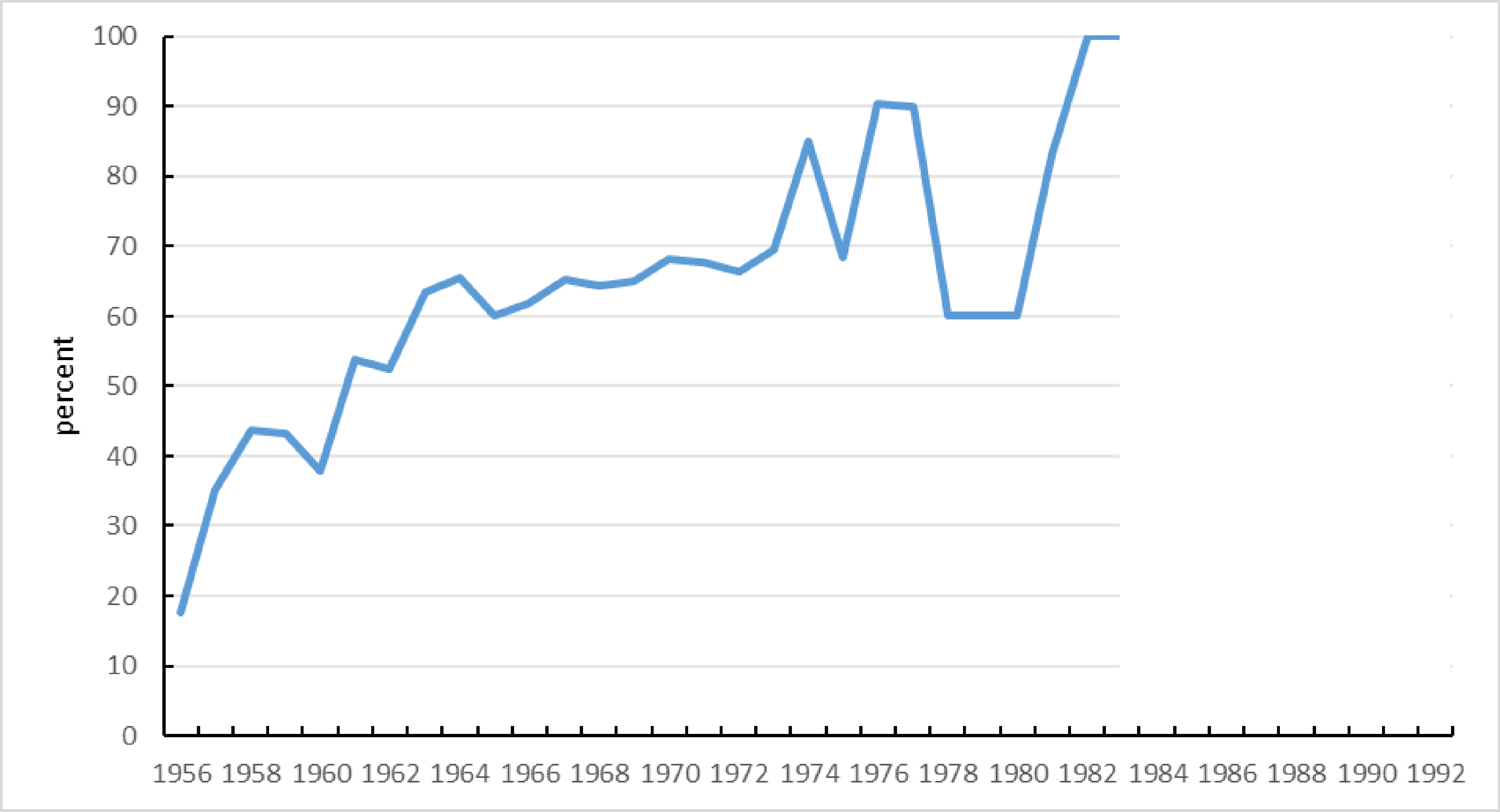
"If you simply open your borders, you simply get wiped out," said Ajit Singh, a fellow at Queens College and a member of the university's economics department, who is the most active of the Cambridge group involved in Mexico. "The notion of efficiency that says you should compete with the best in the world is nonsense. Japan didn't suddenly start producing cars for the world market; they protected cars and learned to

Continued on Page 10

Strong words of that sort have elicited an equally strong response from advocates of unhampered trade, long the credo and goal of most industrial countries. Martin Wolf, director of research at London's Trade Policy Research Center, called the Cambridge position ''deeply dangerous and motivated by most dangerous ideas.'' The Cambridge economists, he said, ''are basically preaching catastrophe.''

