LESSONS FROM THE SOUTHERN CONE POLICY REFORMS

by

Vittorio Corbo

and

Jaime de Melo

February 1987

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1. Introduction

Few reform packages have led to as much controversy as the Southern Cone reforms in Chile, Argentina and Uruguay. Some observers, notably in the press, have concluded that the reform effort as a whole was a failure. Others, including the present authors (1985a) have suggested that many of the microeconomic reforms were quite successful and that most of the problems that emerged resulted from problems with the macroeconomic management during the transition to a more open economy. Still others have blamed failure on unfavorable external shocks (Sjaastad, 1983). Finally, some have asked whether the sequence in which the reforms were implemented may have been the major cause of failure (Edwards, 1985; Frenkel, 1983).

Meanwhile, many countries now attempting to resume growth and maintain external balance are designing policy packages that invariably include some if not most of the programs implemented by Southern Cone Governments. Because of apparent past failures, however, hesitation and doubt persist about the efficacy of these kinds of broad-based reform efforts. Thus, a better understanding of the proximate causes of their failure in the Southern Cone countries is not only of interest to the economic historian; it is also a matter of pressing practical importance to today's policymakers elsewhere in the developing world, who need a clear sense of what opportunities they should seize, what pitfalls they should avoid--and perhaps above all, what their own rational expectations of success should be.

This paper uses the benefit of hindsight to examine these controversial reforms once more--their pervasiveness, their implementation, and the contribution of external factors to their overall failure. The paper complements our earlier paper (Corbo, de Melo and Tybout, 1986), where we drew country-specific conclusions from what our research suggested were the major
causes of ultimate failure in each country's reform package. Here we ask whether the reforms were undertaken in accordance with what seems to us to be the emerging consensus on how to implement stabilization and liberalization policies in developing countries. To set the stage, in section 2 we briefly review initial conditions at the eve of the reforms. In section 3, we summarize and evaluate the reforms. We evaluate the reforms in terms of the emerging consensus on how to implement stabilization and liberalization reforms. In particular, we ask how far Southern Cone experience deviated from our view of what the consensus would suggest. An interpretation of the outcome of the reforms follows in Section 4. Policy lessons are drawn in Section 5. Conclusions follow in Section 6.

2. The Pre-reform Period: Initial Conditions

After more than three decades of import substitution, the economies of the three Southern Cone countries had by the early 1970s become among the most distorted among middle income developing countries. Expansionary demand policies to promote output growth, combined with fixed or slowing adjusting exchange rates, pervasive price controls (over 90% of the CPI basket was controlled in each country) and restrictive trade regimes, resulted in an acceleration of inflation, bottlenecks in production, chronic balance of payment difficulties, and slow export growth. 1/

During the pre-reform period, trade policies in the three countries were similarly and strongly biased in favor of import substituting industrialization (ISI) and against exports. All three countries had experienced mild trade liberalization experiments: Chile in 1956-62 and again in the late 1960s, Argentina in the second half of the 1960s, and Uruguay in 1959. In
each case, there was a return to a very restrictive trade regime with widespread tariff and non-tariff barriers.

Fragmentary evidence on effective protection (see Tables 1a, 1b and 1c) shows high effective rates of protection to domestic sales in each country: 84% in Argentina (1969); 151% in Chile (1974); 384% in Uruguay (1969). The variability of protection across sectors, an indicator of distortion in incentives, was also very high in the three countries, and for no good economic reason; rather, it was the piecemeal result of pressures imposed over decades by different domestic interest groups.

As a result of increasing protectionism, the openness of the three economies had decreased steadily since the late 1920s. As shown in Tables 1a, 1b, and 1c, the total share of trade (exports plus imports) in GDP was only 25.1% for Uruguay, the smallest of the three countries, in the early 1970s. Chile's share was only 20.3% and Argentina's was only 17%. These percentages were well below the norm for countries of similar size and level of development (see Chenery and Syrquin, 1975).

In addition to distortions created by the prevailing price controls and commercial and fiscal incentives, all three countries were in severe macroeconomic disequilibrium (see Table 2). Both Chile (1973) and Argentina (1976) faced high fiscal deficits, severe deficit-induced inflation and balance of payments crises with acute foreign exchange shortages. Public sector deficits averaged 10 percent of GDP in Argentina in the period 1973–1975, 16.1 percent in Chile during 1971–73 and 3.2 percent in Uruguay during 1971–73. 2/ Uruguay was the only country of the three not in deep crisis by the early 1970s and the only one to have some foreign exchange reserves;
### Table 1a

Effective Protection and Trade Openness in Argentina

<table>
<thead>
<tr>
<th>Industry</th>
<th>Legal Tariff Rates ($)</th>
<th>Realized Protection Rates ($)</th>
<th>Effective Protection Rates ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>December 1977</td>
<td>February 1977</td>
<td>February 1977</td>
</tr>
<tr>
<td>Primary Activities</td>
<td>-8.0</td>
<td>321 Textiles</td>
<td>57.4</td>
</tr>
<tr>
<td>Processed Foods</td>
<td>44.0</td>
<td>322 Clothing</td>
<td>95.0</td>
</tr>
<tr>
<td>Beverages and Tobacco</td>
<td>95.0</td>
<td>341 Paper &amp; Paper Products</td>
<td>29.0</td>
</tr>
<tr>
<td>Construction Materials</td>
<td>31.0</td>
<td>351 Industrial Chemicals</td>
<td>35.2</td>
</tr>
<tr>
<td>Intermediate Products I</td>
<td>146.0</td>
<td>352 Other Chemicals</td>
<td>17.0</td>
</tr>
<tr>
<td>Intermediate Products II</td>
<td>9.0</td>
<td>355 Rubber Products</td>
<td>45.0</td>
</tr>
<tr>
<td>Nondurable Consumer Goods</td>
<td>50.0</td>
<td>362 Glass</td>
<td>41.8</td>
</tr>
<tr>
<td>Consumer Durables</td>
<td>145.0</td>
<td>369 Other Nonmetallic Mineral Products</td>
<td>11.0</td>
</tr>
<tr>
<td>Machinery</td>
<td>120.0</td>
<td>371 Basic Ferrous Metal Products</td>
<td>48.2</td>
</tr>
<tr>
<td>Transport Equipment</td>
<td>207.0</td>
<td>372 Basic Nonferrous Metal Products</td>
<td>44.5</td>
</tr>
<tr>
<td>Equally Weighted Arithmetic Mean</td>
<td>83.9</td>
<td>381 Metal Products</td>
<td>45.9</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>69.7</td>
<td>382 Nonelectrical Machinery</td>
<td>65.5</td>
</tr>
<tr>
<td>Variability Coefficient</td>
<td>0.8</td>
<td>383 Electrical Machinery</td>
<td>61.3</td>
</tr>
<tr>
<td>Range</td>
<td>215.0</td>
<td>384 Transport Equipment</td>
<td>87.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>385 Scientific &amp; Other Equipment</td>
<td>50.0</td>
</tr>
<tr>
<td>Weighted Average</td>
<td></td>
<td></td>
<td>52.7</td>
</tr>
</tbody>
</table>

### Foreign Trade as % of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>36.0</td>
<td>39.4</td>
<td>15.6</td>
<td>17.0</td>
<td>19.2</td>
<td>17.6**</td>
</tr>
</tbody>
</table>

**Note:** Both sets of estimates based on price comparisons; 1977 estimates are for 90 products and probably underestimate protection because of the prevailing high real exchange rate in 1977 (see Figure 1).


