The Sequencing of Economic Liberalization in Developing Countries

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THE SEQUENCING OF ECONOMIC LIBERALIZATION IN DEVELOPING COUNTRIES

I. Introduction

1. The reduction (elimination) of distortions has traditionally been an important component of the Bank's policy advice. More specifically, in its policy dialogue with member countries, the Bank has many times recommended that, among other things, these countries raise real interest rates, reduce import tariffs, eliminate import quotas, and increase the degree of integration of their economies with the international financial markets. Even though there is an agreement on the general desirability of pursuing these reforms, the problem of recommending a specific sequencing for these policies continues to be a difficult one, but one which must be addressed by policymakers. Many times, due to political or other constraints, it is not possible to pursue both the liberalization of the trade and capital accounts simultaneously; it may not even be desirable to do so. In those cases, the question of sequencing becomes very important. Until recently, very little analytical work had dealt with issues such as: should domestic interest rates be raised before, after or at the same time capital controls are lifted? Should the trade account be opened up before the capital account or vice versa? This note addresses some of these problems from a policy point of view and suggests a specific sequence of economic liberalization.

2. It has generally been recognized that opening the economy to the rest of the world is an integral part of any economic reform. However, determining the appropriate sequencing of economic liberalization is not easy; there are
no theorems or recipes. Depending on the country under consideration and on the nature of the initial distortions, alternative sequencing paths can be followed. However, there are a few general principles that are applicable to almost every case.

3. Even though many of the principles discussed here are relevant to most developing countries, the analysis applies better to a middle-income economy which, before the liberalization reforms, is characterized by: (a) fairly high inflation; (b) large fiscal deficit, financed by money creation; (c) non-existent, or very rudimentary domestic capital market, and controlled interest rates; (d) high impediments to trade in the form of tariffs; or (e) controls to capital movements in and out of the country.

4. In this note, those general principles that apply to most situations are addressed first. The note then discusses those issues where policy recommendations have to be somewhat qualified. Since there has been very little empirical work done in this area — the dynamics of liberalization — much of the discussion is based on analytical considerations. When possible, country specific cases are provided as examples. What is clear is that our understanding of this area is still limited, and this note summarizes the state of knowledge as of today.

II. Domestic Interest Rates and the Opening of the Capital Account

5. One of the few aspects of reform sequencing that is well established, and almost unanimously accepted, refers to the liberalization of the domestic capital market and of the capital account of the balance of payments. It is clear that impediments to capital movements (both inflows and outflows) should not be relaxed before liberalizing the domestic financial sector. This is
because if the capital account is liberalized at a time when domestic interest rates are fixed at arbitrarily low or negative levels, an outflow of capital will result. If the domestic interest rate is below the world interest rate (appropriately corrected by expected devaluation), financial capital will tend to leave the country. Capital flight has indeed been the result of acute imbalances between domestic and international real interest rates. For example, much of the capital flight that Argentina experienced in the early 1980s responded to the fact that the (ex-ante) real interest rate was perceived to be well below the ex-ante real interest rate in the rest of the world.

6. Restrictions to capital movements, then, should not be lifted before domestic interest rates have been raised. However, in an inflationary environment, the liberalization of the domestic financial market can only be fully undertaken if the fiscal deficit is tightly under control. The existence of a large fiscal deficit which is financed by an inflation tax necessitates that reserves requirements on banks be kept high, and interest payments on deposits be kept low. In this way it is assured that the base on which the inflation tax is collected — the stock of base money — is not eroded. The fiscal deficit, then, has to be controlled before domestic interest rates can be liberalized. If this is not done, the inflation tax base will be reduced, and the rate of this tax — the rate of inflation — will have to be increased for the government to collect the same amount of resources. This could lead to very high inflation rates which would become increasingly difficult to reduce without a major monetary reform. Again, Argentina in the late 1970s and early 1980s provides a good example. During this period the domestic capital market was liberalized without the fiscal
deficit being reduced. As a consequence, and not surprisingly, all efforts to reduce inflation failed; in fact, given the reduced tax base, the financing of the deficit required an even higher rate of inflation. 1/

7. In terms of reform sequencing, therefore, the first principle is that capital controls should only be lifted after the domestic financial market has been reformed, and domestic interest rates have been raised. In turn, interest rates can be raised only once the fiscal deficit is under control.

