Latin America

Facing the Challenges of Adjustment and Growth

Volume 5

Structural Adjustment
Deregulating the Domestic Economy

Joaõ do Carmo Oliveira, editor

Assisted by:
Caroline Fawsett
Kamlesh Gillespie

EDi Working Papers

National Economic Management Division
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Preface

In July 1990, the National Economic Management Division (EDIEM) of the World Bank's Economic Development Institute conducted a Senior Policy Seminar that examined the issues of adjustment and growth in Latin America. The three day seminar held in Caracas, Venezuela brought policymakers and academicians together to discuss their experiences in Latin America and to compare these experiences with those outside the region. The seminar was directed by João do Carmo Oliveira, at that time of the National Economic Management Division (EDIEM) and now in the Bank's South Central and Indian Ocean Department Country Operations Division (AF3CO). The discussion of the seminar revolved around two themes: the consensus on the main causes and consequences of the current Latin American instability and the conditions for achieving stability and equitable growth in the next decade.

The seminar was organized around sixteen papers offered in three modules:

I. A Diagnosis of the Current Situation: Divergency or Consensus?

II. Structural Adjustment and Conditions for Stable Growth

III. Restoring Policy Credibility

The two papers in the first module examined the policy consensus and divergence within the adjustment process and established a policy framework for the seminar's discussion. The ten papers of the second module addressed the topics of macroeconomic balance, public sector rationalization, trade reform, domestic economy deregulation, and the social costs of adjustment. The third module focused on the topics of debt management and investment recovery and financing. Two country cases were presented on each topic: one an insider's analysis of a Latin American country, and the second a successful country experience outside the region.

Aiming at a wider dissemination of the seminar's findings, EDIEM publishes these sixteen papers along with the rapporteur's report as EDI Working Papers. The first series relates to Module I, and reviews the diagnosis of the Latin American economies. The papers included in this section are:

The Rapporteur's Report by Eliana Cardoso.

"Adjustment and Stabilization: Review of Some Latin American Experiences" by Roberto Frenkel, and

"On the Origins and Course of Latin America's Economic Crisis" by John Williamson.
The second module on "Structural Adjustment and Conditions for Stable Growth" covers five topics and is published in sets of two papers as follows:

**Restoring Macroeconomic Balance**

"The Process of Restoring Macroeconomic Balance in Israel" by Nissan Liviatan

"The Big Bang Approach to Macroe Balance in Venezuela: Why so Sudden? Why so Painful" by Ricardo Hausmann

**Structural Adjustment: Rationalizing the Public Sector**

"Structural Adjustment and Rationalization of the Public Sector in Indonesia, 1983-1988", by Erik Thorbecke

"Rationalizing the Public Sector: the Mexican Experience in 1982-1990" by Guillermo Ortiz and Carlos Noriega

**Structural Adjustment: Reforming the Trade Regime**

"Spain's Experience of Structural Adjustment: Reforming the Trade Regime" by Angel Torres

"Trade Reforms in Chile: Policy Lessons for the Nineties" by Ricardo Ffrench-Davis and Joaquin Vial

**Structural Adjustment: Deregulating the Domestic Economy**

"Deregulating the Domestic Economy: Korea's Experience in the 1980s" by Kihwan Kim

"Structural Adjustment: Internal Deregulation of the Bolivian Economy, 1985-89" by Juan L. Cariaga
Mitigating the Social Cost of Structural Adjustment Programs

"Mitigating the Social Costs of Adjustment Programs in Latin America: Issues and Policies" by Roberto Macedo

"Social Policy During Adjustment: the Poor and Beyond" by Vanessa Cartaya and Gustavo Marquez

The last module on "Restoring Policy Credibility" covers two topics and again is published in sets of two papers as follows:

Managing Domestic and External Debt

"Debt Management in Turkey: Any Lessons for Latin America" by Dani Rodrik

"Renegotiating External Debt: An Inside View of the Case of Costa Rica" by Eduardo Lizano and Silvia Charpentier

Investment Recovery and Financing

"Investment Recovery and Financing: Thailand" by Virabongsa Ramangkura

"Investment Determinants and Financing in Colombia" by Antonio Ocampo

Peter T. Knight
Chief
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Deregulating the Domestic Economy: Korea’s Experience in the 1980s

Kihwan Kim
Abstract

Korea has achieved phenomenal economic success in the last decade. The deregulation of specific sectors of the economy and trade liberalization policies are key reasons for the economic growth. The author describes the domestic economic reforms, particularly of the financial and labor markets. As stated at the outset of the paper, the lack of reforms in these sectors prescribes the policy agenda for the Korean economy in the 1990s.

Financial liberalization policies were implemented in 1982 with the divestiture of government equity in the five main national banks and the liberalization of interest rates. Delays in the program mounted due to the weak financial position of the large conglomerates financed by these banks. The non-bank financial institutions were less constrained and grew considerably under this liberalization program.

Labor market deregulation was a reaction to the severe labor unrest of 1987. Massive strikes led to significant real wage increases from 1987-1989. The author identifies a number of outstanding labor issues facing Korea today, such as the political nature of the unions and the lack of experience of both employers and employees in wage bargaining. Yet even with this unfinished agenda, the long-term prospects for growth in Korea are excellent.
1
DEREGULATING THE DOMESTIC ECONOMY: KOREA'S EXPERIENCE IN THE 1980s

Kihwan Kim

In the early 1980s Korea undertook wide-ranging liberal economic policy reforms. Thanks in large measure to these reforms, Korea has achieved remarkable economic success in recent years. Between 1982-88 the average annual growth rate of real GNP was over 10.5 percent, doubling its size in less than 7 years. Growth was particularly pronounced between 1986 and 1988 when the average annual growth rate was more than 12 percent. Korea's chronic inflation had also been brought under control. During the period 1982-87, the average annual rate of inflation was less than 1 percent measured in wholesale prices and 3.5 percent measured in consumer prices. In 1986, the nation's balance of payments, which had also been in chronic deficit, turned into a surplus of considerable magnitude. With price stability the distribution of income also improved.

However, this outstanding economic performance has begun to falter. In 1988 inflation had rekindled and consumer prices rose by 7.1 percent. In 1989 the growth rate fell to 6.7 percent and inflation stayed at 5.7 percent. The current account surplus fell to $5 billion from $14 billion a year earlier. Although this year the rate of growth will be higher than last year, the external surplus will in all likelihood disappear altogether and inflation will easily reach the double-digit level. Moreover, over the past year and a half the nation has been experiencing a resurgence of inflationary expectations and feverish speculation in real estate.

The questions that naturally come to mind are: (1) what were the social and economic conditions that led the country to undertake liberal economic policy reform in the early 1980s? (2) What were the specific reform measures and their consequences? (3) What recent developments account for the current setback? (4) Finally, what are the prospects of Korea undertaking further reform and maintaining growth with price stability and equity in income distribution?

The purpose of the present paper is to answer all these questions in a comprehensive yet succinct manner. Accordingly, the paper will be divided into four parts. The first part will review the background against which Korea undertook wide-ranging liberal economic policy reforms in the early 1980s. The second will examine the contents as well the consequences of the reforms. The third will analyze recent policy developments and the
Deregulating the Domestic Economy: Korea's Experience in the 1980s

problems they have generated. The last section will conclude by considering the prospects for further policy reform and growth in Korea.

Korea's economic policy reforms of the early 1980s were truly wide-ranging. They included not only the liberalization of policies on trade, investment and the transfer of technologies in the external economy, but also the introduction of anti-monopoly laws, the adoption of new budgeting principles, the restructuring of the industrial incentive system and financial liberalization in the domestic economy. In addition, the government tried to institute a new system of labor management relations.

It will of course be very difficult, if not impossible, to treat all these reforms in a single paper. Accordingly, the paper will limit itself only to major policy reforms in the domestic economy. The paper will give special attention to two sectors in particular, namely, the financial and the labor markets. There is little question that these two sectors are the most important part of any economy. Yet, in the case of Korea, it happens that compared to other sectors of the economy, over the past ten years liberalization has progressed least in these sectors. Thus, by focusing on these sectors, one can hope to gain much insight into the nature of the major economic policy problems facing the country today.

In retrospect it appears that the liberal economic policy reforms undertaken in Korea in the early 1980s succeeded beyond anyone's expectations. However, the reform program seems to have suffered from one major weakness. Inadequate attention was paid to labor management relations at certain stages of the reform effort and there was slow progress in financial liberalization. In more recent years some shortcomings in microeconomic management have greatly accentuated some of the economic and social difficulties Korea is now facing. Because of these difficulties, it seems that Korea will experience some economic problems in the immediate short-run, but the long-term prospects still remain good.

Background to Reform: The Legacy of the 1970s (1971-78)

The immediate impetus for Korea to undertake extensive reforms in the early 1980s was an economic and political crisis of major proportion. The crisis was most acute in 1980. In that year, Korea experienced negative growth of 4.8 percent for the first time in more than 20 years.\(^1\) Inflation was accelerating and reached an annual rate of nearly 40 percent in wholesale price terms and nearly 30 percent measured by consumer prices. The nation's current account deficit for the year was $114.7 billion or 8 percent of GNP. Moreover, the country was experiencing widespread political upheaval and social unrest.

Two questions arise here: first, how did such a crisis come about? Second, why did the government choose liberal economic policy reform as a

\(^1\) The magnitude of this negative growth varies from 3.7 percent to 5.2 percent depending on different income data based on different base years.
solution? Answers to these questions can be found in large part by reviewing Korea's industrial and labor policies in the 1970s; and their consequences.

**Industrial Policies in the 1970s**

In the early 1970s, there were a number of external developments that were very disturbing to Korea. First, there was a conspicuous surge of protectionism in industrially advanced countries. Protectionism was particularly strong against labor-intensive manufactured products from developing countries such as Korea. After a decade of successful economic "take-off" based on the export of these products, Korean policymakers were concerned with the vulnerability of further growth based on such a strategy.2

In 1971, under the Nixon Doctrine, the level of US troops in Korea was reduced by one-third. Korean policymakers regarded this as the first of several moves toward the eventual withdrawal of all US troops from Korea. The total withdrawal of the US from Vietnam in 1973 did little to ease Korea's concern over its security. Nor did the failure of several attempts to engage North Korea in serious dialogue to reduce tensions on the Korean peninsula help the situation.3

Under these circumstances, it is not at all surprising that in promoting heavy and chemical industries (HCIs) Korean policymakers found one stone that could kill two birds.4 By accelerating the development of strategic industries, which included iron and steel, non-ferrous metals, shipbuilding, automobiles, machinery, petro-chemicals, and electronics, Korea would not only develop indigenous defense industries but also increase the export of high value-added products that were less likely to encounter protectionist barriers. From this point on, all the government policies on money, tax, and trade were geared to the achievement of these dual objectives.

In order to finance large-scale investment projects in the HCIs, the government established a National Investment Fund mobilizing public employee pension funds and a substantial portion of bank funds. When these sources proved to be insufficient, banks were directed to make additional loans to HCIs on a preferential basis.

Partly because investment projects in the strategic industries had long gestation periods, loans were extended to them at very low nominal interest rates, which in most cases were negative in real terms. For example, during the second half of the 1970s bank rates for export related loans and equipment investment loans for these industries averaged 8 and 13 percent respectively, compared with 17 percent for general bank loans and the WPI (wholesale price index) inflation rate of 16 percent.