**Does not include 1982.
### Table 1b
Effective Protection and Trade Openness in Chile

<table>
<thead>
<tr>
<th>Sector</th>
<th>1967</th>
<th>1974</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Goods</td>
<td>138.8</td>
<td>189.7</td>
<td>13.2</td>
</tr>
<tr>
<td>Intermediate Goods</td>
<td>172.9</td>
<td>139.6</td>
<td>14.0</td>
</tr>
<tr>
<td>Machinery and Transport Equipment</td>
<td>265.3</td>
<td>96.0</td>
<td>13.0</td>
</tr>
<tr>
<td>Equally Weighted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Arithmetic Mean</td>
<td>176.7</td>
<td>151.4</td>
<td>13.61</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>279</td>
<td>60.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Variability Coefficient</td>
<td>1.57</td>
<td>0.399</td>
<td>0.124</td>
</tr>
<tr>
<td>Range</td>
<td>1,163</td>
<td>216</td>
<td>6</td>
</tr>
</tbody>
</table>

**Openness:** Foreign Trade as % of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Openness (%)</td>
<td>66.3</td>
<td>21.7</td>
<td>24.0</td>
<td>20.3</td>
<td>36.1</td>
<td>32.6</td>
</tr>
</tbody>
</table>

**Sources:**
- Corbo and Meller (1981)
- Aedo and Lagos (1984)
- IMF
### Table 1c

**Protection and Trade Openness in Uruguay**

#### Nominal Protection and Redundant Protection

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic sales: formal</td>
<td>263</td>
<td>86 (72) a/</td>
<td>40</td>
<td>46 (39) a/</td>
<td>60</td>
</tr>
<tr>
<td>Implicit</td>
<td>na</td>
<td>25</td>
<td>36</td>
<td>38 (1) d/</td>
<td>41</td>
</tr>
<tr>
<td>Export sales (NMP)</td>
<td>4</td>
<td>16</td>
<td>16</td>
<td>1 (-18) a/</td>
<td>22</td>
</tr>
<tr>
<td>Redundant protection by on domestic sales</td>
<td>na</td>
<td>23</td>
<td>6</td>
<td>1</td>
<td>8</td>
</tr>
</tbody>
</table>

#### Effective Protection: 1966 and 1981

<table>
<thead>
<tr>
<th>Year</th>
<th>Weighted</th>
<th>Unweighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic sales: formal (Potential) c/</td>
<td>384</td>
<td>75 (27) d/</td>
</tr>
<tr>
<td></td>
<td>(399)</td>
<td>(37) d/</td>
</tr>
<tr>
<td>Export sales (Potential) c/</td>
<td>37</td>
<td>30 (13) d/</td>
</tr>
<tr>
<td></td>
<td>(200)</td>
<td>(33) d/</td>
</tr>
<tr>
<td>Effective protection to Domestic sales by major product categories (1981)</td>
<td>na</td>
<td></td>
</tr>
<tr>
<td>Durables</td>
<td>317</td>
<td></td>
</tr>
<tr>
<td>Nondurables</td>
<td>37</td>
<td></td>
</tr>
<tr>
<td>Intermediates</td>
<td>101</td>
<td></td>
</tr>
<tr>
<td>Machinery &amp; Transport equipment</td>
<td>na</td>
<td>286</td>
</tr>
</tbody>
</table>

#### Openness: Foreign Trade as % of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average Openness (%)</td>
<td>19.6</td>
<td>27.3</td>
<td>25.1</td>
<td>36.2</td>
<td>33.9</td>
</tr>
</tbody>
</table>

**Notes:**
- 1982 calculations with 1981 weights. All rates, unless otherwise noted, represent weighted averages: product weights at world prices.
- a/ Without reference prices.
- b/ Computed as the difference between the formal nominal rate of protection and the landed price (inclusive of customs duties) of corresponding imported goods.
- c/ Potential effective protection computed using formal nominal rates of protection.
- d/ Adjusted for exchange rate deviation from purchasing power parity.
- C.V. = coefficient of variation.

**Sources:**
### Table 2:

#### Southern Cone Macroeconomic Indicators by Subperiod: 1941-83

<table>
<thead>
<tr>
<th>Country</th>
<th>Pre-Reform</th>
<th>Reforms</th>
<th>Post-Reform Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Chile</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Annual Growth Rate (Percent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>4.00</td>
<td>4.40</td>
<td>4.50</td>
</tr>
<tr>
<td>Expenditure</td>
<td>4.00</td>
<td>4.50</td>
<td>4.70</td>
</tr>
<tr>
<td>Exports</td>
<td>11.6</td>
<td>11.4</td>
<td>9.8</td>
</tr>
<tr>
<td>Imports</td>
<td>12.3</td>
<td>8.8</td>
<td>6.5</td>
</tr>
<tr>
<td>Cross Fixed Investment</td>
<td>na</td>
<td>41.80</td>
<td>1.70</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td>na</td>
<td>37.60</td>
<td>27.20</td>
</tr>
<tr>
<td>Fiscal deficit/GDP</td>
<td>na</td>
<td>na</td>
<td>1.62</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Real Wage (1969=100)</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Cross Investment/GDP</td>
<td>16.30</td>
<td>33.40</td>
<td>89.40</td>
</tr>
<tr>
<td>Terms of Trade (1969=100)</td>
<td>na</td>
<td>1.10</td>
<td>2.40</td>
</tr>
<tr>
<td>Current Account/GDP</td>
<td>na</td>
<td>23.2</td>
<td>47.9</td>
</tr>
<tr>
<td><strong>Uruguay</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Annual Growth Rate (Percent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>4.0</td>
<td>0.04</td>
<td>1.6</td>
</tr>
<tr>
<td>Expenditure</td>
<td>4.0</td>
<td>0.8</td>
<td>1.3</td>
</tr>
<tr>
<td>Exports</td>
<td>16.3</td>
<td>-5.7</td>
<td>6.5</td>
</tr>
<tr>
<td>Imports</td>
<td>16.3</td>
<td>5.7</td>
<td>5.7</td>
</tr>
<tr>
<td>Cross Fixed Investment</td>
<td>na</td>
<td>5.8</td>
<td>-1.5</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td>na</td>
<td>23.2</td>
<td>47.9</td>
</tr>
<tr>
<td>Fiscal deficit/GDP</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Real Wage (1969=100)</td>
<td>na</td>
<td>13.00</td>
<td>12.20</td>
</tr>
<tr>
<td>Cross Investment/GDP</td>
<td>114.30</td>
<td>115.60</td>
<td>109.30</td>
</tr>
<tr>
<td>Terms of Trade (1969=100)</td>
<td>na</td>
<td>na</td>
<td>3.50</td>
</tr>
<tr>
<td>Current Account/GDP</td>
<td>na</td>
<td>23.2</td>
<td>47.9</td>
</tr>
<tr>
<td><strong>Argentina</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average Annual Growth Rate (Percent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross Domestic Product</td>
<td>2.5</td>
<td>3.5</td>
<td>4.4</td>
</tr>
<tr>
<td>Expenditure</td>
<td>na</td>
<td>6.5</td>
<td>3.1</td>
</tr>
<tr>
<td>Exports</td>
<td>13.0</td>
<td>2.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Imports</td>
<td>25.1</td>
<td>5.6</td>
<td>4.3</td>
</tr>
<tr>
<td>Cross Fixed Investment</td>
<td>na</td>
<td>13.3</td>
<td>20.6</td>
</tr>
<tr>
<td>Consumer Prices</td>
<td>15.3</td>
<td>30.5</td>
<td>21.5</td>
</tr>
<tr>
<td>Public Sector Deficit/GDP</td>
<td>5.9</td>
<td>6.0</td>
<td>4.4</td>
</tr>
<tr>
<td>Unemployment Rate</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Real Wage (1969=100)</td>
<td>na</td>
<td>na</td>
<td>na</td>
</tr>
<tr>
<td>Cross Investment/GDP</td>
<td>22.5</td>
<td>18.8</td>
<td>19.1</td>
</tr>
<tr>
<td>Terms of Trade (1969=100)</td>
<td>124.6</td>
<td>100.8</td>
<td>103.0</td>
</tr>
<tr>
<td>Current Account/GDP</td>
<td>na</td>
<td>1.9</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

Sources: National Accounts and Orto, de Meo and Tybout (1986, Table 1) unless otherwise indicated.

2. Imports and exports in dollars.
3. Other Sources: CEPAL data for Balance of Payments & IFS
nonetheless, its economy had registered virtually zero per capita growth for 20 years.


3.1 Stabilization Policies

What Was Done

The first task facing the new economic teams in each country was to restore external balance and to control galloping inflation. Programs to this end were implemented in two identifiable phases: first, an orthodox program that included a large devaluation with a unification of the different exchange rates accompanied by an attempt to control the growth in the money supply and to restrain or reduce public expenditures; and second, an exchange-rate-based stabilization starting in 1978. 4/

It was expected that these "orthodox" measures would be contractionary but it was thought that their potential benefits would easily outweigh the temporary costs of recession. Reducing absorption and restoring external balance was much more important in Argentina and Chile than in Uruguay. The short run recession was most severe in Chile, the country where the external shock was the most severe in the 1974-75 period (Corbo and de Melo 1987) and where most progress was made in controlling inflation. In Argentina, where inflation was more severe, intense concern about the political consequences of unemployment limited the stabilization effort (Fernandez, 1985).

Anti-inflationary policy measures alone were considered insufficient for eliminating balance of payments difficulties. Hence, stabilization policies in each country also included major attempts to switch expenditures. 5/ To avoid a repetition of previous external crises, all three countries eliminated multiple exchange rates for commodity trade and, more
importantly, complemented their initial parity changes with a passive crawling peg exchange rate regime aimed at maintaining purchasing power parity adjusted by changes in the terms of trade.

