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TRADE AND EXCHANGE RATE POLICIES IN  
GROWTH-ORIENTED ADJUSTMENT PROGRAMS

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ABSTRACT

The search for "growth-oriented adjustment programs" reflects a widespread malaise concerning IMF stabilization programs in countries suffering from external debt crises. A new orthodoxy is emerging from this search, which links recovery in the debtor countries to a shift to "outward-oriented" development, based on trade liberalization. This paper describes many important limitations of this new orthodoxy. The heavy emphasis on liberalization is ahistorical, and indeed runs contrary to the experiences of the successful East Asian economies. It also distracts attention from more pressing needs of the debtor economies.

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## I. Introduction

The search for "growth-oriented adjustment programs" reflects a widespread malaise concerning IMF stabilization programs in countries suffering from external debt crises. After several years of poor economic performance, most of the LDC debtor countries under IMF supervision have still not resumed economic growth. The political will of the debtor governments to continue with IMF adjustment programs, much less debt servicing, is clearly on the wane. The cooperative arrangements between debtors, creditors, and the IMF which have been in place for the past five years seem to be in danger of collapsing. Hence, the search is on for new policies that might enable the debtor countries to resume economic growth while continuing to service their debts.

A new orthodoxy is emerging from this search, which links recovery in the debtor countries to a shift to "outward-oriented" development strategies, designed to produce export-led growth. Increased exports from the debtor countries are seen as the key to more output, more employment, and more foreign exchange to service the foreign debts. The new orthodoxy defines the policy content of "outward orientation" to include the following measures: (1) trade liberalization, especially the conversion of quantitative restrictions to low, uniform tariffs; (2) real exchange rate depreciation, and unification of the exchange rate; (3) an emphasis on the private sector as the source of growth, including the privatisation of state enterprises; and (4) a general reduction in all forms of market intervention by the government, in capital markets, factor markets, and in the overall level of government taxation and

expenditure. This "liberalization package" is urged by the U.S. government as part of the Baker Plan, by many influential academicians, and by the IMF and World Bank (as exemplified by the papers by Guitian and Michalopoulos for this conference).

The perceived urgency of such liberalization policies is causing a redesign of IMF and the World Bank programs. Increasingly, the liberalization package, including the attendant exchange rate management, is viewed by both institutions as a key tool of crisis management in the debtor countries. IMF missions put ever-increasing stress on the promotion of exports, mainly by urging an activist policy of exchange rate depreciation to raise export profitability. Inflation targets are downplayed in the process. This increased emphasis on exchange rate adjustment was suggested recently by data in IMF Occasional Paper No. 36. on IMF exchange rate policies, which shows that while exchange rate actions were contained in only 31 percent of IMF programs during 1963-72, such actions were part of 51 percent of programs during 1973-80, and 64 percent of programs during 1981-83 (and fully 82 percent, if countries belonging to monetary unions are excluded from the sample).

With respect to the World Bank, structural adjustment loans and sectoral adjustment loans are becoming a much bigger part of World Bank business. With increasing frequency and perceived urgency, the World Bank is offering detailed blueprints for deregulation, privatisation, and trade liberalization to member countries. Policy-based lending (as opposed to project lending) accounted for no less than 35 percent of World Bank lending to the heavily indebted countries in 1986, up from less than 10 percent five years ago.

Additionally, the IMF and the World Bank are increasingly working in tandem to plan medium-term programs to support "outward-oriented" structural adjustments.

As a general matter, there is much evidence of the relative success of outward-oriented development strategies over inward-oriented development strategies. The outward-oriented developing economies of East Asia have certainly outperformed the inward-looking economies of Latin America, a conclusion which has been reached by many observers, including the present author (see Balassa, 1982 and Sachs, 1985, among others). It is also plausible to link much of this superior performance directly to the trade regime. But general observations such as these do not really justify the equation of outward orientation with market liberalization, nor the emphasis on liberalization as an instrument of crisis management in the debtor countries. In my view, the increasing policy emphasis on liberalization as a tool of debt crisis management is fraught with difficulties.

At the very least, the strategy can find little historical support. The success stories of East Asia, so frequently pointed to as illustrations of the benefits of export-led growth, do not demonstrate the utility of trade liberalization in the midst of a macroeconomic crisis. In the first place, Japan, Korea, and Taiwan did not adopt their strategies during, or in response to, macroeconomic or debt crises. These countries solved their macroeconomic and financial difficulties of the late 1940s and early 1950s long before they embarked on the path of export-led growth. The real historical cases of liberalization during macroeconomic crisis are the Southern Cone countries (Argentina, Chile, and Uruguay) during the 1970s, and these episodes are

well-known debacles, in part because of the conflicting requirements of stabilization and liberalization.

Moreover, the East Asian exemplars of outward orientation demonstrate the practical distinction between export promotion and liberalization, i.e., laissez-faire policies, a distinction which casts doubt on some of the policy advice emanating from the international institutions (see Bhagwati, 1975, for an entertaining and astute discussion of similar points). In the case of Japan, for example, MITI is today world famous for its use of foreign exchange controls and administrative guidance to spur export industries, but the World Bank is apparently not recommending such activist ministries in countries seeking to promote exports! Nor is it advocating that governments pursue policies to support the formation of giant trading companies, as in Korea. The East Asian experience suggests that export promotion policies can be pursued (and maybe have been most successfully pursued) by a dirigiste government, and even in the presence of tight import controls and tight regulations in the capital markets.

The important role of the government in East Asian development does not, of course, imply that the public sector should be involved in every aspect of economic affairs. Moreover, the successes of dirigiste policies in East Asia have likely depended on the presence of a highly educated and well trained professional bureaucracy in these countries, a crucial human capital base that is currently lacking in many other developing countries. The Asian experience does suggest, however, that successful development might be helped as much by raising the quality of public sector management as by privatizing public enterprises or liberalizing markets.

From a global point of view, liberalization might be defended not as in the interest of the initiating country, but rather in the interest of the rest of the world, to the extent that trade restrictions are beggar-thy-neighbor policies. Some of the U.S. pressures for liberalization in the developing countries (e.g. vis-a-vis Brazil, Korea, and Mexico) indeed emanate more from concerns about U.S. trading interests than from concerns about the welfare of the developing countries. However, to the extent that this is the real motivation for pressures for liberalization, then it should be acknowledged that poor countries in dire economic difficulties are being pressed to make rapid structural changes on behalf of the rest of the world.

The current focus on liberalization distracts attention from other urgent needs of the debtor countries, by overloading the political circuits in those countries, and by absorbing the energies and attention of the international financial community. In countries such as Argentina, Bolivia, Brazil, Mexico, and Peru, with high inflation levels and acute macroeconomic imbalances, only a return to a position of greater fiscal balance and lower inflation, will provide a macroeconomic foundation of stability necessary for sustained growth. As there are macroeconomic and political limits to cutting budget deficits in the short run, and as these limits are especially constraining in the middle of an economic crisis, debt forgiveness and more generous foreign aid may have a role to play in stabilizing the economies of a number of countries. Moreover, I shall emphasize that the attempt to stimulate exports at all costs through trade liberalizations or aggressive depreciations of the exchange rate can often undermine a stabilization program and thus postpone a resolution of debt crisis.

Since comparative case studies provide a good antidote to facile orthodoxy, and since the goal of this paper is to urge a bit less neoclassical orthodoxy and a bit more realism in the analysis of exchange rate and trade policies that are recommended to the middle-income debtor countries, section II is devoted to a further discussion of the experiences of the East Asian countries. Then, in Section III of the paper, I turn the focus to Latin America, to take up the linkages of exchange rate policy, budget policy, and debt relief. Discussions of exchange rate management sometimes leave the impression that there is a technical fix for the exchange rate that can be divorced from budget policies, issues of income distribution, and so on. Nothing could be further from the truth, as I hope to stress.

