THE SEQUENCING OF THE LIBERALIZATION REFORMS IN CHILE*

by

Sebastian Edwards

Alejandra C. Edwards

University of California, Los Angeles

April 1986

Working Paper Number 394

Revised Draft
April 1986

CHAPTER 7

THE SEQUENCING OF THE LIBERALIZATION REFORMS*

by

Sebastian Edwards

and

Alejandra C. Edwards

University of California, Los Angeles

April 1986

*This is a draft of Chapter 7 of S. Edwards and A.C. Edwards Monetarism and Liberalization: The Chilean Experiment.

CHAPTER 7

The Sequencing of the Liberalization Reforms

One of the lessons that emerges from the Chilean experiment is that there are a number of issues related to the dynamics of the liberalization of the external sector that are not fully understood by the policymakers, economists and other observers. Some of the most important of these dynamic problems are related to the speed and sequencing of economic liberalization. With respect to the former, the main question is how fast should an economy be liberalized? In analyzing this aspect of the problem, considerations related to efficiency gains, income distribution, and feasibility of the attempt should be taken into account. Regarding the sequencing of liberalization, the main question relates to the order in which markets should be liberalized.[1]

In terms of the sequencing of liberalization, the case of Chile and the other Southern Cone countries is particularly interesting, since these countries followed opposite orders -- Argentina and Uruguay opened the capital account first, while Chile opened the current account first. An important policy question that has emerged from these experiences has to do with defining liberalization policy packages, including a specific sequencing, that are credible to the public. This issue has recently gained great prominence in specific policy discussions. For example the recent debate on the liberalization reforms in Korea have focused on the definition of an appropriate sequencing of liberalization for that country. Also, recent policy discussions in Ecuador have evolved around this important issue.[2]

In this chapter a particularly important aspect of the sequencing of economic liberalization -- the order of liberalizing the current and capital accounts of the balance of payments -- will be discussed within the context of

the Chilean experience. The approach followed in this chapter is somewhat different from that of the previous chapters. First, the material presented here is of a more analytical nature. Without repsorting to a technical presentation, the discussion rigorously covers different aspects of the sequencing of liberalization. The main conclusion of this chapter is that in a liberalization experience the sequence chosen to reform markets can be crucial. More specifically, the most prudent strategy calls for liberalizing the current account first; only when this phase of the reform has been finalized the capital account should be slowly opened.

7.1 The Sequencing of Liberalization in Chile

As has been discussed in the previous chapters, the liberalization reforms of the more critical markets in Chile were undertaken at different points in time. In this section, and in order to provide some perspective to the analytical discussion that follows, we summarize the order in which the reforms were undertaken.

The domestic goods market was liberalized first. In October of 1973 domestic prices of all goods -- with the sole exception of 51 "necessities" -- were freed. This represented a major departure from the Allende regime, where prices of over 500 commodities were closely controlled by the Ministry of Economy and Industry. The freeing of domestic prices was followed by the initial steps toward liberalizing the domestic financial market and international trade in goods. Starting in 1977, with Chile's withdrawal from the Andean Pact, the trade liberalization reform was greatly accelerated. By mid-1979 the trade reform was completed with tariffs for all, but two items, having been reduced to a uniform 10%. Significant measures towards lifting controls in international capital movements were enacted for the first time in June 1979. As was explained in detail in Chapter 3, by mid-1981 the

liberalization of capital movements had achieved significant proportions. Short term capital movements, however, were tightly controlled until mid-1982. As pointed out in Chapter 6, the labor market never attained a very high degree of liberalization.

In terms of the external sector, then, Chile liberalized trade in goods first, and only when the desired level of import restrictions was achieved -- the uniform 10% tariff in June of 1979 -- did the process of liberalization of the capital account really started. This sequencing of liberalization of the external sector contrasted with the approach followed by Argentina and Uruguay. Both of these countries opened their economies to capital movements well before their trade account was liberalized.[3] The fact that the reforms ultimately failed in the three countries has added considerable interest to the issue of the appropriate sequencing of economic reform.

7.2 The Appropriate Sequencing of Liberalization of the External Sector: Analytical Aspects

In this section we deal with some of the more important analytical issues related to the sequencing of liberalization of the external sector.[4] The discussion draws heavily on the Chilean case. The question that we address is the following: when designing a strategy for the liberalization of the external sector in a particular country, which account -- the current account or the capital account -- should be opened up first? Of course, from a pure theory perspective the answer to this question is trivial. If there are no rigidities or market failures all markets should be liberalized simultaneously and instantaneously. In most real world situations, however, there are a number of reasons, both political and economic, why this theoretical first best path is not feasible. The discussion assumes that the initial conditions correspond to those of a country like Chile in the mid-1970s, and focuses on

three aspects of this problem: (a) the relationship between the sequencing of liberalization, macroeconomic management and the real exchange rate; (b) welfare aspects of alternative sequencings of liberalization; and (c) the sequencing of liberalization and adjustment costs.

The Sequencing of Liberalization, Macroeconomic Management and the Real Exchange Rate

Not only Chile, but also the other major liberalization episodes in South America during the last decade (Argentina and Uruguay) were characterized by a highly unstable macroeconomic environment. There is little doubt that this macroeconomic instability was not completely exogenous, but that it was in some sense related to the liberalization strategy followed in these countries. In particular, the effects of the opening of the capital account on the real exchange rate was a major problem that affected the final outcome of these liberalization attempts. (See Chapter 3.)