**What Should Have Been Done:**

For countries with inflation of about 25 percent or more a year an emerging consensus would suggest a stabilization program up front before undertaking liberalization. This is because inflation reduces substantially the information content of relative prices. However, the objective of liberalization is mostly to adjust relative prices in accordance with economic costs. Inflation has also other side effects. Side effects of inflation that impede appropriate economic performance are well documented (Fischer, 1986b), Yeager (1981)) and are of four main kinds: (1) high inflation makes relative prices very volatile, reducing their information content (this is because changes in the rate of inflation do not affect all prices and costs uniformly and at the same time); (2) the interest rate controls usually observed in countries with high inflation result in negative real rates that lead to credit rationing, distort investment decisions, and reduce the size of the formal financial system; (3) uncertainty about future inflation rates leads to financial transactions being concentrated in instruments with short rather than long term maturities, thus reducing the availability of funds for long-term investment; (4) high inflation is also associated with balance of payments crisis as periodic attempts to control inflation through the exchange rate result in protracted periods of real currency appreciation. The resulting periodical balance of payments crisis and/or capital flights reduce both actual and potential output.

The recommendation for an up front stabilization program also stems from the fact that a successful liberalization depends on the credibility of
the program, and on having a real exchange rate that creates stable incentives to the tradable producing sectors. High inflation makes both these objectives very difficult to attain. Not surprisingly, there are few historical examples of simultaneous achievement of stabilization and liberalization. Indeed, one of the most extensive studies of trade liberalization reforms has concluded that their failures have stemmed mainly from the failure of the accompanying anti-inflationary programs (Krueger, 1978; 1981)). Hence the prevailing view that stabilization should precede liberalization when inflation is over, say, 25 percent a year (Fischer, 1986a; Sachs 1986). 6/

For countries with "intermediate" annual inflation rates of, say, 15-25 percent, stabilization still remains a high priority but there is no absolute ban on introducing liberalization and stabilization programs simultaneously. Any stabilization program should, however, avoid introducing major distortions that could jeopardize successful liberalization. In particular, real exchange rate appreciation should not be used as a major stabilization device. 7/ Neither should export taxes be used in countries where the anti-export bias of the trade regime needs to be corrected.

During a liberalization, macroeconomic policy should ensure an appropriate and stable real exchange rate, a low inflation rate, and a sustainable balance of payments position. This implies that countries starting a liberalization from high inflation will face complications. The first complication comes from the simultaneous implementation of stabilization and liberalization policies. On the one hand, the success of stabilization depends on applying contractionary pressure to the economy as a whole, while, on the other, trade liberalization calls for the contraction of highly protected import competing firms and a delayed expansion in export oriented firms and import competing ones with little protection. With simultaneous
application of both programs, the net contractionary pressure on highly protected import competing activities might be too strong to withstand.

The second complication is downward price inflexibility. To overcome this phenomenon, trade liberalization has to be accompanied by a devaluation up front to achieve the desired improvement in the relative prices of exportables. However, the devaluation will also temporarily accelerate inflation or weaken the fight against it.

In countries with low or intermediate inflation rates (below 25 percent a year), macropolicies should be designed to maintain an "appropriate" and stable real exchange rate. For economies operating fixed or crawling peg exchange rate regimes, the initial tariff reduction should be accompanied by a devaluation that, while not restoring the pre-liberalization landed prices of imports, would permit an improvement in the relative prices of exportables (Mussa, 1986). And for those countries that have discriminated against exportables for a long time, an up front improvement in the relevant incentives is also necessary to move resources toward exportables.

Besides exchange rate policy, other elements of macroeconomic policy should also be redesigned to support the liberalization effort. Thus, monetary expansion should be compatible with exchange rate pegging rules, so as to avoid a loss of confidence in the pegging rule that in turn might jeopardize the success of the overall reform package. Fiscal policy should try to ensure that the fiscal deficit is compatible with the domestic credit expansion resulting from a stable pegging rule (Buiter, 1986). Also, the part of the deficit that is financed in the domestic capital market should not crowd out the financing of the sectors that are meant to expand. Likewise, credit policy should ensure access to credit at competitive rates for the expanding sectors, while simultaneously denying cheap credit to previously
heavily protected import competing sectors (because its availability could slow down their adjustment). Finally, labor market arrangements should be flexible enough to allow for a drop in the consumption wage in previously heavily protected sectors and/or to allow the reallocation of labor toward the sectors that were previously discriminated against. Otherwise, unemployment will result.

Evaluation:

In the three countries the initial focus in eliminating the balance of payments crises and controlling inflation was certainly in line with the framework suggested above. In the event, however, inflation remained disturbingly high several years after the contractionary policies had been implemented. 8/

In Argentina, substantial monetization of the public sector deficit continued until late in 1978. In Chile although the public sector deficit was drastically reduced and transformed into a surplus by 1978, the reduction of inflation was bound to be a lengthy process as ex-post indexation (Fischer 1984) was widespread (Corbo 1985a and 1985b). In Uruguay, although inflation initially was substantially lower than in the other two countries it proved very difficult to reduce it as many non-tradables suffered strong demand pressures from spillovers from the macro disequilibrium in Argentina (Hanson and de Melo 1984).

In the three countries the persisting inflation prompted a major shift in tactics, towards a second phase of stabilization policy in which the pre-announcement of the future trajectory of the exchange rate was used as the main instrument to control the evolution in the price of tradables as well as overally inflationary expectations. Expectations about inflation and devaluation were recognized as important determinants of the dynamics of
stabilization, and it was believed that exchange rate targets announced up to six months in advance and with forward devaluations at a decreasing rate would break inflationary expectations. In practice, the rate of devaluation, which was set in accordance with a preannounced schedule known as the tablita, was less than the existing difference between domestic and world inflation. This policy corresponded to an "active" crawling peg, and was clearly a departure from orthodoxy. 9/

Proponents of the new approach thought that purchasing power (especially in Chile) and interest parity (in Uruguay and Argentina)—both resulting from the forces of competition in freely operating commodity and capital markets—would come fairly rapidly. In Argentina and Uruguay, the anti-inflationary policy took precedence over other economic objectives with the adoption of the tablita in December 1978. In Chile too, bringing down inflation became a main concern when the tablita was adopted in February 1978. All three countries, but especially Argentina and Uruguay, sometimes used tariff reductions to impose price discipline rather than to rationalize the trade regime (see Tables 3a, 3b, 3c).

At the time, the exchange-rate-based approach to stabilization represented a departure from prevailing orthodoxy. The approach was a seductive novelty, and a number of other countries including Brazil, Israel, Peru, Portugal, Turkey and Sri Lanka flirted with it—hoping, like the Southern Cone countries, to avoid the recessionary costs known to accompany orthodox stabilization efforts. In contrast to the Southern Cone countries, however, pragmatic attitudes prevailed elsewhere, and the exchange rate strategy was soon abandoned when tradable sectors accumulated a large loss in competitiveness.
Although in the three countries stabilization was pursued before the introduction of the liberalization, reforms in none of the three countries liberalization started before reduction of inflation to below 50 percent per year, going against the recommendations above. In defense of the selected policies, one could say that distortions were so widespread that there were substantial gains to be obtained from liberalization. However, the danger of an inappropriate macroeconomic policy mix was quite high. Indeed, one of the key lessons from successful liberalization policies, importance of supporting the liberalization effort with an appropriate and stable (but not necessarily constant) real exchange rate, was not followed. The large real appreciation that developed in the three countries in the post 1978 period weakened considerable the extent and credibility of the overall liberalization effort (see Figure 1).