## II. Policy Aspects of Outward-Oriented Growth in East Asia

Let us begin with a country example. Country "X" pegged its currency to the dollar in 1950, and kept the nominal parity absolutely fixed for more than twenty years. During the first fifteen years of this period (until 1964), foreign exchange was strictly rationed by a government agency, and the currency was always overvalued. PPP calculations using home and U.S. consumer price indices show a 60 percent real appreciation in the 20 year period. A Foreign Exchange and Foreign Trade Control Law of 1949 required that exporters remit all earnings to the government within 10 days, making the government the only legal source of foreign exchange, a privilege jealously guarded by the bureaucrats in charge of foreign exchange rationing. No explicit rules governed the distribution of foreign exchange. Bureaucrats allocated foreign exchange to favored sectors, and clearly gave attention to

particular firms that they were interested in nurturing. Government bureaucrats often retired to those firms at the end of their official careers. Rationing was so tight that private individuals were not allowed any foreign exchange for tourism abroad between 1950 and 1964.

Domestic capital markets were highly regulated, and completely shut off from world capital markets. The government was the only sector with access to international borrowing and lending. Foreign direct investment was heavily circumscribed, with majority ownership by foreign firms both legally and administratively barred. During the early to mid-1950s, about a third of external funds for industrial investment originated in loans from government financial institutions, at preferential rates that varied across firms and industries. These state financial institutions remained an important source of cheap financing until the 1960s.

The country in question, as will be familiar to many, is Japan. But the description sounds like many countries in Latin America, complete with overvalued exchange rates, foreign exchange rationing, restrictions on foreign direct investment, government allocation of credit, and so on. Moreover, this policy framework was in place for much of the "rapid growth period" in Japan (conventionally dated as 1955-1973), which may arguably be the most remarkable two decades of a country's economic development in world history. I begin with this example to urge on the reader a humble and inductive state of mind regarding growth-oriented adjustment. The policies of "outward orientation" in Japan, and in East Asia generally, have not been modelled on a free market approach as is frequently asserted.

Even though the real lessons of the East Asian successes are not yet understood by scholars, a brief review of the experiences of Japan, Korea, and

Taiwan, (henceforth JKT), can do much to inform the current debate about growth-oriented adjustment programs. The histories of JKT demonstrate that, while not mainly free market in spirit, these governments have consistently followed certain basic precepts in the design of their economic policies. First, government budgets have generally been maintained near balance, often with large surpluses on the current account of the budget. Tight budgets have had several salutary effects. Inflation rates have been low and fairly stable, since governments in East Asia have not had to resort to the inflation tax for purposes of government finance. This has meant, among other things, that nominal exchange rates could be maintained at fairly stable levels without jeopardizing export profitability. Also, with surpluses in the current account of the budget, government savings have contributed to the rapid rate of capital accumulation in these countries. A third benefit of tight budgets has been that governments have had the resources and flexibility to use subsidies and other fiscal incentives to promote particular sectors of the economy, or to offset reductions in general export profitability that might arise from an overvaluation of the nominal exchange rate.

With respect to export policy, once these economies started on the path of export-led growth in the early 1960s, the profitability of exports was jealously guarded, not through a generalized liberalization of imports, but rather through a combination of exchange rate management and fiscal incentives for exports. Incentives have generally been applied to promote exports with a natural comparative advantage (labor-intensive manufactures initially; capital-intensive manufactures later). Agriculture has not been taxed, but if anything protected, relative to industry. Nominal exchange rates have been

adjusted periodically to keep real exchange rates at realistic levels (a policy which has been easier to pursue than in Latin America because of the lower inflation), and when exchange rates have become overvalued, they have been devalued or compensated for by greater export subsidies. In the three countries, exporters have enjoyed certain key fiscal incentives, especially the rebate on tariffs that they paid on imported inputs for export production, low or zero export taxes, and subsidized credits. A cardinal principle for export policy has been to maintain the input and output prices faced by exporters at world levels so that exporters may compete effectively with foreign firms facing similar prices and technology.

The preservation of export profitability is an orthodox policy recommendation, but much else about export promotion in Japan, Korea, and Taiwan deviates significantly from typical IMF-World Bank policy recommendations. This is not surprising given the absence of a liberal tradition in the histories of any of these countries. In each of the countries, policymaking on exports has started from the premise that successful export promotion requires the import of foreign technologies and the exploitation of static and dynamic scale economies, and this must take place in the context of weak and fragmented domestic capital markets. In these circumstances, purely free markets have little to recommend, and even neoclassical economics recognizes a strong potential case for government intervention, as was recently stressed by Robert Lucas (1986). The case for intervention is strongest when the adoption of new technologies involves positive externalities (e.g. via industry-wide learning curves), or when production involves significant economies of scale.

In Japan, the government role started as far back as the Meiji restoration, when state enterprises were set up as the country's first exporting firms. As Smith (1955, p. 102) notes in his classic study of the Meiji period,

In developing modern industry the government had no choice but to act as entrepreneur, financier, and manager. Except in the silk industry, where uniquely favorable conditions prevailed, private capital was too weak, too timid, and too inexperienced to undertake development -- even with government aid which was given generously but without initial success.

Johnson (1982) details many of the features of government intervention in the years after World War II. In this period, the promotion of industry was less through direct state production than through an activist role of the government in supporting large enterprises, strengthening their bargaining position vis-a-vis foreign firms (especially in the licensing of foreign technologies and in the imports of raw materials), and preventing their acquisition by foreign firms. Until the 1960s, for example, Japan maintained strong explicit controls on foreign direct investments into the country (e.g., by requiring Japanese majority ownership of firms), and even after the formal liberalization, MITI has continued to block foreign direct investments in industries that MITI is trying to promote.

The whole nexus of Japanese policies may be seen as having the goal of fostering domestic entrepreneurs, with a sound technology base, and with a strong bargaining position vis-a-vis foreign rivals in home and foreign markets. Other policies discussed by Johnson in support of these goals include: the state role in allocating credit through state banks and the Fiscal Investment and Loan Plan (which is the public sector investment budget,

under the control of the Ministry of Finance); the elaborate trade promotion apparatus of MITI; the virtually total control over foreign exchange by MITI until 1964; the virtually total screening of foreign capital imports and exports by MITI and the Ministry of Finance until 1980 (despite de jure liberalization of foreign direct investment in the 1960s); and public-private forums such as the Industrial Rationalization Councils run by MITI.

Taiwan has also pursued activist industrial policies, that are most marked in the large role of state-owned enterprises in the industrial sector. Taiwan is more heavily dependent on state-owned industry than is probably any country in Latin America, with the possible exception of Venezuela. During 1978-80, for example, state-owned industry in Taiwan accounted for no less than 32 percent of domestic capital formation, while the comparable shares for Argentina, Brazil, and Mexico were 19.6 percent, 22.8 percent, and 29.4 percent respectively.<sup>1</sup> Outside of the state sector, the government has encouraged small and medium-sized enterprises through a variety of tax incentives and regulatory policies.

Korean export policies have differed from Taiwan's, and have been closer to Japan's, in the emphasis on fostering large-scale firms in the private sector through extensive state support. A major policy instrument has been interest rate subsidies for export firms. While many observers feel that the emphasis on state support of heavy industry was pushed too far at the end of the 1970s, government support was critical in development of several industries, particularly iron and steel, cement, fertilizers, and petroleum. As in Japan, the state has consciously fostered a few large trading firms that account for a large share of the country's international trade.

Table 1: The State Sector in the Macro Economy, Selected East Asian and Latin American Countries (percent of GNP)

	Government Expenditures	Government Revenues	State Enterprise Value Added <sup>a</sup>	State Enterprise Investment <sup>b</sup>
Japan	18.9	n.a.	n.a.	11.6
Korea	19.5	19.1	6.4	25.1
Taiwan	27.5	20.0	13.6	35.0
Argentina	21.6	16.5	4.8	20.7
Brazil	21.8	26.1	n.a.	22.8
Mexico	31.7	17.0	6.1 <sup>c</sup>	27.0

<sup>a</sup>Percent of Aggregate GDP at factor cost.