''Industries are always very inefficient at the beginning and they become efficient as a result of expansion and growth,'' said the 74-year-old Lord Kaldor, in the solarium of his comfortable home here. ''For a country like Mexico it was impossible under conditions of free trade. They cannot compete.''

Mexico – share of imports covered by licensing



Mexico's battle of ideas

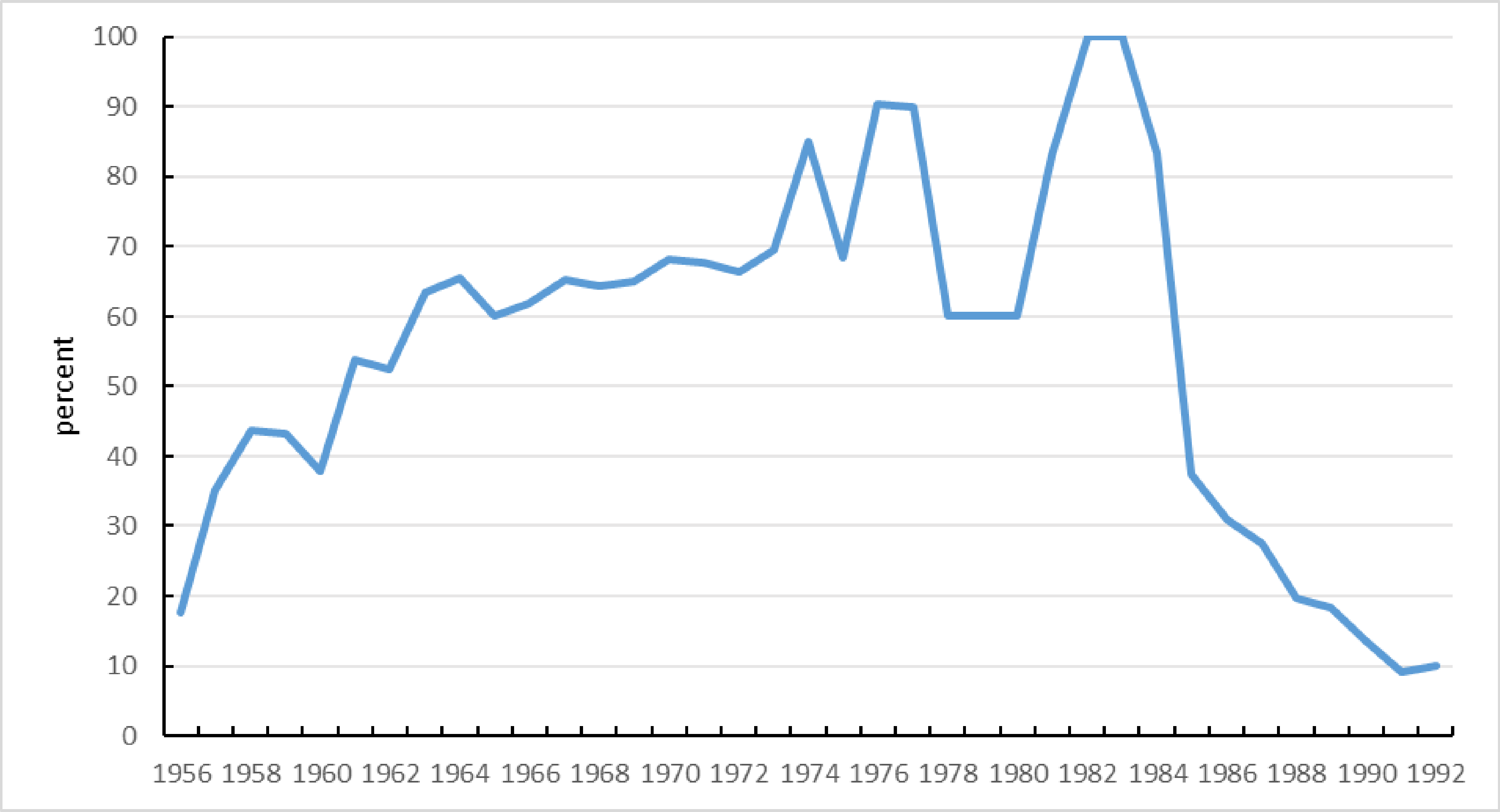
- President Jose Lopez Portillo (76-82)
- Ajit Singh, Nicholas Kaldor

