MACROECONOMIC POLICY AND TRADE LIBERALIZATION: SOME GUIDELINES

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Trade liberalization seeks to reform a country’s international commercial policies in order to improve economic welfare by achieving a better allocation of resources in the long term. In contrast, macroeconomic policy is concerned with shorter-term management of the whole economy, especially aggregate output and employment, the price level, and the balance of payments. Despite these fundamental differences, successful trade liberalization is linked to the conduct of macroeconomic policy. In particular, problems resulting from poor macroeconomic policies may cause liberalization to be perceived as a failure, prompting a return to the protectionist policies that injure economic welfare in the longer run.

This paper examines the interaction between trade liberalization and macroeconomic policies. It describes the policy environment of a country opting for liberalization, which has many of the characteristics of developing countries with highly protective trade policies. Liberalization is assumed to reduce the general level of protection and to narrow the range of protection rates among different activities. In the long run, these policies are assumed to achieve a shift of resources toward exports and away from import substitutes. This long-run adjustment, however, cannot be achieved without some shorter-run difficulties that may be ameliorated or exacerbated by macroeconomic policies.

The first macro issue to be considered is the exchange rate. At a constant nominal rate, a country adjusting to a major trade liberalization needs to reduce its domestic prices. Alternatively—and often more appropriately—it may choose to devalue the exchange rate suf-
ficiently to offset the effects of trade liberalization on the general level of domestic prices.

Fiscal and monetary policies are then discussed. Most developing countries maintain some form of pegged exchange rate, which imposes serious constraints on monetary policy, and they frequently rely on the domestic banking system to finance budget deficits. This strategy leaves the government little latitude for conducting monetary policy independently of exchange rate and fiscal policies. As for fiscal policy, the critical task is to control the government deficit. This task can be made more difficult by three possible results of trade liberalization: a decline in revenues from tariffs and export taxes; a decline in revenues from import-competing enterprises (and larger deficits of public enterprises); and an increase in financial assistance to exporters and as a cushion for firms affected by competitive imports.

Wage policy is also discussed, particularly the need to reduce real wage rates in some sectors of the economy in conjunction with a trade liberalization. Avoiding a fall in the general price level, and perhaps allowing some increase, may make a desirable contribution to this goal. Also, the government can set a good example by insisting on appropriate cuts in real wages for government employees and by preventing public enterprises from running large deficits to avoid or delay the necessary cuts.

In regard to credit policy, the government needs to ensure an adequate supply of credit to finance the expansion of exporters. A key requirement is that the government does not allow its own deficit to crowd out private investment. It should also ensure that the financial problems of firms previously benefiting from protection do not jeopardize the financial system. If private borrowers have direct or indirect access to international credit markets, it may also be appropriate to limit destabilizing surges of foreign borrowing.

In all these areas, success depends on the government's establishing and maintaining a credible commitment to a liberal trade policy and to macroeconomic policies consistent with this reform. If this commitment is in doubt, it will discourage movements of resources out of import-competing activities and into the expansion of exports. Because political pressure from those injured by a sudden removal of protection might stop or reverse liberalization, a government may want to liberalize gradually. If it moves too gradually, however, it creates doubts about its seriousness and encourages the political forces opposing liberalization. The right policy is likely to be the one that recognizes that previously protected groups are going to lose but seeks to moderate their losses. The other requirement for a credible policy of liberalization is to avoid a severe deterioration of the balance of payments, because that might induce the reintroduction of protectionist policies.
For analytical purposes, it might be supposed that the economy liberalizing its trade falls into one of two camps. At one extreme, take the example of a country with little market power in world trade, where resources move costlessly and instantaneously among alternative uses in response to the signals provided by relative commodity and factor prices; all markets clear, so all resources are fully employed; and there are no distortions of the economic system that significantly diminish the benefits of trade liberalization. On such extreme assumptions, there is little to be said about the macroeconomic policies that should be adopted in conjunction with trade liberalization. Exchange rate and monetary policies would influence nominal prices and the central bank's reserves of foreign exchange but would not affect relative prices or any of the real consequences of trade liberalization. Fiscal policy might affect the division of economic activity between the public and private sectors but would not have any significant connection with trade liberalization, aside from the need to replace government revenues previously derived from restrictive trade policies. The same can be said for other categories of macroeconomic policy.