<sup>b</sup>Percent of total fixed investment.

<sup>c</sup>Largest 22 state enterprises only.

Source:

Government Expenditures: Japan, Korea, Argentina, Brazil, and Mexico from WDR, Table 26, 1986. For Taiwan, Myers (1986), p. 43. Data are for 1982 for all countries except Taiwan, for which 1981 is reported. Government revenues, same as expenditures. State enterprise data are from Floyd, et al. (1984), Table 1, and apply for the following years: Japan, 1974-77; Korea, 1974-77; Taiwan, 1974-77; Argentina, 1976-77; Brazil, 1980; Mexico, 1975-77.

We can summarize this part of the discussion by saying that the role of government in Japan, Korea, and Taiwan has been large, as in Latin American, but it has been systematically different. In Table 1, some summary data show that there is also no case for calling Asia a case of "small" government versus Latin America as a case of "big" government by more standard criteria, such as tax revenues and government expenditure as a percent of GNP, or the predominance of state enterprise in industrial production and domestic fixed investment.

A third fundamental aspect of government policy in JKT has been the promotion of relatively equal income distributions, most fundamentally through policies that equalized the rural income distribution and that kept the urban-rural differentials much narrower than in other developing countries. One measure of the greater income equality in JKT than in Latin America is shown in Table 2, where income shares of upper and lower quintiles are shown. By historical accident, Japan, Korea, and Taiwan were all pushed to undertake fundamental land reforms in the late 1940s and early 1950s. In Japan, the impetus was from the U.S. Occupation authorities, who assumed (with some exaggeration) that wealthy rural landlords had been important supporters of Japanese militarism. In Korea, the impetus came from several sources, including the example of North Korean land reform in 1946, and the fact that many large landholdings had been held by the Japanese, or by individuals linked to the Japanese. In Taiwan, the land reform was carried out by the new Chinese Nationalist government at the expense of a Taiwanese landholder class to whom the Nationalists had no obligations or ties. As in Korea, the expulsion of the Japanese made the case for land reform easier. The land

Table 2: Income Shares of the Top and Bottom Quintiles  
in East Asia and Latin America

	Income share of households:		
	Bottom 20 Percent	Top 20 percent	Ratio, Top to Bottom
Argentina (1976)	4.4	50.3	11.4
Brazil (1972)	2.0	66.6	33.3
Mexico (1977)	2.9	57.7	19.9
Japan (1979)	8.7	37.5	4.3
Korea (1976)	5.7	45.3	7.9
Taiwan (1976) <sup>a</sup>	9.5	35.0	3.7

<sup>a</sup>Approximate, read off of chart.

Source:

World Development Report, 1985, Table 28, pp. 228-229, and for Taiwan, Myers (1986), Figure 6, p. 24.

reform was viewed as vital in establishing peasant support for, or at least acquiescence in, the Nationalist rule over Taiwan. In all three cases, the land reform was extensive, virtually eliminating farm tenancy, which was very extensive prior to the reforms. In Japan in 1936, pure tenancy accounted for 27 percent of farmers, while 42 percent leased some of their land from landlords (see Allen, 1965). These farmers were converted almost in entirety to individual proprietors by the reforms. In pre-reform Korea, 49 percent of the farm households consisted entirely of tenant farmers, while 35 percent were partly tenants (Cole and Lyman, p. 21). In Taiwan, tenancy accounted for approximately 44 percent of households before the reform, and dropped to about 15 percent five years after the land reforms went into effect (Fei, Ranis, and Kuo, p. 43).

The extent of these land reforms is among the greatest in modern history, and could be accomplished only because of the extraordinary national circumstances in each of the countries. Not only was the land redistributed, but the land reforms represented a substantial expropriation of landlords, since compensation for the land taken was in each case substantially reduced by high concurrent inflations. The landlords, without political power in U.S. Occupied Japan, Taiwan under the Nationalists, and Korea in wartime conditions, could not effectively mobilize political opposition.

The political and economic importance of these reforms for subsequent growth cannot be overstated. By creating a rural sector of small, independent proprietary farmers, the reforms allowed JKT to escape from a seemingly endless cycle of rural violence and instability, and instead created a conservative peasantry that lent strong support to the national governments.

In terms of production, the long-term effects were highly salutary, with a great boost to farmer incentives. In part, this reflects the good fortune of technology since the reforms applied mainly to paddy rice, for which plantation-style economies of scale do not exist. In fact, the conversion of tenants to proprietors probably had little direct effect on technology, since the pre-reform tenants already worked the land as individual producers.

All studies show that the land reforms directly narrowed the income distribution to a substantial extent (other factors that also contributed to income equality were the destruction of wealth by war in all three countries; the fact that much wealth was held by colonial Japanese in Korea and Taiwan; and the high inflations in all three countries, which wiped out the values of government bonds). The land reforms also had a pervasive long-term but indirect effect on the income distribution by shifting the political balance towards rural interests. As an interest group, farmers were strengthened significantly because a tiny class of unpopular landlords was replaced by a massive class of small and prosperous peasants, who could now voice demands on their own behalf. In all three countries, government expenditures and regulations subsequent to the reforms have acted to give positive effective protection to agriculture, and to devote a sizable fraction of government infrastructural investment to the rural sector. In the 1986 World Development Report, for example, Korea is shown to give the highest degree of producer protection in wheat and rice of all of the countries covered in the study (Figure 4.1, p. 64; Japan and Taiwan are not in the sample of countries).

In Sachs (1985), I speculated that the political strength of the rural sector in East Asia could help to explain the historical willingness of the

East Asian economies to make timely exchange rate depreciations, in distinction to the notorious Latin American resistance to depreciations. Relying on computable general equilibrium models and well-known analytical results, I noted that exchange rate depreciations can be expected to transfer incomes from the urban to the rural sector, compared with a policy of quantity rationing of foreign exchange. In Asia, rural interests of the class of independent farmers has been influential. In Latin America after the Great Depression, the class of rural landlords has lost out to urban interests. In Asia, the effect of devaluation on income distribution will be neutral or even equalizing, since incomes of a large class of small farm proprietors will be raised. In Latin America, the effect will be to widen the income distribution, or at least will be perceived to be so by political actors, since large landholders will benefit by increased rental income, while landless peasants may well experience a fall in their real incomes. Unfortunately, the IMF Staff Papers has apparently never contained in thirty years an empirical study on the actual distributional effects of devaluations.

The preceding sketch of the basic macro, trade, and industrial policies in East Asia might leave the wrong impression that economic success in the region has been fundamentally the result of particular government policies. Economists do not know enough even in principle to draw such a conclusion, and it is also clear that there have been several other factors at work. For completeness, one must mention: high private-sector savings rates; a low degree of labor unrest, which in Korea and Taiwan is partly due to government suppression of union activity; remarkable political stability, with thirty years of one-party rule in all of the countries (democratically so in Japan,

of course); and extensive political, strategic, and financial support from the U.S., especially in the key early phases of the high growth period.

Finally, we should examine the critical issue of the time phasing of the policies in JKT. There is much talk about the need for proper phasing of stabilization and liberalization, but there is less serious attention to the matter in practice. The paper by Michalopoulos states, for example, that "There is little disagreement that stabilization needs to precede structural adjustment if the latter is to succeed." But there are few cases indeed in which the World Bank has been content to let structural matters sit for a period of months, not to mention years, while waiting for stabilization to solidify. The East Asian experience does not suggest that stabilization can be completed in one year, and liberalization in the next. A successful phasing is likely to be much more extended.