Under most circumstances the opening of the capital account of the balance of payments will result in the short-run in large destabilizing capital flows -- either outflows or inflows. If, for example, the capital account is opened at a stage where the domestic capital market is still repressed, with domestic interest rates fixed at artificially low levels, massive capital outflows will take place. For this reason most if not all authors that have discussed this issue have indicated that the capital account should only be opened after the domestic capital market has been liberalized, and domestic interest rates have been raised. This was indeed the case in Chile, where the domestic capital market was reformed well before any important relaxation of exchange controls was taken.

It is also generally accepted that in an inflationary environment the domestic financial market should only be liberalized after the fiscal deficit

has been controlled. McKinnon and Mathieson (1981), for example, have pointed out that the existence of a large fiscal deficit, which is financed by an inflation tax, necessitates that banks' reserve requirements are kept high and interest payments on deposits are kept low. In this way it is assured that the base on which the inflation tax is collected -- the stock of high powered money -- is not eroded. In fact, as has been suggested by Rodriguez (1983) and Sjaastad (1983) among others, the inability to control the fiscal deficit in Argentina was one of the major causes for the failure of the liberalization with stabilization attempted in that country. Also, as Dornbusch (1984) has recently pointed out capital flights played a key role towards the latter part of the Argentinian experience of 1978-82.

If, on the other hand, the fiscal deficit has been controlled and the domestic financial market liberalized, the opening of the capital account in a developing country will generally result in large inflows of foreign capital, triggered by portfolio adjustments and the existence of interest rates differentials.[5] These inflows will allow an increase in the level of aggregate expenditure both on tradable and nontradable goods, and will generate a real appreciation.

While the opening of the capital account will usually generate a <u>real appreciation</u>, a successful liberalization of the trade account will generally require a real <u>devaluation</u> of the domestic currency. This real depreciation would help the exportables sector to expand as the new structure of relative prices replaces the old protective structure. In fact, as noted in Chapter 5, the Chilean trade liberalization was indeed accompanied initially by a remarkable real depreciation.[6]

If, however, due to the opening of the capital account this real devaluation is precluded, the transition in the goods sector from a protective

to a freer environment will become more difficult. The appreciation generated by the opening of the capital account will tend to squeeze profitability in the tradable goods sector at a moment when this sector (or part of it in the import substitution industries) is going through a costly readjustment. Consequently, it has been suggested by a number of authors that the capital and current accounts should not be open simultaneously, and that during the transition period after trade has been liberalized, capital inflows should be tightly controlled. For example, according to McKinnon (1973, p. 160):

> ...unusually large inflows of foreign capital...inhibit the exchange rate to depreciate sufficiently....[P]reviously protected competing industries, which face a significant adjustment problem, could have their difficulties magnified....[H]ence the capital inflow could trigger a decline in overall domestic output.

McKinnon then goes on to recommend that an economy that liberalizes its foreign trade should "deliberately avoid an unusual or extraordinary injection of foreign capital" (1973, p. 161, emphasis added). More recently this kind of reasoning has also been made by Dornbusch (1983a), Edwards (1984), and again by McKinnon (1982). As Dornbusch (1983a, p. 176) has put it: "The worst thing to do is to liberalize the capital account...before the required real depreciation has been achieved."

A critical question regarding this line of argument is to what extent the freeing of the capital account will result in an "extraordinary" injection of foreign capital, in the sense of the McKinnon quote. If the opening of the capital account results in large capital inflows which are sustainable in the long-run, the resulting appreciation should be viewed as a long-run equilibrium phenomenon. Under those circumstances it is not clear that the opening of the capital account should be delayed on the grounds of its effects on the real exchange rate.

It turns out, however, that it is not difficult to build simple models of an economy that restricts capital inflows, where an opening of the capital account will result in short-run overshooting of the level of capital inflows. In order to illustrate this point assume a country with restrictions to capital movements similar to those existing in Chile in the mid- and late 1970s. In this case, and assuming that capital has to be imported via domestic banks, capital inflows (ΔK) can be represented by the following equation

$$\Delta K = \text{minimum } [\theta(D^*-D_{-1}), \overline{\Delta K}] \qquad (7.1)$$

where D^* is the level of domestic assets that foreign investors want to hold in their portfolios (i.e., Chile's sustainable level of foreign debt). D^* will basically depend on the perception that the international financial community has on the profitability of the domestic economy. Of course, there is no reason for D^* to be constant through time. In fact in a growing economy D^* will go up as time passes. Also, changes in domestic policies will tend to generate changes in D^*. D_{-1} is the actual stock of debt in the previous period. The term θ is a partial adjustment coefficient that represents the maximum increase of foreign liabilities domestic banks can incur in each period (i.e., in the case of Chile, 5% of equity or US$ 2 million per month between June 1979 and April 1980). $\overline{\Delta K}$ is the maximum (possibly zero) amount of (net) capital inflow allowed by the economic authority in every period.