- Carlos Tello – head of central bank
- Jose Andres de Orteyza, Ministry of National Patrimony and Industrial Development
- Vladimiro Brailovsky, director-general of the Institute of Industrial Planning

- President Miguel de la Madrid (82-88)
- Balassa, Harberger, Dornbusch

- Manuel Mancera – head of central bank (Yale)
- Francisco Gil Diaz – central bank (Chicago)
- Pedro Aspe (MIT)

Mexico – share of imports covered by licensing



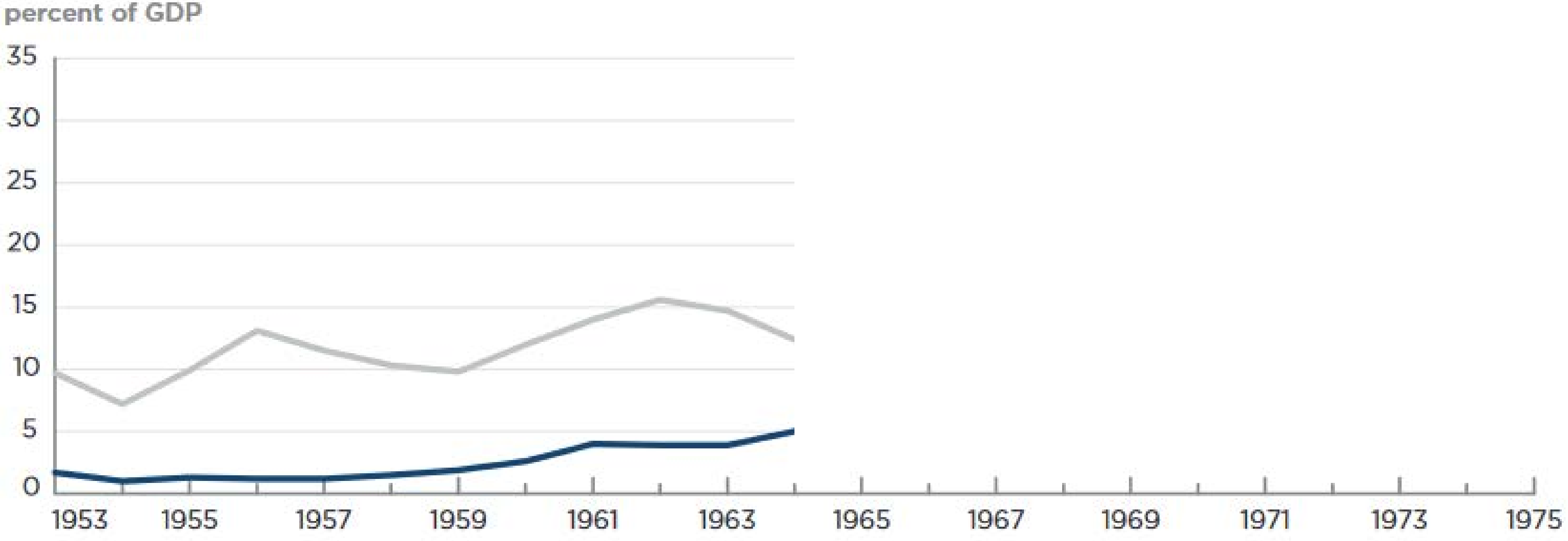
Reduction in foreign aid → reform

- Greece (1953)
- Taiwan (1958)
- Israel (1962)
- Korea (1964)

- Vietnam (1989)
- Tanzania, Kenya (1992)