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3 In the literature on the economic policies of this period not enough attention has been paid to the effects of the failure of North-South dialogue.
4 This expression is borrowed from Nam (1989), p. 137.
In the early 1960s many tax incentives were provided, particularly for export expansion, but over the years these incentives had been reduced to achieve neutrality in resource allocation. But, with the inauguration of efforts to promote HCIs, this policy was reversed. For example, the 1974 Tax Exemption and Reduction Control Law provided three optional incentives for firms qualified to undertake HCI projects: (a) tax holidays for five years, (b) 8 investment tax credits for machinery and equipment, and (c) 100 special depreciation allowances. Assuming that firms took full advantage of these incentives, the effective marginal tax rate from the mid-1970s to the early 1980s was estimated to be below 20 percent for the favored industries, while that for other industries was around 50 percent.\(^5\)

Trade policy was also restructured to promote strategic industries. In both 1973 and 1976, the government increased tariffs on imports competing with HCI products. Furthermore, many quantitative restrictions were placed on these imports. Maintaining a low fixed exchange rate throughout the latter half of the 1970s was also dictated in part by considerations given to the HCIs. Had the nominal exchange rate depreciated, the effective cost of financing the purchase of equipment abroad would have been higher.\(^6\)

The results of these policies on money, taxation, and trade were predictable. Thanks to these policies, almost 80 percent of all fixed investment in the manufacturing sector during the late 1970s took place in the HCIs. Furthermore, the generous incentives combined with over-optimistic assumptions regarding the prospects of world trade brought about excess capacity in many areas of the HCIs, particularly in power generating equipment, automobiles, diesel engines, and copper smelting.

The policy of promoting the HCIs also gave rise to a rapid expansion of the money supply. The low interest rates on loans created excess demand for credit, which in turn stimulated growth of the money supply. During the 1971-79 period both M1 and M2 expanded at about 30 percent annually. This rapid rise in the money supply brought about an increase in inflation. Inflation measured in consumer prices accelerated from 10.2 percent in 1977 to 14.4 percent in 1978, 18.3 percent in 1979, and 28.7 percent in 1980.

Inflation in the 1970s had many cost-push elements as well. When inflationary pressure became pervasive in the economy, the government responded with price controls.\(^7\) Thus inflation was repressed, causing extensive distortions in the relative price structure and inefficiency in the economy.

In addition, when the development of HCIs was planned, the need for skilled manpower was seriously underestimated. With the expansion of HCI investment projects, there was a rapid rise in the demand for highly skilled workers. This pushed up wages for skilled workers, resulting in a widening wage gap between skilled and non-skilled workers. When the

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5 Kwack (1985), particularly p. 54.  
7 The price controls at this time were based on the Price and Fair Trade Act enacted in 1975.
widening gap became a political issue, the government pressured employers to pay higher wages to non-skilled workers, which in effect amounted to minimum wage legislation. This measure, together with a construction boom in the Middle East, where Korea sent a large number of its workers, led to a rapid increase in the overall wage level.

While funds were generously supplied to HCIs, small and medium industries, which for the most part specialize in producing daily necessities, were starved of funds. As these industries were unable to increase their production capacity, the prices of necessities rose faster than those of other goods. This had a seriously adverse effect on income distribution due to the fact that low-income groups spend a larger proportion of their incomes on necessities than high-income groups.

Adverse developments in income distribution occurred for yet other reasons. Since HCI projects were very capital intensive, their contributions to the growth of employment was rather limited. Furthermore, once inflation got under way, the prices of real assets such as land and houses rose faster than the prices of ordinary commodities, leading to rampant speculation in real estate. Since the low-income groups had limited means to engage in speculation as a hedge against inflation, there was a drastic redistribution of wealth in favor of high-income groups. This of course greatly undermined the social and political stability of the country.

With the rise in inflationary expectations, financial and real savings suffered; with a decline in savings, the nation's external deficits grew. External deficits grew for other reasons as well. The quadrupling of oil prices in the wake of the first oil shock and the doubling of oil prices following the second oil shock was a key element for the deficits. Maintaining a fixed exchange rate regime at a time when domestic inflation was higher than that of Korea's major trading partners was still another factor. The over-valued exchange rate weakened Korea's export competitiveness while creating pressure for imports to rise. In 1979 Korea experienced a negative growth of exports in real terms. With a decline in exports came a decline in the growth of GNP.

The preemption of Korea's limited financial resources by HCIs, resulted in other industries being denied an opportunity to invest. This not only had an adverse effect on income distribution but also had a lasting effect on the industrial structure of the nation. It was of course the large industrial groups that were in a position to undertake large projects in the HCIs. The concentration of economic power in the hands of the so-called chaebul, which has become a big social issue in recent years, has its origin in the policy of promoting HCIs in the 1970s.
One last adverse effect of promoting HCI is should be noted. Forcing banking institutions to extend loans at interest rates below the market equilibrium levels had a retarding effect on the growth of the banking system. Furthermore, the extension of loans at such low rates gave rise to much corruption in the banking system. The underdevelopment of banking institutions, which remains a key structural weakness of the Korean economy to this day, also has its origin in the industrial policy of the government in the 1970s.

Labor-Management Relations in the 1970s

The modern labor movement in Korea started out as an anti-government, independence movement during the Japanese occupation. In the early post-world War II years the movement was highly infiltrated by communist organizations. As a result, both the Korean government and general public always had a tendency to look upon the labor movement with great suspicion considering it a potential source of subversion. Because of these historical and political reasons, the Korean government always had strict controls and surveillance on the nation's labor movement. Nevertheless, in the 1960s Korean workers for the most part enjoyed the so-called "three basic labor rights," namely, the right to organize unions, the right to engage in collective bargaining, and the right to strike. All this changed, however, in 1971 when a Presidential Emergency Decree was issued. For all practical purposes the Decree suspended two of the three rights, i.e., the right to bargain and the right to strike.12

The natural question is why? A large part of the answer is to be found in the disturbing external developments noted before. The perception held by leaders in the government was that the nation was under a real threat of invasion from the North. Given this situation, they thought, it would be a waste of energy and resources if the nation tried to resolve labor-management problems through an adversarial proceeding as conceived in the law. The government leaders also reasoned that if labor and management could resolve differences amicably through discussions in a Labor-management Cooperation Council at the enterprise level, so much the better. As a result, the idea was introduced and incorporated in subsequent legislation. At this time, however, establishment of a Labor-Management Cooperation Council at each enterprise was still optional.14

Needless to say, labor-management relations did not work out as the government desired. For one thing labor leaders, who in many cases had been hand-picked, did not respond to the needs of ordinary workers. Thus, grievances accumulated but there were few ways to resolve them legally. As a consequence, workers sought guidance and support from dissident groups. Even in the months before the death of President Park in October 1979, many workers were deeply involved in anti-government demonstrations led by student and other dissident groups. In addition to

12 Ibid.
13 For a similar view, see Vogel and Lindauer (1989), p. 5.
14 In 1980, this was made mandatory for an enterprise with 100 or more workers.
wage increases, they demanded the "three basic labor rights" and full political liberalization. Furthermore, workers disavowed the existing union structure that vested power in the hands of central and industrial federations whose leaders were little more than government appointees. Predictably, they demanded resignations of those leaders.¹⁵

It is worth noting that many of the workers who joined the demonstrations were from either the labor-intensive manufacturing sectors or geographical areas where such manufacturing activities were concentrated, such as Pusan and Masan. These were precisely the areas that were experiencing economic stagnation due to increased protectionism in industrial countries on the one hand and the domestic government policies that favored HCIs on the other. It is also interesting to note that violent labor disputes in Pusan and Masan led to the proclamation of martial law in these areas, and it was the strong difference of opinion regarding the merits of this proclamation among close aides of President Park that was the probable cause of his assassination.

It should not be inferred that strict government controls and surveillance over the unions in the 1970s led to suppressed wages. To be sure, improvement in average real wages lagged behind improvement in labor productivity in the early 1970s. This was, however, due more to the supply and demand conditions in the labor market than to anything else. At that point, the supply of labor of all grades was still abundant relative to demand. During most of the second half of the 1970s, however, the rise in real wages far outpaced improvement in labor productivity for the reasons already noted. Because of this development, Korea's unit labor costs rose much faster than those of Korea's competitors. This was an additional reason why Korea's export competitiveness seriously suffered, and this in turn undermined social and political stability.¹⁶

Stabilization and Reform (1979-86)

Achieving Internal and External Balances

Many of the economic difficulties noted above were readily apparent even before the death of President Park. In order to overcome these difficulties, the Korean government announced in April 1979 a comprehensive stabilization program. The ultimate goal of the program was no less than the restructuring of the whole economy to enable the nation to make full use of its potential for continued growth. Given this far-reaching goal, it was certainly more than a short-run stabilization program with the usual emphasis on demand management. The 1979 stabilization program was far-reaching in still another sense. The approach it took was

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¹⁶ One might ask if anything positive was achieved by the industrial policy of the 1970s. The main answer is that while investments in HCIs were being carried out, the economy achieved high growth and subsequently the structure of Korea's exports was upgraded in favor of HCI products.
to make full use of the market mechanism and private initiative—a fundamental break from the previous interventionist approach.

The 1979 stabilization program had three major components. First, to control excess liquidity, the government set lower targets for the growth of the money supply and proposed a fundamental reform in the banking sector. Second, to correct over-investment in HCIs and under-investment in light industries, the government suspended all new HCI projects and realigned credit priorities in favor of light industries. Third, to eliminate price distortion and promote competition, the government decontrolled prices on many items and stepped up import liberalization. All in all, the 1979 stabilization program should be seen as the first major government effort to deal with serious internal macro and micro imbalances.

The efforts to correct external imbalances came later. As noted earlier, devaluation of the won was long overdue. Deterioration in the balance of payments accelerated with the second oil crisis. The doubling of oil prices added another $3.0 billion annually to the current account deficit. This amount was equal to 5 percent of GNP in 1980 and 20 percent of total merchandise exports for the year.

In January 1980 the won was devalued by 20 percent. In place of the fixed exchange rate system that pegged the value of the won to the US dollar, a flexible exchange rate system based on a basket of currencies was adopted. In order to offset the inflationary impact of devaluation, interest rates on bank loans and deposits were sharply raised. Interest rates on policy loans were raised more than those on ordinary loans—obviously an attempt to undo some of the interest rate differentials that had developed before.

Although the fundamental direction and approach was sound, the results of the 1979 stabilization program and the 1980 devaluation measures were not immediately apparent for two reasons. First, three months after the stabilization program was launched, the second oil shock struck, triggering a new round of cost-push inflation and a rapid deterioration in the nation's external balance. The deterioration in the external balance made it very difficult to push import liberalization with vigor. Second, by the spring of 1980 the cement that had held society together under President Park began to crack. Between January and April as many as 848 strikes took place. The worst of these strikes turned the coal mining town of Sabuk into a state of complete anarchy for three days. Meanwhile, student demonstrations escalated throughout the country, culminating in the tragic Kwangju incident in May. Under these circumstances, the government was forced to temporarily relax its restrictive monetary and fiscal policy stance.

In spite of these problems, it would be a mistake to minimize the positive achievements of either the 1979 stabilization program or the 1980 devaluation measures even in the short run. The stabilization program had many positive results. For instance, thanks to the decontrolling of prices on a large number of commodities, the price structure was by and large normalized by the end of 1979, and artificial shortages of basic necessities and dual pricing due to price controls were eliminated.

After the worst of the political crisis was over, tight monetary and fiscal policies were restored. Furthermore, fears that restrictive demand management relying on monetary and fiscal policies alone would be overly contractionary led the government to make use of incomes policy as well. This included setting informal wage guidelines, stabilizing government purchase prices of major foodgrains, and controls on interest rates and dividend payments.

By 1982, the combined effects of all these policies became apparent. Inflation measured in consumer prices plunged from 28.7 percent in 1980 to 7.0 percent in 1982. The current account deficit fell from $5.3 billion in 1980 to $2.6 billion in 1982. However, because the balance of payments adjustment was carried out simultaneously with a strong dose of anti-inflationary policy the impact on the economy seems to have been rather severe. The 4.7 percent negative growth in 1980 was followed by a modest recovery with a positive 6.2 percent growth in 1981 and a 5.6 percent growth in 1982.