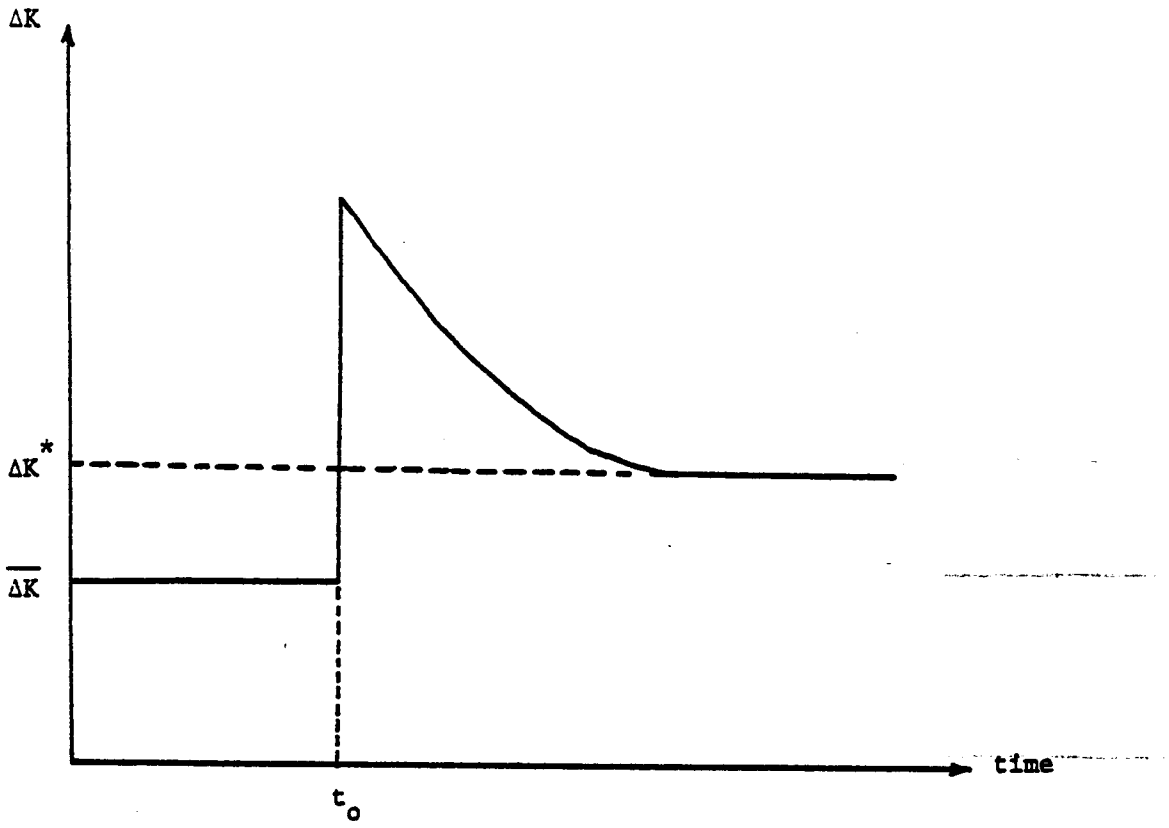
Clearly, if before the liberalization capital controls are binding $\overline{\Delta K} < \theta[D^*-D_{-1}]$, an actual capital inflows will be equal to $\overline{\Delta K}$. Once the restrictions on capital inflows are lifted, actual inflows will become equal to $\theta[D^*-D_{-1}]$. An important consequence of a liberalization reforms that results in a more extensive use of market mechanisms is that foreign investors will generally perceive an increase in the overall profitability of investing in the domestic country.[7] As a result of this the amount of domestic

securities they want to hold (D*), will increase to a substantially higher level after the liberalization reforms are enacted. Immediately after the opening of the capital account an initial jump in the level of capital inflows as in Figure 7-1 will take place. As capital flows into the country, the gap (D^*-D_{-1}) is slowly reduced until it reaches a new equilibrium level.

This sudden increase (i.e., overshooting) of capital inflows will initially generate a large current account deficit — as was the case of Chile during 1979-81. As was pointed out in Chapter 3, as long as a fraction of these additional foreign funds are spent on nontradable goods, the absorption of these capital inflows will require an increase in the relative price of nontradables and real appreciation of the domestic currency. Harberger (1982) has argued that the increase in the level of capital inflows in Chile is capable of explaining a real appreciation of the peso of up to 25 percent between 1979 and 1981.

Once the gap between desired and actual debt begins to close, the relative price of nontradables will decline towards its new long-run equilibrium. This part of the adjustment process, however, can run into some serious problems if the economic structure exhibits some inflexibility. For example, if for some reason the nominal price of nontradables is inflexible downward the country will run into difficulties under a fixed exchange rate. This will be the case, for example, if real wages are institutionally inflexible downward, as was the case in Chile after the enactment of the backward indexation law of 1979. In this case, the real depreciation required to attain equilibrium once the level of capital inflows decreases will not take place. Instead the quantity produced of nontradables will drop, with a resulting important increase in unemployment. In fact, if real wages are rigid, there will be problems with the adjustment process even under a

Figure 7-1



flexible exchange rate (Dornbusch 1984; Edwards 1985).[8] As Harberger (1984, pp. 2-3) has pointed out:

> [H]igh rates of capital inflow drive the real exchange rate down (i.e., cause it to be highly appreciated), a situation that then has to be sharply reversed when the rate of capital inflow is curtailed.