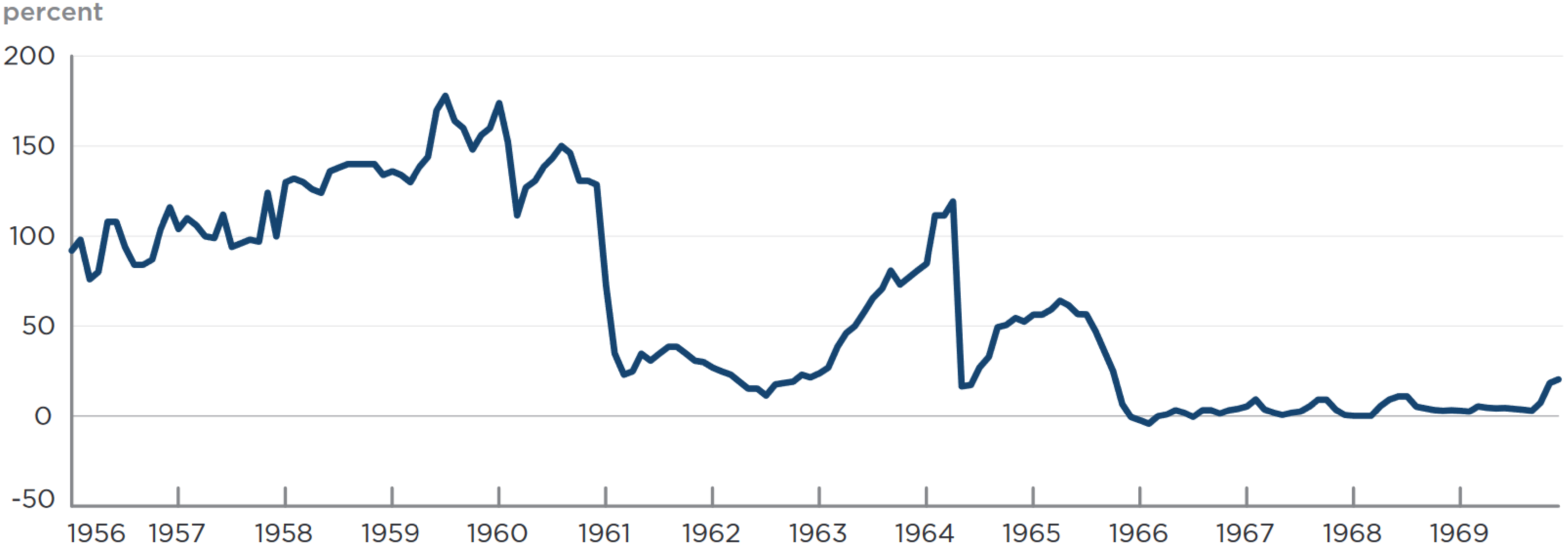
- Michael Bruno (World Bank): “We did more for Kenya by cutting off aid for one year than by giving them aid for the previous three decades”

Figure 3
South Korea's exports and imports as a share of GDP, 1953–75



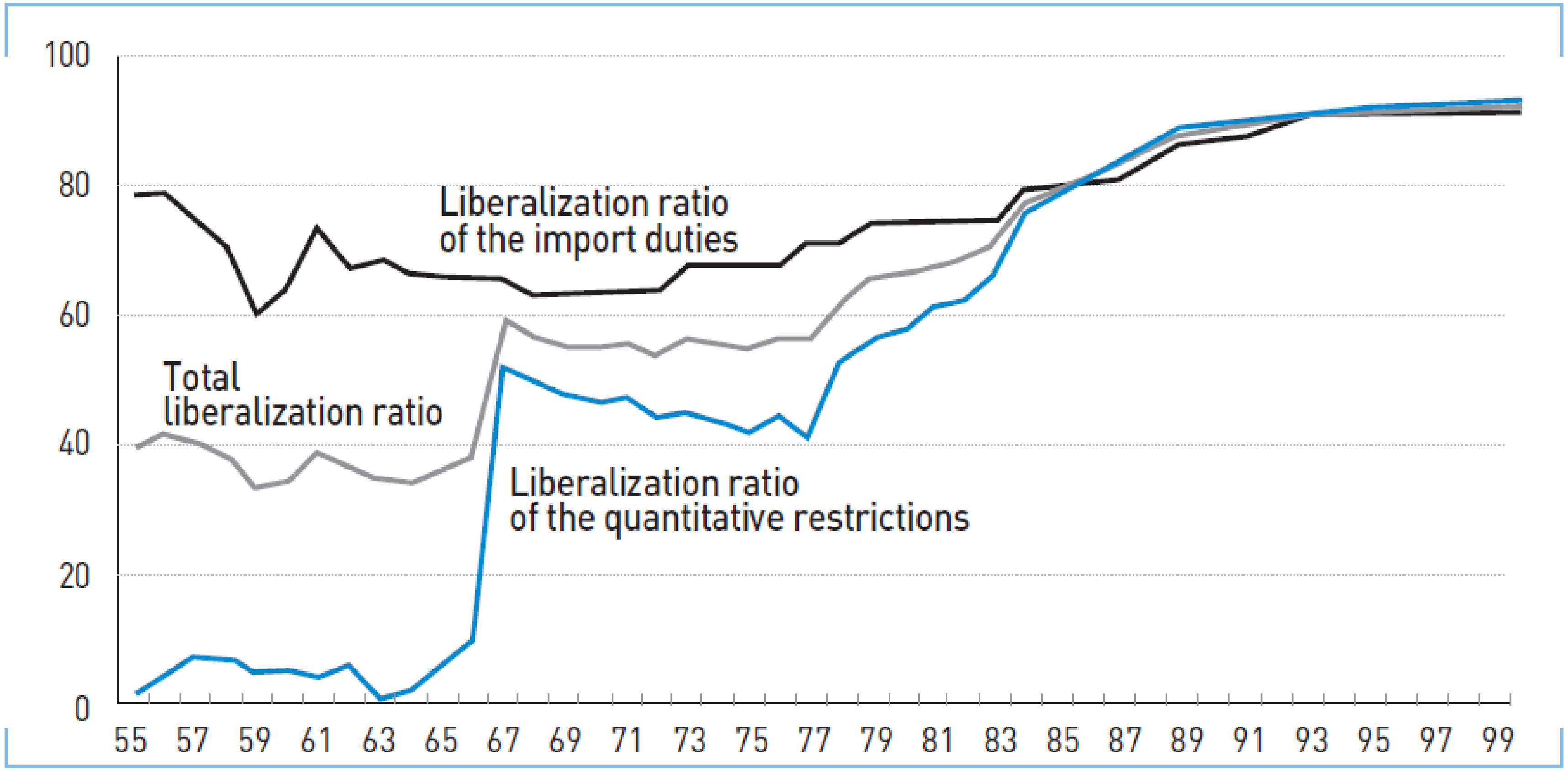
Source: Economics Statistics System, Bank of Korea, http://ecos.bok.or.kr.