At the other extreme, a country might have permanent rigidities of nominal and relative prices of commodities and factors, and the allocation of its real and financial resources might be highly inflexible because of binding political or other noneconomic considerations. In this example, too, there is little to be said about the macroeconomic policies accompanying trade liberalization. If the economic system is so inflexible that it cannot achieve any reallocation of resources, except at great cost, then trade liberalization itself may not be desirable. Rather than attempting any macroeconomic reform, a country would do better to try to eliminate or reduce microeconomic rigidities.

This article does not adopt either of these extreme models. Rather, it assumes an environment similar to that which might be found in developing countries contemplating a major trade liberalization. The country is assumed to start out with a high level of protection for its import-competing industries (especially in manufacturing) and to plan a large reduction in protection over a few years. Specifically, the average nominal level of protection for import-competing activities is assumed to be 50 percent, declining to 10 percent. Some exports may initially benefit from incentives that partially offset the protection given to import-competing industries. As trade is liberalized, incentives to particular exporters are reduced along with reductions in explicit and implicit export taxes. Specifically, the average equivalent tax on exports relative to imports is assumed to fall from 60 percent to 10 percent—made up of a reduction in the average equivalent nominal tariff rate from 50 percent to 10 percent and a
reduction in the average equivalent export tax rate from 10 percent to zero.

In the long term, the major effect of this trade liberalization should be an expansion of exports, both traditional and nontraditional, at the expense of import-competing activities. Among import-competing activities, resources should shift away from those with previously high effective rates of protection toward those with previously low or negative rates of protection. There may also be a net shift of resources between the tradable and nontradable goods sectors, since greater efficiency in the tradable goods sector allows its output to expand without any increase in the total resources employed. This increased output of tradable goods may or may not exceed the increase in domestic demand for such goods that would normally be the result of trade liberalization.

Costs and delays in moving resources to alternative uses are assumed to prevent the economy from responding immediately to the incentives of a liberalized trade policy, even in the absence of stickiness in the adjustment of commodity and factor prices. Costs and delays are also encountered in expanding many exports that cannot be sold at a given price, in unlimited quantities, on world markets. Also, some temporary stickiness is assumed to affect nominal and real wages.

The country adopting the trade liberalization is assumed to maintain a fixed exchange rate and to pursue monetary and credit policies consistent with its exchange rate policy and with the maintenance of balance of payments equilibrium. Fiscal policy is assumed to be consistent with exchange rate and monetary policies and with the requirements of balance of payments equilibrium before the trade liberalization. For these conditions to be satisfied, the general level of domestic prices, adjusted for the nominal exchange rate and for existing commercial policies, must bear the appropriate relationship to world prices, and the supply of domestic credit must not be expanded more rapidly than the growth of demand for domestic money (at the pegged nominal exchange rate) in order to finance budget deficits or for other purposes. Furthermore, government borrowing from abroad must not exceed the amount that the government could reasonably be expected to repay by securing command over future export revenues.

In many developing countries, these assumptions may not be satisfied, so this article will also consider the implications of alternative assumptions. It will show that some combinations of exchange rate, monetary, and fiscal policies are consistent with the success of trade liberalization; others create difficulties of their own and interfere with the possible success of trade liberalization.

Other assumptions include reasonable credibility in the government's trade and macroeconomic policies. Private agents, of course, recognize the possibility that the liberalization policy may be reversed.
but do not believe that such a reversal is likely unless the policy shows serious adverse consequences. Similarly, private agents may doubt the government's capacity to maintain the nominal exchange rate, but these doubts are assumed to become serious only when there is concrete evidence of developments that will force the government to change its plans.

Conditions in the rest of the world can have considerable influence on the success or failure of a country's reforms. Liberalization is more likely to succeed when the world economy is growing rapidly than during a recession. Proper macroeconomic management also tends to be easier during periods of rapid growth. Unfortunately, these observations do not provide any real clues as to the specific time to liberalize. Moreover, since freer trade is a long-term policy with long-term benefits, it is most convenient to consider it being introduced when world economic conditions are broadly neutral.