The conflicting movements of the real exchange rate as a result of opening the capital and current accounts (i.e., real appreciation and depreciation respectively), captures the fact that these policies will exercise pressures for resources to move in opposite directions. The opening of the capital account will generate, at least in the short-run, an expansion of the nontradable goods sector and a contraction of the importables and exportables sectors. This indeed has been the case in countries that have opened the capital account. As discussed in the preceding chapters, in Chile, after the capital account was opened in 1979, an important fraction of the massive capital inflows was used to finance the expansion of the construction sector. This was also the case of Argentina and Uruguay (see Nogues 1983; Hanson and de Melo 1983). The opening of the current account, on the other hand, will result in an expansion of the exportables sector, a contraction of the production of importables, with the nontradables sector either expanding or contracting (see Edwards 1986). To the extent that there are adjustment costs associated with resource movements between sectors it is advisable to implement policies that would avoid unnecessary resource switches (i.e., resource movements that will be reversed after a short period of time.

Consider, for example, the case where both accounts are opened simultaneously. Since financial markets adjust faster than goods markets, we will observe an immediate inflow of capital (see Figure 7-1). In the goods market sphere, however, nothing or very little in terms of commodity arbitrage will happen in the very short-run. The result, then, will be that at this

early stage the capital account effect will dominate, with the real exchange rate appreciating and resources (capital and labor) tending to move into the nontradable goods sector. As time passes, the goods market will begin to adjust and the capital account will enter the phase, after the initial overshooting, where capital inflows will slowly decline towards their new long-run equilibrium (see Figure 7-1). At this point the effect of the tariff reduction will begin to be felt and resource movements will be reversed, with capital and labor now moving out of the nontradables sector. To the extent that there are real economic costs related to those resource movements (i.e., adjustment costs), policy measures aimed at reducing these costs should be implemented. In particular, on these macroeconomic grounds, a synchronization of the effects of opening the capital and current accounts, in the sense suggested by Frenkel (1982, 1983) will be called for. Frenkel has proposed that given the differential speeds at which the goods and capital markets adjust, this synchronization could be achieved by opening the current account first, and only after some time opening the capital account.[9]

As is discussed below in more detail, the real appreciation associated with the opening of the capital account will have two additional disrupting effects. First, it will tend to compromise the credibility of the liberalization episode as a whole. Second, after the initial overshooting of capital inflows, the expected real depreciation will result in higher — and in sometimes exorbitantly high -- real interest rates, at a time when the real side is going through the costly adjustment that follows the liberalization of trade restrictions. These negative macro effects of opening the capital account before than, or simultaneously with, the current account should then be weighted against the positive effects of being able to trade at world intertemporal prices, when deciding on the appropriate sequencing of liberalization.

The Welfare Effects of Alternative Sequences of Liberalization of the External Sector

In the preceding section we discussed the macroeconomic implications of alternative sequencing of liberalization of the external sector. In the present section we will deal with the welfare effects of alternative sequencings. In fact, welfare considerations are at the center of the analytical discussion on the order of economic liberalization in developing countries. At the level of the simple textbook case of the small economy without rigidities, the answer to the sequencing question is quite trivial: in order to maximize the present value of welfare both accounts should be liberalized simultaneously and instantaneously. In more complicated (and realistic) cases the answer may be quite different.

We first consider the case where for some reason -- political or other -- all markets cannot be liberalized simultaneously. Under these circumstances we are in a second-best world, and there may be (negative) welfare implications of reducing or eliminating one distortion while other distortions are kept in place. This argument has been made, among others, by McKinnon (1973), Frenkel (1982, 1983), Krueger (1983), and Edwards and van Wijnbergen (1986). These authors have generally concluded that welfare considerations indicate that the current account should be liberalized first, and that only after tariffs have been reduced, and the adjustment process has been completed, the capital account should be opened. This policy recommendation is based on the belief that the negative indirect welfare effect of opening the capital account in the presence of trade distortions will exceed the negative indirect effects arising from the opposite ordering. McKinnon (1973, p. 157), for example has stated that "the liberalization [of] capital inflow[s]... increase[s] the basic distortion in the economy. Krueger (1983, p. 19) has noted that:

> Since exchanges of assets are exchanges of capitalized values of income streams, income streams generated by distorted prices are probably the inappropriate ones at which to trade. It would then follow that capital account liberalization should not be undertaken unless both current account and domestic financial transaction are already liberalized.

While according to Frenkel (1983, p. 167):

> ...when the trade account is opened first the cost of the remaining distortion (i.e., the closed capital account)...is likely to be relatively small. On the other hand, when the capital account is opened up first the cost of the remaining distortion (i.e., the close trade account)...is likely to be very large. Thus a comparison of the costs of distortions...supports the proposition that the trade account should be opened first.