In retrospect, it was fortunate that the government that came into power in September 1980 not only endorsed the short-term stabilization policies that were already under way but also provided the necessary leadership for such long-term structural adjustments and institutional reforms as the ones mentioned at the beginning of this paper. Without the strong commitment at the highest political level, neither stabilization policies nor structural reforms would have gone very far.

**Table 1. Major Macroeconomic Trends**

<table>
<thead>
<tr>
<th>Year</th>
<th>GNP Growth (%)</th>
<th>Current Account Balance (US$ Billion)</th>
<th>CPI Inflation (%)</th>
<th>Wage Increase (percent)</th>
<th>Exchange Rate (won/$, period-end)</th>
<th>M2 Growth (percent, yr. av.)</th>
<th>Unified Budget Balance (percent of GNP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971-75</td>
<td>8.3</td>
<td>-1.1</td>
<td>15.4</td>
<td>20.9</td>
<td>484</td>
<td>28.5</td>
<td>-3.7</td>
</tr>
<tr>
<td>1976-78</td>
<td>10.6</td>
<td>-0.5</td>
<td>13.2</td>
<td>34.2</td>
<td>484</td>
<td>35.1</td>
<td>-2.7</td>
</tr>
<tr>
<td>1979-81</td>
<td>3.0</td>
<td>-4.7</td>
<td>22.8</td>
<td>24.1</td>
<td>484</td>
<td>36.7</td>
<td>-3.3</td>
</tr>
<tr>
<td>1982-86</td>
<td>9.8</td>
<td>-0.4</td>
<td>3.5</td>
<td>10.6</td>
<td>701</td>
<td>16.6</td>
<td>-1.4</td>
</tr>
<tr>
<td>1987-88</td>
<td>12.7</td>
<td>12.0</td>
<td>5.0</td>
<td>12.8</td>
<td>861</td>
<td>20.3</td>
<td>0.8</td>
</tr>
<tr>
<td>1989</td>
<td>6.7</td>
<td>5.1</td>
<td>5.7</td>
<td>21.1</td>
<td>684</td>
<td>19.8</td>
<td>-0.0</td>
</tr>
</tbody>
</table>

Introducing Anti-monopoly Laws and Redesigning the System of Industrial Incentives

In order to promote competition and at the same time provide equal opportunities for all economic agents, in April 1981, the government implemented the Anti-monopoly and Fair Trade Law, the basic purpose of which was to eliminate or control such monopoly practices as cartel arrangements, price collusion, price discrimination, and artificial barriers to entry. To implement this policy most effectively, a Fair Trade Commission was established directly under the Deputy Prime Minister and the Minister of Economic Planning, the chief economic policymaker of the government.

In line with the philosophy of relying on market mechanisms for the efficient allocation of resources and equity in income distribution, the government also restructured the industrial incentive system. The guiding principle here was to replace industry specific incentives with uniform incentives for investment and technical innovation applicable to all industries. In line with this principle, the 1981 tax reform abolished all special tax treatments for strategic industries except the 100 special depreciation allowance. Furthermore, the Industrial Development Law, which became effective in 1986, replaced seven individual industrial promotion laws and defined the role of government as a trouble shooter in only two areas of market failures. One of the areas comprises industrial sectors whose international competitiveness yields positive externalities to the economy. Even in this area, however, the role of the government is limited to promoting technological advancement. The other area is declining industries where the government may extend readjustment assistance.

Freezing and Restructuring Government Expenditures

Throughout the 1970s the unified government budget was chronically in deficit. On the average, the annual deficits amounted to 3.7 percent of GNP in the period 1971-75. The deficits eased somewhat in the subsequent years when the government introduced the defense surcharge and value added tax as revenue boosters. But the deficit grew again to 3.3 percent of GNP in the early 1980s when the government was forced to undertake many expenditures in the face of mounting social and economic crisis.

In a determined effort to eliminate the chronic deficits, check the growth of public expenditures relative to GNP, and at the same time restructure the expenditures in line with the changing needs of the country, the government decided to freeze its 1984 spending levels at the 1983 levels. It also placed all spending categories on a zero-base budget principle, i.e., the amount of spending in different categories for 1984 was not to be automatically carried over from the level of the previous year. What was very remarkable about this policy was that the policy, which was by no means popular but was good for the nation as a whole, was implemented a year before the general election.
Financial Liberalization

Financial liberalization started with the divestiture of government equity shares in five nationwide commercial banks in 1982. By 1983 all these were in private hands, paving the way for autonomy in banking operations. In order to increase competition, the government also allowed two new commercial banks and many mutual savings and short-term finance companies to be established.

In 1982, a major step was taken toward normalizing the structure of interest rates. Most policy loans were no longer extended at preferential interest rates. This was accomplished after inflation was brought down. Thanks in large measure to the success of stabilization policy implemented during the preceding two years, inflation dropped to the one-digit level by the first half of 1982. The lower inflation rate turned existing nominal bank interest rates into high real interest rates hindering the recovery of investment, and thus interest rates had to be lowered. The government took advantage of this situation to reduce the interest rate differentials between ordinary and policy loans by lowering all bank loan rates to a uniform level of 10 percent.20 In 1984, however, banks were allowed to vary, within a given range, interest rates on loans depending on the creditworthiness of borrowers. The range started at half a percentage point but later increased to one and half percentage points. Reducing interest rate differentials between policy and ordinary loans greatly facilitated the scaling down of policy loans.

In 1982, the government also began to lift restrictions on bank management by relaxing regulations governing the personnel, organization, budgeting, branch operations, and other business practices of banks. In addition, the government reduced restrictions limiting the types of services in which different categories of institutions could engage, thus breaking down the artificial business boundaries of different categories of financial institutions.

It is important to note, however, that financial liberalization was greatly hampered by the legacy of the past policies. As the stabilization policy took hold, many firms experienced serious financial difficulties. It was embarrassing to the government that many of the financially troubled firms were the very large conglomerates that the government itself had supported through preferential credit. Apart from this reason, the government could not let these firms go bankrupt for fear of enormous financial losses to the banking sector and rising unemployment. The banks' own financial positions were also very weak due to the large amount of non-performing loans in their portfolio. The government tried to alleviate this problem in a variety of ways: (a) delaying financial liberalization itself, (b) allowing banks to go into attractive new services, (c) extending

20 It might seem a little foolhardy to have only one uniform interest rate on loans. The reality was not as bad as one might think because in the inflationary period, the bulk of bank loans had a maturity of one year or less.
subsidized central bank credit, and (d) exempting the capital gains tax on
the disposition of the collateral supplied by the troubled firms.

Compared to banks, non-bank financial intermediaries (NBFIs) were
much less constrained in terms of their operations and allocation of credit.
For example, they were often allowed to circumvent interest rate ceilings,
which were already set at higher levels than those on bank deposits and
loans. Being less tightly controlled, the privately-owned NBFIs have been
able to operate on more of a commercial basis than banks. As a result, they
have grown faster than tightly regulated banks. As noted by Cho and Cole
(1986), by growing faster and increasing their share in total domestic credit
from 17.2 percent in 1981 to 29.6 percent by 1986, these NBFIs have greatly
contributed to the liberalization of the financial system as a whole and to
the integration of financial markets.

This differing degree of government control over banks and NBFIs was
due to three considerations. First, an important policy motivation behind
establishing NBFIs was the desire to bring the operations of the curb
market into the formal financial sector as much as possible. Second,
-economic and social repercussions due to the failure of financial institutions
would be less in the case of NBFIs than banks. Third, as policymakers faced
the task of liberalizing financial institutions, they simply found less
obstacles in the case of NBFIs than in the case of banks.21 For one thing,
NBFIs have held few non-performing assets.

As far as the domestic capital markets were concerned, the Korean
government did little to liberalize them in the early 1980s. This was
because of two reasons. First, policymakers felt that opening capital
markets should come after liberalization in such areas as imports and
direct foreign investment. Furthermore, the immediate policy problem of
the capital market at the time was not one of lack of competition, but
rather one of frequent irregularities in securities transactions by dealers. In
addition, securities firms had a very low capital base. In order to deal with
these problems the government tightened regulations on such matters as
accounting and holding securities by dealers in the name of their customers.
The government also encouraged securities firms to increase their capital.

Economic Effects of Stabilization and Structural Reform.

The question now is how the economy fared under the stabilization
and reform policies just outlined. As already noted, the success of the
stabilization policy removed distortions in the relative price structure and
did away with inflationary expectations. This not only paved the way for
greater reliance on the market mechanism but prepared the country to open
its markets to the outside world. The stabilization programs together with
other policies promoting competition went far to bring about improvements
in quality and innovation. The stabilization programs together with the

21 Policymakers in the early 1980s felt that while the opportunity was available
they should push as much reform as possible in the financial sector as a whole.
Therefore, postponing reform in the non-banking sector until conditions matured
in the banking sector would have been a waste of time.
liberalization of the external sector also brought about a rapid rise in the inflow of foreign investment and technology. All these contributed greatly to the strengthening of external competitiveness and recovery in the growth of exports by 1983. The stabilization program also had a dampering effect on the growth of imports. As a result, even when imports were rapidly being liberalized, Korea did not experience a rapid rise in imports.

Introduction of anti-monopoly regulations did not produce tangible results in the short run, but over time most flagrant monopolistic abuses have been clearly reduced. Furthermore, there has been an appreciable decline in the share of total industrial output accounted for by the top 30 largest business groups in the country.

As for the effect of freezing government spending and implementation of the zero-based budgeting principle, there is little question that the measure eliminated remaining deficits in the consolidated budget. In addition, it reduced total government expenditures as a percentage of GNP from 22.4 in 1980-83 to 18.9 in 1984-87. Furthermore, applying the zero-based budgeting principle went far toward realigning government expenditures with new priorities. For example, expenditures on national defense, which had accounted for more than 34 percent of the general budget of the central government, were reduced to about 30 percent by 1987. Meanwhile government expenditures on research and development as a percentage of the total budget went up from 1.3 percent during the 1980-83 period to the 2 percent level by 1987. Realignment, however, left something to be desired. Due to bureaucratic inertia and strong resistance from vested interest groups it was not possible to implement as many cuts in on-going programs as was desired. Consequently, some sacrifices seem to have been made on new capital spending programs. On balance, however, the experiment was definitely worth the effort.

Reducing the interest rate differential between ordinary and policy loans no doubt worked to the advantage of small and medium enterprises in particular. In addition, many measures taken to increase the availability of credit to small and medium enterprises, such as raising the minimum amount of loans that commercial banks were required to make to these enterprises from funds generated by new deposits, greatly benefitted them. Furthermore, as the government allowed many NBFIs to be established, their share in total domestic credit increased, and this greatly enlarged access to credit for small and medium enterprises. In view of all these, it is no accident that there was an appreciable rise not only in the number of

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22 For this positive effect, see Kim, K. (1989), particularly tables 1-3, pp. 17-18 and table 7, p. 21.
23 Young (1986).
24 For a compilation of the activities carried out by the Fair Trade Commission, see Fair Trade Commission, Reference Data (in Korean) June 1990, particularly pp. 37-41.
25 It is regrettable that no definitive assessment of this experiment is yet available.
small and medium enterprises but also in their shares of total employment, value added, and exports in 1981-1985.26

Achieving price stability transformed minimal interest rates at financial institutions into real positive rates and brought about a steady rise in savings. The savings/GNP ratio rose from 23 percent in 1980-81 to 31 percent in 1985-86. By increasing financial savings these policies contributed greatly to financial deepening. The M2/GNP ratio stagnated at about 30 percent between 1973-80, when real interest rates were negative for the most part, but the ratio rose to 43 percent in 1984-86. A more pronounced trend toward financial deepening is observed when the stock of total liquidity (M3) is used. As M3 grew much faster than M2 due to NBFIs' ability to offer more attractive interest rates than banks the M3/GNP ratio rose faster than the M2/GNP ratio.27

Price stability together with other structural reforms also brought about an improvement in income distribution. The ratio of the percentage share of income for the lower 40 percent of households over that of the upper 20 percent was 0.35 in 1980 but 0.41 in 1985. The Gini coefficient for 1985 was 0.3631 compared to 0.3891 for 1980.28

**Adopting Stringent Labor Laws**

A system of labor-management relations consistent with the liberal economic policy reform in the early 1980s would have been one that promoted competition in all segments of the labor market. In areas where competition was impractical due to the monoplistic power of employers, allowing workers to form unions to serve as a countervailing power would have been justified. From the point of view of both efficiency and equity, one could argue that a bilateral monopoly situation is preferable to either a monopsony or a monopoly situation. Even where a union is desirable, however, workers should be guaranteed the right to choose whether or not to join a union. In other words, an open-shop union would have been better than a union shop or closed-shop union.