The nominal exchange rate, together with commercial policies (tariffs, quotas, export taxes, and the like), has a major influence on local-currency prices of imported goods and domestic goods that compete closely with them. At a given nominal exchange rate, the major trade liberalization described earlier would induce (a) a reduction of about 40 percent in the local-currency prices of imports (corresponding to the 40 percent cut in the average equivalent nominal tariff rate) and (b) an increase of about 10 percent in the local-currency prices of exports (corresponding to the 10 percent cut in the average equivalent export tax rate). The local-currency prices of import substitutes would presumably need to fall by roughly the same amount as the prices of imports. Under reasonable assumptions about demand and supply elasticities, the local-currency prices of nontraded goods would also need to fall significantly, though less than those of import substitutes. If all these factors are taken into account, the general level of domestic prices would need to decline by 15 to 30 percent to reach its new equilibrium.

If the local-currency prices and wages were perfectly flexible, adjusting immediately to maintain full employment of all resources, then the only reason to adjust the nominal exchange rate in conjunction with a major trade liberalization would be to avoid losing foreign exchange reserves. According to the monetary approach to the balance of payments, this loss of foreign reserves would otherwise occur because, at a constant nominal exchange rate, the long-run equilibrium level of demand for domestic money declines as a result of the fall in the long-run equilibrium of domestic prices. The decline in long-run money demand may be slightly smaller than the fall in domestic prices because trade liberalization induces some growth in

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real domestic output and hence in the real demand for domestic money.) With a constant supply of domestic credit, this decline in money demand would require a corresponding loss of foreign exchange reserves. To avoid this, it is necessary to devalue the nominal exchange rate by enough to maintain long-run money demand at its level before the trade liberalization. The devaluation should normally be a little less than the fall in domestic prices that would result without a devaluation. With the exchange rate falling, trade liberalization would then reduce only slightly the general level of domestic prices, but would still require large cuts in the local-currency prices of imports and import substitutes.6

Avoiding a loss of foreign reserves is not the only reason for considering devaluation in conjunction with trade liberalization. For economies in which prices and wages are not perfectly flexible, it can be argued that the minimum appropriate devaluation is one that would avoid a decline in the long-run equilibrium level of domestic prices. This in turn would avoid the need for unemployment of resources in most sectors of the economy in order to achieve a general decline in product and factor prices. However, prices and wages in import-competing sectors would still need to fall; a devaluation of 15 to 25 percent would not compensate them for a 40 percent cut in the average equivalent nominal tariff rate.

That conclusion does not mean that it would be right to devalue by the full 40 percent, so as to shield import-competing activities. They had previously been highly protected; resources need to be moved out of them; and economic incentives are needed to encourage such movement. A large devaluation would simply generate a massive increase in the general price level, and even that would not nullify the effects on import-competing sectors. After all, money illusion is not unlimited. People cannot be fooled into accepting without a whimper big cuts in real wages and profits when these are brought about by a general price rise, if they would strongly resist similar cuts brought about by a decline in nominal wages and profits. Indeed, a big devaluation that attempts to shield import-competing activities from trade liberalization can easily be self-defeating, if it makes all sectors try to protect their real incomes from the effects of general price inflation.

For a country with a reasonable record of exchange rate and price stability, the best exchange rate policy to accompany a major trade liberalization is likely to be a modest devaluation that can plausibly be represented as “an adjustment of the exchange rate to avoid the deflationary consequences of trade liberalization.” Theoretically, the need for such a devaluation is clear; it could also be made apparent to the general public.6

The timing of the devaluation also needs to be considered in conjunction with the phasing of the trade liberalization. If trade is liberal-
ized all at once, then it probably makes sense to devalue at the same time. If the liberalization is phased in over three or four years, then it may be desirable (for a country with a history of exchange rate and price stability) to devalue the exchange rate once, at an early stage of the liberalization process. The right moment is probably the first big reduction in import tariffs (or tariff equivalents), rather than the time of a switch from quotas to tariffs, and the devaluation should be slightly smaller than the cut in tariffs. This would put relatively little initial pressure on the nominal prices of import substitutes, but the knowledge that further tariff reductions would follow would encourage people to switch resources out of import-competing activities. In addition, by concentrating all the exchange rate devaluation into this stage of the liberalization, exporters are given some extra (if temporary) incentives—these incentives should help to promote the switch of resources.

Policy prescriptions are harder for a country that has had rapid inflation and a large exchange rate depreciation. People are likely to see a faster devaluation as the precursor of faster inflation, even though this need not be true when a major trade liberalization is being implemented. Hence, a devaluation intended to neutralize the deflationary effects of trade liberalization is likely to have some inflationary effect as workers and capitalists try to protect real wages and real profit margins from the general inflation they expect.