III. External Sector Reforms and the Real Exchange Rate

8. What should be the sequence of liberalization of the current and capital accounts of the balance of payments? Should tariffs be reduced prior to the lifting of capital controls, or vice versa? Different sequencing of the liberalization of the capital and current accounts will imply different paths for the critical macroeconomic variables and, in particular, of the real exchange rate. In fact, countries have followed different sequencing of liberalization of these two accounts. For example, Argentina and Uruguay in the 1970s opened the capital account first. Chile, or the other hand, reduced barriers to international trade before lifting capital controls. In the 1960s, Korea also opened its trade account before relaxing controls on capital movements. Indonesia, in the late 1960s, reduced trade barriers in a significant way and simultaneously eliminated most controls on capital movements.

9. In general, the opening of the capital account will generate important movements of financial flows. In most countries, if the fiscal

1/ In fact, during this period the Argentinian government resorted to foreign borrowing to finance part of its expenditure.
deficit has been previously controlled and the domestic financial market liberalized, the opening of the capital account of the balance of payments will very likely result in significant inflows of foreign capital, triggered by perceived differentials between the domestic and foreign returns to capital. These inflows of foreign funds will then be monetized and, under a fixed exchange rate, will result in inflation and a real appreciation of the domestic currency. On the other hand, if the country in question chooses to adopt a floating exchange rate, the large inflow of capital will result in an appreciation of the nominal and the real exchange rate. In this case, the opening of the capital account will not only generate a real appreciation of the domestic currency, but since financial markets adjust fast — indeed much faster than goods markets — this real appreciation could be quite abrupt.

10. While under the conditions stated above the opening of the capital account will generate a real appreciation, a successful liberalization of the trade account (i.e., reduction of import tariffs and elimination of import quotas) will generally require a real devaluation of the domestic currency. 2/ This real devaluation will help the exportables sector to expand as the new structure of relative prices replaces the old protective structure. If, however, due to the opening of the capital account this real devaluation is precluded, the transition in the exportable and importable goods sector from a protective to a freer environment will become more difficult. The appreciation generated by the relaxation of capital controls will squeeze profitability in the tradable goods sector precisely at the moment when it is

2/ This point has been made repeatedly in the literature on trade reform. For example, Harry Johnson stated that the "...liberalization [of trade] would necessarily involve a balance of payments deficit and the consequence necessity of devaluation..."
going through a costly real adjustment. Consequently, a number of economists including Ronald McKinnon, Jacob Frenkel and Rudiger Dornbusch, have suggested that the capital and current accounts should not be opened at the same time. Moreover, during the transition period after trade has been liberalized, capital inflows should be tightly controlled. For example, Dornbusch has recently said that "the worst thing to do is to liberalize the capital account...before the required real depreciation has been achieved." This policy recommendation is reinforced by the fact that, in general, the opening of the capital account will result in an overshooting of capital inflows, which will provoke a steep real appreciation in the short run. Immediately after the relaxation of controls capital inflows are likely to be quite large; after some time the flow of capital will decline towards its new long-run equilibrium level.

11. There are a number of examples where the opening of the capital account has resulted in excessive capital inflows and a significant real appreciation of the domestic currency. Perhaps the better known cases refer to Korea and Chile. In mid-1966, a large inflow of short-term financial capital flooded the Korean economy. As a result, there was an increase in inflation and a substantial real appreciation, which between 1965 and 1969 amounted to 20 percent. Chile, in 1978-1981, is another clear example of how the opening of the capital account can severely affect the level of capital inflow in the short-run. For example, in 1977 net capital flows into Chile amounted to little less than US$500 million. In 1980 these inflows had increased by more than six times to US$3.1 billion, and in 1981 they further
increased to almost US$5 billion. On the other hand, between 1978 and 1981 the real exchange rate appreciated by 30 percent. 3/

12. The conflicting pressures on the real exchange rate as a result of opening the capital and current accounts (i.e., real appreciation and depreciation respectively) capture the fact that these policies will exercise pressures for resources to move in opposite directions. To the extent that there are economic and social adjustment costs associated with resource movements between sectors it is advisable to implement policies that would avoid unnecessary resource switches (i.e., resource movements that will be reversed after a short period of time). Once more Chile provides a good example. Starting in 1976, exporters embarked on extensive investment programs aimed at increasing their export capacity only to find that in 1979-81 the real exchange rate turned drastically against them. At this point, investors moved away from the export sector and switched their resources to the nontradables sector and especially towards the construction sector. One simple way of avoiding these unnecessary resource switches is by opening the current account first, and, only after the new productive structure has been established, opening the capital account slowly. 4/

3/ Throughout their experiences with major inflows of capital, Korea and Chile followed different strategies. Whereas in Korea the nominal exchange rate was adjusted periodically, in Chile a fixed nominal rate was in effect during most of the period. In both countries, however, a real appreciation took place, with the real exchange rate moving against exporters.