Ideally, Korea should have adopted such a system of labor management relations in the early 1980s. However, the traumatic impact of events such as the miners strike in Sabuk in the spring of 1980, together with the unfavorable perceptions regarding labor unions traditionally held by leaders in the government and the general public, precluded the adoption of such a system. Thus, the unfortunate upshot was the adoption of very stringent labor laws instead.29

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26 For evidence, see Ministry of Trade and Industry (1988), p. 31, p. 72, and p. 256.
27 The M3/GNP ratio was 39 percent in 1974-76, but it rose to 73 percent by 1984-86.
29 Under normal circumstances, enacting such laws would have met considerable opposition in the legislature. But in the summer of 1980, under martial law the National Assembly was dissolved and an interim Legislative
The 1980 amendments to the Trade Union Law weakened the power of unions, first, by shifting the primary power to organize unions and bargain collectively from the national and industrial federations to enterprise-level local unions. This was done by barring third parties from any role in organizing unions, collective bargaining, or strikes. Third parties were defined so as to exclude any individual or organization other than the members of local unions. Furthermore, the 1980 amendments made the very forming of unions procedurally difficult. For example, for a union to be certified by the government, it was required to have the approval of 30 employees or one-fifth of all employees, whichever was smaller. The authorities could take up ten days to certify the union. On top of this, the amended law gave the government the power to dissolve any union that either violated the laws of the country or threatened to do so.

The amended Labor Dispute Adjustment Law gave the government the power to review the report of a dispute to determine if the dispute was for a permissible cause. In addition, the law provided a cooling-off period for conciliation and mediation. If the dispute failed to be resolved during the cooling-off period, the authorities could demand that the unresolved matter be submitted to compulsory arbitration, in which case the strike was prohibited for another 20 days. In short, under the amended law, strikes were not an option easily available to workers.30

There is little question that these labor laws did contribute to stabilizing the critical labor situation facing the country in the early 1980s. Furthermore, they were instrumental in containing the rise in real wages within the bound of improvement in labor productivity. But in the course of time strict enforcement of these laws resulted in recreating the labor-management problems the country had experienced in the 1970s. Since workers had few legal avenues for resolving their grievances, not only did their frustration accumulate but in many cases they sought help and guidance from dissident groups.31

Macro Policies and Further Liberalization Since 1987

Exchange Rate and Monetary Policies

Thanks to the stabilization policies and structural reforms undertaken during the first half of the 1980s, the Korean economy had fully regained external competitiveness by 1986, and thus was in an excellent position to make use of favorable developments in the world economy.

Council was called into session. It was this Council that enacted these laws. Since the labor problems were considered primarily as a security matter at that time, experts from economic ministries were hardly consulted in drafting the bills.30 For an excellent analysis and evaluation of the 1980 amendments to the Trade Union and Labor Dispute Adjustment Laws, see Bognanno (1985), pp. 21-32. 31 Since there was a ban on third party participation in organizing unions, collective bargaining and strikes, members of the dissident groups infiltrated unions by disguising themselves as normal employees. This naturally gave rise to many headaches for the authorities and also greatly politicized unions.
Favorable developments came in the form of the so-called three lows or three blessings: low oil prices, low interest rates, and the low value of the dollar. The first two helped the Korean economy on the supply side. The third helped on the demand side in two ways. The weight the dollar carried in the determination of Korea’s exchange rate was still very large even under the flexible exchange rate system in use since January 1980. Thus, when the dollar fell relative to major currencies after the Plaza Accord, the Korean won also became weak relative to other major currencies, including the Japanese yen. In addition, the Korean won remained weak even against the US dollar for quite some time following the Accord, strengthening the demand for Korean exports.32

Helped by these factors, the economy was well on its way toward a boom. As if these were not enough, the government followed a rather expansionary monetary policy. The growth of the money supply (M2) increased from 15.5 percent in 1985 to 18.4 percent in 1986 and 19.1 percent in 1987. Due to this combination of monetary and exchange rate policies, exports expanded rapidly. The growth of commodity exports was 14.6 percent in 1986, 36.2 percent in 1987 and 28.4 percent in 1988. Thanks in large part to the rapid growth in exports, the economy experienced real growth rates of 12.9 percent in 1986, 13.0 percent in 1987, and 12.4 percent in 1988.

There is no question that this rapid expansion of exports did some good for Korea, especially in the short run. The expansion of exports led to a dramatic improvement in the current account balance. The nation’s chronic current account deficits turned into a surplus of $4.6 billion in 1986. The surplus rose to $9.9 billion in 1987 and reached $14.2 billion in 1988, which was equal to 8.0 percent of GNP for that year. The surplus enabled Korea to pay off much of its external debt. But the surplus also gave rise to new problems. For one thing, it invited pressure from the United States to appreciate the won and open Korea’s markets at a faster pace. The pressure was particularly strong in 1987, the year in which Korea was busy preparing for the forthcoming presidential and general elections. Under these circumstances, it was extremely difficult to accommodate US pressure.

The excessive surplus created still another problem for Korea. In the days when the country had suffered from external deficits, the external sector presented no problems whatsoever in terms of the control of the money supply. But the situation was no longer the same. Owing to the lack of significant progress in financial liberalization between 1984 and 1987, the nation’s financial system had not acquired the capacity to channel the surplus with minimum impact on the domestic money supply. As a result, the economy was subject to strong and pervasive inflationary pressure. It is little wonder that the rate of inflation measured in consumer prices rose from 2.8 percent in 1986 to 3.0 percent in 1987 and 7.1 percent in 1988. As it turned out, the rise in inflation and the over-heated economy hardly provided an environment conducive to dealing effectively with the labor-management problems that erupted in the summer of 1987.

32 The nominal exchange rate of the Korean won against the US dollar appreciated by 24 percent between the fourth quarter of 1985 and the first quarter of 1989. On a real effective basis, the won depreciated vis-a-vis the dollar up until 1987.
The June 29 Democratization Pledge and the Eruption of Labor Disputes

The failure on the part of the government and the ruling Democratic Justice Party (DJP) to carry out timely labor reform paved the road for the severe labor unrest of recent years. In 1985 the ruling party barely won the general election and the support it got from workers was minimal. This led the party to seriously consider revising the labor laws in preparation for the presidential election in 1987, and the general election in 1988. The party and the government, however, failed to understand the full extent of the problems associated with these laws. As a result, a golden opportunity was lost to overhaul the labor laws—a job that was long overdue. The only substantive change made to the laws in 1986 concerned the highly controversial third party provision. Under the 1986 amendments, the national and industrial federations were no longer barred from organizing unions or participating in collective bargaining. However, this change alone hardly satisfied workers.

On June 29, 1987, DJP Presidential Candidate Roh Tae Woo announced his now famous Pledge for Democratization. Many workers took the Pledge as a signal that the government would no longer clamp down on strikes. The result was an unprecedented eruption of labor disputes throughout the country. In the two months following the Pledge, there were no less than 2,600 strikes. This was more than the total number of strikes over the preceding quarter century. No less than 70 percent of all manufacturing firms with ten or more employees experienced a strike in the second half of 1987. For the whole of 1987, 3,529 strikes were recorded, compared to 256 and 276 for 1985 and 1986 respectively.

Table 2 below shows the full extent of labor disputes between 1987-1989. The number of disputes significantly decreased in 1988 and 1989, but the average length of disputes increased from 5.4 days to 13.9 days in 1988 and to 18.9 days in 1989. Thus, in terms of total output and work days lost, the situation remained serious through 1989.

<table>
<thead>
<tr>
<th>Table 2. Trends in Labor Disputes</th>
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<tr>
<td>Number of Disputes</td>
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<tr>
<td>Av. Length of Dispute</td>
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<td>Output loss</td>
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<td>Export output loss</td>
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The effects of such labor disputes on the economy can easily be surmised. The number of work days lost led directly to a reduction in output and export production. Total output loss was estimated at 2.8 trillion won or 2.6 percent of GNP in 1987, 3.2 trillion won or 2.5 percent of GNP in 1988, and 4.2 trillion won or 3.0 percent of GNP in 1989. Export production losses were
estimated at $537 million, $7.3 billion, and $1.4 billion or 1 percent, 12.0 percent, and 2.2 percent of total exports in 1987, 1988, and 1989 respectively.

The average wage rates in the manufacturing sector increased 11 percent, 20 percent, and 25 percent in 1987, 1988, and 1989 respectively, greatly exceeding productivity increases (see table 3 below). The rapid wage increases over these three years have made Korea's average wage the highest in Asia except for Japan. The gap between increases in wage rates and increases in productivity brought about a rapid rise in unit labor costs. Between the last quarter of 1987 and the second quarter of 1989, Korea's unit labor costs rose by 33 percent, compared to a 22 percent decline in Japan and a 16 percent increase in Taiwan. As the won was rapidly appreciating against the dollar during the same period, unit labor costs measured in dollars rose much faster than unit labor costs measured in won. The rise in labor costs, coupled with the appreciation of the won, doubly squeezed the profitability of Korean exporters and undermined their competitiveness. With a decline in competitiveness came a slowdown in the growth of exports. In fact, in 1989 the growth of exports was a negative 6.9 percent in real terms.

Table 3. Increases in Nominal Wages, Real Wages, and Labor Productivity in Manufacturing

<table>
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<th>(unit: percent)</th>
<th>Nominal Wages</th>
<th>Real Wages&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Real Wages&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Productivity&lt;sup&gt;c&lt;/sup&gt;</th>
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<tbody>
<tr>
<td>1986</td>
<td>9.2</td>
<td>6.2</td>
<td>4.7</td>
<td>14.5</td>
</tr>
<tr>
<td>1987</td>
<td>11.2</td>
<td>8.4</td>
<td>15.1</td>
<td>9.6</td>
</tr>
<tr>
<td>1988</td>
<td>19.6</td>
<td>12.4</td>
<td>18.5</td>
<td>13.1</td>
</tr>
<tr>
<td>1989</td>
<td>25.1</td>
<td>18.3</td>
<td>21.5</td>
<td>8.2</td>
</tr>
</tbody>
</table>

a. Nominal wages adjusted for changes in consumer prices.
b. Nominal wages adjusted for changes in the GNP deflator.
c. Valued added per worker in constant prices.


As wages rose so did prices. Rising prices were most pronounced in the housing and other real estate markets. The rapidly rising prices of housing put tremendous pressure on the government to control real estate prices and take measures to increase the housing supply. Various measures taken by the government to increase the housing supply have created an

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33 In terms of the current exchange rates, at the end of the second quarter of 1989, the average monthly wage rates were, Korea—$749, Taiwan—$734, Singapore—$589, and Japan—$2,110. For more details, see Economic Planning Board, *Major Policy Issues* (in Korean), March 1990, pp. 71-75.

unprecedented construction boom.\textsuperscript{35} With a growing share of the total resources of the economy being committed to meeting internal demand in this manner, it is difficult to expect an early restoration of export competitiveness.