In the three East Asian countries under review, the postwar period began with an initial phase of macroeconomic instability, which was followed by several years of stabilization and import-substituting growth, and eventually by a turn to export-led growth in the early 1960s.<sup>2</sup> In Japan, hyperinflation prevailed after Japan's defeat in World War II until the stabilization program of 1949 (the so-called "Dodge Line"). From 1950 to about 1960, growth was mainly oriented toward import-substitution and the building of domestic infrastructure. The export-led high growth spurt may be dated from the onset of the "Growth Doubling Plan" of 1960. In Korea, the hyperinflation during the Korean War was not finally brought under firm control until 1957. During the 1950's, the democratic Administration of Rhee Seung Man pursued a policy of import-substitution financed heavily by U.S. aid. The export-promotion

phase first got started after the toppling of Rhee in 1960, with a devaluation in 1961, but it is usually dated to the major policy reforms undertaken by the military government of General Park Chung Hee in 1964 and 1965. The prospects of the phased withdrawal of U.S. financial assistance in the mid-1960s was a major prod to these policy changes. In Taiwan, the hyperinflation of the Chinese Civil War was brought under control by 1951. As in Korea, the new government pursued a policy of import substitution during most of the 1950s. The prospect of declining U.S. financial assistance was again a major spur to the shift to export promotion at the end of the 1950s. In 1958-59 the Nationalist Government introduced a devaluation and unification of the exchange rate, as well as other reforms, to initiate the phase of export-led growth.

There are three notable features of these transitions. The first is the significant time interval between economic stabilization and the beginning of export-led growth. By the early 1960s in each of the countries, the dire macroeconomic imbalances of the preceding decade were long in the past. Inflation and budget imbalances had been under control for at least five years. Economic growth was adequate, if not spectacular in Korea and Taiwan, and it was already truly spectacular in Japan. The governments had in hand, and in prospect, the financial means to make large infrastructural investments, to provide export subsidies or other fiscal incentives to exports when desirable, and to avoid a debilitating fiscal contraction in the near future. Of course the economies did not look as strong in prospect as they now look in retrospect, and the anticipated withdrawal of U.S. financial assistance from Korea and Taiwan was viewed with great anxiety, but at least the reforms were not emergency measures.

There are good conceptual reasons for believing that this phasing was important for the political and economic success of the export-led growth policies. In an unstable macroeconomic environment, investors are unlikely to begin to expand export capacity to absorb the slack from a declining import-competing sector. Moreover, the instruments of stabilization may well compete with the instruments of liberalization. Stabilization might require the confidence-building measure of a stable exchange rate; liberalization might require a real exchange rate devaluation. Stabilization might require a rise in trade tax revenues; liberalization might require a cut in trade taxes or even an increase in export subsidies. Stabilization might require a cutback in public investments; liberalization might require a rise in public infrastructure investment in ports, communications, and transportation. And as Calvo (1986) has stressed, the welfare gains from a reform can be diminished, or even become losses, when the sustainability of the reform is doubted by the public, or in Calvo's terms, when it is an "incredible reform". All of these problems obviously afflicted the Southern Cone stabilizations at the end of the 1970s.

The second important aspect of the transition process was the substantial levels of U.S. financial assistance provided to each of the countries. There is presently a dangerous myth that governments can work their economies out of any difficulties, no matter how severe, if only the correct policies are followed; the East Asian economies are often taken as examples where such hard work paid off. The truth, however, in the cases of Japan, Korea, and Taiwan, is that extensive financial and political assistance from the U.S. was a vital component of stabilization. (The same key stabilizing role of foreign

assistance, in the form of substantial debt forgiveness, as well as foreign aid is evident in the case of the Indonesia after the fall of Sukarno). The U.S. paid for a large share of the imports and budgets of Korea and Taiwan for most of the 1950s, and U.S. military expenditures in Japan (the so-called "special procurement funds") similarly provided enormous balance of payments support. The importance of this foreign aid is illustrated in Table 3, where we see that U.S. foreign aid to Taiwan and Korea financed a large share of their imports during the period, and a large share of government expenditures (other estimates of import shares covered by foreign aid, as in Mason et al. (1980), pp. 165-208) in the case of Korea, show an even larger role for aid). We will return later to the case for partial debt forgiveness in the Latin American economies as a way to give them a comparable financial fresh start.

The third aspect of timing involves the policy reforms once export-led growth commences. In none of the countries was there a sudden removal of tariff or quota protection for domestic industry, or indeed anything approaching the adoption of a flat tariff of 10 to 20 percent in the course of a five year period (this is the policy recommendation of Balassa, et al. (1986, p. 89) for Latin America, one that is made after the inevitable bow to East Asian success). As Lin (1984, p.46) notes with regard to Korea and Taiwan:

In fact, systematic decontrol of imports did not occur in either country until the late 1960s, well after the success of their export promotion efforts. In the interim, trade liberalization measures consisted primarily of allowing imports of intermediate products duty-free for use in export processing and of requiring domestic producers of import substitutes to reduce their prices relative to potential imports in order for their products to remain under import control.

In Japan as well, the process of shifting to export-led growth got underway only in the 1960s, and indeed it was not until 1964 that the Yen became a

Table 3: U.S. Financial Assistance to Korea  
and Taiwan, 1955-59

	1955	1956	1957	1958	1959
<u>Taiwan</u>					
Total U.S. Aid (\$m)	90.4	97.3	96.9	93.7	86.3
% of Taiwan Imports	43	39	36	30	29
<u>Korea</u>					
Total U.S. Aid (\$m)	149.3	131.4	103.2	97.0	105.9
% of Korean Imports	46	n.a.	36	30	35
% of Korean Central Government Expenditures	68	n.a.	27	16	33

Sources:

For Taiwan, Lin (1973), pp. 72-73. For Korea, Cole and Lyman (1971), p. 266,  
and International Financial Statistics Yearbook, 1985.

convertible currency in the sense of adherence to Article 8 of the IMF Articles of Agreement. Even after Japan adopted the formal commitments to currency convertibility and to reduced tariffs, the process of liberalization has been slow. Certainly no U.S. trade official would be willing to cite Japan as a case where rapid liberalization was the instrument of export promotion!

### III. Exchange Rate and Trade Policies for the Latin American Debtors

#### (a) Overview

When viewed against the backdrop of the East Asian experience, the current policy debate over the Latin debtor countries is problematic in several ways. Much of the policy debate in Latin America, and between the Latin American governments and the international institutions, is about market liberalization even though across-the-board liberalization is probably not the key to export promotion, and even though liberalization is unlikely to succeed in the midst of macroeconomic instability. Also, the international institutions are addressing income distributional concerns in a vague way at best, even though it is income distributional conflicts that are at the core of the many of the region's problems.

For most of the Latin American countries, the most pressing problem is an ongoing fiscal crisis that erupted in the early 1980s. The crisis erupted for several reasons, including: (1) overspending in the 1970s, that left a legacy of enormous foreign and internal debts; (2) the sharp rise in world interest rates in 1980, that increased the burden of the public sector debt; (3) the cutoff in international lending to Latin American governments in 1982, that

suddenly left them unable to finance fiscal deficits with foreign loans; (4) the adverse shift in the terms of trade, which depressed public sector revenues; and (5) the enormous declines in real income in the Latin countries since 1982, which have further depressed tax collections. As a result, public sector finances are under enormous strain in several countries. The very high inflations in Argentina, Bolivia, Brazil, Mexico, and Peru are the best reflections of the dire fiscal situation.

The foreign debt crisis in Latin America is to a large extent an aspect of this fiscal crisis. Three fourths of the foreign debt in Latin America is a liability of public sectors. The problem of the debt is not only (or even mainly) that the various countries owe large sums to foreign creditors, but that the sums are owed by cash-strapped public sectors. In some cases, particularly Argentina, Mexico, and Venezuela, it is suspected that the country's net foreign debt position is rather modest as a percentage of national income, because the public sector's external debts are matched partially by the private sector's external assets (the cumulative capital flight of the past). According to one estimate (Dooley, 1986), by the end of 1983, cumulative capital flight accounted for 61 percent of Argentina's gross external debt, 44 percent of Mexico's debt, and 77 percent of Venezuela. To the extent that external debts and assets balance, the relevant transfer problem is to get money from the private sector to the public sector of the debtor country, rather than to transfer income between the country and the rest of the world.