4/ There are a number of ways of opening the capital account slowly. For example, only long-term flows can be allowed in at first, or the relation between banks' equity and liabilities denominated in foreign exchange can be raised slowly through time.
13. The discussion presented above has assumed that once the capital account is opened, domestic agents will be able to borrow from abroad and capital will flow into the country. This is indeed what would be expected in a normal situation, where (real) interest rates would be substantially higher in developing countries than in developed countries. However, in the post international debt crisis period (i.e., after 1982) many countries face a (temporary) situation of credit rationing imposed from abroad. Under these circumstances it is likely that the opening of the capital account will not result in additional capital inflows. Moreover, depending on the approach the country is taking to solve its debt problems, capital may even tend to flow out if capital restrictions are relaxed. This is so because in some instances the stabilization program is carried out through timid small steps, which introduce significant uncertainties regarding the future behavior of the exchange rate and domestic interest rates. These considerations again point towards delaying the opening of the capital account. Only after the initial steps towards stabilization and external adjustment have been taken, and the trade account has been opened, should capital restrictions be slowly relaxed.

14. To sum up, from a macroeconomic perspective and considering real exchange rate responses, we obtain a second element of the sequencing policy: it is more prudent to liberalize the current account before relaxing capital controls.

IV. Trade Policy, Adjustment Assistance and Credibility

15. The reduction of trade barriers will result in changes in domestic relative prices. They will move closer to world relative prices and resources will be reallocated across sectors. In general, any process of trade
liberalization will require an adjustment period where firms go through a retooling process and labor acquires new skills. In many cases, this adjustment process will take time and will be quite costly. Some experts have postulated that in order to increase the probability of success (i.e., non-reversal) of the trade reform, the adjustment costs related to the tariffs reduction should be minimized. The idea of minimizing adjustment costs is generally translated into two forms of policy recommendations: (1) liberalization of trade should be done slowly and (2) adjustment assistance — usually in the form of foreign funds — should be provided. These arguments usually focus on the political economy of policy reform and emphasize that any major structural change will necessarily result in pressure groups lobbying to defend their interests. Of particular importance are those groups organized by firms that will be harmed by the reform.

It has, therefore, been argued that one way of reducing the adjustment costs is through the importation of "cheap" foreign capital, which would be used to finance a smoother adjustment of the import-competing industries. According to this view, the capital account should be opened first, or simultaneously with the trade account. This would increase the availability of "cheap" funds that could then be used to ease the adjustment process. However, some economists — most notably Ronald McKinnon from Stanford University — have strongly opposed the idea of using foreign capital flows to assist the trade reform transition period. In fact, McKinnon has pointed out that if capital inflows are allowed, the liberalization episodes will generally be aborted. His view is that since such capital inflows are simply not sustainable in the long run, during the liberalization process they will provide incorrect market signals.
17. This debate about the use of assistance during the adjustment period critically depends on the degree of *credibility* of the trade reform. The credibility of the reform will generally affect the perceived path of relative prices and incentives. If a reform announcement is credible, firms and investors will anticipate future movements in prices and relative returns to investment; they will react accordingly, mobilizing resources domestically and from foreign aid and investing in the "new exports" industries. On the other hand, if the public believes that the reform is not credible, and that there is some probability that the reform will be reversed in the future, "cheap" foreign funds, obtained through the opening of the capital account, may be used by the owners of firms in the import substitution industries to maintain their firms functioning at a (temporary?) loss. These funds could also be used to finance lobbying activities aimed at convincing government officials of the desirability of reversing the trade reform. It is important to stress that the degree of credibility — which is critical for the analysis of the sequencing of liberalization — should not be viewed as completely exogenous. On the contrary, the strategy followed during the liberalization process will tend to affect this credibility. A fundamental and critical aspect of establishing credibility is related to the internal consistency of the policies that have been and are currently being pursued. For example, the inconsistency between fiscal and exchange rate policies in Argentina in the late 1970s, played an important role in the eventual abortion of that country's liberalization reform, primarily because there was very little credibility that these inconsistent policies could be sustained. Also, in Chile, many economic agents believed that since tariff reduction was accompanied by a significant real appreciation of the exchange rate, the trade
reform was actually unsustainable. The extraordinarily large current account deficit observed in that country during 1979-1981 further fueled the feeling of the reforms being unsustainable. This aspect of credibility should be a very important consideration for the Bank when it provides adjustment assistance to countries undertaking trade policy reforms.