To deal with this difficulty, a larger-than-average depreciation may sometimes be appropriate for a country with a history of rapid inflation and exchange rate depreciation. The evidence suggests that even in highly inflationary countries, a big devaluation of the nominal exchange rate tends to produce a temporary reduction in the real rate. In other words, a big devaluation tends to raise the domestic price of internationally traded goods relative to the general level of domestic prices. However, a devaluation large enough to have a significant effect of this kind in the short run is likely to contribute considerably to domestic inflation through a substantial once-and-for-all increase in the equilibrium level of domestic prices and perhaps also through subsequent price increases due to the effects of indexing. Since many high-inflation countries attempting trade liberalization may also be trying to curb inflation, this is a serious drawback.

Is it therefore sensible for a government to try simultaneously to liberalize trade and to reduce inflation? The initial stages of a trade liberalization are likely to squeeze the import-competing sectors, and perhaps even the economy as a whole, unless the exchange rate is devalued. However, a devaluation is likely to hamper or frustrate anti-inflation policies. A serious anti-inflation policy is also likely to
squeeze the whole economy, placing strain on a country's economic and political fabric. If the strains are too great, trade liberalization and anti-inflation policies may both be reversed, and the whole exercise abandoned.

If the potential benefits of trade liberalization are large relative to the costs of inflation, it may make sense to pursue the liberalization first. For a country that pegs its nominal exchange rate between devaluations, it will then often be desirable to combine the first major reduction in protection with a devaluation. A lower exchange rate would offset some of the deflationary consequences of tariff cuts and give some extra incentives to exporters. The devaluation should probably be larger for a high-inflation country, where domestic and international prices are usually most out of line. Furthermore, the benefits of devaluation are likely to be eroded more rapidly in a high-inflation country. Later, as tariffs are reduced further, more devaluations may be desirable. However, governments need to be careful to limit the speculative movements in capital and trade that would occur if devaluations were widely anticipated.

For a high-inflation country with a crawling peg exchange rate, it will often be appropriate to combine the first big reduction in protection with a maxi-devaluation designed to avoid the deflationary consequences of trade liberalization. If subsequent reductions in protection are made in small steps, they might be timed to occur with normal devaluations of the nominal exchange rate. However, maxi-devaluations that coincide with later measures to liberalize trade on a big scale undermine the principal advantage of a crawling peg system for a high-inflation country. A crawling peg allows a country with rapid inflation (relative to the rest of the world) to devalue its nominal exchange rate smoothly, without the disruptions that go with occasional big devaluations or with exchange rates that remain overvalued for long periods. Under a crawling peg, occasional maxi-devaluations may be necessary to correct major price misalignments. However, it is desirable to keep such maxi-devaluations to a minimum; hence, they may not make sense as a regular and predictable element in trade liberalization.

If a government decides to pursue an anti-inflation program before liberalizing its trade, it can still implement those liberalizing measures that assist its anti-inflation goals. These measures include cuts in tariffs that are redundant or provide very high levels of protection, as well as shifts from import quotas to tariffs. Reducing protection for the most protected activities is desirable because it allows the squeeze of an anti-inflation program to be concentrated on those sectors that have the highest domestic resource cost relative to social value added. A government can also boost its revenues by cutting tariffs to levels that allow imports to increase to revenue-maximizing levels. Since the
rents associated with quotas are rarely captured by governments, the shift from quota to tariff also increases government revenue. These extra revenues can make a useful contribution to the anti-inflation program by helping to alleviate one of the main causes of inflation in many countries—the government's need to create money to finance its budgetary deficit.

In many industrial countries, there is no essential link between fiscal and monetary policies or between them and commercial policies (tariffs, import quotas, export incentives, and so forth). Governments can borrow to finance their deficits without automatic resort to the central bank. Revenue from tariffs is not an important source of government finance. In many developing countries, by contrast, monetary and fiscal policies are closely linked because opportunities for financing budget deficits other than from the central bank are limited. Also, taxes on trade are a considerable source of government finance.