### 3.2 Liberalization Policies

**What Was Done:**

With different timing and intensity, all three countries removed price controls, liberalized interest rates, reduced restrictions on commodity trade and capital flows, and partly deregulated their labor markets. A chronological synopsis of reforms roughly classified by market for each country appears in Tables 3a, 3b and 3c. With the exception of domestic financial market deregulation, which proceeded rapidly in all cases, the sequencing of the reforms differed in each country. Uruguay removed all controls on capital flows and many commodity price controls early on, but progressed more slowly on the liberalization of foreign trade (Table 3c). Uruguay also rationalized its fiscal system the most, eliminating the income tax and moving to a VAT. Chile, on the other hand, went the furthest in
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<td>(i) Monetary Policy</td>
<td>Restrictive monetary policy to cope with 1973 IMF crisis</td>
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<td>(ii) Fiscal and Public Sector Policy</td>
<td>Start of sale of publicly owned firms (90% sold by 1979)</td>
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<td>(iii) Exchange Rate Policy</td>
<td>Starting Oct '73; multiple exchange rate reduced to three-rate system; 20% devaluation and establishment of crawling peg</td>
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<td>(iv) Domestic Product Markets</td>
<td>Starting Oct '73; many product prices deregulated</td>
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<td>(v) Taxation</td>
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<td>(vi) Labor Markets</td>
<td>May '74: Interest rates fixed for capital market transactions by Florence. Oct '74: Interest rates fixed for commercial banks. (Since 1974 maximum debt/capital ratio for commercial banks set at 20%)</td>
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<td>(viii) External Financial Flows</td>
<td>Regulations governing inflows of external funds into Chilean banks liberalized</td>
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<td>(ix) Commercial Policy</td>
<td>Late 1973 to end of 1974; new government revenue (the redenomination tariff from 100 to 600, maximum rate at 15%)</td>
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### B. Liberalization

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<td>(vi) Commercial Policy</td>
<td>Late 1973 to end of 1974; new government revenue (the redenomination tariff from 100 to 600, maximum rate at 15%)</td>
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### Table 1b

**Unification Stabilization/Liberalization Measures**

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<tr>
<td>(1) Monetary Policy</td>
<td>New Establishment of system of all-in-one credit. Central bank to pay interest on reserves required by law</td>
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<td>(II) Fiscal and Public Expenditure Policy</td>
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<td>(III) Exchange Rate Policy</td>
<td>Exchange rate for capital transactions freely determined, positive creating for goods transactions</td>
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<tr>
<td>(1) Domestic Product Markets</td>
<td>Jul: Liberalization of domestic prices of non-commodities goods began (4% of CPI inflation controlled)</td>
<td>Jul: Liberalization of prices of some CPI goods</td>
<td>Jul: Friedmanization of prices of CPI goods (except unemployment), later in 78, liberalization of another 25% of CPI goods</td>
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<td>(II) Taxation</td>
<td>Jul: Removal of personal income &amp; inheritance taxes, Corporation profit tax (25% of net) established</td>
<td>Jul: Reduction of tax on goods with administratively fixed prices</td>
<td>Jul: Reduction of tax on goods with administratively fixed prices</td>
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<td>(III) Labor Markets</td>
<td>May: Gradual lifting of interest 'call on pass income'</td>
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<td>May: Gradual lifting of interest 'call on pass income'</td>
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<td>(IV) Domestic Financial Markets</td>
<td>May: Liberation of capital market &amp; regulations on foreign exchange holdings &amp; transactions. In fact, convertibility of the mark through unrestricted purchases or sales of assets denominated in foreign currency.</td>
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Note: (v) external financial markets refers to the introduction of a uniform 25% tariff in 1985.
A. Stabilization

(1) Monetary Policy
   (a) Price Controls
      March: Imposition of 120 day prior control period to reduce inflation.
   (b) Exchange Rate Policy
      Apr: Stabilization of exchange rates from multiple rate system to dual (commercial & financial) rate system with fixed but periodically adjustable parities. Dec: Convergence of financial and commercial exchange rates.

(2) Fiscal and Public Expenditure Policy
   (a) Domestic Product Markets
      Apr: Prices gradually liberalized
   (b) Taxation
      Wages progressively decontrolled till 1982
   (c) Labor Markets
      Wages progressively decontrolled till 1982
   (d) Domestic Financial Markets
      May: Preliminary attempt to correct negative real interest rates for borrowing through new tax on loans
      Oct: Authorization of use of gold coins in bureaux of exchange
      Apr: Guarantee on deposits raised
   (e) External Financial Markets
      Jul: Liberalization of rules for negotiating foreign exchange loans
      Progressive removal of restrictions on foreign exchange transactions; from Ø155,000 (June) to Ø220,000 (Sept.)
      Sept: Authorization to sell foreign exchange obtained from exports on commercial (85%) and financial (15%) markets
   (f) Commercial Policy
      Apr: Progressive removal of prior peso deposit requirements and of O/F on imports
      Further relaxation of O/F on imports as foreign exchange reserves increased
      Dec: Elimination of prior peso deposit requirement for financing foreign trade. Program announced for reduction of tariffs to 10% average, and elimination of export taxes by 1986.

B. Liberalization

(1) Domestic Product Markets
   Apr: Prices gradually liberalized
   Prices progressively decontrolled till 1982
   Jul: Reintroduction of dual exchange rate system

(2) Taxation
   Wages progressively decontrolled till 1982
   May/Aug: Attempt to obtain voluntary prices/wages agreement

(3) Labor Markets
   Wages progressively decontrolled till 1982
   May/June Guarantee on deposits lowered

(4) Domestic Financial Markets
   May: Preliminary attempt to correct negative real interest rates for borrowing through new tax on loans
   Apr: Guarantee on deposits raised

(5) External Financial Markets
   May: Preliminary attempt to correct negative real interest rates for borrowing through new tax on loans
   Jul: Liberalization of rules for negotiating foreign exchange loans
   Progressive removal of restrictions on foreign exchange transactions; from Ø155,000 (June) to Ø220,000 (Sept.)
   Sept: Authorization to sell foreign exchange obtained from exports on commercial (85%) and financial (15%) markets

(6) Commercial Policy
   Apr: Progressive removal of prior peso deposit requirements and of O/F on imports
   Further relaxation of O/F on imports as foreign exchange reserves increased
   Dec: Elimination of prior peso deposit requirement for financing foreign trade. Program announced for reduction of tariffs to 10% average, and elimination of export taxes by 1986.

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<td>(a) Price Controls</td>
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eliminating domestic price controls and reducing trade barriers, but maintained controls on short-term capital flows for a long period (Table 3b). Chile also maintained important labor market regulations. Argentina eliminated price controls, and removed most restrictions on medium term (more than one year) capital flows, and quantitative import restrictions (with some important exceptions) before implementing some ad hoc tariff reductions (Table 3a). Uruguay virtually eliminated price controls by the end of 1979, but adopted only minimal commercial policy reforms to lower protection.

The evidence on persistently high effective protection to domestic sales in Argentina and Uruguay makes it clear that liberalization by no means affected all markets. In fact, contrary to popular belief, only Chile experienced extensive trade liberalization; Argentina and Uruguay, where liberalization was much less widespread, pressure from foreign competition was only felt at the height of real exchange rate overvaluation. For example, in Uruguay redundant protection was only eliminated in 1981 (see Table 3c and Figure 1). At that time the bias against export sales was still 35%.

Rapid and pervasive deregulation of domestic financial markets was a common feature of the reforms in all three countries. Prior to deregulation, non-price allocation of credit and strongly negative real interest rates had been widespread and longstanding. The reforms began by progressively eliminating ceilings on interest rates, and then reduced restrictions on financial intermediaries. Argentina went from 100 percent reserve requirements and directed credit programs to a decentralized fractional reserve system. The Chilean government began by loosening its control of the financial system by allowing non-bank intermediaries to operate without interest rate controls. Then, over several years, it removed interest rate ceilings for commercial banks and returned state owned commercial banks to the
private sector. In Uruguay, dollar deposits were legalized and directed credit programs were progressively dismantled starting in 1974. Later, in 1977, controls on entry to the banking system were also lifted.

With respect to international capital flows, the sequencing and speed of reforms differed from country to country. Uruguay legalized unrestricted movements of private capital as early as 1974 and reached full convertibility by early 1977. Argentina eliminated most controls on capital movements between 1977 and 1979. Chile progressively deregulated medium-term capital flows, eliminating global limits on borrowing in 1979 and restrictions on monthly inflows in April 1980. Restrictions on short-term capital inflows were not dismantled until late 1981, however.

Finally, in all three countries, there was relatively little liberalization of labor markets. These markets continued to be controlled through penalties or prohibitions on labor dismissals, together with legislated wages and/or wage indexation. However, the weakening of trade union power in the early stages of the reforms amounted to a degree of de facto deregulation.

What Should Have Been Done:

There is broad agreement on general principles that go a long way towards defining the final contents of any liberalization package. However, there is room for much disagreements on issues of sequencing, speed and extent of liberalization. In highly regulated economies with widespread price controls, the suggestion would be to lift price controls so as to improve resource allocation, while simultaneously deregulating domestic factor markets. Financial markets should be deregulated (subject to appropriate banking supervision rules), so as to improve credit allocation and thus to distribute investment more efficiently. Similarly, labor market restrictions
should be lifted, so as to facilitate the contraction of inefficient sectors and the expansion of new, efficient ones.