V. Economic Sequencing and Welfare Effects

18. Welfare effects are at the center of the analytical and technical discussion on the sequencing of economic liberalization in developing countries. According to the "second-best" theory, if existing restrictions are only relaxed sequentially, it is not possible to know a priori if, due to the partial liberalization, some of the remaining distortions will be magnified. If this is the case, the partial reform will generate some negative results. Moreover, if the magnification of the remaining distortion is big enough, the partial reform may have a negative overall short-run effect on the economy.

19. Even though there have been no conclusive theoretical or empirical results on this subject, there are strong presumptions that the relaxation of capital controls under the presence of tariffs will amplify the existing distortions. Once capital controls are lifted a proportion of the funds obtained from abroad will be used to increase investment in the import substitution sector. However, since tariffs have not been lowered yet, this sector is already producing "too much" and "too inefficiently" relative to what it would produce under a neutral trade regime; the existing distortion has, thus, been amplified. On the other hand, the presumption is that the reduction of tariffs in the presence of capital controls will generally not produce negative amplifications of the existing distortions. On the contrary,
it is likely that a positive indirect effect will result. This is because the reduction of tariff will likely result in a higher demand for foreign funds to finance the acquisition of the now cheaper imports. Since, due to the existence of capital controls, the country was importing "too little" foreign funds, this effect will move this market closer to the undistorted equilibrium. To sum up, in spite of the fact that no firm conclusions are available as yet, the presumption is that from the welfare perspective it is preferable to open the trade account before the capital account is liberalized and this supports the similar conclusion reached earlier.

20. Another important problem related to the welfare effects of economic liberalization in developing countries is whether the external sector should be fully or only partially liberalized. From an analytical perspective the answer to this question is clear. Unless the country in question can alter world prices, and in the absence of other distortions, the first-best solution is to completely liberalize the economy, eliminating tariffs, quotas and all restrictions to financial movements. If, on the other hand, the country has a monopoly or monopsony position and can affect world prices there is a first-best argument for the imposition of some restrictions.

21. While in practice there are a number of developing countries that have a monopoly position in the production of certain commodities, most (if not all) LDCs are small in the world financial market. This, however, does not mean that these countries can borrow infinite amounts at a given interest rate. Quite the contrary, these countries face borrowing limits in the world financial markets and they are charged a premium which is positively related to the perceived degree of country risk. The existence of this country-risk premium implies that even (very) small countries face an upward-sloping supply curve for foreign funds, where the interest rate at which they can borrow will
increase with a higher level of indebtedness. There is then a distortion associated with the process of borrowing from abroad if there is an implicit or explicit government guarantee involved or it is understood that, in the final analysis, private debt will be nationalized as in the case of Chile. In such circumstances there will also be a moral hazard problem in that private firms will borrow "more" than is socially optimal. Since when one domestic firm borrows more, the costs of funds to all borrowers goes up. However, since any particular firm (or bank) will only consider its own position, it will not realize that through their actions they affect all other borrowers. As a consequence of this, the private sector will borrow more than what is optimal for the economy as a whole. From a policy perspective, the best way of dealing with this problem is to reduce the total amount of borrowing through the imposition of a tax on capital importation. In this case, there is a genuine first-best argument for retaining some controls — the optimal tax — on capital movement.

VI. Summary and Conclusions

22. This note has analyzed different issues related to the sequencing of economic liberalization. Whereas it is generally accepted that the liberalization of both the trade and capital accounts is beneficial for the country in question, many times the simultaneous liberalization of both accounts is not feasible or even desirable. It is under these circumstances that the definition of a policy strategy for the sequencing become important. The analysis presented in this note has not yielded a strong theorem regarding the sequencing for liberalizing the current and capital accounts of the balance of payments. It was established, however, that the domestic capital market should be reformed before the capital account is
opened. If this is not done, the opening of the capital account will result in massive capital flights. It was also established that prior to liberalizing the domestic capital market, the fiscal deficit had to be controlled.

23. Regarding the balance of payments, both the historical evidence and the theoretical considerations discussed suggest that a more prudent strategy would be based on liberalizing the current account first. The strongest case for this ordering is based on the relationship between macroeconomic stability, capital flows and the real exchange rate. The experience with destabilizing capital flows immediately following a capital account liberalization — especially in Korea in 1966 and in Chile, Uruguay and Argentina in the late 1970s — has generally been negative and has jeopardized other aspects of the reform package. Some of the historical experiences also suggest that the capital account should be opened slowly, so that the possible increase in the stock of foreign debt that will follow the liberalization will be spread through time, reducing the degree of real appreciation and negative protection provided by the exchange rate.
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