This type of reasoning, which focuses on the welfare effects of opening the capital account in the presence of trade distortions, is in some sense related to the argument of immiserizing capital accumulation originally advanced by Harry Johnson (1967). This argument points out that if there are tariffs and the importable good is capital intensive, capital accumulation may be welfare reducing. When capital is accumulated, production of the capital intensive (i.e., the importable) sector will increase (Rybczynski 1955), and the negative welfare effect of the pre-existing distortion will be reinforced. This effect can be strong enough, so that the accumulation of capital will result in a reduction of welfare (Johnson, 1967). If this is the case, however, why would the recipients of capital flows from abroad use them to accumulate capital? The answer is that the private domestic real return to capital will exceed the world's real interest rate when importables are capital intensive. Therefore, the accumulation of capital will be beneficiary from a private perspective but will be less desirable from a social perspective -- and could even be immiserizing.[10]

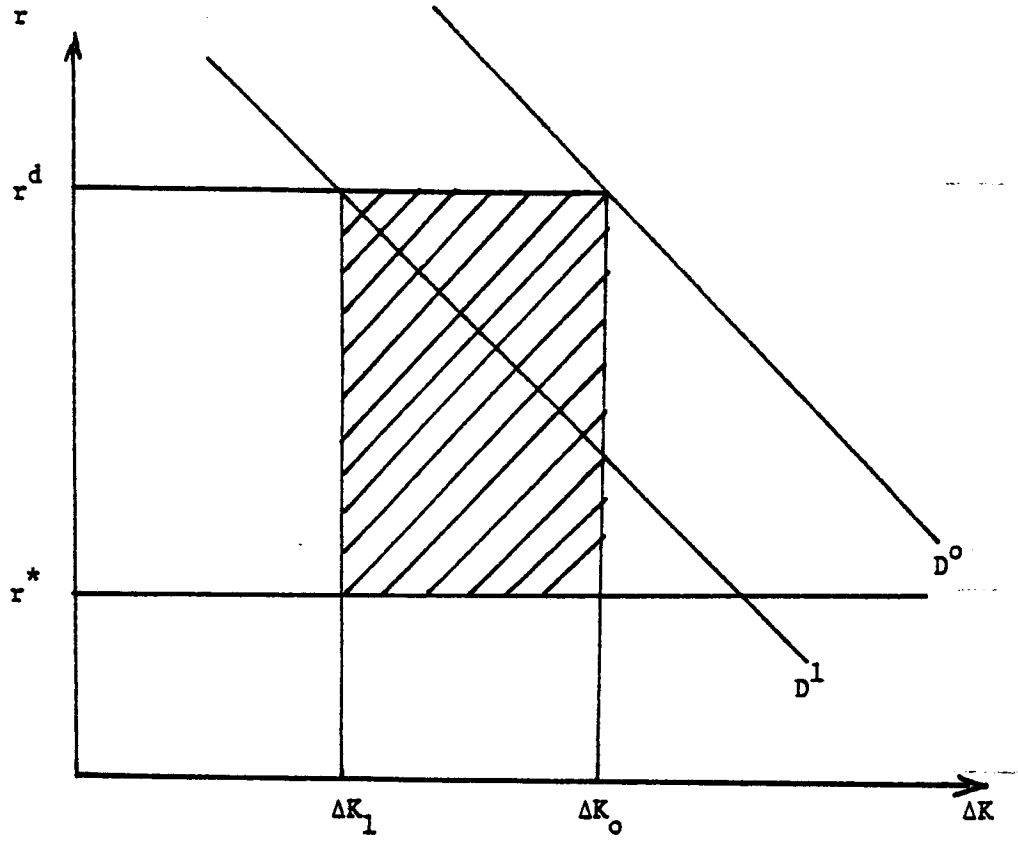
What are the welfare effects of liberalizing trade in the presence of a closed capital account? Are there circumstances under which this particular order of liberalization will result in some indirect negative welfare effects?

In principle, it is conceivable that under certain circumstances this result will emerge. Specifically, if the restrictions in the capital account take the form of a tax on foreign borrowing that introduces a wedge between foreign and domestic rates of interest, and the liberalization of the current account results in a reduction (i.e., leftward shift) of the demand for foreign borrowing, an indirect negative welfare effects could result. This case is illustrated in Figure 7-2 where the shaded rectangle represents this cost.

In practice, however, this case is somewhat implausible. First, it is unlikely that the reduction of tariffs will generate a reduction of the demand for foreign borrowing. On the contrary, once tariffs are reduced there will generally be a tendency for the demand for importables to increase, with part of this increase in demand being financed by additional foreign borrowing, as was indeed the case in Chile.[11] Second, in a large number of cases the distortions associated with the capital account take the form of quantitative restrictions, where a given maximum amount of foreign borrowing is allowed. In this case there is no indirect welfare cost (i.e., welfare rectangle), in the borrowing market associated with the reduction of trade distortions. These considerations, then, tend to support the presumption that trade liberalization is welfare improving even if distortions in the capital account are maintained.

An important problem related to the welfare effects of economic liberalization in developing countries is whether the external sector should be fully or only partially liberalized. From a theoretical perspective the answer to this question is again clear. Unless the country in question can alter world prices, and in the absence of other distortions, the first best solution is to completely liberalize the economy, eliminating tariffs, quotas and all restrictions to financial movements. If, on the other hand, the

Figure 7-2



country has a monopoly or monopsony position and can affect world prices there is a first best argument for the imposition of some restrictions. This case has been extensively discussed in the trade literature on optimal import tariffs and optimal export taxes (Bhagwati and Srinivasan 1983). From a practical point of view, however, there may be a number of reasons why all restrictions on external transactions should (or could) not be removed. For example, it is possible that, in some instances, there are no superior ways of dealing with other domestic distortions. Even though in these cases trade and capital controls are clearly third-best options, they may be the only alternative available (see Johnson 1965).

