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ANATOMY AND CONSEQUENCES OF EXCHANGE CONTROL REGIMES

by Jagdish Bhagwati

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A Special Conference Series on Foreign Trade Regimes and Economic Development

VOLUME XI

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Foreign Trade Regimes and Economic Development: ANATOMY AND CONSEQUENCES OF EXCHANGE CONTROL REGIMES

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(Resolution adopted October 25, 1926, as revised through September 30, 1974)

Dedication

For

Alex and Rachel

Erlich

Contents

Figures

Tables

Foreword

This volume by Jagdish Bhagwati, together with Anne Krueger's *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences*, published earlier, brings to a conclusion the National Bureau of Economic Research Project on Foreign Trade Regimes and Economic Development, directed by Professors Bhagwati and Krueger. Professor Bhagwati's synthesis volume concentrates on the exchange control regimes themselves, while Professor Krueger's focused on attempts at liberalization. The syntheses draw on the previously published studies of Turkey, Ghana, Israel, Egypt, the Philippines, India, South Korea, Chile, and Colombia, as well as the two studies that were begun but not completed on Brazil and Pakistan. The Project, which began in 1970, is being followed up under the National Bureau's program on International Economic Relations by a study of Alternative Trade Strategies and Employment under Professor Krueger's direction. Both of these studies have been financed under research contracts with the Agency for International Development of the U.S. Department of State.

Perhaps the outstanding point of both syntheses is the conclusion that an export-promoting strategy is superior to an import-substitution strategy for the promotion of economic growth in developing countries. Professor Bhagwati defines export promotion policy as one which removes import bias, and in fact he finds that what are called export promotion policies usually do not involve a bias toward exporting but something closer to neutrality and therefore to a free-trade position.

The very isolation from world markets fostered by an import-substitution strategy leads to "chaotic" incentives, so that the strategy is far from an "ideal" one that might be theoretically constructed. Export-promoting strategy, on the other hand, seems to lead to incentives that are less chaotic—more neutral among industries—and on this ground alone should contribute to economic growth. One reason why export-promotion policies do not involve large biases toward exports is that export subsidies,the main possible source of export bias, are an open cost in national budgets. An import-substitution policy, operating typically through quantitative restrictions, does not involve any budgetary cost for the Treasury, and inadvertent major distortions are therefore much more likely.

Given the way an import-substitution regime actually works, including the fact that it typically operates largely through physical measures (quotas) rather than price measures (tariffs), many aspects of the regime seem to be at best irrelevant for development and often clearly injurious in ways that are barely touched on by the theoretical literature Professor Bhagwati reviews. As in Professor Krueger's volume, there is strong evidence here not only of the effects of domestic political considerations but also of that appears to have been sheer inadvertence. Quantitative controls became so complex that governments did not realize their impact, as in the case cited for India in which ". . . the import control regime seems to have provided the private sector with incentives to add to capacity in the face of excess capacity."

The gains from an export-promotion strategy are thus largely in the removal of such unintended consequences of import substitution as excess capacity, excess inventories, and bottlenecks. These effects are reinforced by the apparent success of export promotion in inducing greater capital inflows, despite the high profits for local production offered by import-substitution policies. Professor Bhagwati's explanation is, first, that foreign capital inflow is encouraged by the prospect of higher exports, which can finance the servicing and repatriation of the debt. His second point is that the type of "tariff-jumping" direct investment induced by import substitution may lower real income in the receiving country, while under an export-promotion strategy the investment is more likely to take advantage of the country's abundant resources, particularly labor, and thus raise the country's (and the world's) real income.

Professor Bhagwati points out that both tariffs and quantitative restrictions give rise to opportunities for illegal transactions, favoritism, and corruption. However, quantitative restrictions, by producing larger deviations from free market prices than do tariffs, offer larger temptations to illegal behavior. The awarding of import licenses has produced the most flagrant examples, but quantitative restrictions also offer greater incentives to smuggling and false invoicing than tariffs because the implicit tariffs resulting from quantitative restrictions are so high. Explicit tariffs of over 100 percent are rare, but implicit tariffs over 100 percent resulting from quantitative controls are numerous.

Even where the quantitative restrictions do not give rise to illegal transactions or corruption, the effort to avoid favoritism in awarding licenses often leads to mechanical methods of allocation on the basis of "fairness," or "equality of treatment." The result of such efforts is to ignore efficiency in favor of rules of thumb that seem "fair" such as allocation by past shares, capacity, employment, and so on, all of which shelter and thus preserve the least efficient firms.