The failure to link the debt crisis and the fiscal crisis has left many observers puzzled as to why the "debt crisis" doesn't get better despite large

trade surpluses in many of the debtor countries. Bankers expressed annoyance, for example, that despite Mexico's large trade surpluses in 1984 and 1985, the Mexican debt situation did not improve. The bankers' interpretation for Mexico (and other countries in a similar situation) was that net export surpluses were being "lost" in capital flight, so that the net exports were not reducing Mexico's debt burden. One policy prescription was to prevent the accumulation of foreign assets by Mexican exporters. But this view fundamentally misunderstands the problem. The Mexican government owes the debt, but it does not own the net exports. The fact that large trade surpluses did not relieve the debt crisis is a result of the fact that with national trade surpluses or not, the Mexican government still could not afford to service the public sector debts.

Even an export boom would have no direct bearing on the debt crisis, except to the extent that it raises national income and therefore government revenues. An export boom might improve the welfare of Mexican citizens, but it would not directly relieve the debt crisis per se. Policies to stimulate exports, e.g. large depreciations of the real exchange rate, or tariff cuts on imports, may worsen or improve the state of the budget, and if they worsen the budget deficit they may thereby worsen the debt crisis even if exports increase. A cut in tariffs will tend to worsen the budget deficit, and could well intensify the debt crisis; a conversion of quantitative restrictions to tariffs will tend to reduce the budget deficit, and thus ameliorate the crisis.

Liberalization measures that do not directly bear on the budget, such as a removal of quantitative restrictions, can also have important though

indirect effects on the budget balance. Government makes expenditures on nontradeables (e.g. public sector salaries) and tradeables (e.g. interest payments on the foreign debt), while collecting income from nontradeables (e.g. taxes on labor) and tradeables (e.g. earnings from state enterprise exports, and from trade taxes). Shifts in the relative price of nontradeables and tradeables can therefore have an important bearing on the budget balance. With a large overhang of external debt, a real exchange rate depreciation (i.e. a fall in nontradeables prices relative to tradeables prices) will tend to worsen the budget deficit. The dollar cost of foreign debt servicing will stay the same, but the dollar value of domestic tax receipts (which arise partly from taxes on nontradeables) will tend to fall. Thus, the removal of quantitative trade restrictions, by tending to cause a real depreciation, might intensify a budget deficit even if the QRs have no direct fiscal effect. (On the other hand, in cases where the government receives a large fraction of income from the sale of tradeable goods by state enterprises, the a real depreciation might help to reduce the fiscal deficit).

My focus on budget problems does not undermine the case for more export-led growth for Latin America, but rather stresses the need for a thorough macroeconomic stabilization of the region as the prerequisite for long-term growth. The stabilization phase will require several years, and will have a greater chance of success if the implementation of reforms for export-led growth is gradual during this phase. The region's long-term growth prospects will certainly be enhanced by a greater outward orientation, as stressed in Sachs (1985) among many other places, as long as it takes place in the context of macroeconomic stability. Judging from the East Asian

experience, the greatest long-term gains to export-oriented growth would be a more rapid transfer of technology to the region, the exploitation of the region's comparative advantage in labor-intensive manufacturing, the end of discrimination against agriculture in region, and the benefits from important static and dynamic economies of scale achieved by producing for world markets. Another lesson from East Asia is that as the Latin American countries move toward outward orientation, they may do so with a shared role for the public and private sectors.

Nor should we be pessimistic about export growth over the longer term. It is clear that even in the hothouse environment of Latin American import substitution, many Latin American countries have been able to stimulate manufacturing exports, a point stressed by Pazos (1985-86). As an example, Brazil's dollar earnings from manufactured exports rose more than tenfold between 1972 and 1981, despite a heavily controlled and protected economy (World Bank, Economic Memorandum on Brazil, 1984, Table 3.3). Manufacturing exports rose from 21 percent of total exports to 48 percent of total exports. The key was a realistic exchange rate, attention to labor-intensive manufactures, and sustained export promotion policies, but not a laissez faire economy with a liberal import policy.

(b) Inflation Control and Budget Deficits

Without necessary fiscal actions, no extent of exchange rate devaluations or trade liberalizations can stabilize the economies of Latin America, even if such policies stimulate exports and improve trade balances. The large inflations throughout the hemisphere are first and foremost a reflection of

the continuing fiscal deficits. In the absence of fiscal correction, continuing resort to the inflation tax will be necessary, and the exchange rate will have to be devalued in line with the underlying budgetary needs for the inflation tax. If the government attempts to hold the line on a freely convertible exchange rate without correcting the fiscal situation, it will lose foreign exchange reserves. If it then institutes exchange controls, and rations foreign exchange, it will suffer from a growing black market premium on foreign exchange, which will not prevent prices from rising, but which will arbitrarily squeeze exporters, to the extent that they have to relinquish foreign exchange at the official rate, or to the extent that they have to engage in costly smuggling.

Several countries have attempted to stabilize exchange rates for the purpose of ending high inflations without correcting underlying budget deficits. Such a policy for the exchange rates can be seriously harmful, and particularly pernicious, since the policy will appear to be working in its early stages, even when the public knows that it will eventually break down. The dangers can be illustrated with a simple theoretical example. Suppose that a country is relying on inflation taxation to finance a budget deficit. Inflation is proceeding at a high rate, and the exchange rate is depreciating at the same rate, with a constant real exchange rate. Let us assume that purchasing power parity holds so that by fixing the exchange rate even temporarily the inflation rate can be made to fall to level of the world inflation rate, which we will take to be zero. The demand for real money balances is a decreasing function of the instantaneous inflation rate, and thus of the instantaneous rate of currency depreciation. Suppose finally that

the currency is perfectly convertible. When the government acts to stabilize the exchange rate, it freely buys and sells foreign exchange at that rate unless and until it runs out of reserves (or hits an acceptable minimum level of reserves), at which point it allows the exchange rate to float.

If the government starts out with a positive level of reserves it will be able to peg the exchange rate for a while (during which time the reserves run out) even if the budget deficit is not brought under control. The inflation will temporarily be brought under control. Eventually, the pegged rate will collapse and the high inflation will return. The specific time pattern of reserves and inflation in such a case is especially interesting. At the time that the government begins to peg the rate, inflation drops to zero. Even though everybody in the economy understands that the program will break down (perhaps in six months or a year) when the reserves run out, they know the program will not break down immediately. Therefore, they choose to increase their holdings of real money balances in the short term, knowing that inflation will be low during the short period. They rebuild money balances by bringing in assets from abroad, fully preparing to reverse the process before the fixed rate breaks down and the inflation resumes. Thus, upon the announcement of the fixed rate, foreign exchange reserves at the central bank increase, but this is not as a sign of long-term confidence, only of very short-term confidence.

Over time, reserves will fall from their now higher level, while inflation will be zero. Eventually, reserves will fall low enough that the prudent private sector will once again begin to move its assets out of the country. This will occur before the minimum reserve level is reached. A

speculative attack on the central bank will occur, even though reserves appear to be well above the minimum, and the speculative attack itself will in fact rapidly drive the reserves down to the minimal level. The pegged exchange rate collapses, leading to a renewed inflation cum depreciation. Now, however, the inflation will occur at a faster rate than originally, because the government is now deeper in net debt (it has lost foreign exchange reserves during the life of the program). It therefore needs a higher inflation tax to pay for the higher net interest servicing on its debts.