While in practice there are a number of developing countries that have a monopoly position in the production of certain commodities, most (if not all) LDCs are small in the world financial market. This, however, does not mean -- as the recent experience has forcefully shown -- that these countries can borrow infinite amounts at a given interest rate. Quite on the contrary, countries face borrowing limits in the world financial markets, and they are charged a premium which is positively related to the perceived degree of country risk (Eaton and Gersovitz 1980, 1981; Harberger 1983; Sachs and Cohen, 1982). The existence of this country-risk premium implies that even (very) small countries face an upward sloping supply curve for foreign funds, where the interest rate at which they can borrow will increase with a higher level of indebtedness. An empirical study by Edwards (1984b) has found a significant and robust positive relation between the spread charged over LIBOR on foreign loans to developing countries and their level of foreign indebtedness. This evidence suggests that there is a negative externality associated with the process of borrowing from abroad in developing countries, stemming from the fact that there is a divergence between the average and marginal cost of

foreign borrowing. From a policy perspective the best way of dealing with this problem is by imposing a tax on capital importation.[12] In this case there is a genuine first-best argument for not fully liberalizing the capital account. As Harberger (1982, p. 13) has put it:

> The corrective for any such externality [the difference between the marginal cost of international credit and its average cost] is something that will lead economic agents to internalize it. In the present case a tax would be the obvious instrument for accomplishing this task.

The Sequencing of Liberalization Adjustment Costs and Credibility

The reduction of trade barriers will result in changes in domestic relative prices and in resources being reallocated across sectors. In general, any process of economic liberalization will require an adjustment period where firms go through a retooling process and labor acquires new skills. Generally this adjustment process will take time and will be quite costly. Some authors have postulated that in order to increase the probability of success of the trade reform, the adjustment costs (unemployment and others) related to the tariffs reduction should be minimized (see for example, Michaely 1982). The idea of minimizing adjustment costs has been translated into two forms of policy recommendations: (1) liberalization of trade should be done slowly; and (2) adjustment assistance -- usually in the form of foreign funds — should be provided. One possible way of reducing these adjustment costs is through the immportation of foreign capital, which would be used to finance a smoother adjustment of the import competing industries.

According to this view, the capital account should be opened first, or simultaneously with the trade account. This would increase the availability of "cheap" funds that could then be used to ease the adjustment process (Little, Scitovsky and Scott 1970, Ch. 10; and Michaely 1982, p. 17). Anne Krueger (1983, p. 11), for example, while not agreeing with the order "capital account

first and trade-account second", has also recognized the possible important role of foreign funds to help achieve a smoother transition. As she puts it:

> [O]ne of the important contributions international lending can make to a country when its leaders are genuinely committed to full liberalization, [is to]...permit higher levels of imports than would otherwise be feasible....Not only does this reduce the economic and political strains associated with liberalization, it also reduces uncertainty of business as to the likelihood that liberalization will persist.

Paul Clark (1982, p. 2), on the other hand, argues that the successful liberalization of the Egyptian economy in the 1970s was due, to a large extent, to the adjustment assistance provided by foreign sources: "Egypt's liberalization experience has taken place during a period in which external assistance first rose dramatically...."

Arguments for using foreign funds to smooth the adjustment process during a trade liberalization episode are related to arguments in favor of providing adjustment assistance to industries that are negatively affected by (exogenous) changes in the terms of trade.[13] As Bhagwati (1982) has pointed out, the analysis of the adjustment assistance issue requires knowing the path the economy will take following the change of relative prices (i.e., changes in terms of trade and/or tariff reductions). According to the simple textbook case, following a change in relative prices, resources will immediately move out of the sector whose relative price has declined and into the expanding sector. In more complex models, however, there will be adjustment costs and resource reallocation will only take place slowly, and will possibly result in a short-run loss of output. However, it is important to clearly specify the nature of these adjustment costs before making inferences regarding the desirability of intervening through assistance. If these costs are related to the activity of moving resources between sectors, as in Mussa's (1978) model, and there are no externalities, there is no welfare-related reason to provide

adjustment assistance. However, even in the absence of distortions, adjustment assistance might be called for other reasons, like income distribution considerations, as has been argued by Leamer (1980). If, on the other hand, adjustment costs arise from market imperfections -- like the existence of minimum wages for example — there is room for intervention. The first best policy, of course, is to try to eliminate the source of these market imperfections. If, for whatever reason, this first best policy is not available, second best solutions should be sought.

McKinnon (1973, 1982), has strongly opposed the idea of using foreign capital flows to assist the trade reform transition period. In fact, in his 1973 book he points out that if capital inflows are allowed the liberalization episodes will generally be aborted. He refers to these cases as "partial liberalization with foreign capital" (1972, p. 155). This view, of course, is consistent with his position of tightly controlling capital inflows throughout the trade liberalization, and is based on the idea that short-term capital movements provide incorrect signals to the private sector. As he has stated (1982, p. 163):

> [T]rade liberalization should proceed without relying on unusual short-term inflows of private capital....Such capital inflows are simply not sustainable in the long-run; and during the liberalization process itself they throw out incorrect market signals.