Figure 1
Black market premium on the Korean *won*, 1956–70



Source: Carmen Reinhart, based on Pick's Currency Yearbook, https://carmenreinhart.com/exchange-rates-official-and-parallel.

Figure 4 | Import Liberalization (Percent)

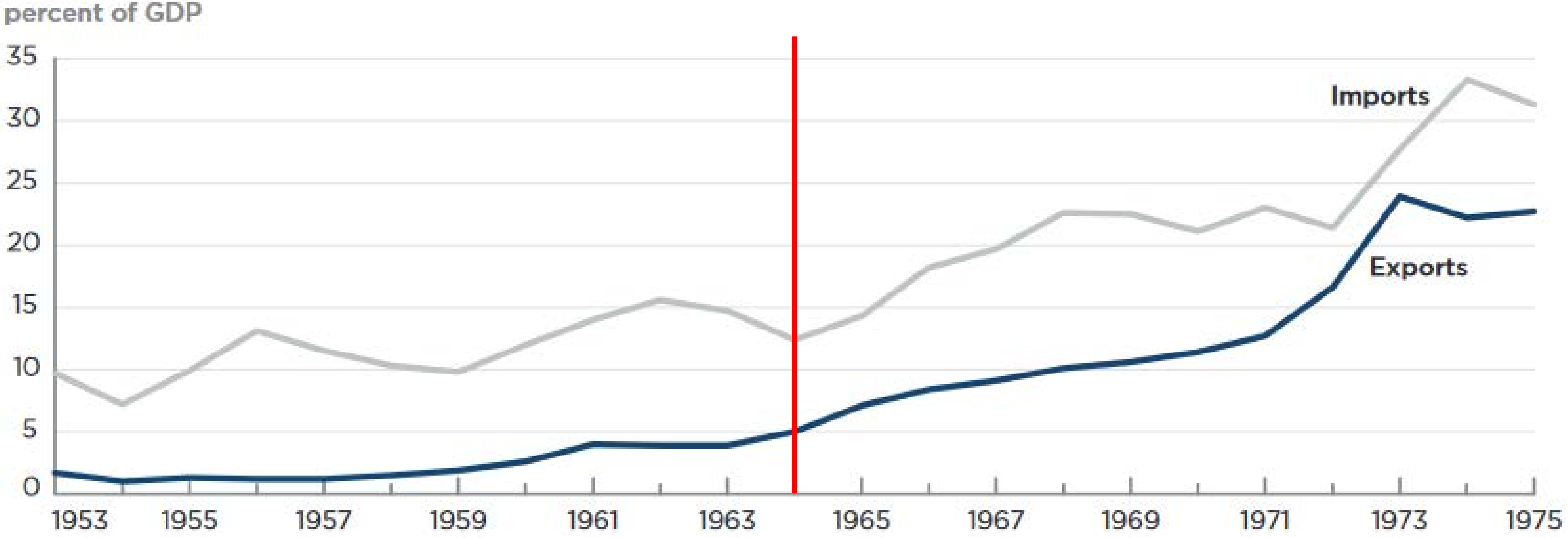


Source: Kim, Kwang Suk (1988), *The Economic Effect of Import Liberalization and the Industrial Adjustment Policies* (Seoul: Korea Development Institute), Table 5.