The fiscal consequences of trade liberalization are diverse:

- Some measures normally taken during the early stages of trade liberalization help to boost government revenue and thereby reduce the need to create money to finance the budget deficit.
- In the later stages of trade liberalization, however, cuts in tariffs below revenue-maximizing levels and lower export taxes are likely to reduce government revenue by more than the reduction in spending on export incentives.
- Taxes collected from previously profitable firms in the import-competing sector are likely to decline and not be replaced immediately by taxes collected from newly profitable exporters.
- Losses of government enterprises in the import-competing sector will drain the budget, especially if there is prolonged resistance to reductions in real wages and payrolls in these enterprises.
- Adjustment assistance or benefits paid to distressed workers or firms in the import-competing sector are another possible drain on the budget.

As the positive effects of trade liberalization come through, however, these pressures on the government budget should diminish. In the longer run, liberalization should produce budgetary benefits, except for the direct loss of revenue from taxes on trade. A government whose fiscal position is initially strong may therefore be able to absorb the temporary fiscal strains of liberalization. Other governments may have difficulty. If they have access to commercial credit, one possibility would be to finance the social investment in trade liberalization by borrowing abroad. Another possibility would be to obtain “structural adjustment assistance” in the form of a loan from the
World Bank, the International Monetary Fund, or another official agency. A third option is to devalue.10

Because trade liberalization may squeeze economic activity in the short term, it might be argued that monetary and fiscal policies should become more expansionary to offset this effect. For monetary policy, this question is essentially the same as how much to devalue in conjunction with trade liberalization.11 For fiscal policy, it is doubtful that general fiscal expansion is sensible to pursue in conjunction with trade liberalization. For many governments pursuing trade liberalization, the problem is to find ways to replace revenue lost from taxes on trade.

**Wage Policy**

A major trade liberalization normally requires adjustments in the equilibrium structure of real wages in different parts of the economy. The real wages of skilled workers in highly protected import-competitive activities often need to decline. The real wages of skilled workers in export industries may rise as a consequence of trade liberalization. To the extent that workers can shift from contracting to expanding sectors of the economy (with little deterioration in the economic value of their skills), real wage adjustments will be moderated—though still not eliminated.12

Resistance to required wage adjustments tends to lead to higher unemployment and more business failures in sectors previously benefiting from high levels of protection. To the extent that such resistance is to cuts in nominal rather than real wages, this problem may be ameliorated by a devaluation that cuts real wages but not nominal ones. It is doubtful, however, that general price inflation can remove all of the difficulties involved in cutting real wages.

It is also doubtful that the government’s wage policy can resolve all these difficulties. Governments in developing countries rarely have complete control over all wages. But they usually have direct influence on the wages of government workers, and some indirect influence on wages in public enterprises. Government regulations may prescribe minimum wage rates for public and private sector workers. Government policies may influence indexing arrangements for both public and private sector workers. These influences can be used to help minimize the transitional difficulties of liberalizing trade. For example, if the exchange rate is to be devalued, the government should use its influence on indexing arrangements to avoid wage increases in those sectors where real wages need to be cut.13 If workers in the private sector are to forgo the indexing that preserves their real wages, then workers in the public sector should do the same. Public enterprises in the import-competitive sector should not be allowed to run large deficits in order to maintain the real wages of their workers. This not
only sets a bad example for the private sector, it also can defeat the government's efforts to control its budget deficit.

Wage subsidies are sometimes recommended as a policy to deal with high unemployment in particular sectors of the economy. In conjunction with a trade liberalization, such subsidies should be used very cautiously, if at all. The aim of trade liberalization is to shift resources into sectors where they have a higher social marginal product, and the pressure to do this is diminished if workers in previously protected sectors receive wage subsidies. Subsidies also worsen the government's fiscal position.

Governments of developing countries exert varying degrees of influence over the allocation of credit. In many countries, the public sector is the main demander of credit from the domestic banking system and often has a virtual monopoly on obtaining credit from abroad. The terms and conditions on which credit is available to private enterprises also are often strongly influenced by the government. How can credit policies be used to assist trade liberalization?

Expansion of exports is usually a primary goal of trade liberalization. For such expansion to occur, exporters must increase their fixed investment and working capital. Private entrepreneurs may be able to finance part of this expansion, but they often need more credit as well. Governments should seek to ensure that adequate credit is available on terms and conditions that reflect the opportunity cost of capital and the risks of particular enterprises. An essential requirement for such a policy is that the government and public enterprises do not place excessive demands on the total supply of domestic credit.