On the foreign trade side, commercial policy should first replace QRs with equivalent tariffs. Then the variance of tariff rates and their average level should be reduced, with the objective of moving towards a low, uniform tariff. As a rule, incentives should avoid discrimination against export oriented activities, and lead to approximate, uniform effective across-the-board incentives for import competing activities (Little, Scitovsky and Scott, 1970; Corden, 1974; Balassa, 1976).  

Once we get beyond the content of a reform package, however, there are uncertainties on implementation. Implementation raises questions of dynamics, about which we know little. Here the literature addresses two sets of issues: (1) the speed of the reforms; and (2) the sequencing of the program (i.e., which markets to liberalize first). We now discuss each of these in turn.

Speed of reforms: The issue here is how fast one should implement a particular reform. Should one liberalize trade totally and instantly, or do it over 5 or 10 years? Should price controls be removed at a stroke or gradually? Should the interest rate ceiling be lifted at once or progressively?

In approaching these and other questions of implementation, it is essential to keep in mind the fact that liberalization is not an end in itself, but a means to achieving a more efficient use of existing and new resources. As resource allocation depends on expected prices, the credibility of the reforms is very important. In particular, reform initiatives need to be phased in terms of realistic timetables for reaching its objectives—which may differ from one policy area to another and from one country to another. A
reform package that ignores the pace at which adjustment to the reforms can reasonably be expected to take place (a variable that is partly determined by political circumstances) runs the risk of failure and undermines the credibility of future reform efforts.

The credibility of a reform package might be enhanced by including policies aimed to speed up the adjustment call for by the reforms. Indeed, from the rational expectation view, we have learned that matters of coherence and credibility are very important in determining the likely effect of a reform package on such variables as the size and direction of investment and labor hiring, and thus on the success or failure of the program (Calvo, 1986a, and 1986b).

On the foreign trade side, for example, the main purpose of liberalization is to raise total factor productivity by eliminating discrimination against export-oriented industries (and import-competing industries with low levels of protection), and by reducing the variance of incentives across import-competing activities as well as helping to shift resources to tradables. The speed of liberalization must therefore depend on the speed with which resources can realistically be expected to be reallocated to the sectors that have hitherto been discriminated against; otherwise substantial unemployment would result. Initial conditions, specific to each country, will determine the speed at which the redeployment of resources can take place. For example, the smaller the investment/GNP ratio, the slower should be the speed of trade liberalization. Similarly, the greater the extent of labor mobility and the more competitive the labor market, the more quickly resources can be reallocated and thus the faster trade liberalization can proceed. 12/
Whatever the initial conditions, a substantial reform package which is undertaken within an agreed and reasonably paced timetable offers major advantages. First, the required reallocation of resources will not occur unless the signal given is strong enough and in a clear enough direction to make the reforms credible. Second, an unduly slow pace of reforms will delay the emergence of export activities and of interest groups whose support for the reforms could help counter the antagonism toward the reforms of the existing vested interest that have been benefiting from the protective regime (Papageorgiou et al. 1986).

Deregulation of financial markets can create several problems if initial conditions are overlooked. For example, if regulation has led to a substantial proportion of financial institutions' assets being held at below market rates, and real lending rates are substantially negative, then deregulation of interest rates will create difficulties for existing financial intermediaries. In particular, if deposit and lending rates are deregulated simultaneously and new entrants are allowed into the financial system, then existing banks will be forced to pay market rates. Existing banks may then experience substantial capital losses, in turn putting the banking system's solvency in jeopardy. This implies that in the transition phase, lending rates should be deregulated first, and deposit rates gradually thereafter. In this way, the capital losses of existing banks are minimized; then, as existing preferential loans come to maturity, controls on deposit rates can be lifted over time.

Deregulation of controls on capital flows is another example of the importance of taking initial conditions into account. On the one hand, rapid liberalization of capital flows with deposit rates that are below free market levels, will result in capital outflows that could threaten the survival of
the domestic financial system. On the other hand, if domestic interest rates are free and substantially above international levels, (when expressed in the same currency) decontrol of capital flows will result in large capital inflows that will create a real exchange rate appreciation which in turn will jeopardize the success of trade liberalization efforts (Bruno, 1983; Corbo, 1983, de Melo 1986).

Sequencing of Reforms: here too, economic theory offers little guidance about an optimal sequence for removing distortions when many markets are initially regulated. Nevertheless, some broad recommendations can be derived from general principles that recognize that the objective of liberalization is to improve resource allocation. This objective suggests that domestic markets should be deregulated first, so as to ensure that resource reallocation will take place.

The second stage then involves liberalization of economic relations with the rest of the world. Here, it is usually argued that the current account of the balance of payments should be liberalized first with liberalization of the capital account later. Much has been written on this issue lately, (see McKinnon, 1982; Frenkel, 1982, 1983; Krueger, 1984; Edwards 1985). Two arguments have been put forward for liberalizing domestic markets and the current account before the capital account. First, since asset prices are determined by the present value of income streams, income streams generated by distorted prices will result in distorted asset prices and thus trade in assets will be done at distorted prices (Krueger, 1984). Second, since asset markets in general adjust much faster than commodity markets, liberalization of the capital account could result in large capital flows with unwanted consequences for the real exchange rate. By the same argument, the overall balance of payments constraint requires that the current and capital
accounts be brought into line with each other, and thus, even though the two accounts tend to respond at different speeds, the overall constraint implies that the two speeds of adjustment must be harmonized. It is much easier to achieve this by slowing down capital flows than by accelerating current account liberalization (Frenkel, 1983; Edwards, 1985). This point could be extended farther by arguing that, within the current account, import flows respond faster than export flows: thus, opening up the capital account first could jeopardize the overall process of trade liberalization by resulting in a sharp increase in import flows much in advance of the export expansion.

Evaluation

With respect to the sequencing of liberalization some significant departures from the emerging consensus become apparent. Argentina and especially Uruguay deregulated capital flows early on. Here the Uruguayan experience is particularly interesting since none of the perverse side-effects (e.g. real exchange rate appreciation) suggested by proponents of a sequencing starting with current account deregulation was observed so long as the exchange rate was not used to bring down inflation. Indeed the contractionary effects associated with orthodox stabilization was avoided because of capital repatriation and the deregulation of the domestic financial market (de Melo 1986). With high capital mobility, the deregulation of domestic financial market and the maintenance of a stable real exchange rate with the passive crawl was a key to improved growth during 1974-78—though other factors, including higher savings and investment rates than in the pre-reform period, also helped. Though the sequence of liberalization was reversed in Uruguay, following the recommendation of maintaining a stable real exchange rate avoided the appearance of macroeconomic disequilibria.
Chile, in contrast, followed the recommended sequence of liberalizing the current account first and the capital account much later on. However, due to a combination of ex-post indexation of wages and interest rates and substantial capital inflows a large real appreciation developed that put the trade liberalization in jeopardy.

With respect to deregulation of domestic markets, along with the lifting of domestic price controls, the most extensively implemented liberalization program in all three countries was the deregulation of financial markets. This is not surprising: one might reasonably expect much less resistance from threatened interest groups to the reduction of restrictions in this area than, say, to reduction of trade barriers or removal of protective labor market regulations (where, as just noted, very little was indeed done). Eventually all three countries also decontrolled short-term external capital flows—a liberalization measure rarely carried out in developing countries—but only Uruguay adopted a fully liberalized regime in this area. Finally in foreign trade, only Chile virtually eliminated protection.

With respect to the speed of the reforms, as the chronological summary in Tables 3a, 3b and 3c shows, deregulation was usually gradual. The exceptions were the rapid removal of capital flows restrictions in Uruguay and to a less extent in Argentina and the rapid sale of public enterprises in Chile. Otherwise domestic prices were decontrolled gradually, interest rate ceilings were lifted slowly and trade liberalization in Chile took place over a five year period. On the whole, therefore, the reform process cannot be criticized for its abruptness; indeed, trade liberalization in Argentina and Uruguay was, if anything, too little, too late, and too slow.
4. Outcomes

In evaluating the results of the reforms we will distinguish three periods. The first corresponds to the management of the macroeconomic crisis and the reduction of some micro-economic distortions (1974-78 in Chile and Uruguay; and 1976-78 in Argentina). The second period starts with the use of the exchange rate to bring down inflation, often referred to as the "tablita" period, and ends with the sudden reduction in foreign financing availability by August 1982. The third is the post-August 1982 period.