Professor Bhagwati examines each aspect of the anatomy of exchange controls theoretically and points out the often severe limitations that the required assumptions place on the applicability of the theory. He then combs the country studies and related literature for examples, counter-examples, and statistical tests of the nature and consequences of exchange control regimes. He carefully points out the difficulties in tracing clear effects of exchange controls and calls attention to the exceptions and ambiguous cases.

In a sense, by examining the anatomy of exchange control regimes, Professor Bhagwati opens up an area beyond the usual theory of optimum development policy. What is needed is a theory of how policy will actually be made and administered under different trade regimes given the incentives for the policy-makers, the administrators of the policy within the government, and the firms that must live with or evade the policy. It may be irrelevant to any actual problem whether a quantitative restriction program can be imagined that would maximize real income or growth. A policy of import substitution, particularly under quantitative restrictions, may involve so many opportunities to secure private profits in ways that defeat the ostensible purpose of the restrictions that it is bound to be manipulated to that end. Even if an export promotion policy were not theoretically superior, it might be superior in fact because it offered fewer opportunities for exploitation.

The success of Professors Bhagwati and Krueger in drawing substantial conclusions about trade policy from such intractible materials testifies to the value of this type of large-scale comparative study that could draw on the experience of many countries and expert contributors. In a study of any single country the complexities and national peculiarities would obscure the lessons. A series of studies, in a well-designed common framework, can bring out the major common themes of each country's experience and provide conclusions for scholars and policy-makers.

Robert E. Lipsey
Director, International Studies

Preface

This volume is designed to be a partial synthesis of the major findings of the National Bureau of Economic Research Project directed by me and Professor Anne Krueger. It is meant to be a complement to the more substantial synthesis written by Professor Krueger and therefore is deliberately kept extremely brief in regard to both the description of the country studies and its overall size, the former so as to avoid undue repetition and the latter so as not to strain the patience of the reader who seeks to gain a total view of the Project's findings.

Two caveats must be entered. First, the two synthesis volumes complement each other in focusing on different aspects of the Project. This volume is addressed to the static efficiency and dynamic effects of exchange control regimes whereas the Krueger volume is addressed principally to the causes and consequences of liberalization attempts. Nevertheless, inevitably, several overlaps of topics do exist. In these instances, no attempt has been made to impose uniformity of views. This is, in fact, in the spirit of the Project, and we hope that it also encourages the readers of the synthesis volumes to refer to the original country studies and attempt their own syntheses! Nonetheless, the reader of both volumes should find a substantial conformity in the overall conclusions reached by Professor Krueger and myself, especially in regard to the major questions addressed by the Project.

Second, the syntheses cannot expect to, and in fact do not, capture the full complexities and subtleties that the reader will find in many of the country studies. At least this volume should therefore be treated as a guide to certain key contributions in the country studies rather than as a perfect substitute to reading them for their many insights.

In the course of reflecting over the questions posed in the Project and interacting with the many distinguished collaborators in the Project, I have chalked up a number of intellectual debts. I should particularly like to thank Hal Lary of the National Bureau of Economic Research who oversaw the Project over its long life. Although he is an economist with distinguished contributions of his own, he selflessly gave an immense amount of time, energy, and intellectual ability to the Project. While therefore no volume bears his name, the stamp of his meticulousness, carefulness with data and interpretation, and insightfulness is evident in all the volumes published under the Project, and none of them has failed to improve from his generous input. I should also like to add that I have profited much from the collaboration with Anne Krueger in co-directing the Project. Over the several years that we have worked on the Project, we have discussed many things, and it is now impossible to take the partial derivatives and assign marginal product to either of us. But it is evident to me that, without her many contributions, the Project would have been much the poorer. Next, all the country authors have freely placed at our disposal their ideas, in penciled comments on early drafts, through their excellent studies, and at the on-the-way conferences that were held to discuss the progress of the Project. The penultimate draft in particular has profited immensely from the detailed and careful comments of Bent Hansen, Clark Leith, Larry Westphal, Jere Behrman, Anne Krueger, Hal Lary, T.N. Srinivasan, Padma Desai, and Gideon Fishelson.

Finally, the reader should be warned that, except for minor revisions, the writing of this volume was substantially finished by June 1977.

Cambridge
March 1978

Jagdish N. Bhagwati

Other Books by the Author

The Economics of Underdeveloped Countries
Trade, Tariffs and Growth
The Theory and Practice of Commercial Policy
The Amount and Sharing of Aid
India: Planning for Industrialization (with Padma Desai)
India in the International Economy
Contributions to Indian Economic Analysis (with S. Chakravarty)
Foreign Trade Regimes and Economic Development: India (with T.N. Srinivasan)

International Trade (editor)
Foreign Aid (co-editor with R.S. Eckaus)
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