Furthermore, with the economy being increasingly oriented to meeting internal demand, imports have grown rapidly. The annual rate of growth of imports was 30 percent in 1987, 26 percent in 1988, and 20 percent last year. This combined with the stagnation of exports to bring about a rapid decline in external payments surplus. The current account surplus fell from $14 billion in 1988 to $5 billion last year. This year, the surplus is expected to turn into a deficit.\textsuperscript{36}

With the rapid rise in wages, businesses have been increasingly motivated to undertake labor-saving investment. Accordingly, employment in the manufacturing sector no longer seems to be expanding. In 1987 employment in this sector increased 6.0 percent, but it declined by 0.5 percent and 3.3 percent in 1988 and 1989 respectively. In addition, foreign firms, which had come to Korea to take advantage of low wages, have been withdrawing from Korea, while Korean manufacturers in labor-intensive industries have sought opportunities for overseas investment in countries where wage levels are still low compared to Korea.

Owing in part to rapid wage increases in recent years, wages and salaries are now a larger share (57 percent) of national income.\textsuperscript{37} There are also signs that income is more equally distributed among workers. The Gini coefficients for income distribution among workers was 0.367 in 1984, 0.354 in 1984, and 0.314 in 1988. In all probability, this improvement stems from the fact that wage increases have been greater for unskilled workers than skilled workers, thus narrowing the wage gap between the two groups. One should ask whether this leveling effect of wages is indeed desirable. It would seem that at a time when Korea needs more skilled manpower to accelerate the development of high technology, its wage structure is becoming increasingly perverse.

\textsuperscript{35} The level of construction activities measured in total area for which construction permits have been issued shows an annual 45.5 percent increase and measured in the value of orders received a 84.5 percent increase in 1989. In the first quarter of this year, these figures were 48.8 percent and 89.7 percent respectively.

\textsuperscript{36} Currently, the Korea Development Institute forecasts a $1.8 billion deficit while the Bank of Korea believes the current account will balance in 1990.

\textsuperscript{37} Wages and salaries as a percentage of national income were 51-53 percent between 1980-87. But the figure rose to 54.2 percent in 1988 and 56.6 percent in 1989. This increase might not mean much in the long-run if inflation continues. In recent years the high income group who are for the most part owners of land at the same time has profited immensely from the capital gains on the land they own. Due to a rapid increase in the value of real estates, capital gains accrued to the owners of land was estimated at nearly 69 trillion won for 1988, an amount equal to 54.9 percent of GNP and 135.4 percent of wages and salaries for the same year. Of this amount, about 40.5 trillion won accrued to the top 5 percent of land owners. See Sohn (1990), particularly pp. 76-77.
Recent Progress in Financial Liberalization

It is unfortunate that for the 1984-87 period progress in financial liberalization was limited. During this period no important steps were taken to further liberalize the financial sector. In 1988-89 this situation, however, changed. During these two years, the government established many new financial institutions including several commercial banks specializing in small and medium enterprises, security investment companies, leasing companies, and life insurance companies, mostly outside Seoul.

In addition, extensive interest rate deregulation was undertaken in December 1988. Three considerations led to this step: first, with price stability from 1982-87 and the excess of national savings over investment, the disparity between regulated and free market rates was narrowed; second, with freer external capital flows, flexible interest rates were essential for domestic monetary stability; third, with a rapid increase in wages, continued interest rate controls could have meant the underpricing of capital, leading to an excessive amount of capital intensive investment.

The interest rates decontrolled in December 1988 include most bank and non-bank lending rates and some long-term deposit rates. Other deregulated interest rates or yields include those on financial debentures, corporate bonds, asset management accounts and funds, and such money market instruments as CP, CDs, and large Rps. These rates were deregulated on the rationale that unless these rates reflected market conditions, the assets in question could not be easily transacted. Rates on CMA, BMF, business cash trust accounts, mutual investment trust funds, household cash trust funds, and retirement trust funds were deregulated because these rates are determined ex-post through portfolio management. Rates on policy loans, however, still remain regulated not only because they serve public policy objectives but because they involve the use of government funds. Short-term deposit rates are still controlled for fear that their deregulation might create excessive competition among financial intermediaries.

The result of interest rate deregulation so far has not been very encouraging. Bank lending rates and most rates in the primary securities markets are still quite rigid and unresponsive to market conditions. This may be due to two reasons: (1) that interest rates are not yet fully deregulated, and (2) that many managers of financial institutions still feel that either they are not yet permitted to compete freely, or it is not in their interest to do so. In many primary securities markets, the rates on new

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38 Nam (1990), p. 149.
39 There has been an interesting episode in this regard. As a foreign bank raised its deposit as well as lending rates far above those of other banks, it was not only criticized in a newspaper column but subsequently pressured by the authorities to realign their interest rates more or less in line with those of other banks. For details, see Chosun Ilbo (Chosun Daily), June 28 and 30, 1990.
issues have deviated from market rates, resulting in various irregularities in connection with underwriting.

**Liberalizing International Portfolio Investment**

An initial step toward opening the capital market to foreign investors was taken in 1981 when the government established open-ended trust funds. Two corporate-type closed-end funds—the Korea Fund and the Korea-Europe Fund—were launched in 1984 and 1987 respectively. In 1985, the government allowed Korean companies to issue convertible bonds in overseas markets, and since then seven Korean companies have taken advantage of the new policy. In 1983 foreign securities firms were allowed to own up to ten percent of the paid-in capital of large Korean securities companies in anticipation of their contribution to business upgrading in the process of internationalization.

In December 1988 a timetable was announced for the opening up of the capital markets to foreigners and for allowing domestic investors to purchase foreign securities. According to the timetable, foreign securities firms will be able to open branch offices for joint ventures in 1991, and, beginning in 1992, foreign investors will be allowed to buy stocks in the domestic market.

In the meantime, security investment funds and trusts for foreign investors are being expanded, and restrictions on issuing convertible bonds (CBs) in overseas markets have been relaxed. Korean corporations have also been encouraged to diversify their overseas securities issues to include bonds with subscription warrants (BWs) and depository receipts (DRs). The maximum permissible equity participation of foreign securities firms in an existing Korean securities firm has been increased from 5 percent to 10 percent individually, and from 10 percent to 40 percent collectively. Foreign investors will be permitted to sell stocks converted from CBs among themselves in the over-the counter market, and such CB-converted stocks may be traded on the Korean Stock Exchange from 1991.

Along with the opening of the domestic capital market, the government plans to gradually liberalize overseas securities investment by Koreans. Overseas securities investment funds are being expanded, and restrictions on overseas investment by institutional investors are also being relaxed. By 1992 individuals will be able to purchase foreign securities. One hopes that the government will implement all these plans in accordance with the timetable.

**Current Problems and Prospects for Further Reform and Growth**

**Prospects for Further Financial Liberalization**

Despite all of the reforms undertaken, financial liberalization in Korea is still in its early stages. Many interest rates are still regulated, and
the management of commercial banks has yet to enjoy full autonomy and behave like their counterparts elsewhere in the world.

Further reform in the financial sector is being hindered by four major factors. First, there is the problem of non-performing assets. As long as commercial banks are burdened with this past legacy they remain handicapped vis-a-vis NBFIs. What is worse, the government makes use of this as a justification for a gradual approach. Unfortunately, the gradual approach often reflects a desire to prolong the status quo.

Second, there is the problem of policy loans. Policy loans still account for nearly one-third of total domestic credit. These include credit by development institutions such as the Korea Development Bank, credit by the Korea Housing Bank, credit by the National Agricultural and Fishery Cooperatives, loans to small and medium enterprises, foreign currency loans for capital good imports, and short-term export credit by the National Investment Fund. Until recently, the interest rate differential between these loans and other loans has been kept to a minimum, but more recently the differential has been growing. In the current political environment, where political leaders have greater incentives to pay attention to the views of their constituencies, strong pressures are at work to expand the scope of policy loans. Unfortunately, as long as financial institutions are not freed from the growing obligation to provide policy loans, financial liberalization will remain compromised.40

Third, there is the need to provide institutional arrangements to protect the safety and soundness of financial institutions. Without such arrangements, public confidence in financial institutions will be weak, and society will be in danger of losing the benefits of a sound payments system.41 In industrially advanced countries this need is being met in the form of deposit insurance, but Korea has yet to devise such a system. In the absence of such a system, the government provides such insurance in an implicit manner; i.e., when some banks are in difficulties, they are bailed out by the central bank in the form of special loans with low interest rates. This of course creates moral hazard and prolongs the financial weakness of banks. In other words, as long as the government plays such a role, it will make use of the financial weakness as a further justification to intervene extensively in the operation of banks.

Fourth, there is a problem associated with the attitude of regulators. In Korea, regulators often point out that the existing large gap between market interest rates and deposit rates at financial institutions is a major obstacle to further deregulation. This is self-serving. As long as regulations exist, a gap will exist, and as long as a gap exists, regulators will point to this gap as an important reason for proceeding slowly with financial liberalization. Of course, the only way to break this circle is to deregulate interest rates. However, recent government actions have been to the contrary. On June 26, 1990, the government announced that beginning in July

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41 For an examination of the idea that the services provided by money and a payments system are public goods and hence that the government should be involved in regulating the financial sector, see Park (1987), particularly, p. 5.
it will mandate the lowering of various rates of deposits at NBFI\textsubscript{s} by 0.3-3.3 percentage points with a view to bringing about an average one percentage point reduction in their lending rates in the months ahead.\textsuperscript{42} Such regressive measures hardly justify an optimistic outlook on further liberalization in the financial sector.

**Major Issues in Labor-Management Relations**

There are at least five major issues that must be resolved before Korea can look forward to a stable and productive labor-management relationship.

The first of these concerns intra-union rivalry. In the opinion of many experts, a large number of labor disputes for the past two years have been caused by intra-union rivalry. Ironically, this problem was aggravated by several "pro-labor" amendments to the labor laws adopted in 1987. After having suffered from the eruption of labor disputes nationwide in the months following the June 29 Democratization Pledge, the DJP was more than eager to accept the demands of organized labor. As a result, the requirement that the establishment of a union at a given firm had to be approved by a minimum number of employees was abolished. In addition, the ten day waiting period for the certification of a union was reduced to a three day period. These changes in the law have made it very easy for a small group of workers to establish a union without obtaining support from the majority of workers. Since the present law does not recognize more than one union in a firm, there have been many fights among small groups of workers who have taken advantage of the law, thus preempting union leadership on the one hand and the majority of workers who want to take the leadership away from them on the other. Since the current law says little as to how such disputes can be resolved, the fights between the two groups have been prolonged at the expense of the general public.

The second issue concerns the inadequacy of dispute settlement procedures. The 1987 amendment to the Labor Dispute Adjustment Law took away the power to review the reports of disputes to rule on their validity from the government. Furthermore, the cooling off periods have been shortened to such an extent that they are of no use for the purpose intended. Thus, these changes have led to a situation in which it is almost impossible to resolve significant labor disputes except through strikes. Needless to say, this is very costly for all the parties concerned.

A related issue perhaps far more fundamental than the institutional ones just mentioned has to do with the lack of experience on the part of both employers and employees engaging in serious bargaining. The style of bargaining has so far been all-or nothing rather than give-and-take. What is more, both employers and employees do not trust each other. Nor for that matter do they trust the government. Considering the history of the relationships involving all three parties, this is understandable. But in any case, solving this type of problem takes time.