4.1 The First Period: Stabilization with Some Liberalization

During the first period, all three countries were gradually implementing anti-inflation programs and liberalizing markets. In Chile, as progress was being made in reducing the fiscal deficit and in controlling inflation, the commodity terms of trade fell sharply resulting in a real income loss of close to 5 percent of GDP. The decline in terms of trade plus the sharp reduction in the fiscal deficit produced a severe recession with a 12.9% drop in GDP in 1975. Following the 1975 recession, GDP grew at an annual rate of 8.3 percent during 1975-78. The urban unemployment rate, which had reached 15.0 percent in 1975 and 16.3 percent in 1976, was reduced to 13.3 percent in 1978. The inflation rate, which had averaged 358.0 percent a year in 1974-76, fell to an average annual rate of 79.0 percent in 1977-78. In spite of the sharp deterioration in terms of trade, exports grew in current dollars at an average annual rate of 23.5 percent in 1974-76 and 7.9 percent in 1977-78. The fiscal deficit was only 5.1 percent of GDP in 1974-76 and 1.3 percent of GDP in 1977-78. Real wages, which had dropped by 29.6 percent between 1971-73 and 1974-76, rose by 18.8 percent between 1974-76 and 1977-78.
The tariff rate inclusive of the real exchange rate peaked in 1975 and then depreciated, but was almost constant between 1977 and 1978.

The most unexpected results were the slow pace of disinflation, despite a substantial reduction in the public sector deficit, and the very high real interest rates that followed the freeing of domestic rates and deregulation of domestic financial markets. Indeed, the ex-post real interest rate on peso loans was 127.2 percent in 1975; 65.2 percent in 1976; 58.0 percent in 1977 and 43.8 percent in 1978 (Corbo 1985a). Different hypotheses have been advanced to explain these high rates: the fiscal and monetary squeeze resulting from the stabilization effect; the restrictions on capital inflows; the high cost of financial intermediation arising from reserve requirements; the unexpected reduction in inflation; and distress borrowing by firms that were heavily protected on the eve of trade liberalization; etc. (Edwards, 1986, Ramos, 1984, and Zahler, 1985). These explanations have not been corroborated, however, and they leave unanswered the issue of the appropriateness of credit risk evaluation for loans made at such outrageous real interest rates. We return to this in Section 5.

Argentina had a smaller terms of trade loss than Chile and Uruguay at the beginning of the reforms, yet, GDP growth rates were very flat and even lower than in the pre-reform period even though exports grew at an annual average rate of 29.9 percent in the 1976-78 period and the current account had a surplus equivalent to 2.1 percent of GDP. The average unemployment rate increased from 2.4 percent in 1973-75 to 3.4 percent in 1974-76, and would have risen higher had it not been for the military government's explicit efforts to keep it low to prevent political unrest. Real wages fell by 33.3 percent between 1973-75 and 1976-78. The inflation rate, which had reached 443.2 percent in 1976, was reduced to 176.1 percent in 1977 and remained
virtually unchanged in 1978 at 175.5 percent (Fernandez, 1985). This slow pace of disinflation is not surprising, given that the public sector deficit as a percentage of GDP increased from 10.1 percent in 1973-75 to 11.6 percent in 1976-78.

The freeing of Argentina's domestic interest rates and most commodity prices in the middle of 1977 also resulted in a period of positive ex-post real interest rates between the last quarter of 1977 (when they reached an annual rate of 10%) and the last quarter of 1978 [when they again turned negative until the end of phase 1 (Fernandez 1985, Table 2)]. Not surprisingly, these rates were not as high as in Chile's, since capital inflows were not restricted.

In Uruguay, output grew from the very beginning of the reforms. This is all the more remarkable because of the huge fall in terms-of-trade during the reform years (Table 4) in comparison with 1965-70 and the especially favorable 1971-73 period (see Table 2). Several factors accounted for this turnaround. First, real exchange rate variability was reduced after the adoption of the passive crawling peg in 1972. Furthermore, exporters were partially compensated for the anti-export bias of the high tariff on imports through the elimination of taxes on traditional exports and the application of fiscal and financial incentives to non-traditional exports. On average, exports grew by 21 percent a year during 1974-76. This sizable change in the contribution of exports to growth was of course helped by the accompanying reduction in costs (e.g., the fall in real wages) and expenditure switching policies.

The removal of QRs on imports of investment goods together with increased public investment dramatically raised total investment (see Table 2). By 1978, public investment had risen by nearly 400% in real terms over
its depressed 1974 level, while private investment doubled in real terms between 1974-78. As a result, GDP growth which barely averaged one percent a year during 1955-73, rose to an annual average of nearly 4 percent between 1974 and 1978.

The final positive factor contributing to this dramatic change was the rise in capital inflows. Uruguayan capital repatriation as confidence grew, together with increases in deposits by Argentines averted a severe drop in real liquidity (de Melo, 1986). As a result the balance of payments capital account improved, allowing Uruguay to prepay debt incurred under an IMF stabilization plan. The cumulative totals of "net errors and omissions" in the balance of payments accounts -- a crude proxy for capital flight were -US$250 million for 1970-74 and +US$51 million for 1975-81. Confidence in the stability of Uruguay's financial system was on the rise.

The fiscal deficit which averaged 3.8% of GDP during 1974-6, was brought down to 1.9% during 1977-8. Nevertheless, inflation (which had peaked at 97% in 1973) proved stubborn and averaged 51% over 1977-8. As in Argentina, the gradual lifting of domestic interest rate ceilings raised ex-post average real borrowing interest rates, which increased progressively from -30% in 1973 to 3.6% in 1978 (Hanson and De Melo 1985, Table 3).

4.2 The Second Period: Stabilization through Pre-announcement of the Exchange-Rate

The second phase corresponds to the use of pre-announced exchange rates to bring down inflationary expectations. In Argentina, the public sector deficit still remained close to 10 percent of GDP and in Chile a wage indexation mechanism that was bound to result in a lengthy period of real appreciation was maintained. In Uruguay the fiscal deficit increased
substantially in 1981. Thus these anti-inflationary programs started (Chile and Argentina) or faced later on (Uruguay) major inconsistencies.

In this second period, absorption grew faster than income in the three countries (Table 2). The large increase in absorption, facilitated by easy access to external financing, fueled demand for the non-tradable sector causing a real exchange rate appreciation (Figure 1). The international depreciation of the dollar and demand pressures on non-tradables limited the effectiveness of anti-inflationary policies. In Chile, the annual inflation rate was reduced from 50 percent in 1978 to 20 percent in 1981 and 0 in early 1982 but the accumulated real appreciation became substantial. In Argentina it only fell from 175 percent in 1978 to 101 percent in 1980. Finally, in Uruguay the rate actually rose from 44.5 percent in 1978 to 66.8 percent in 1979 (due in part to the deregulation of domestic beef prices in August 1978, and demand pressures resulting from Argentine tourist expenditures), subsequently falling again to 63.5 percent in 1980 and 34.0 percent in 1981.

In all three countries, the real exchange appreciation was a reflection of the sharp increase in expenditure, a fraction of which was spent on tradable goods. Increased imports and loss of export competitiveness combined to raise the current account deficit as a percentage of GDP in all three countries. In Chile, the proportion rose from 5.6 percent in 1977-78 to 9.1 percent in 1979-81; Argentina moved from a current account surplus equal to 2.1 percent of GDP in 1976-78 to a deficit of 1.8 percent of GDP in 1979-80; and in Uruguay the deficit increased from 3.2 percent of GDP in 1977-78 to a deficit of 5.4 percent of GDP in 1979-81 (Table 2). Because all three economies were booming, the average unemployment rate was reduced from 14.2 to 13.6 in Chile, from 12.4 to 8.4 in Uruguay and from 3.4 to 2.2 in Argentina.
Figure 1

Real Exchange Rates and Real Interest Rates During the Active Crawling Peg

NOTES: Real Exchange Rate Index on right hand scale
Real Interest Rate and GDP index on left hand scale
At least two mechanisms contributed significantly to the increase in expenditures and the resulting current account deficits. First, specially in Argentina and Uruguay short term real exchange rate appreciation led to higher expenditures on imported durables through intertemporal substitution while their prices were low (Dornbusch, 1985). Second, the general increase in asset values in all three countries during the boom phase raised the market values of wealth which in turn contributed to increases in expenditures (Barandiaran, 1984; Corbo, 1983; Dornbusch, 1985; Fernandez, 1985; Hanson and de Melo, 1985; and Harberger, 1983).

The sustained real exchange rate appreciation raised doubts about the sustainability of the tablita, which were reflected in growing interest rate spreads in spite of falling (Chile) or non-existent (Argentina, Uruguay) impediments to short-term capital flows (Argentina, Uruguay). The "boom" gave rise to a "squeeze" as real interest rates increase sharply. The squeeze from higher financial costs (in spite of portfolio shifts towards dollar-denominated debt) was aggravated in tradable-goods producing sectors by falling earnings as competition from abroad intensified because of the strong real currency appreciation (Figure 1). Towards the end of phase 2, agents were responding with increased "distress" borrowing to stave off bankruptcy, and awaiting a post-devaluation bailout (Diaz-Alejandro, 1985, Tybout (forthcoming)).