As trade is liberalized, enterprises in previously protected sectors may run into financial difficulties. So long as these difficulties are not too severe and widespread, no general problem of economic policy need arise. The creditors of some previously profitable firms will simply need to write down some of their loans. If credit problems are acute, however, there may be a significant danger of a crisis in the financial system. This danger increases if financial institutions continue lending to effectively bankrupt enterprises in order to avoid writing off losses on their earlier loans. To guard against this danger, the pace of trade liberalization and the extent of devaluations should be controlled to limit the likelihood that credit difficulties will threaten the financial system. Government supervision of financial institutions should discourage unsound lending practices.

Special problems arise when credit is quantitatively allocated and provided at real interest rates well below the social opportunity cost of capital. This often happens in high-inflation countries, where interest rates for depositors and borrowers are fixed well below the
inflation rate. The savings needed to support a more liberal trade regime—for bigger exports and budget deficits—are discouraged by a high effective tax on savings. The allocation of resources among potential export activities is likely to be strongly influenced by bureaucratic decisions about who gets artificially cheap credit, rather than by considerations of economic efficiency and prospective profitability. The financial difficulties of firms that previously benefited from heavy protection and subsidized credit are likely to be especially severe when they are faced with less protection and a diversion of credit toward exporters.

There is no good way to avoid the difficulties caused by a distorted credit system, except by reforming that system. Depositors should be allowed a rate of return that encourages them to save. Borrowers should be required to pay real interest rates that reflect the social opportunity cost of capital and the riskiness of their business. The allocation of credit should depend on economic efficiency and profitability. Since the economy may have difficulty digesting simultaneously a financial reform and a trade liberalization, the governments may need to choose which reform to introduce first. The right choice is often to start with financial reform, because it usually makes sense to correct distortions in factor markets before implementing policies that will shift the allocation of resources.\(^5\)

International borrowing is another area of concern when trade is being liberalized. When private companies cannot borrow abroad (as is the case for some developing countries), the prime concern is limiting official borrowing to a level that can be repaid out of future tax revenues and export surpluses. When private enterprises can borrow abroad (either directly or through domestic financial institutions), it may also be appropriate to control their borrowing in order to avoid a credit-financed import binge when trade restrictions are relaxed.\(^6\) The motivation for such a binge may come from accumulated demand for imports built up during a long period of import controls, from fears that the relaxation will be temporary, and from concern that such borrowing may be restricted or a devaluation effected if the balance of payments deteriorates badly during the course of liberalizing trade.

A surge of foreign borrowing can create serious problems for trade liberalization. It boosts domestic spending, putting upward pressure on the prices of nontradable goods in relation to tradable goods. While it lasts, this tends to shift resources toward the production of nontraded goods—to an extent that is not consistent with the long-run effects of trade liberalization.

Another problem sometimes associated with trade liberalization is a sharp rise in real interest rates. This has occurred particularly in countries that have rapid inflation and distorted financial markets and that liberalize trade at the same time as they try to reduce inflation.
and liberalize their financial markets. Indeed, the very high real interest rates that have recently afflicted some developing countries are probably more related to cycles of inflation and disinflation and to financial policies than to trade liberalizations.

In a country with a history of rapid inflation, market-determined nominal interest rates are likely to reflect not just the government's current efforts to control inflation, but also past inflation and fears of a resurgence. For this reason, realized real interest rates (the difference between nominal interest rates and current inflation) can be high during a period when the government is bringing down inflation but markets remain doubtful of the longer-term success of anti-inflation policy. For borrowers, realized real rates are likely to be especially high relative to past experience if interest rates were previously held down by financial controls.

Whatever the cause, a sharp rise in real interest rates is a serious threat to the success of trade liberalization. High real interest rates discourage the expansion of export industries and worsen the problems of firms in previously protected sectors. They are also likely to aggravate the government's own fiscal position by increasing the real cost of its borrowing. Successful trade liberalization then needs to be more carefully coordinated with efforts to reduce inflation and improve the workings of credit markets.\(^{17}\)

Some of the efforts to liberalize trade in developing countries ultimately fail. In some cases, returning to heavy protectionism may be due to a judgment that such a policy is in a country's long-run interest. In others, the political power of groups that benefit from protectionism may be so great that autarkic policies are dictated by the political equilibrium of a country. In many cases, however, failure of the liberalization effort may be due to problems encountered in the transition from protectionism to liberalism.\(^{18}\) These problems can be exacerbated by doubts about the government's willingness and ability to liberalize trade and its commitment to important related policies.