There are two potential problems with this view. First, it is not clear what is meant by "unusual" inflows of capital. Second, there is no theoretical *a priori* reason to believe that these "unusual" capital inflows will provide the wrong signals. In order for this argument to make sense it is necessary to explicitly specify why the private sector will not realize (as the government presumably does in McKinnon's model) that these inflows are temporary and "unusual". If, on the other hand, the private sector does realize the temporary nature of the inflows, they will not throw incorrect

signals and there is no reason, at least on these grounds, to restrict capital movements.

A critical, and perhaps even central question regarding this problem is related to the credibility of the trade reform. If the public believes that there is some probability that the reform will be reversed in the future, foreign funds, obtained through the opening of the capital account, may be used by the owners of capital in the import substitution industries to maintain their firms functioning at a (temporary?) loss. Alternatively, these funds could be used to finance lobbying activities aimed at convincing government officials of the desirability of reversing the trade reform. This was the recent case in Argentina where, due to the lack of credibility on the future of the pre-announced trade reform, firms used foreign funds in order to survive in the short-run. As Carlos Rodriguez (1983, p. 28) has put it in his evaluation of the Argentina experience of 1978-82:

> As a consequence of the lack of credibility on the continuity of the economic program, many firms -- which would have disappeared due to the tariff reductions -- decided to get into debt in order to remain operating while waiting for a change in the economic strategy. [emphasis added]

Also, if agents believe that the trade reform will be reversed, they will tend to borrow heavily today, in order to finance a higher present consumption of imported goods. This, indeed, seems to have been the case in Chile in 1981. This is a perfectly rational strategy if it is expected that importable goods in the future will be more expensive, due to the perceived hike of tariffs. This optimal behavior from a private perspective, however, may result in excessive (i.e., non-optimal) borrowing from the social point of view.

Depending on the degree of credibility a larger availability of foreign funds may either help the adjustment process -- by making it politically more pallatable as Krueger suggests -- or may frustrate the experience. The degree

of credibility, however, should not be viewed as a completely exogenous variable. On the contrary, the strategy followed during the liberalization process will tend to affect this credibility.

A fundamental aspect of establishing credibility is related to the perception the public has on the internal consistency of the policies being pursued. In that respect, for example, the inconsistency of the Argentinian fiscal policy -- which maintained a very large fiscal deficit -- and the preannounced exchange rate policy severely undermined the degree of credibility of the reform process. In the case of Chile the markedly overvalued currency was seen by large segments of the public as inconsistent with the long-run viability of the liberalized economy. In general, if the real exchange rate experiences an unprecedented real appreciation the public will probably think that exports will not be able to develop, and that there is a nontrivial probability of the reform being reversed in the future. Under these circumstances it will be optimal for consumers to get into debt today in order to acquire "cheap" importables.

The present section has focused on some analytical aspects of the sequencing of liberalization of the capital and current accounts of the balance of payments. There are, however, other important issues related to a broadly defined liberalization process that deserve to be briefly mentioned. First, if a liberalization will not completely eliminate all distortions, the question of welfare effects of partial reforms will become critical. Even though theoretically and from a second-best perspective almost anything, in terms of welfare, can happen as a consequence of a partial reform, there are well founded conjectures that the liberalization of some markets only will be welfare improving (see Krueger, 1983).

Second, the question of the speed of liberalization is also important. In the simplest textbook case with no market imperfections and/or externalities, markets should be liberalized very quickly (now). If externalities and/or market failures are present, however, and the first best policies to deal with them are not available, a gradual liberalization might be called for (Mussa 1986).

Third, the relationship between liberalization and stabilization is crucial to understand the success or failure of liberalization reforms, since many liberalization attempts have been undertaken in conjunction with major stabilization programs (Krueger 1978; Little 1982).[14] There are some important aspects of the relationship between these two policies that deserve further attention. In particular, in light of the Chilean experience it seems that it may not be desirable to implement an almost complete liberalization at the same time as the economy is going through a major stabilization effect. The reason for this is that, in the public's eyes, it is not clear whether the adjustment costs that have taken place are due to the liberalization or the anti-inflationary programs. Also if the stabilization program relies to any degree on exchange rate management a real appreciation -- which will be detrimental for the liberalization effort -- will occur.

7.3 The Sequencing of Liberalization: Lessons from Chile

While the analysis presented in this chapter has not yielded a strong theorem regarding the appropriate order of liberalizing of the current and capital accounts of the balance of payments, both the historical evidence and the theoretical considerations discussed suggests that a more prudent strategy would be based on liberalizing the current account first. Perhaps the strongest case for this ordering is based on the relation between macroeconomic stability, capital flows, the real exchange rate, and credibility. The

experience with destabilizing capital flows immediately following a capital account liberalization has generally been negative and has jeopardized other apsects of the reform package. Historical experiences also suggest that the capital account should be opened slowly, so that the possible increase in the stock of foreign debt that will follow the liberalization will be spread through time, reducing the degree of real appreciation and exchange rate deprotection. Also to the extent that due to the existence of country risk these countries face an upward sloping supply curve of foreign funds there is an argument for imposing an optimal tax on foreign indebtedness.