4.3 The Third Period: The Crisis

Signs of inconsistency in the three countries' economic policies became apparent in late 1980 in Argentina, and in early 1982 in Uruguay and Chile. In Argentina with an externally financed public sector deficit of over 10 percent of GDP and with no prospect of fiscal reform, doubts about the
sustainability of the exchange rate regime set in as early as the first half of 1980. This was made worst by the April 1980 collapse of the BIR (Banco de Intercambio Regional) which produced a 25 percent increase in the money supply in a single month. The absence of a commitment about future exchange rate policy by President-elect Viola accelerated private capital outflows. The 10 percent devaluation introduced in February 1981 was a case of "too little and too late" and only exacerbated the crisis.

In Chile, although an unprecedented fiscal surplus equal to 2.1 percent of GDP was achieved in 1979-81, the current account deficit reached 14.6 percent of GDP in 1981. Real exchange rate appreciation from the second quarter of 1979 (when the rate was fixed) to the last quarter of 1981 was 29.8 percent (Corbo, 1985a). Doubts about the sustainability of the exchange rate regime started to set in, with private capital inflows decreasing from 1.6 billion dollars in the second half of 1981 to only .9 billion dollars in the first half of 1982. The monetary contraction that followed resulted in high interest rates and a sharp recession.

In the case of Uruguay, the fiscal position (which had improved continuously up to 1980) started to deteriorate in 1981 with an underfunded social security reform. Meanwhile, real exchange rate appreciation between 1978 and 1981 was 27.4 percent. Furthermore, with the collapse of the stabilization attempt in Argentina, Uruguay's real appreciation vis a vis Argentina was even larger (Hanson and de Melo, 1985). Emerging doubts about the sustainability of the tablita were reflected in increased private capital outflows starting in 1981 (de Melo 1986).

Thus capital flight was evident in Argentina and Uruguay (and to a lesser extent in Chile) before their economies were hit by the adverse external developments of the early 1980s--when changes in the mix of fiscal
and monetary policy in the industrial countries and especially the U.S. produced an unanticipated world recession, an appreciation of the US dollar, a drop in the terms of trade, and a sharp increase in international interest rates. The debt crisis that followed, and the interruption of voluntary capital flows, had severe adverse consequences for all three countries and other countries that had become used to or had encouraged a large gap between expenditures and output. Specifically in the Southern Cone countries, the private sector was too dependent on foreign financing in the case of Chile and the public sector was the main borrower in the case of Argentina. Uruguay was somewhat in the middle when the international debt crisis that followed the Mexican crisis broke in August 1982, the Southern Cone countries were already in serious trouble. The debt crisis closed the option of using public borrowing to finance private capital outflows, but private sector adjustment had started earlier. All the August 1982 crisis implied was a faster cut in absorption and a faster real depreciation. The downward inflexibility of nontradable prices and wages in a regime with backward wage indexation (e.g., Chile) contributed further to the depth of the recession. In Uruguay, the large real appreciation vis-à-vis Argentina exacerbated the recession as expenditures were rapidly shifted to Buenos Aires. The abandonment of the exchange rate regime came in June 1982 in Chile and in November 1982 in Uruguay.

How important were unfavorable external events? Table 4 decomposes terms-of-trade and interest rate shocks were for the Southern Cone countries. The interest rate shock, which began to be felt after the rise in U.S. interest rates starting at the end of 1979, not only affected the cost of new borrowing but also the interest charge on existing debt. Not surprisingly, this latter effect was particularly strong in the three
### Table 4:
External Shocks: 1974-83
(% of GDP)

<table>
<thead>
<tr>
<th></th>
<th>Terms of Trade (%) of GDP</th>
<th>Interest Rate (%) of GDP</th>
<th>Total (%) of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina*</td>
<td>-2.9  -3.3  -3.3</td>
<td>n.c.  2.8  -6.4</td>
<td>-2.9  2.5  -6.7</td>
</tr>
<tr>
<td>Chile</td>
<td>-5.7  -1.9  -4.8</td>
<td>n.c.  0.2  -7.4</td>
<td>-5.7  -1.7  -12.2</td>
</tr>
<tr>
<td>Uruguay</td>
<td>-7.6  -4.4  1.9</td>
<td>n.c.  0.9  -2.9</td>
<td>-7.6  0.5  -1.0</td>
</tr>
</tbody>
</table>

Notes:
- n.c. - not calculated.

Methodology. The real income effect of terms of trade changes is computed from import and export unit value indexes in ECLA weighted by the import share of GDP. The real interest rate is calculated as

\[
i - \hat{p}^T_T = \left(\hat{p}^X_T + \hat{p}^M_T\right) 0.5 \text{ where } \hat{p}^X_T \text{ and } \hat{p}^M_T \text{ are percentage changes in } \hat{p}^X_T \text{ and } \hat{p}^M_T
\]

the export and import price indexes and the nominal interest rate is computed from the world debt tables (1986) as the ratio of interest payments to disbursed debt. The interest rate effect is computed as the debt to GDP ratio of the previous period multiplied by the interperiod change in the real interest rate. \( \hat{p}^M_T \) is measured by the export unit value of industrial countries from the IFS. The same methodology is used in Sachs (1985). Changes are computed with respect to previous period.

* For Argentina the periods are 1976-78, 1979-80 and 1981-82.

Source: Corbo and de Melo (1987).
countries during 1982-3 because much of their debt was contracted at variable interest rates through syndicated commercial bank loans. As shown in Table 4, the combination of declining terms of trade and increasing interest costs amounted to 12.2% of GDP in Chile and 6.7% of GDP in Argentina. This said, however, external shocks were insignificant during 1979-81 which was when the unsustainability of the exchange-rate-based stabilization program became apparent.

Further evidence based on simulation of an econometric model estimated with annual data for 1962-83 confirmed the decomposition results of Table 4 (Corbo and de Melo, 1987). In Chile, where external shocks were heaviest before the crisis, our simulations suggest that if during 1981-3, the average interest rate of 1974-9 and the terms of trade of 1980 had been in place, GDP growth would have only been 2.1 percent a year and external debt at year-end 1982 would have still been 87 per cent of its historical value. In a further simulation in which a more normal expenditure path was assumed, average GDP growth over 1981-3 would have been 2.7% and 1982 year-end external debt would have been only 67 per cent of its historical value. This more favorable outcome comes from smaller external borrowings together with lower real wages that would have benefitted employment, especially in the non-tradable sector. Simulation results of external shocks for Argentina and Uruguay were even less significant than for Chile.

5. Lessons from the Southern Cone Reforms

The first lesson relates to the micro-efficiency effects of the reform packages. These are difficult to detect because the reforms were short-lived. This was especially true in Argentina where deregulation was
mostly confined to the financial sector. Hence Chile and Uruguay provide most of the relevant data.

Uruguay offers the clearest evidence. During 1955-73, GDP grew at 1.0 percent per year; during 1974-83, it grew at 2.4 percent. There is additional evidence that private savings and investment rose during the reform period. Econometric estimates of savings and investment over 1962-83 reveal a clear upward shift in both schedules. Further analysis controlling for factors affecting private savings and investment indicate that the upward shift could not be predominantly associated with financial reforms; rather the shift was attributable to the entire reform package. 13/

In Chile, GDP growth was sustained in spite of low rates of investment and employment growth, suggesting that productivity and capacity utilization increases contributed significantly to growth. Estimate of total factor productivity (TFP) growth for manufacturing show a sharp increase in the reform period compared with the pre-reform years: during 1960-70, annual TFP growth had averaged -0.61 percent while during 1977-81 it averaged 2.50 percent (Mierau 1986). Further calculations from a simulation model for 1977-81—in which account was taken of capacity utilization increases during 1977-79—suggest that reform induced productivity gains raised GDP in 1981 by 19 percent over what would have been achieved with historical TFP growth rates for 1965-74 (Condon, Corbo, de Melo, 1985).

Evidence of productivity gains also appeared in interviews with entrepreneurs in each country. Several noted productivity gains that exceeded their expectations, as a result of consolidation of product lines, labor dismissals and improvements in product quality to meet foreign competition (Corbo and de Melo, 1985b).
Given that the reforms ultimately faced severe problems one must ask how importantly external shocks contributed to their failure. The conclusion—and our second lesson—must be that these adverse events did not contribute much to the final outcome. Indeed, the overall economic situation in the three countries was well under stress before August 1982, when the greatest adverse shocks were witnessed. Furthermore, the discussion in Section 4 shows that even in Chile, where negative external shocks were the strongest, the contribution of terms-of-trade and interest rate shocks cannot account for the deterioration in growth during 1981-83.