One obvious difficulty is that, if heavy protection is suddenly and unexpectedly removed from import-competing activities, capitalists and workers in these industries may suffer large losses. Slower and preannounced liberalizing will reduce these losses.\(^{19}\) So too will a policy that provides some incentive for increasing exports before applying a major squeeze on import-competing activities. However, no serious policy of freer trade can avoid causing some losses in hitherto protected activities. Policymakers should seek to control social losses and to keep private losses below the point where political pressures jeopardize the liberalization effort. In doing so, they should remember that excessive timidity can be as damaging as excessive aggressiveness.
If a government implicitly admits that it is unwilling to impose any significant losses, even on the most heavily protected industries, grave doubts may arise about its commitment to freer trade. Those doubts impair the chances of any liberalization effort. People in protected activities may be encouraged to exaggerate claims of injury in order to weaken the liberalization effort. They may also be encouraged to keep resources in previously protected activities in the expectation that their protests will be effective. Expansion of exports may be deterred by the slowness of liberalization and by the perceived likelihood that the policy will be reversed.

Another threat to more liberal policies is a massive deterioration in a country’s balance of payments. In the long run, freer trade should have little impact on a country’s overall balance of payments. The growth of imports should be matched by a growth of exports, leaving the current account unchanged at a higher level of total trade. In the short run, however, the current account may deteriorate as trade is liberalized, even if the exchange rate and fiscal policies are managed properly. Imports are instantly available and thus may expand before exports (which require investment and market development) have a chance to grow. If the deterioration of the current balance is too large, a government may be induced to restrict imports again.

This danger is acute if the government tries to support the nominal exchange rate through sterilized intervention. Intervention to support the exchange rate requires either that the government spend existing foreign reserves or that it borrow from international lenders. In either case, the government’s fiscal deficit will expand, thereby contributing to the deterioration of the balance of payments.20

As the balance of payments worsens, private agents may begin to anticipate either a devaluation or import controls. These expectations can lead to speculative purchases of foreign goods and speculative outflows of capital, further worsening the balance of payments. To forestall such a crisis, it is critical that the exchange rate be adjusted during the early stages of liberalization, and be adjusted further if the balance of payments suggests that such measures are necessary.

Credibility depends, finally and crucially, on the government’s ability to show that its own finances are under control. Large government deficits reflect an excess of spending over income that contributes directly to trade deficits and raises the relative prices of nontraded goods. Government deficits financed by creating money raise domestic prices in relation to international prices. At a given nominal exchange rate, such inflation injures import-competting industries, blunts the incentives for increasing exports, and worsens the balance of payments. People who observe and understand this process will recognize that the government cannot sustain its announced policies and will have justifiable doubts that trade liberalization will continue.
Appropriate conduct of macroeconomic policy can play a crucial role in the success of trade liberalization. At a given nominal exchange rate, a trade liberalization that significantly reduces tariffs and quantitative restrictions on imports normally implies a reduction in the general level of domestic prices and wages, especially in the import-competing sector. To diminish recessionary effects of domestic price and wage deflation, it is often appropriate to devalue a country's currency in conjunction with a major trade liberalization. Monetary policy needs to be consistent with exchange rate policy—avoiding both restrictiveness that might induce recession and excessive ease that would fuel inflation and force future devaluations. Since trade liberalization can induce a short-run deterioration of the government's budget position, fiscal policy needs to remain restrained in order to limit the dangers posed by large government deficits. Wage policy should be directed toward facilitating adjustments in relative wage rates that accompany resource reallocations stimulated by trade liberalization. Credit policy should assume that adequate credit is available to finance expansion of export industries and that difficulties experienced by import-competing enterprises do not threaten the financial system. Finally, government policy should avoid large balance of payments deficits that create doubt about the government's ability to maintain a liberal trade policy.

This article expresses the opinion of the author and does not reflect the ideas or positions of the Council of Economic Advisors.

1. According to the analysis in Mussa (1976), with a constant nominal exchange rate and a constant supply of domestic credit by the central bank, trade liberalization would generate a temporary official settlements deficit and a permanent loss of foreign exchange reserves. These effects arise because trade liberalization reduces the long-run equilibrium level of nominal money balances desired by domestic residents.