This basic story captures the essence of many episodes of pegged exchange rates in recent years. The Martinez de Hoz policies in Argentina (1978-81), the Aridor policies in Israel (1982-84), and the Cruzado plan in Brazil (1986-87), have all harbored the misconception that exchange rate stabilization alone can eliminate a high inflation, even though the underlying fiscal deficit is not relieved. In the case of Martinez de Hoz and Aridor, inflation upon the collapse of the programs was indeed well above the initial rates, and the same may soon be true of the Cruzado Plan. The advocates of these policies often misunderstand even in retrospect why they fail. After all, the finance minister observes that the reserves go up at the beginning (a sign of confidence!) and that inflation stabilizes (success!). And then, even when reserves appear to be adequate ("oh sure, with a little slippage"), the program collapses. The public appears to be fickle, ungrateful, and even a bit unpatriotic, for instigating a run on central bank reserves.

Even when governments have understood the need for budget cutbacks, there has been only a slow process of reconstructing the public sectors in Latin

America. There are two interrelated reasons for the lack of decisive progress. First, the size of the shocks has been enormous, far larger than anything that industrial countries have had to grapple with in decades. Second, there is a powerful stalemate over income distribution in most of the Latin America countries, which prevents decisive fiscal actions. The wealthy can block higher taxes, but they cannot enforce spending cuts without provoking unrest. The situation is aggravated by the fact that the external public debt is a large part of the fiscal burden, and the will to undertake powerful actions on behalf of foreign commercial banks is understandably limited. The IMF and World Bank sometimes seem oblivious to the distributional struggle, which is remarkable given the degree of unfairness and inequity that is pervasive in Latin American society.

Several of the major Latin American countries exercised remarkable fiscal laxity during the easy money period of the 1970s. Mexico squandered an enormous increase in oil revenues with public sector deficits that reached almost 18 percent of GNP in 1982. Argentina, Bolivia, and Brazil similarly ran large and chronic budget deficits during the 1970s, that were easily financed with foreign borrowing. By 1980, the public debt levels in these countries was already extraordinary. The real fiscal crisis did not become obvious, however, until world interest rates on the public sector debt rose sharply in the early 1980s and until access to foreign loans was cut off, which occurred in most countries in 1982 (1981 for Bolivia; 1983 for Venezuela). The ferocity of the shocks has meant that even stringent adjustments since 1982 have proven insufficient given the size of the resulting fiscal crisis. I will illustrate this with a case I know well,

Bolivia, which almost fell into anarchy because of its fiscal crisis (see Sachs, 1987, for further details). While the Bolivian picture is extreme (inflation eventually reached 50,000 percent in 1985, before being brought under control), the underlying mechanics are indicative of Argentina, Brazil, Mexico, and Peru as well.

The Bolivian government was receiving a net foreign transfer of resources of about 5 percent of GNP during 1978 to 1980. When world interest rates rose sharply in 1980, Bolivia entered a fiscal crisis, and new lending ceased. A succession of unstable Bolivian regimes attempted nonetheless to maintain debt servicing. With skyrocketing world interest rates and no new loans, the net resource transfer of the public sector shifted to an outflow 5 percent of GNP. The various Bolivian governments during 1980 to 1983 did little to reduce spending or increase taxes. Rather, they substituted seignorage (i.e. money printing) for the lost foreign borrowing. Seignorage as a percent of GNP therefore rose by almost 10 percent of GNP between 1980 and 1983, about equal to the size of the shift in net resource transfers.

Inflation naturally accelerated. A new democratic government came to power in October 1982, determined to stabilize the situation, but it was overwhelmed by the task. While the Siles government did not raise spending despite enormous social pressures from its political constituency, and indeed fought several bitter fights to cut spending, it presided over a collapse of the tax system before it really recognized it. High inflation undermined a fragile system of property taxes fixed in nominal terms, specific trade taxes, specific excise taxes, and income taxes paid with a significant lag. The Tanzi effect operated with a vengeance. Public sector prices also lagged

seriously in real terms, as did nominal exchange rate devaluations. Between 1980 and the first half of 1985, government revenues as a percent of GNP fell from about 10 percent to just over 1 percent! Even though the Siles government presided over the world's worst hyperinflation in 40 years, the government should not be considered profligate or expansionary. Real cuts in government spending under Siles were certainly the largest in Bolivian modern history. The government was overwhelmed by a cumulative process in which large deficits led to high inflation, an erosion of tax collections, and a further widening of the budget deficits.

The Paz government was elected in August 1985, and ended the hyperinflation within two months. Actions on the budget, and supporting actions on the exchange rate were fundamental. The exchange rate was stabilized vis-a-vis the dollar, which rapidly stabilized prices, but in contrast to the earlier theoretical example about fixing the exchange rate, the exchange rate stabilization took place in the context of deep fiscal reforms. Government expenditures were reduced by a complete moratorium on foreign debt payments, as well as by a cut in public sector pay and a virtual cessation of public investment projects. Government revenues were raised at first mainly through higher public sector prices, and later via a tax reform program, which became possible to implement once prices were stabilized.

While the budget crises are less severe in the other debtor countries, the same pattern is found. The public sectors in each of the major countries experienced a sharp turnaround from positive to negative net resource transfers from abroad between 1980 and 1983. In the cases of Argentina, Brazil, Mexico, and Peru, the governments substituted money financing for part

or all of the lost borrowing. In each of the countries, the cutback in international lending contributed to a fall in real output, which together with rising inflation depressed tax revenues. By 1985, the burden of the external public debt was a very large share of the budget. This is illustrated in Table 4 for Argentina, Bolivia, and Mexico, by measuring the external debt and the interest charges on all public debt, relative to general government revenues. Interest expenses alone account for about a third of government revenues. (Note, however, that Bolivia has suspended interest payments to the commercial banks and has rescheduled 100 percent of interest payments due in 1986 to bilateral official creditors.) In Argentina and Bolivia, the high inflation wiped out the real value of most of the internal debt, while in Mexico, the real debt grew rapidly, because domestic bond financing supported much of government spending during 1983-1986, before the emergence of triple-digit inflation. Through bond financing, Mexico postponed its high inflation until recently, but now will pay with much higher inflation rates than if it had closed its budget deficits earlier.

Debt-strapped governments have several fiscal choices concerning the size of the deficit and the methods of financing it. Different ways of closing budget deficits have different macroeconomic consequences, not to mention distributional consequences. Normally, it is supposed that a cut in the budget deficit will have a contractionary effect on the real economy in the short run, and this is probably correct for a shift from debt financing to higher taxes or reduced spending. However, when the shift is from inflationary finance to taxes, the contractionary effect is likely to be much smaller. A rise in taxes that allows a stabilization of prices is really a

shift from one tax, the inflation tax, to another. There is little reason why such a shift in taxes should be contractionary. For this reason, "shock" anti-inflation programs, involving simultaneous tax increases and sharp cuts in inflation, need not have a major contractionary effect on the economy. In the case the fiscal cutback involves a suspension of foreign debt servicing, as in Bolivia and Peru, then the program might be expansionary on balance, since the drop in the inflation tax is matched by a decline in transfers to foreigners, rather than a rise in domestic taxes. The private sector on balance ends up paying less "taxes" (inclusive of the inflation tax).

The postwar examples of East Asia and the histories of the Central European hyperinflations teach the limits of fiscal reform. Foreign financing has almost always been needed to help a government end a high inflation, as we already noted in the cases of Japan, Korea, and Taiwan. Foreign largess has similarly played a role in the Israeli stabilization of 1986, with Israel's receipt of \$4.5 billion of U.S. aid, or about 20 percent of GNP. Some stabilizations have started without foreign support (e.g. Germany in 1923), but have been sustained later through foreign finance (e.g. the Dawes Loan of 1924). Since the Latin American countries do not receive much foreign aid, and are unable to float new stabilization loans, they may be unable to stabilize without debt relief from the commercial banks and from the bilateral creditors. The relief would be most effective if it were sanctioned internationally, as in the case of Indonesia at the end of the 1960s. The IMF and the World Bank could play a major role in designing international norms for such relief. But if internationally sanctioned relief is not forthcoming, then debtor countries may pursue the path of a unilateral debt moratorium, as have Bolivia and Peru with some success during the past year.