\textsuperscript{42} For details of this policy announcement, see *Hanguk Kyongjae Shinmun* (Korean Economic Daily), June 29, 1990, particularly, p. 3.
The fourth major issue relates to the question of whether unions should be permitted to engage in political activities. Currently, opposition parties are in favor of the union’s right to engage in political activities while the ruling party, now called the Democratic Liberal Party (DLP), opposes it. Given the long historical tradition of Korean unions’ involvement in politics, the DLP is not likely to compromise on this issue.

A final problem that does not portend well for the future concerns the current attitude of the government and the general public toward labor. As a result of widespread labor disputes over the past three years, they have taken the simplistic view that enough is enough. In recent months this has led the government to take a hardline approach toward labor disputes. In the opinion of many, the rapid decline in the number of labor disputes since the beginning of this year has been due more to this hardline approach than the enhanced capacity on the part of both to engage in genuine dialogue. If this is indeed the case, there is a danger that communications will cease and many critical issues will again go unaddressed.

Short- to Long-term Economic Outlook

As far as the short-term economic outlook is concerned, there is no way for Korea to avoid some difficulties ahead. The economic outlook of the countries where Korea has its major export markets is not very good at the moment. The US economy seems to be heading for a recession in 1991. Japan's economy also seems to be slowing down. What is more important, there is as yet no evidence that the country has regained its competitiveness. During the first half of this year the growth of exports recovered but not enough to offset the real loss suffered last year. Furthermore, what is very disturbing is that the economy is still saturated with excess liquidity. Due to this excess liquidity, many expect that inflation measured in consumer prices this year will reach the double digit level. This problem of excess liquidity was created in part toward the end of last year when the government tried to support the stock market with an expansion of credit. Nearly 3 trillion won worth of credit was supplied by the central bank to the securities market. The amount was equal to about 5 percent of the total money supply (M2) then outstanding. Unfortunately, much of this excess liquidity found its way into realestate speculation. As a consequence, the rise of prices in land and other realestate accelerated. During the past three years, the prices of housing units have risen more than twice as fast as consumer prices, and the price of land more than three times as fast. But during the first quarter of this year realestate prices were rising even faster. Frightened by this development, the government has recently applied various administrative measures including the forced sale of land by business groups in order to control realestate prices. This policy in the short-run may succeed in controlling speculation in realestate, but if it continues, it holds the great danger of introducing numerous distortions in the market of another important factor, namely land. If this happens, Korea will soon have to deal with the problems of an economy where both land and capital are underpriced while labor is overpriced.

Now, what can one say about Korea’s long-term economic prospects? Here one can be far more optimistic. Korea’s long-term growth potential is
still very rich. For one thing, Korea is well endowed with high quality manpower. Its population is young and well educated. By now the nation has also acquired an exceptional capacity not only to make good use of foreign technology but also to develop high technology on its own. Korea's entrepreneurs are still energetic and forward-looking. As a matter of fact, a recent Korea Development Institute (KDI) study shows that as far as the supply side is concerned, Korea can expect to grow at 7-8 percent per year throughout the entire decade of the 1990s. Whether or not this potential can be exploited depends of course on such considerations as the state of the world economy, the willingness on the part of the Korean people to continue to work hard, and the capacity of the government to choose the right policies.

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Structural Adjustment:
Internal Deregulation of the
Bolivian Economy 1985—89

Juan L. Cariaga
Abstract

Bolivia embraced a wide range of economic reforms in 1985. The structural adjustment program is a showcase of the possible policy options: a unified exchange rate, labor and capital market deregulation, and trade liberalization. The paper offers a descriptive analysis of reform efforts, with particular attention to the banking, trade, and capital markets. The emphasis of the analysis is on how these reforms were carried out, such as the bond market auction and the deregulation of interest rates.

Accompanying this discussion is a critique of the reforms. The initial results of the reforms are mostly positive. Inflation was cut from an annual rate of 24,000 percent (1985) to 21 percent (1988). Yet investment and growth remain sluggish. Five years of reform efforts have not been sufficient to rebuild the confidence required for investment recovery. The author identifies various legal and economic obstacles in attracting investment capital and recommends further domestic reform.
For decades, Bolivia was one of the prime examples of what was termed a mixed economy with state intervention. On the one hand, market forces were allowed to operate, but always subject to a set of constraints. On the other, the State was permitted to participate actively in production and control of a large proportion of economic activities, all within the context of the populist macroeconomic policy that predominated in Bolivia from the 1950s onward.

Bolivia was in fact a typical case of a country where economic agents operated freely, but were at the same time subject to state intervention. The economists of the time, who were trained in universities that placed considerable emphasis on state planning and import substitution, firmly believed that it was their duty to program and direct all economic activities. The politicians, for their part, found that they could use the instruments of macroeconomic policy for populist purposes and to favor the interests of the big pressure groups.

This entire situation changed as of 1985, when the government of President Paz Estenssoro implemented Supreme Decree No. 21060, known as the New Economic Policy (NEP). Application of this decree enabled Bolivia to solve the serious problem of hyperinflation, which in September 1985 had reached the astronomic level of 24,000 percent p.a. It also enabled important structural reforms in the Bolivian economy with a view to correcting the distortions created by excessive state control and intervention.

This paper will give a description of the Bolivian economy before and after the structural reform that began with the NEP. An attempt will be made to explain the reasons that prompted the reform, and its limitations will be assessed, together with certain of the results obtained. Next, the mechanisms used by the NEP in deregulating the exchange markets and the banking system and opening foreign trade will be described briefly. To conclude, an effort will be made to assess the results achieved, in terms of both the stabilization process and the growth prospects for the economy.

* The author is an Executive Director of the Inter-American Development Bank and was Minister of Finance during the period when Bolivia's stabilization program was implemented. The views expressed by the author do not necessarily reflect those of the Inter-American Development Bank. January 17, 1991
The Bolivian Economy Before and After the NEP

The Bolivian Economy Before 1985 (Supreme Decree 21060)

Prior to 1985 Bolivia was one of the most clear-cut examples of a mixed economy with state intervention. While limited freedom of action was allowed to economic operators, the State regulated the greater part of economic activities. There are several reasons why Bolivia adopted this economic structure.

In the 1950s the universities focussed on theories of State planning and import substitution. The mistaken interpretation of these theories and the exaggerated way in which they were applied caused political leaders to set up centralist states that followed a pattern of extensive intervention in the economy.

The extreme poverty prevailing in Bolivia, as in other Latin American countries, stimulated the adoption of populist macroeconomic policies. These policies used intervention and regulation to achieve political objectives and favored the most powerful pressure groups. Economic operators in Bolivia adapted to this style of running the State. A segment of the private sector atrophied as a result of the lack of economic freedom, while another grew accustomed to living at the State's expense.

Price Control

For decades, the Bolivian State practiced price control, especially for essential items (food and clothing). Maximum selling prices were set and strict control was exercised to ensure compliance. The policy rationale for this measure was that price control was presumed to benefit the most impoverished segments of society. In practice, however, it amounted to nothing more than a considerable subsidy from the rural sector to the urban areas and the mines, where the politicians' electoral support was concentrated. Paradoxically, the 50 percent of the population living in the rural areas were the ones who had to bear this implicit tax, which instead of benefiting the poorest groups, in fact favored the country's middle class.

Exchange Control

During this period, the Bolivian State practiced exchange control. In times of abundant reserves this policy permitted free purchase and sale of foreign exchange, while when reserves were low it enabled rationing and discretionary allocation through the Central Bank. The policy rationale for this measure was that the exchange rate was always considered an instrument for resource allocation and not one of economic policy. It was therefore consistently used to keep the cost of food and input imports down, supposedly to subsidize the poorest groups. As a result the political leaders resisted the idea of adjusting the exchange rate, not only because of the impact this would have on the cost of living, but also because of its effect on other economic variables. In practice, the policy of a fixed rate and exchange control as applied in Bolivia was no more than a tax on exporters and an implicit subsidy for imports. As can be seen from table 1, application of this policy—and especially the dogged resistance to adjusting the
exchange rate—was one of the main causes of the significant exchange lag with respect to prices in the period 1981-86.

**INTEREST RATES SET BY THE CENTRAL BANK**

Interest rates were discretionally set by the central bank. This policy was based on the misinterpreted need to provide an incentive for the productive sector of the economy, to which end the central bank fixed differential interest rates with the aim of keeping production costs down for national industry. In practice this amounted to a subsidy for the productive sector—which was not always productive—at the expense of negative real interest rates received by national savers. As table 1 shows, application of these policies during the period 1981-85 resulted in significant negative real interest rates in the Bolivian banking system.

**Table 1. Bolivia: Economic Indicators 1981-1985**

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<td>10.89</td>
<td>13.04</td>
<td>15.51</td>
<td>18.23</td>
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SECURITY OF TENURE AND GUARANTEED EMPLOYMENT

In violation of the General Labor Law of 1939, succeeding governments introduced legislative provisions that effectively permitted security of tenure (guaranteed permanent employment) in both public and private sector activities in Bolivia. The policy rationale in this case was to ensure employment security, particularly in the urban areas where, once again, the politicians' electoral support was concentrated. In practice, this policy was nothing more than a major cause of unemployment. It made the private sector reluctant to take personnel on so that it only hired when it absolutely had to. The political consequence of these provisions was the strengthening of labor unions in Bolivia, which became a second political power factor capable of confronting the government's decisions. As can be seen from table 1 application of these policies accentuated by the crisis and hyperinflation, helped to significantly raise unemployment levels between 1981-85.

PROTECTIONIST TARIFFS AND IMPORT BANS

In accordance with the ill-conceived import substitution policy the Bolivian State favored the setting of highly protectionist tariffs and the prohibition of some imports. The policy justification for these measures—in addition to very short-term revenue collection concerns that continually predominated—was to protect domestic industry. In practice, however, the outcome was no more than negative effective protection for a very large variety of products and the sprouting of a number of artificial industries. These industries imported duty-free inputs and sold their end products under the umbrella of protection and import prohibitions. The consequence of this policy (which survived unsuccessful efforts to change it in 1965 and again in 1971) was the establishment of inefficient and uncompetitive industries, development of large-scale contrabanding, and a permanent distortion in foreign exchange allocation. The latter supposedly favored the productive sector of the economy (see Morales 1982 pp. 216-217). In the period 1981-85 (see table 2) the application of these policies certainly did not contribute to the growth of Bolivia's manufacturing sector.

The Bolivian Economy under the NEP of 1985

This entire scenario changed with the promulgation of Supreme Decree 21060, known as the New Economic Policy (NEP). The government of President Paz Estenssoro used this decree to implement important structural reforms in the Bolivian economy, moving it toward a market economy. The reasons that prompted the government to carry out these reforms were possibly the following:

1. The political freedom of the newly elected democratic government encouraged this freedom in economic activity. In this connection the NEP sought to give full freedom to economic operators who participated actively in the economy with full acceptance of the laws of the marketplace.

1. Based on the arguments set forth in the preambles to Supreme Decree 21060 (1985) and 21137 (1986) and the author's assessments.
Table 2. Bolivia: Economic Indicators 1985-1989

<table>
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<td>Manufactures</td>
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<td>1.92</td>
<td>2.51</td>
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<tr>
<td>Other 1</td>
<td>-1.09</td>
<td>-1.35</td>
<td>1.74</td>
<td>-1.27</td>
<td>0.65</td>
</tr>
</tbody>
</table>

Consumer price Index
(1980 = 100) 2
1,815.8 6,833.6 7,829.9 9,082.8 10,461.0

Standard Exchange rate
(1980 = 100) 2
1,993.6 7,599.9 8,226.0 9,401.2 10,766.4

Real interest rates
(fixed term deposit)
-97.46 19.63 19.93 5.18 3.62

Exports 3
(1980 = 100)
69.4 61.0 52.0 53.9 74.5
Minerals
41.6 29.7 26.8 33.7 56.0
Hydrocarbons
168.7 148.8 112.5 97.3 96.8
Nontraditional
24.6 57.6 68.6 77.6 129.6

Unemployment rate
(percent)
9.68 10.89 13.04 15.51 18.23


2. Average index expressed in thousands.
The stabilization measures and structural reform sponsored by the NEP were to set the foundations for the Bolivian economy to recommence its growth process. In the preceding four years the Bolivian economy had posted negative real growth rates.