The Chilean experiment offers some important lessons for the sequencing debate. First, this episode shows that the destabilizing effects of massive capital movements are much greater than what most observers initially thought. With hindsight we can say that in the Chilean case it would have been advisable to distance even more in time the two reforms. More generally, the experience suggests that in countries whose initial conditions resemble those in Chile in the early 1970s, the capital account should be opened rather slowly, and after "sufficient" time has elapsed since the trade reforms have been completed. Of course, it is not possible to state in a precise fashion what "sufficiently after" means. Policymakers, however, should monitor real exchange rate movements and the external sector behavior when deciding how to relax capital movement controls.

Second, the Chilean experiment clearly shows that the destabilizing effects of massive capital movements are greatly magnified in the presence of other distortions like legally imposed wage ridigity.

And third, this experience highlights the crucial role of credibility in the success of an economic reform. Obviously, if the public believes that the reform attempt will be reversed, it will act accordingly and may even be able

to frustrate the whole liberalization reform. In the Chilean case the combination of marked exchange rate overvaluation and a passive government macroeconomic policy undermined the public's credibility on the maintenance of both the exchange rate and tariffs policy.[15] It is, we believe, in the credibility sphere where the most important lesson on the sequencing of liberalization lies. In a sense the implementation of a consistent and credible policy package is more important than determining "the correct" order of liberalization.

Footnotes to Chapter 7

[1]A related question — in fact one that preceeds the sequencing of a speedy one -- is whether countries should liberalize at all. We believe that the answer is positive, and we discuss the issue in more detail in Chapter 8.

[2]See, for example, Park (1985), Yoo (1985) and World Bank (1986). The issue of the appropriate order of liberalization has also become important in the more analytical literature. See, for example, Rodnick (1985), Edwards (1984, 1986), McKinnon (1983), Frenkel (1983) and Bruno (1985).

[3]On Argentina see, for example, McKinnon (1983) and Fernandez (1986). On Uruguay see de Melo and Hanson (1986).

[4]Parts of this section draw from Edwards (1984).

[5]McKinnon (1973) discussed this problem in his classical analysis of economic liberalization policies.

[6]This is not always the case. Under some circumstances a trade reform may result in a real appreciation. On this issue see the discussion in Chapter 3 of Edwards (1987). However, under the most plausible circumstances in terms of elasticities a trade liberalization will require a real depreciation.

[7]This point is made, for example, by McKinnon (1986). See also Edwards (1986b).

[8]The dynamic effect of a capital account liberalization resembles that of the Dutch-Disease. On Dutch-Disease see, for example, the essays collected in Neary and van Wijnbergen (1986). See Chapter 5 of Edwards (1987) for a thorough discussion on the effects of capital movements on the real exchange rate.

[9]Deepak Lal (1984) has recently presented an alternative view. According to him, since exchange rate behavior is critical during the transition period from a protected towards a liberalized trade account, it is better <u>not</u> to let

the government manipulate the nominal exchange rate during this transition. There have been plenty of cases, he argues, where exchange rate management has been inappropriate and has resulted in the trade reform being finally aborted (i.e., the recent experience of Argentina). For this reason Lal has proposed that a floating exchange rate system with full currency convertibility should be implemented before the trade reform takes place. This, of course, means that the capital account should be liberalized before the trade account. See Edwards (1984a) for a discussion of this proposition.

[10]The above discussion, and the arguments of McKinnon (1973), Frenkel (1982, 1983) and Krueger (1983) focus exclusively on the case where as a consequence of the liberalization of the capital account the additional borrowing is used to increase investment. This, of course, needs not be the case. A fraction (possibly zero) of the new borrowing could be used to increase present consumption. Indeed, that will happen as long as prior to the liberalization the domestic rate of time preferences exceeded the (given) world rate of interest. It is easy to show that under these circumstances and according to the traditional trade model, if all of the (new) foreign borrowing is used for additional present consumption (with the world rate of interest below the domestic rate of time preferences) welfare will not deteriorate even if there are tariffs.

[11]There is an important problem, however, related to the speed of tariff reductions. It is conceivable that if a slow tariff reform is announced today borrowing will decrease, since the public will postpone consumption towards the future, when tariffs will be lower. See Edwards and van Wijnbergen (1986a,b).

[12]It should be noticed that this argument for imposing a first-best optimum tax on capital imports should be qualified in an important way. If

borrowers and lenders have the same perception about the probability of default, the country risk premium is not a real part of the cost of borrowing, and no tax should be imposed on these grounds. If, however, as argued by Harberger (1976, 1980) lenders perceive a larger probability of default than borrowers, there is a first-best reason for imposing such a tax. See also Edwards (1986a,b).

[13]An important issue, however, is how are these additional funds made available. In one case the capital account is fully opened and free international borrowing and lending is allowed. Alternatively, the capital account is only partially opened and some sectors only are allowed to obtain funds from abroad. This latter case is more similar to the adjustment assistance literature.

[14]There have been, of course, important exceptions to this. For example the 1983-87 Korean liberalization is being carried out in a framework of great price stability.

[15]It is very important to emphasize that from the fact that there are some macroeconomic problems related to the sequencing of reform, it does <u>not</u> follow that the capital account should never be opened. Quite on the contrary, there are some obvious benefits from dismantling capital controls -- the most important being the possibility of trading, intertemporally at world prices. What our discussion points out is that in a country like Chile in the early 1970s, there are clear indications that it is more prudent to liberalize the current account first.