So far, the international institutions have given scant attention to this case for relief. Indeed, even in the midst of Bolivia's 50,000 percent hyperinflation, the IMF mission pressed hard on the government for a resumption of interest servicing on Bolivia's commercial bank debts. This was despite the fact that normal interest servicing of the bank debts on market terms would have required about half of central government expenditures at the time, and a larger share of central government revenues. The Bolivian Government refused to come to terms with the commercial banks on normal rescheduling terms, and the IMF threatened to withhold approval of the standby program. Eventually the Fund relented on this threat. Incredibly, after several months of price stability in Bolivia in 1986, and after a 50 percent terms of trade decline (tin and natural gas) in late 1985 and early 1986, the IMF continued to press for a large devaluation. The Fund complained that the Bolivian Government could not otherwise close the foreign exchange gap as computed by the IMF, a gap which included significant interest payments to the commercial banks. In effect, the IMF was proposing to the Bolivian government that it use renewed inflation as a financing instrument for renewed debt servicing. The Government of Bolivia declined the offer.

(c) "Shock" Programs for Ending High Inflations

Shock stabilization programs are now underway (or are in an intermediate stage of collapse) in Argentina, Bolivia, Brazil, Israel, and Peru. All of these programs hark back to the ends of the European hyperinflations, as well as to the ends of the postwar inflations in Japan, Korea, and Taiwan, in their attempt to achieve a sudden end to high inflations (see Sargent, 1982, for

case studies of the ends of the Central European hyperinflations). Of the group, only Bolivia was suffering from a true hyperinflationary rise in prices, with inflation equalling 20,000 percent in the twelve months (August 1985 over August 1984) preceding stabilization. In the other cases, the pre-shock rise in prices was much less: Argentina, 3,000 percent; Brazil, 300 percent; Israel, 700 percent; Peru, 200 percent.

All of the programs share the feature of pegging the exchange rate to the U.S. dollar as a device for bringing the inflation down suddenly to the world dollar inflation rate. The central idea is to make this new pegged rate viable by bringing the government budget deficit under control in a decisive manner. In Argentina, Brazil, Israel, and Peru, the exchange rate pegging and the accompanying fiscal actions are complemented with a wage and price freeze, that aims to make sure that domestic wages and prices stop rising at the same time that the exchange rate is pegged. Finally, in Argentina, Brazil, and Peru, a new currency was introduced at the time of pegging, which served in Argentina at least as a brilliant technical device to overcome the legacy of pre-existing financial contracts.

Pegging the exchange rate to end a high inflation is familiar from the ends of most hyperinflations in history. A controversial aspect of the current programs, with the exception of Bolivia, is the use of wage and price controls in conjunction with the exchange rate peg. The theoretical argument for such ancillary policies is clear. The key point is a distinction between hyperinflations (as in Bolivia), and merely high inflations. During a true hyperinflation, domestic nominal contracts virtually disappear. Goods prices are generally quoted in a foreign currency. The domestic prices of

commodities are calculated according to the world price, converted at the spot exchange rate prevailing at the time of a transaction. Thus, in a true hyperinflation, stabilizing the exchange rate is sufficient to stabilize the domestic currency price of goods. At a lower inflation, however, nominal contracts and lagged indexing schemes still exist. Pegging the exchange rate is not sufficient to the end the inflation instantaneously, because of the overhang of nominal wage and price contracts written before the stabilization is put into effect. The result of immediate pegging can therefore be a significant and unwarranted real exchange rate appreciation, as in Chile during 1979-81. The wage and price controls are used to override the pre-existing contracts, and to make wages and prices conform to the newly pegged exchange rate.

In the case of Bolivia, which reached hyperinflationary rates of price change, pegging the exchange rate was sufficient to stabilize domestic prices, without the use of wage and price controls (indeed, existing controls were dismantled at the start of the stabilization program). As documented in Sachs (1987), domestic prices stopped rising and began falling within 9 days of the new exchange rate peg. In the cases of the other high inflations, the starting conditions were much less severe. Pegging the exchange rate was probably not sufficient to stabilize the exchange rate, and was not perceived to be so by the national authorities. Thus, controls were instituted along with the pegged rate. In all of these countries, the initial effect of the combination of a pegged rate and a wage-price freeze was sufficient to reduce the measured inflation rate almost to zero. In Brazil and Peru, however, the controls provoked almost immediate shortages of some commodities, with attendant black market increases in prices.

As I have illustrated earlier, a pegged exchange rate without accompanying fiscal actions will have some short-run viability, even if it is widely believed that the peg will break down in the near future. The key to maintaining the new peg for the longer term is, of course, a degree of fiscal adjustment which obviates the need for the inflation tax. While comparable up-to-date data on fiscal positions are not publicly available for the five countries with shock programs, it appears that varying degrees of fiscal correction have been taken. In Bolivia and Israel, the fiscal actions were deep, and probably large enough to maintain low inflation for a sustained period of time (unless political pressures force a reversal of the fiscal austerity). In Argentina and Peru, the fiscal actions were more moderate, and probably only enough to reduce the inflation rates to high double digits (or low triple digits) for the near future. In Brazil, the fiscal actions were probably perverse, in the sense of widening the deficit at the outset of the program. Not only were real public sector salaries raised, but the government deficit widened as well because of increased subsidies that were used to help sustain the price freeze. The absence of corrective fiscal actions in Brazil has been manifest to close observers of the Cruzado Plan, and this is why many expressed widespread skepticism of its success already in the summer of 1986, despite the near euphoria of the Brazilian government and the international commercial banks.

It is noteworthy that a major part of the fiscal action in Bolivia, and perhaps the major fiscal action in Peru, was a partial suspension of interest payments on external public-sector debts. Quantitatively, this suspension of payments has been a crucial factor in the success of the Bolivian program.

Perhaps the greatest threat to the program is that the government will eventually accede to the pressures of the international community to "be responsible", and resume using the inflation tax to finance debt servicing to the international creditors. In Israel, the need for such an action was largely obviated by the extensive foreign aid received by the U.S., as well as by the large fiscal actions in other areas undertaken by the Israeli authorities. In Argentina and Brazil, where domestic fiscal actions of the necessary magnitude have not been forthcoming, an eventual turn to a debt servicing moratorium cannot be ruled out.

A crucial aspect of the shock programs is the matter of timing in the integration of all of the pieces of the program. A problematic fact of life is that the exchange rate and price actions will almost necessarily supercede many of the supporting fiscal actions. It is simply impossible to plan and execute a tax reform in the midst of a very high inflation, for example, so that price increases must be halted before new kinds of tax revenues can be raised. In Bolivia, the tax reform package passed the Bolivian Congress only 9 months after the start of the anti-inflation program, and the beginning of implementation took a full year after the start of the program. The budget cycle might similarly require that certain budget cuts be postponed until after the beginning of the shock program. The lag between the exchange rate (and wage-price) actions and the supporting fiscal actions need not cripple a program however as long as expectations are stabilizing during the interim period, since households give the government some fiscal breathing room by rebuilding real money balances (and thereby increasing central bank reserves) at the beginning of the stabilization program. The real risk is that the

authorities come to believe during the interim that the program runs on its own, without the need for the supporting and politically painful fiscal actions.