2. Noncompetitive behavior by domestic sellers of imports may limit the immediate reduction in import prices. The fact that domestic services (distribution, packaging, marketing, etc.) are frequently bundled with imported products might mean that the final price of these products to consumers does not fall by the same amount as the price of raw imports.

3. The extent of the decline in the nominal price of nontraded goods, in the general domestic price level, and in the domestic prices of factors depends on budget shares, demand and supply elasticities, and the production structure of the economy. For a formal analysis of the relevant determinants of these price changes, see Dornbusch (1974 and 1980) and Sjaastad and Clements (1986).


5. It is possible to describe circumstances in which the nominal demand for domestic money would rise as a consequence of trade liberalization at a constant nominal exchange rate. It is doubtful, however, that these circumstances would be relevant for major trade liberalizations by developing countries.

6. If trade liberalization consisted of simultaneous removal of a general ad valorem import tariff and a general ad valorem export tax, the effect would be equivalent to an appreciation of the nominal exchange rate; an offsetting devaluation of the nominal exchange rate would thus be required to maintain price level stability.

7. The government should make it clear that devaluation is a one-time affair and that no further devaluations will occur at subsequent stages of the liberalization.

8. This evidence for the case of a large number of devaluations is summarized in Harberger and Edwards (1980).

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9. For a discussion of the benefits of crawling peg arrangements, see Williamson (1966). For further discussion and analysis of the performance of such exchange rate regimes, see the papers in Williamson (1982).

10. The fiscal benefit of devaluation is an additional argument for considering devaluation in conjunction with trade liberalization, beyond the reasons already discussed.

11. Even for a small and relatively open economy, there is probably some latitude for monetary policy to diverge temporarily from the longer-run constraints imposed by exchange rate policy. But it is not appropriate to think that there is great flexibility for using monetary policy independent of exchange rate policy.

12. An important deficiency of most of the standard models employed in international trade theory is their assumption that labor is homogeneous and mobile between industries. Such models suggest that the only effect of trade liberalization on wages is its effect on the wage rate that applies to all workers.

13. It is now widely recognized that in the face of adverse changes in the terms of trade, indexing of wage rates should be related to the price index for domestic product and not the consumer price index; see, for example, Marston (1984) or Aizenman and Frenkel (1985). This principle needs to be extended to sectoral wage rates in circumstances where the relative prices of the outputs of different sectors are changing.

In a high-inflation country, it is desirable not to remove all indexing in the import-competing sector, but rather to allow sufficient flexibility in indexing arrangements that necessary adjustments can be made in relative real wage rates.

14. A big devaluation that allows the relative price adjustments required by trade liberalization to be achieved without large reductions in the nominal prices of import substitutes may assist in resolving these credit problems. Assuming the debt contracts are not indexed, the general price increase associated with such a devaluation reduces the real value of the debts of these firms by effectively imposing a capital levy on their creditors.

The real capital loss sustained by the creditors of import-competing firms because of devaluation may be no greater than the loss they would sustain from the failure and reorganization of these firms in the absence of devaluation. If so, it is appropriate to attribute these real capital losses to the liberalization, and not to the devaluation. Moreover, if there are inefficiencies in the operation of the bankruptcy process, there can be a social efficiency gain from policies that avoid large-scale bankruptcies.

15. It may be desirable to introduce some elements of trade reform or make some adjustments in trade policies in conjunction with financial reform. For example, if an export industry has benefited from cheap credit and is likely to expand under liberalized trade policies, it may be desirable to give it a temporary subsidy to compensate for the removal of credit subsidies.

16. As a result of the recent experience of some Latin American countries, a good deal has been written about the sequencing of trade liberalization and liberalization of controls on international borrowing; see Edwards (1986) for an analysis of this issue and a survey of the relevant literature.

17. For further discussion of these issues, see Mathieson and McKinnon (1981).

18. The reason for the success and failure of liberalization efforts in developing countries is the subject of a study currently being conducted under the auspices of the World Bank.


20. This is the "fiscal effect" of sterilized intervention, which is present if private individuals do not increase their savings to offset the increases in their future tax liabilities that are implicit in the issuance of government debt. See Mussa (1985) for further discussion.