It was imperative to free the State from the political burden of taking decisions in the economic sphere. The experience of the past showed that governments were, in general, reluctant to take steps to correct the economy. This situation caused considerable lags to build, which affected macroeconomic policy and efficient resource allocation.

A consistent philosophy in all government decisions pertaining to economic matters was required. The NEP's measures to market orient the economy should set the course for future government decisions in the economic field.

The economic crisis had reached a point that left no other option: either the country moved to set its economy in order or else the prevailing anarchy would bring about political and social collapse.

A brief description will be given of the policies implemented by President Paz Estenssoro's government to carry out structural reform of the Bolivian economy in 1985. It is important to note, however, that this description will only include those reforms and not others that were implemented in conjunction with the NEP. Together with the structural reforms of August 1985 the NEP carried out a set of macroeconomic reforms that backed by a strategy of negotiating with the multilateral and bilateral agencies, were designed to attack Bolivian hyper-inflation (see Cariaga 1990a and b). The NEP also instituted an array of mechanisms designed to mitigate the social effects of the crisis and hyperinflation. These mechanisms, such as the Emergency Social Fund (a program for the temporary alleviation of unemployment) and the Social Investment Fund (a program for investment in the health and education sectors), have recently been described in the literature (Nelson 1989 and Cariaga 1990c) but a discussion of them would be outside of the scope of this presentation.

The main structural reforms undertaken by the NEP in 1985 were the following:

1. The NEP reaffirmed the steps to eliminate price control taken by the government of President Siles, which in 1984 made a timid attempt to tackle the hyperinflation problem with a set of macroeconomic measures. Supreme Decree 21060 of August 29, 1985 in fact established absolute freedom for price setting in all activities of the economy. As can be seen in table 1, the effects of this policy were striking. In 1984—the year in which price decontrol was started—the agriculture sector posted a positive growth rate of 19.3 percent, followed by 7.7 percent in 1985. Unfortunately, with the exception of 1988, growth was negative in subsequent years owing to the droughts and floods that struck Bolivia. Even so, what happened in 1984 and 1985 indicates that price decontrol in Bolivia had had a positive impact on the agriculture sector's growth rate, notwithstanding the crisis and hyperinflation.
2. By establishing a single and flexible exchange rate system the NEP decontrolled the exchange market in Bolivia. By replacing the outmoded fixed-rate system with a flexible one, the NEP removed the State's discretionary control in setting the exchange rate. As table 2 shows, implementation of this policy made it possible to reverse the exchange lag with respect to prices that had prevailed from 1981 to 1985. Moreover, by allowing market forces to determine the rate, the new policy's chief impact was to permit the determination of a realistic exchange rate in the Bolivian economy. This realistic rate was a decisive factor in the disappearance of exchange control, and in the recovery of nontraditional exports that had been hard hit by those policies (see tables 1 and 2).

3. The NEP authorized the system banks to deal in foreign exchange and to freely set interest rates for operations both in foreign exchange and in Bolivian currency. By permitting the banking system institutions to receive deposits in foreign exchange the NEP tacitly recognized that foreign exchange was a legal medium of exchange. Similarly by authorizing the financial institutions to freely set interest rates, the NEP deregulated the banking market in Bolivia. As can be seen from table 2, the combined effect of these measures was to reverse the negative real interest rates and to enable the recovery of a sizable amount of funds that had fled the banking system owing to the prevailing hyperinflation.

4. By restoring the full effect of the General Labor Law of 1939, the NEP decontrolled the labor market in Bolivia. By bringing that law back into force the NEP eliminated all the subsequent legislative provisions that had ensured security of tenure (permanent guaranteed employment), national wage indexing, the granting of additional wages in cash and kind (many of them not subject to taxation), and other measures which had tended to create distortions in the labor market. In addition, the NEP specified that the State was only responsible for fixing the remuneration of its employees and not those of the private sector. The intention of these measures was to deregulate the labor market. Unfortunately, the difficulty of comparing indicators during this period (see Morales 1989) prevents measurement of the impact of these policies on the level of employment. However, and as was to be expected, the large-scale unemployment caused by the external shocks (21,000 miners in the Bolivian Mining Corporation, 4,000 workers in the state oil fields, and 23,500 government employees) conceivably caused a significant deterioration in the employment indicators as of 1985. As a result of this situation the government was obliged to put into effect a set of mechanisms to mitigate the social impact, which also served to relieve the political and social tensions generated by the crisis and accentuated by adjustment.

5. By freeing imports the NEP opened foreign trade. At the same time, the NEP implemented a uniform tariff for all imports, and also eliminated all tax and duty exemptions other than those established under international agreements, contracts with the State, or the previous investment law. The object of these measures was to complement the decontrolling of prices, prevent development of monopolies by domestic producers as a result of deregulation, and make them more competitive.
with imports. These steps were also intended to provide effective tariff protection for high value added domestic producers. The outcome was that the old tariff structure that had encouraged the proliferation of artificial and inefficient industries in Bolivia was reversed. Table 2 shows that with the decontrolling of prices and application of these policies the manufacturing sector moved into a period of sustained growth as of 1986.

6. By replacing over 450 taxes that accounted for around 2 percent of GDP in 1984 by 9 taxes that brought in 8.7 percent of GDP the NEP carried through an innovative tax reform in Bolivia. The aim of this reform was to transform the old tax system that concentrated on income and profits into a new one that focused on taxing consumption and wealth. This was the only viable option since hyperinflation had impelled a sizable segment of the population into the informal sector—a sector that is traditionally difficult to tax. Taxes were thus primarily levied on consumption and wealth, despite the supposedly regressive implications of doing this. By applying these reforms the NEP significantly increased the tax revenues available for meeting the central government's current and capital expenditures (see table 3). With the application of this system, the NEP also put an end to the abused practice of designated income taxes. Over the years preceding the introduction of NEP, and particularly under the de facto governments, the municipalities and regions had obtained approval of legislation permitting them to collect designated income taxes. This practice arose because of the central government's failure to observe its budgetary commitments to the decentralized entities. The easy solution to this problem was creation of new taxes earmarked for specific purposes that ensured that the local and regional governments obtained the funds they needed. However, these levies multiplied the number of tax obligations and eroded the resources that should have gone to the central government. The tax reform approved in May 1986 reversed this practice, enabling both the departmental governments and the municipalities and universities—which had been the chief beneficiaries of the designated taxes—to share in the revenues collected.

<table>
<thead>
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<th>Table 3. Bolivia: Tax Revenues (percentage of GDP)</th>
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<tr>
<td>Tax revenues</td>
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7. By instituting automatic indexing to the exchange rate for tariffs, especially for gasoline and oil products, the NEP succeeded in closing the financing gap of the public enterprises (particularly those operating in foreign trade) and preventing them from having to turn to the central bank for public credit.
8. The sole area that was not covered by the NEP reforms was the State. Although a determined effort was made to reduce the inflated number of government employees in the administrative and financial spheres, the NEP did not move to privatize state enterprises. The reasons behind this decision were the following: (a) In the 1970s various attempts at privatization in Latin America became mired in improvisation and corruption. The Bolivian government did not want the credibility of its program to be weakened by this possibility. (b) The problem of the public enterprises during the hyper-inflation period was that they acted as independent entities outside of the State's control. The NEP changed this, bringing them under the State and converting them into profitable undertakings. (c) Once the enterprises began generating a return they were no longer a heavy burden on the State. When the state enterprises no longer had easy access to public credit they ceased to be an inflationary factor in Bolivia's fragile economy.

These and other considerations were the primary reasons behind the decision not to privatize the public enterprises at the time. However, as of 1989 the Bolivian government has initiated a privatization process, given legal effect by Supreme Decree 22407 of January 1990.

The Mechanisms Used in Deregulation

This section will outline some of the mechanisms used by the NEP to deregulate the exchange and financial markets and to open up foreign trade. There will not, however, be a discussion on the mechanisms used in other areas of structural reform in Bolivia, in particular those relating to tax reform, since by their magnitude and nature these require a separate presentation (see Cabeza, 1989).

The Foreign Exchange Auction and Deregulation of the Exchange Market

To deregulate the exchange system the NEP used the foreign exchange auction system, known in Bolivia as "El Bolsín." As its name indicates, this mechanism consists of a public auction of foreign exchange conducted by the central bank in accordance with the following rules:

- Daily (or as often as necessary), the central bank sets the amount of foreign exchange to be offered at each auction session, with the objective of fixing a minimum selling price (floor price) together with the amount to be offered.

- The Central Bank Exchange and Reserves Committee opens the bids submitted at a public session on the sale day, evaluates them and allocates the funds based on the best prices offered. The successful bidders then receive the amount of foreign exchange requested in the course of the day.

The NEP effectively deregulated the exchange market by means of these auctions. One of the chief merits of this system is that it frees the
government from the political burden of having to make exchange decisions. Past experience shows that governments are generally reluctant to take steps to correct the economy. This is particularly so in the case of exchange rate measures. With the implementation of the auction system, Bolivia's exchange policy was managed independently of the government's policy decisions and in a manner consistent with the rest of its macroeconomic policy. As can be seen from table 4, this situation is reflected in the present small differential between the official and the parallel rates.

Table 4. Bolivia: Official and Parallel Exchange Rates (in Bs/US$ as of Dec. 31)

<table>
<thead>
<tr>
<th>Year</th>
<th>Official (selling)</th>
<th>Parallel (selling)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>1.83</td>
<td>1.72</td>
</tr>
<tr>
<td>1986</td>
<td>1.92</td>
<td>1.95</td>
</tr>
<tr>
<td>1987</td>
<td>2.18</td>
<td>2.22</td>
</tr>
<tr>
<td>1988</td>
<td>2.45</td>
<td>2.47</td>
</tr>
</tbody>
</table>

Source: Central Bank of Bolivia, Department of Economic Studies, Boletín Estadístico 265, Table 11.02, p. 76, La Paz, March 1990.

However, it is important to note that when this mechanism was proposed there was a debate as to whether the auction should be managed as an administered exchange mechanism or whether the exchange market should be allowed to function in total transparency. Those who advocated the latter felt that the central bank ought to offer an amount of foreign exchange each day equivalent to a proportion of the daily average of the annual demand. If the government only offered that amount the selling price of the foreign exchange would be directly affected by fluctuations in demand. These fluctuations would, therefore, determine the daily quotation and the official exchange rate. "El Bolsín" did not operate in that way. In the first place, such directives were never included in Supreme Decree 21060, and second, the Central Bank decided to administer the exchange rate. Accordingly, when the Exchange and Reserves Committee saw an increase in demand for foreign exchange it simply increased the amount offered. By doing this the central bank administered the exchange rate and, to a certain extent, controlled its effect on other macro-economic variables. As is to be expected, the debate on this point is still continuing. However, for all practical purposes the auction systems—as applied by the central bank—achieved the objective of depoliticizing exchange rate policy and enabled pragmatic administration of the exchange rate in Bolivia.

Finally, although the auction mechanism was valuable in preventing exchange lag in the recently stabilized economy, it is important to note that there is still debate today as to whether an exchange rate administered in this way is competitive or not (see Morales 1990, and Bernholz 1990). Since it would be impossible to resolve this controversy without embarking on

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2. This was the view of the group—which included the author—who drafted Supreme Decree 21060 (1985). At that time, the daily demand for foreign exchange was put at around US$5 million, US$2 million of which was provided by the parallel market.
complicated computations that are beyond the scope of this paper, this aspect must necessarily be left for separate treatment.