The major unresolved analytical issue in the design of "shock" anti-inflation programs is the question of interest rates and monetary policy in the wake of stabilization. Each of the countries has experienced very high ex post real rates of interest in the wake of stabilization. Dornbusch (1986) has attributed the high real rates to the failure of the monetary authorities to allow the money supply to rise adequately in response to falling inflationary expectations. Sachs (1987) attributes the high rates in Bolivia to a continued lack of confidence in the program for many months after its inception. Blejer and Liviatan (1986) seem to support this latter view for the cases of Argentina and Israel. To the extent that the high rates reflect tight monetary conditions, there may be a case for an initial expansion of domestic credit at the beginning of the program in order to supply the increased money demand. To the extent that the high rates reflect a continuing lack of confidence, however, such a domestic credit expansion will just cause a loss of central bank reserves, and would further undermine confidence.

(d) Income Distributional Aspects of stabilization

There are always two fundamental ways to reduce a budget deficit: higher taxes or lower expenditures. Their distributional consequences are of course very different. There is an overwhelming presumption these days at both the IMF and World Bank that lower expenditures are the appropriate method of

adjustment. Blejer and Liviatan (1986, p. 28) are typical of this view in claiming blithely that "the basic task of reducing the public sector is, therefore, the main test the [anti-inflation] programs [of Israel and Argentina] must face in the longer term." Ironically, they discuss favorably the 1967 Argentine stabilization program, without ever noting that the program collapsed in an explosion of labor unrest (the so-called Cordobazo) two years after its inception. The problem for Argentina, and the other countries of the region, has long been to find a set of stabilization policies that are both technically sound but also socially sustainable. Programs based mainly on spending cuts will probably not fit these requirements in many Latin American countries.

Here once again we are reminded of a crucial, but unappreciated, lesson of East Asia. The policy freedom of the East Asian economies to undertake adjustments in the name of efficiency exists by virtue of the relatively equal income distributions in these countries. In the absence of such income equality, policies oriented mainly towards efficiency may exacerbate an already very unequal income distribution, and may be enforceable only with heavy repression, as in Chile. Consider, for example, the policy prescription of a deep real exchange rate depreciation for the purpose of export promotion. In Latin American economies characterized by highly unequal land and natural resource holdings, such a policy might have very adverse distributional consequences, and may indeed be politically destabilizing. The same policy in the more egalitarian setting of East Asia might be both economically and politically efficacious.

The distributions of income in the Latin American countries are among the most unequal in the world, and most observers suspect that income inequalities

Table 4: Budgetary Burden of Public Debt, Selected Indicators for Argentina, Bolivia, Mexico (as proportions of total government revenues)

	Net External Debt (as Proportion of Total Government Revenues)	Interest Payments on Public Debt, (Proportion of Total Revenues)		
		External	Internal	Total
Argentina (1985)	255	27.3	3.1	30.4
Bolivia (1985)	1200	28 <sup>a</sup>	--	28
Mexico (1986)	184	15.5	17.8 <sup>b</sup>	33.3

<sup>a</sup>Commercial bank debt only, which is approximately one fourth of total external debt.

<sup>b</sup>Inflation corrected, thus representing the real interest burden.

Table 5: Shares of Public Expenditures on  
Education and Health (percent)

Country	Share of Expenditures on Education and Health	
	1979	1983
Argentina	10.0	9.0
Bolivia	39.2	30.0
Brazil	13.8	11.0
Chile	21.2	19.8
Mexico	22.6	12.2
Peru	19.9	24.7 <sup>a</sup>
Uruguay	14.1	9.9
Venezuela	24.8	27.7

<sup>a</sup>1982.

Source:

ECLAC (1986), Table 19, p. 111.

have widened considerably in the 1980s (see, for example, ECLAC, 1986). Upper-income individuals have systematically escaped the brunt of the crisis through capital flight, government takeovers of private external debts on favorable terms, and in some cases, declines in tax burdens, while lower income individuals have suffered through reduced public sector expenditures, especially in education and health, and sharply lower real wages in the public and private sectors. Table 5 shows that in the midst of cuts in overall public sector expenditure, the cuts in education and health expenditure have been even sharper than average. (Unfortunately, the data are available only through 1983; the situation since has probably become much worse.) Peru provides a remarkable and tragic example of this situation. Between 1981 and 1984, cutbacks in expenditures forced a reduction in Food Aid to mothers of 54 percent; to nursing mothers and pre-schoolers of 37 percent; and to school age children of 17 percent (ECLAC, 1986, p.53).

The World Bank and IMF should realize that increases in taxes, especially on upper incomes and property, rather than cuts in public expenditures, can often bring about more equitable adjustments to the current crisis and perhaps increase the chances of success for stabilization programs. We have seen that when compared with East Asia, the Latin American countries are not overtaxed, and indeed if anything are undertaxed. There is simply no evidence for the proposition that spending cuts, rather than tax increases, are to be vastly preferred on efficiency grounds as the method of adjustment. Indeed in the absence of much more vigorous policies to meliorate the extremes in income inequality in Latin America, the likelihood of sustained and durable economic growth in a context of social stability may be dim indeed.

#### IV. Conclusions

This paper takes issue with the urgent priority that the IMF and the World Bank appear to be giving to market liberalization in the debtor countries. I suggest that the more pressing problem in these countries is the prolonged fiscal crisis, which has caused a sharp retrenchment of public sector investment and social welfare expenditures and has led to high inflations in several countries. To a large extent the international debt crisis is a reflection of this fiscal crisis, rather than a reflection of the transfer problem from debtor nations to creditor nations. The experience of the successful countries in East Asia is invoked to suggest three major lessons. First, stabilization has almost always preceded any dramatic shift to liberalization. Second, export orientation has been pursued without an across-the-board import liberalization and can be fostered by an activist government. Third, the relatively equal income distributions in East Asia have freed the hand of governments to focus on issues of efficiency. For this reason in addition to social equity itself, adjustment programs in Latin America may well improve their chances of success if they aim in part to improve the extremely unequal income distributions in these economies.

The paper also investigates the use of shock treatments to end high inflations. Such programs, as now underway with significant success in Bolivia and Israel, and partial success in Argentina and Peru, combine a pegged exchange rate with fiscal discipline to achieve a rapid disinflation. In the context of hyperinflation, as in Bolivia, pegging the exchange rate is sufficient to end the hyperinflation. For high inflations, but not hyperinflations, the presence of inertial inflation may provide a reason for

supplementing the exchange rate pegging with incomes policies and price freezes. A troubling part of these programs is that almost inevitably some of the fiscal retrenchment will have to proceed after the initial exchange rate pegging, since major tax increases are likely to be achievable only after the high inflation has been brought under control. This means that the initial step of pegging the exchange rate is fraught with the danger that the fiscal actions will not be forthcoming. This danger is increased by the fact that for a short period of time a program based solely on exchange rate pegging will appear to be successful, with reserves increasing and inflation decelerating.

Given the centrality of the fiscal crisis in Latin America, and the political and economic limits of rapid fiscal reform, a greater measure of debt relief may have a role to play in the stabilization process. Substantial foreign assistance has been a major factor in the ends of most high inflations, including the hyperinflations in Central Europe, the high postwar inflations in Japan, Korea, and Taiwan, the post-Sukarno hyperinflation in Indonesia, and the end of the high Israeli inflation in 1986. Similarly, a suspension of debt service payments was instrumental in ending the recent hyperinflation in Bolivia. Such actions may substantially improve the prospects for successful stabilization in some of the other debtor countries. The outcomes in such a case would be greatly enhanced if the relief is implemented in a cooperative arrangement, mediated by the World Bank and International Monetary Fund, rather than as a unilateral step by the debtor governments.

Footnotes

1. See Floyd, R. H., et al., Public Enterprise in Mixed Economies, Washington, D.C.: International Monetary Fund, 1984, Table 1.
2. The very high inflation rates in the three economies gives an indication of the extent of the initial macroeconomic imbalances. Annual inflation rates reached 334 percent in Japan in 1947, 500 percent in Korea in 1951, and 3,400 percent in Taiwan in 1950.

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