Note: "Liberalization ratio of the import duties" is calculated as 1/(1+import duties), where "import duties" is the weighted average of general and special tariff rates plus foreign exchange taxes. "Liberalization of the quantitative restrictions" is calculated as the number of freely-imported items divided by the total number of items.

Figure 3

South Korea's exports and imports as a share of GDP, 1953–75



Source: Economics Statistics System, Bank of Korea, http://ecos.bok.or.kr.

India’s FX reserves (months of imports)

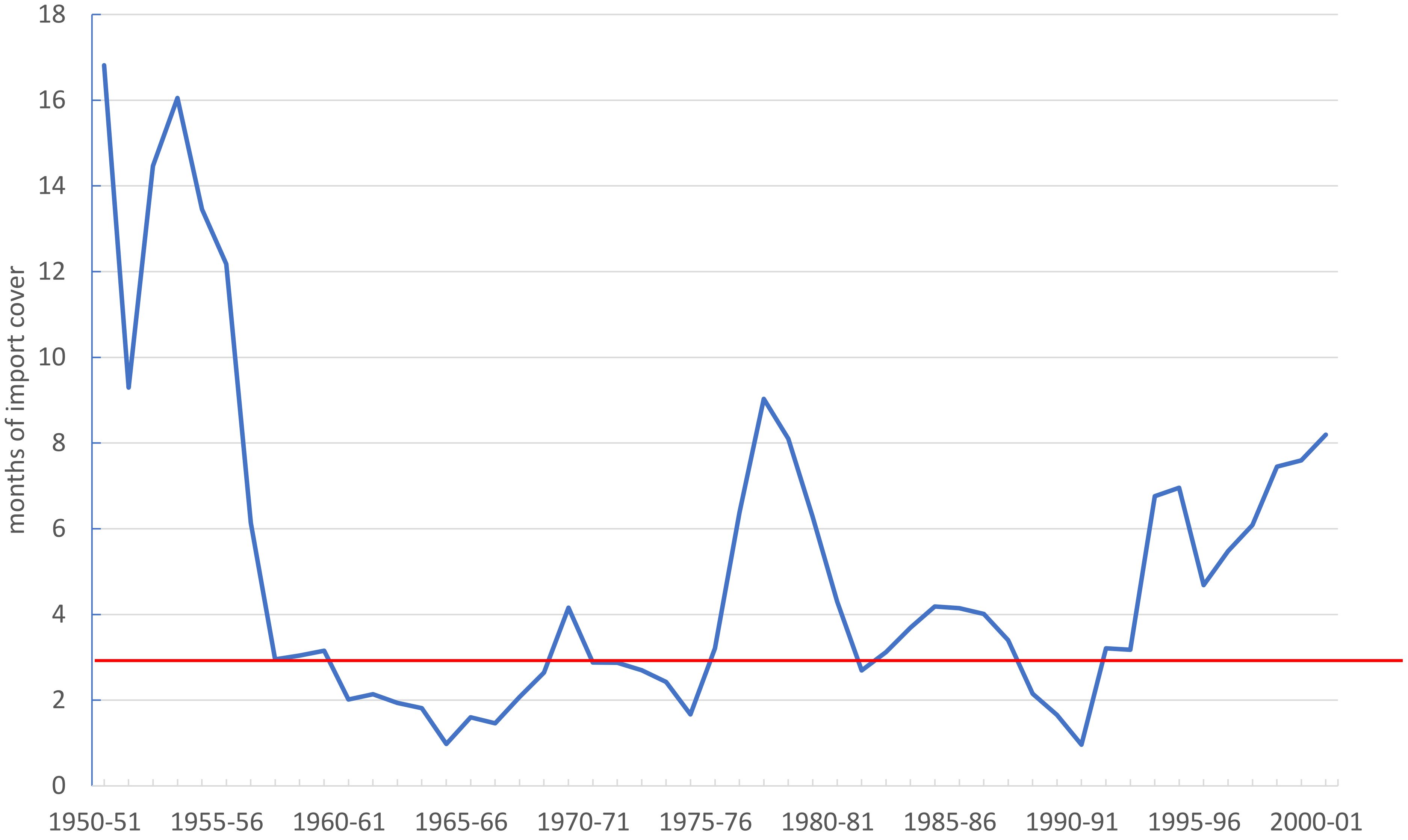
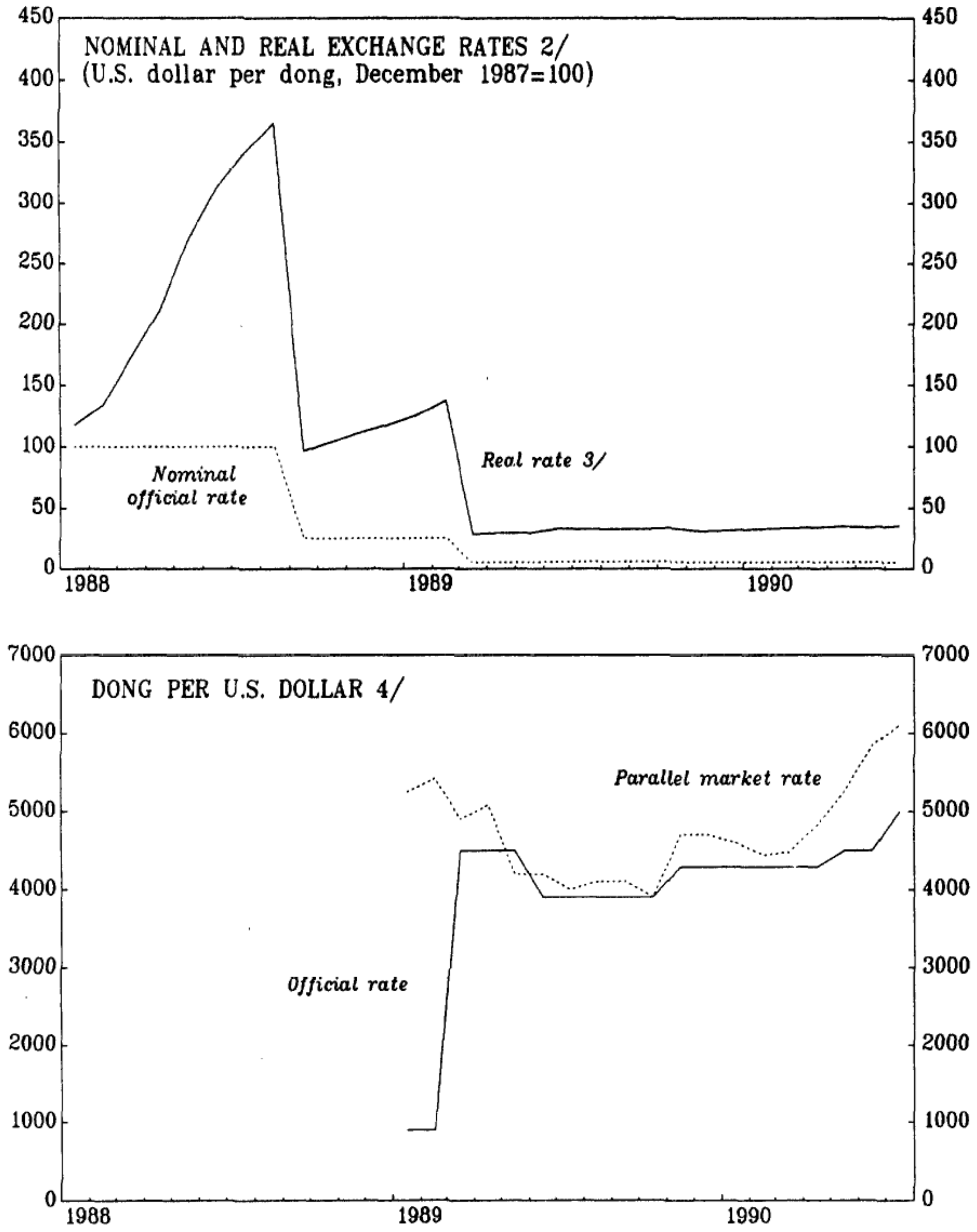