The third lesson relates to the need for consistency of policies as a precondition for credibility. In particular, the macroeconomic framework must be supportive of liberalization reforms. Argentina never reduced its public sector deficit below 8% of GDP, and meanwhile pursued mutually inconsistent exchange rate and fiscal policies. This was especially the case during the tablita phase, when the deficit fed the growing expectations of devaluation during 1980—which are in turn reflected in the interest rate trajectory in Figure 1. The collapse of Argentina's exchange rate regime has been thoroughly studied (Cumby and van Wijnbergen 1984 and Connollay, 1985). Borrowing abroad to finance the fiscal deficit and monetization of non-performing commercial bank loans were inconsistent with the tablita; inconsistent macropolicies doomed the liberalization episode from the start. Inconsistency of macropolicies was at its peak when the three countries were pursuing their exchange-rate-based stabilization programs. In terms of inflation alone, these programs ultimately reduced inflation temporarily, but they meanwhile set a financial trap for all three economies in the form of a powerful boom-squeeze-bust cycle that lead to the abandonment of exchange rate policy. Furthermore, the anti-inflation medicine was slow to work through commodity
and financial markets, meanwhile creating unsustainably large capital movements and real exchange rate appreciation.

The fourth lesson is that each country would have benefitted from closer scrutiny of banking sector activity. This introduces a crucial distinction between wholesale financial market liberalization and properly monitored financial market deregulation. A clear understanding of this distinction could have at least mitigated a range of unfortunate developments, including the following: (a) in Chile, banks allowed the debt of affiliated firms to rise even though these firms were doing relatively poorly and should have been forced to liquidate. Hence less credit was available for more profitable independent firms (Galvez and Tybout, 1985); (b) bankers suddenly placed in a free market environment failed to recognize that the increase in interest rates tended to redirect their loan portfolios away from low-risk-low-return activities, resulting in "adverse selection" (Stiglitz and Weiss, 1981). Better bank monitoring might have resulted in less upward pressure on lending rates; (c) Finally, de facto deposit insurance created a "moral hazard" effect as it provided incentives for undue risk-taking. Banks with poor portfolios were able to attract new funds by raising deposit rates, thereby forcing less-risky banks to match these rates.

The fifth lesson is that in Chile where a combination of external shocks and inappropriate macroeconomic management resulted in a large debt accumulation and a severe depression in 1982-83, the reforms were resilient enough to be maintained. Today Chile is in a sustained recovery in spite of a high debt overhang.
6. Conclusions

This paper has reassessed Southern Cone reforms in terms of what we know about the design of stabilization and liberalization programs. Our synopsis suggests that, with the exception of Chile, the reforms were not as widespread as some believed, although they were large in relation to the status quo ante. In particular, our synopsis shows that very little trade liberalization took place in Argentina and Uruguay, where redundant protection was barely eliminated at the height of real exchange rate overvaluation. Some of the anti-export bias was reduced by eliminating taxes on traditional exports, but the bias remained high throughout the reform period, as did average effective protection to domestic sales and its variance across sectors. Furthermore, labor markets remained fairly highly regulated in all three countries, even though labor dismissal was easier than before the reforms. The synopsis also suggests that, by and large, liberalization was gradual. Even the relatively rapid trade liberalization in Chile still spanned five years. We also show that the collapse of the three economies in the early eighties cannot be ascribed priortarily to external factors—i.e., the terms-of-trade and interest rate shocks of these years. Rather, the main blame for failure must ultimately rest on errors of program design and implementation on the part of the countries themselves.

These errors included relatively restrictive wage legislation (Chile), or political instability combined with a preoccupation with keeping unemployment as low as possible (Argentina), that impeded the resource reallocation process prompted by commodity market liberalization. Most importantly, liberalization measures were thwarted by poorly designed macro policies. This was particularly evident in Argentina throughout the reform period (and in Uruguay towards its end), when the monetary policy required to
deal with growing fiscal deficits was inconsistent with the accompanying exchange rate policy. Last, but not least, financial sector deregulation was not accompanied by appropriate supervision of the financial institutions.

Our review suggests a number of policy lessons for countries attempting to resume growth and restore external balance through a combination of liberalization and stabilization policies. First, we have found evidence that reductions in distortions produced efficiency gains in Chile and Uruguay even though in Uruguay the reforms were short-lived. Second, we demonstrated the adverse consequence of policy inconsistencies for the credibility of the latter stages of the three countries' reforms efforts, and have shown how these inconsistencies contributed to the development of the eventual crisis in each country. Third, we have presented data that call into question the use of exchange-rate-based stabilization because of the very slow convergence of domestic prices and interest rates to international levels, which in turn can produce unsustainably large capital movements. Finally, we have pointed out the need for caution in financial sector deregulation, so as to avoid "moral hazard" and "adverse selection" effects that can be exacerbated when financial institutions are not subject to appropriate monitoring, supervision and regulation.
Footnotes

1/ The introduction of crawling peg exchange rate regimes, in the mid 1960s in Chile and later in Uruguay (1972) and Argentina did reduce the more extreme fluctuations in the real exchange rate, but imbalances persisted.

2/ Annual inflation rates approached 1,000 percent in Chile (September 1973) 2,300 percent in Argentina (March 1976) and 100 percent in Uruguay. The fiscal deficits were substantial well before the collapse of the civilian governments (Table 2). In Argentina and Chile inefficient public enterprises contributed to high public sector deficits.

3/ Much has been written in the last three years on this topic. Our purpose here is to summarize the main reforms. This section draws mostly on Corbo, de Melo and Tybout (1986) and Corbo and de Melo (1985a). Other references are Calvo (1986a), Edwards (1985), Harberger (1982), Rodriguez (1982) and Sjaastad (1983).

4/ Chile's substantial and chronic fiscal deficit was eliminated by drastic across-the-board expenditure cuts (amounting to 15 percent in 1975 alone), followed by a tax reform. In Uruguay, the fiscal deficit was reduced yearly up to 1980. Here, much credit should be given to the rationalization of taxation, including the introduction of a value added tax (VAT) which improved fiscal performance compared to the poor record of the pre-reform period (see Harberger and Wisecarver, 1977). In Argentina, on the other hand, the fiscal deficit was never controlled (Cavallo and Peña, 1983).

5/ In Chile, the switching was achieved through a large real devaluation and reduction of barriers to imports. In Argentina, switching efforts included a combination of real devaluation, reduction of taxes on exports, and some reduction of import barriers. In Uruguay, expenditure switching was combined with a real devaluation, reduction of barriers to imports, and introduction of subsidies for non-traditional exports.

6/ Other recent analyses of stabilization and liberalization policies (e.g. Killick, 1984; and Ching-Yuan Lin, 1985) have shown that simultaneous application of the two is unlikely to be sustainable and successful.

7/ The view that real exchange rate appreciation to bring down inflation should be avoided owes much to Southern Cone experience with this policy. See Section 4.

8/ Chile's rate of inflation was around 50 percent in late 1977, Argentina's was 166 percent in late 1978, and Uruguay's was roughly 50 percent in late 1978.
How exchange-rate-based stabilization was supposed to work is described in Rodriguez (1983). Comparisons of the two approaches is provided in Dornbusch (1982).

For further discussion see Nogues (1986) Petrei and de Melo (1985) on Argentina and Mezzera and de Melo (1985) on Uruguay.

For infant industries a timetable of reduction in protection over, say, a five year period should be adhered to. See Balassa (1976) and Bell, Ross-Larson and Westphal (1985). And, for countries with export earnings derived from natural-resource-based products, it is appropriate and accepted to tax windfall gains during commodity booms and to offer rebates to producers during troughs. See Davis (1983).

Lessons from interviews with manufacturing firm managers in the Southern Cone countries are summarized in Corbo and de Melo (1985b). They found that major efficiency gains were achieved in a short period for some firms but that others delayed adjustment because of lack of belief in the reforms and, in some instances, because of high severance payments costs.

Controlling for other factors, de Melo and Tybout (1987) showed that savings and investment rose during the reform period. However, they could not attribute this rise to financial market reforms only and suggested that fiscal reforms played an important role.

For reference, the first major bank failures in each country occurred on the following dates: Argentina (BIR) March 1980; Chile (Banco Osorno) 1977; Uruguay (Banco Panamericano), 1979. In all cases depositors incurred no financial losses. The "moral hazard" effect is further elaborated in Diaz-Alejandro (1985) and Tybout (1987).
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