**Single and Uniform Tariff: Opening of Foreign Trade**

In order to open the economy up to foreign trade the NEP used the mechanism of a single and uniform tariff applied to all imports without restriction. Although this objective was very clear some significant adjustments have been made in the tariff rates revealing some of the problems that the government encountered in putting this mechanism into practice. These corrections were the following:

- Supreme Decree 21367 set a consolidated tariff of 20 percent on the c.i.f. (carriage, insurance, and freight) value of imports. This decree amended the system established by Supreme Decree 21060 that had left the question of collection of designated income taxes and other para-tariff charges unresolved.
- Supreme Decree 21660 made an exception for imports of capital goods. It also granted deferments of up to three years for tariff payments and clarified the exceptions laid down in Supreme Decree 21060.
- Supreme Decree 21910 established a program of automatic tariff reduction leading to a 10 percent tariff as of January 1, 1990. This decree also set a 10 percent tariff for capital goods imports.
- Supreme Decrees 22103 and 22466 set tariffs of 17 percent and 16 percent, respectively. Supreme Decree 22407 reduced the tariff on capital goods imports to 5 percent.
- Supreme Decree 22585 brought the tariff down to 10 percent and maintained the rate of 5 percent for capital goods imports.

These successive legislative changes show that the introduction of the uniform tariff not only generated considerable internal debate but also led to various adjustments of the rates applied. These adjustments reflected—among other things—the internal pressures exercised by big pressure groups affected by the level of the tariff. An example of this was the lobbying on behalf of mining interests to have the tariffs reduced on the grounds (rightly or wrongly) that tariff payments were a high fixed cost in a sector making very intensive use of capital goods.3

Notwithstanding all these vacillations, an important outcome is that gradually Bolivia realized that tariff policy could not be used to artificially protect industries. It also became clear that the single and uniform tariff ought to be used to protect industries imparting high value-added and that Bolivian industry should be prepared to compete with imports. Surprisingly, despite the internal criticisms based on the supposedly harmful impact of the uniform tariff on domestic industry, one of the sectors that posted sustained growth after 1986 was in fact the manufacturing sector (see table 2).

In recent years a lively debate has arisen as to whether the liberalization of foreign trade was harmful to Bolivia, since domestic

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3. Under the previous tariff system the mining industry was exempted from tariffs on imported capital goods.
production was affected by the highly distorted macroeconomic policies of its neighbors and main trading partners (see Pastor 1988). For his part, Morales (1990) considers that Bolivia's rapid liberalization resulted in haste and uncertainty among domestic producers. In turn, these producers brought immense pressure to secure prohibition of imports that competed with domestic industries (i.e., sugar and edible oils, for which a temporary prohibition is currently in effect). Notwithstanding these points, it is important to note that given the way the NEP was set up, it was virtually impossible to liberalize prices without the natural complement of opening the economy to foreign trade. A gradual opening (or no opening) of foreign trade, together with price decontrol, would have given Bolivian producers extensive monopoly power since they would not have had to compete with imports. This would have been unacceptable from any standpoint and particularly from that of economic efficiency.

**Freeing of Interest Rates and Repatriation of Capital**

To bring back the considerable amount of capital that had fled the country during the hyperinflation period and to deregulate the banking market in Bolivia, the NEP authorized the opening of bank accounts in foreign exchange and the freeing of interest rates. The intention was also to bring interest rates down to a level consistent with the recently accomplished stability. As can be seen from table 5, the combined effect of these policies produced a significant increase in bank deposits as of 1985. Table 5 shows how deposits in the Bolivian banking system, expressed in 1980 bolivianos, rose from Bs 2 million in 1984 to Bs 7 million in 1986, and to Bs 9.27 million in 1987. The public, which had seen its deposits vanish during the hyperinflation period, found that their savings in domestic currency maintained their value during this stable period. Similarly, those who had kept a significant amount in foreign exchange—which was in fact illegal during the hyperinflation period—found that they could now deposit these funds legally in the banking system and receive competitive interest rates.

Table 5. Bolivia: Total Bank Deposits as of December 31
(in millions of 1980 bolivianos)

<table>
<thead>
<tr>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Deposits</td>
<td>13,166</td>
<td>10,469</td>
<td>5,873</td>
<td>2,020</td>
<td>2,571</td>
<td>7,020</td>
<td>9,277</td>
</tr>
</tbody>
</table>

*Source: Central Bank of Bolivia, Department of Economic Studies, Boletín Estadístico 265, tables 2.04p and 16.02, pp. 21 and 26, La Paz, March 1990.*

As in the case of price decontrol, when the NEP used the opening up of foreign trade to make domestic producers competitive, with the liberalization of the financial system the NEP authorized the opening of bank accounts in foreign exchange and established the conditions for the banking system to qualify for lines of credit from international private banks. The objective of these financial reforms was to make interest rates more competitive. Unfortunately, the outcome was not as expected.
Although the negative nature of real interest rates was reversed, they remained relatively high in nominal terms after stability was achieved (see table 6). In commenting on this situation, some analysts such as Morales (1990) attributed this problem to a tight central bank money policy coupled with a rapid buildup of arrears in the private sector. However, another factor must also be added, in the context of the objectives of Supreme Decree 21060. With the deregulation of interest rates the government expected the return of funds that had fled elsewhere and the reopening of credit lines from international private banks would result in a significant increase in the supply of credit. Regrettably this is not what happened. The recovery of flight capital was only partial. Despite a sizable inflow of these funds the amount was never sufficient to bring bank deposits back up to their 1981 level. Moreover, international private banks did not reopen their credit lines, not even short-term ones for foreign trade. Consequently, with a credit demand equal to or greater than that of 1981 and no possibility of attracting sufficient resources into private bank deposits or obtaining lines of credit to increase the credit supply, no significant drop in interest rates was to be expected. In other words, the problem was one of unsatisfied demand, with supply below that prevailing in the early 1980s. There is no doubt that the high interest rates contributed to the rise in arrears and the fragility of the banking system, as referred to by Morales and others.

Table 6. Bolivia: Annual Lending Interest Rates (percent) (total nominal)

<table>
<thead>
<tr>
<th>Year</th>
<th>Bolivian Currency</th>
<th>Indexed to Official Balance Rate</th>
<th>Foreign Exchange</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985</td>
<td>232.10</td>
<td>17.10</td>
<td>17.80</td>
</tr>
<tr>
<td>1986</td>
<td>65.78</td>
<td>21.92</td>
<td>23.11</td>
</tr>
<tr>
<td>1987</td>
<td>39.45</td>
<td>27.30</td>
<td>26.04</td>
</tr>
<tr>
<td>1988</td>
<td>35.07</td>
<td>23.83</td>
<td>22.64</td>
</tr>
</tbody>
</table>

Source: Central Bank of Bolivia, Department of Economic Studies, Boletín Estadístico 265, La Paz, March 1988, table 5.01a, p. 44.

The Results: Growth Prospects

There cannot be the slightest doubt that the Bolivian stabilization program was successful. This has been the assessment of the international press and of the international financial agencies. Inflation, which had reached the astronomic level of 24,000 percent in 1985, was brought down to 65.9 percent in December 1986. Since then, it has been maintained at 10.67 percent in 1987 and 21.5 percent in 1988, which are tolerable figures within Latin American averages.

Thanks to this program, Bolivia also succeeded in reversing the negative growth which prevailed between 1981 to 1986. During this period GDP per capita declined by 20 percent. Since 1987 Bolivia has once again achieved positive growth, albeit at the modest rates of 2.1 percent and 2.8 percent for 1987 and 1988, respectively.
Clearly, the structural adjustment spurred by the NEP had much to do with this resumption of growth, primarily by providing economic operators with the freedom to act and compete without constraint in all economic activities. However, the question everybody asks is the following: why are growth rates so modest, especially now that Bolivia has eliminated hyperinflation and carried out a comprehensive structural adjustment, and the government has made a determined effort to attract resources and channel them to public investment? There is no single answer to this question. A part of the explanation lies in the sudden collapse of the minerals market and the fall in international oil prices at the end of 1985. This accounts for 1986, in particular. But there are also other reasons. For instance, the fact that Bolivia lacked appropriate conditions for inducing investment in the private sector, which, usually generates a significant proportion of growth. The structural reforms implemented in 1985 were not based on law, but were simply set in motion by presidential decrees that could be replaced or superseded at any time by different presidential decrees. The absence of a law to inaugurate the reforms affected the expectations of private sector economic operators. They were apprehensive that the rules of the game could change very quickly and did not feel that the stability needed for investment was assured. Supreme Decree 21060 should have been converted into an appropriate law guaranteeing rights of ownership, free movement of capital, remittance of interest and royalties, and other matters connected with investment.

Legislative provisions were also needed to make it possible to expand private sector operations in state mining and hydrocarbon production—the two most important productive sectors of Bolivia's economy. Under the Bolivian constitution, these activities are strictly reserved for the state and no private sector participation is permitted. If Bolivia decides to promote private investment in these areas, laws will have to be approved to allow the formation of joint ventures in mining operations. An amendment of the Hydrocarbons Law will be required to intensify the operations of the multinational oil companies. Moreover, and perhaps most important of all, private sector operators, and in particular foreign investors, have little confidence in the Bolivian judicial system. In Bolivia there is no tradition of creditors being able to collect from debtors through the courts. Foreclosure of a mortgage through the Bolivian banking system can take anywhere up to 10 years. Lack of confidence on this scale is a major deterrent both for investment in the private sector and for foreign investment.

Four or five years of stability, a comprehensive structural adjustment, and a serious effort to invest in the public sector are not sufficient to bring about significant growth in the economy. Economic operators need important signals from the government that will help to create a climate of confidence

4. The NEP significantly increased approvals and disbursements by the international lending agencies. As a result Bolivia had positive net resource flows in 1986 (Cariaga 1990b).

5 Two thirds of the votes in both legislative chambers is needed for a Bolivian law to be changed; this makes repeal very difficult.

6. The Government of President Paz Zamora has submitted bills to this effect to Congress by Supreme Decree 22407 (1990).
in the economy. This is especially so in a country where uncertainty and political and social instability have reigned for decades. Unfortunately, confidence is something that dissipates very quickly with populist speeches and poor administration of state resources. Reestablishing that confidence can at times take up to a generation.

Some Concluding Considerations

Despite the low growth rates achieved, Bolivia's program is generally considered to have been successful. This assessment is based on the fact that the program succeeded in reversing the negative growth trend. However, much still remains to be done. It is important that the government send signals to the private sector to the effect that the reforms carried out are permanent and will not be undermined by the political programs of succeeding governments. Laws need to be passed to create a climate of confidence that favors investment and to facilitate privatization. Today this is done on a case-by-case basis by congressional approval. Similarly, the foundations must be laid for the operation of a sound and reliable legal system. Once this happens, and once a new entrepreneurial class emerges in Bolivia that is no longer inhibited by the legacy of uncertainty carried over from the past, growth rates should improve. Within the Bolivian context four or five years of stability and a comprehensive structural adjustment are not sufficient to bring about high growth rates. Suitable conditions have to be created to foster investment by the private sector—the sector responsible for the bulk of production and employment in all countries. This is no easy task. It entails erasing from the minds of Bolivians (and foreigners) the memories of decades of political instability and lack of confidence that have characterized the Bolivian economy.
References


Supreme Decree 21060, August 29, 1985.

Supreme Decree 21137, November 16, 1985.

Supreme Decree 21316, July 3, 1986.


Supreme Decree 22407, January 1, 1990.

Supreme Decree 22585, August 29, 1990.