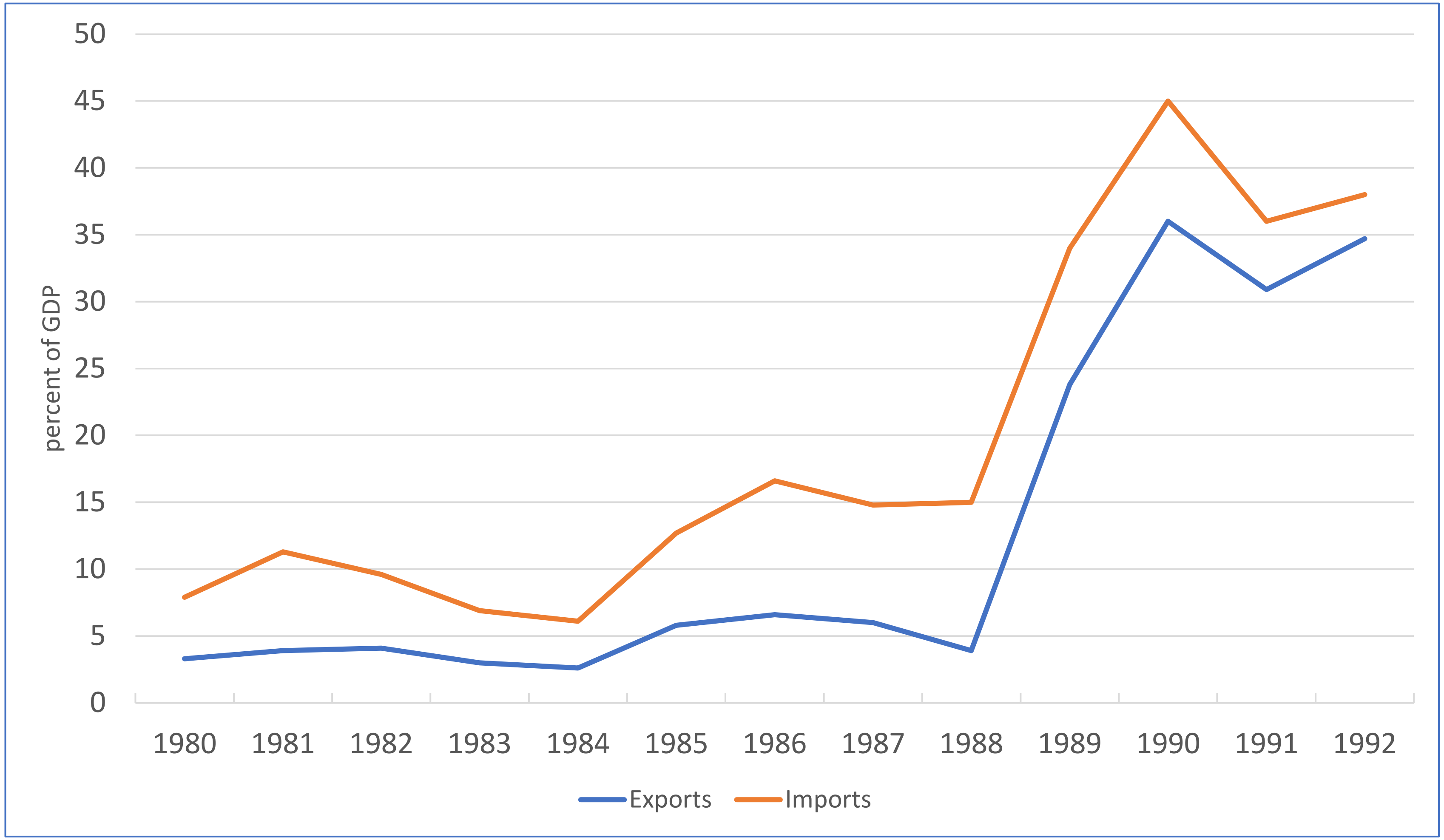
CHART 4

VIET NAM

EXCHANGE RATE DEVELOPMENTS, 1988-90 1/



Vietnam's trade



Conclusions

- Rationale for controls
  - Reluctance to devalue & use trade policy for BOP purposes
- Reform
  - Need to earn more foreign exchange, not just conserve it
  - Use exchange rate for BOP, devalue to realistic exchange rate
  - Not driven by special interests
  - Circumstances and economists in governments from mid-1980s
  - Also – democracy plays a role
- Future
  - Reform more difficult: exchange rates reformed, reserves high, democratic recession