Volume Title: Anatomy and Consequences of Exchange Control Regimes

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PART I
Introduction

Chapter 1

Scope of the Study

This volume and the companion volume by Anne Krueger are the outcome of a Project that was addressed to three principal sets of issues in the area of foreign trade and economic development of developing countries:

1. Given the widespread postwar reliance in LDCs (less developed countries) on exchange controls to manage the balance of payments and cross-sectional differences and changes over time in the nature and degree of such reliance, it seemed necessary to systematize the "anatomy" of exchange control regimes prior to examining their economic consequences in much greater depth than was the current practice. Thus, for example, the consequences of QRs (quantitative restrictions), which were levied so as to confer automatic protection to domestic production, would be clearly different, indeed more adverse, than when QRs were adjusted so as to confer no more than a certain degree of protection. The characterization of the anatomy of exchange control regimes, including the interaction between quantitative and price measures, was thus an important object of inquiry in the Project.

2. The relationship between different types of exchange control regimes and economic efficiency was then the next area of inquiry in the Project. In this matter, we needed to distinguish two broad sets of questions:

a. Were different types of exchange control regimes likely to have systematic differences in regard to their consequences for economic efficiency?

b. Would the conclusions in this regard differ according to whether the consequences were investigated in a static sense (i.e., allocation of given resources) or in a dynamic fashion (i.e., saving, investment, innovation, entrepreneurship, etc.)?

3. Finally, it was clear from even a casual examination of the developing

countries' experience that their exchange control regimes changed from one type to another, with some countries transiting gradually to more liberalized regimes (e.g., South Korea and Israel) and others sticking to roughly the same restrictive patterns for much longer periods (e.g., India). Could we then learn something systematic about the forces that governed the likelihood of success in moving from a restrictive exchange control regime to a liberalized regime?

To investigate these questions, the Project was addressed to an intensive, functional analysis of ten developing countries with diversity of growth, exchange control regimes, size (in terms of population, area, and income), geographical location, and historical experience.[1]

The present volume (as also the companion Krueger volume) draws extensively on the results of these studies[2] to systematize the answers to the questions posed above. At the same time, extensive reference is made, where appropriate, to evidence on specific issues from other empirical studies in the currently available literature.

The present volume focuses essentially on the first two sets of questions distinguished above, the third set of issues (essentially the analysis of the conditions that could contribute to a successful transition to less restrictive regimes) being the principal subject of the Krueger volume. The plan of the volume is to divide its substantive analysis into two parts. Part II deals with the first set of issues delineated earlier, namely, the anatomy of exchange control; Part III deals with the second set of issues, namely, the consequences of exchange control regimes. To avoid undue repetition, the present volume does not review the major economic characteristics of the countries in the Project: these are reviewed in Krueger's companion volume (Chapter 2).

In the analysis of the anatomy of exchange control regimes that follows in Part II, we begin in Chapter 2 with a taxonomic examination of the alternative, direct control dimensions of exchange control regimes. The focus in this chapter is on distinguishing among alternative control methods with which such regimes function: for example, regulating imports by source, by end use, by claimants (e.g., large-scale versus small-scale, foreign versus domestic applicants). Extensive use is made of the country studies in the Project to illustrate specific types of such regulation. There is no attempt made, however, to indicate the precise combination or cluster of such regulatory methods, as distinguished and delineated, that obtained at any period in any of the countries studied in the Project; this task is left until Chapter 3.[3] Chapter 2 concludes with a discussion of the uses of the price mechanism as distinct from controls. Exchange control regimes are rarely "pure," and invariably use is made of price instruments such as tariffs, advance deposits on imports, export subsidies and taxes, and a host of similar instruments. When the phrase "exchange control regime" is used in this volume, it is intended to apply not merely to the control methods and instruments (such as those discussed in depth in

Chapter 2) but also to the associated set of price instruments in use in that regime.[4]

Chapter 3 then shifts attention to a more integrated and functional view of the different control and price instruments, seeking to define specific clusters, types, or combinations of instruments as revealed by the country analyses, distinguishing among these in a manner designed to facilitate analysis of the exchange control regimes. This leads to a delineation of five *Phases* in exchange control regimes, the evolution of the exchange control regimes through these Phases then being also set out in the chapter.[5] In essence, the Phases isolate and denote alternative mixes of resort to price *versus* control measures, the complexity of the control measures, and the degree of discrimination against exports implied by differential, effective exchange rates on imports and exports. In addition to the Phase delineation, Chapter 3 develops explicitly certain general propositions regarding the differential impact of different exchange control regimes and of identical exchange control regimes with different domestic policies.

The delineation of Phases, and the sorting out of individual country experiences with exchange control during the postwar period into these Phases, then permits a systematic analysis of the economic consequences, static and dynamic, of exchange control regimes in Part III. Chapter 4 contains an analysis of the illegal economic transactions as they interact with exchange control regimes. Frustrations of the objectives, alteration of the restrictiveness, and changed economic costs of exchange control regimes that follow from evasions and the growth of illicit phenomena in such regimes need to be noted prior to the more traditional analysis of the economic consequences of these regimes.

Chapter 5 examines the static, allocative efficiency impact of exchange control regimes, extending the analysis also to issues such as excess capacity, competitiveness and cost-consciousness, choice of techniques, and so on. While the focus is mainly on the consequences of tightly restrictive regimes—Phase II type regimes in our Phase delineation—an attempt is also made to see if any evidence exists on the issue whether a shift to more liberalized regime—Phases IV and V—is associated with transition to greater efficiency.[6]

Chapter 6 extends the analysis to the interaction between exchange control regimes and saving, both domestic and foreign. Chapter 7 examines the question whether (1) restrictive regimes, via a differentially low effective exchange rate on exports and other causes, adversely affect *export* performance and whether (2) such an adverse impact on export performance also implies an adverse impact on *economic* performance. Again, the analysis is extended to consider explicitly the question whether a successful shift to a more liberalized regime has been associated with improved export performance and thence with enhanced economic performance. Other, miscellaneous arguments are also reviewed.

Chapter 8 then draws together the major conclusions that emerge from the analysis in the present volume, focusing in a stylized fashion on the lessons to be drawn regarding the optimal foreign trade regime to be adopted by developing countries.

Finally, the reader should be forewarned that the present volume does not generally arrive at strong, prescriptive conclusions in regard to many of the detailed questions that are examined. For example, in Chapter 6, the relationship between exchange control regimes and saving is examined at considerable length, both analytically and in terms of the empirical evidence in the country studies in the Project and elsewhere. But the conclusion is, broadly speaking, that there are several possible linkages here, as also conflicting evidence in some cases. It is thus not possible to argue propositions such as: "restrictive exchange control regimes may be inefficient statically but they lead to more rapid capital formation by generating more saving" or that, conversely, "liberalized exchange control regimes will promote more rapid growth by augmenting savings." While such *general* propositions are not sustainable, *individual* country experiences may, and often do, indicate the dominance of only a subset of the possible linkages and effects, thus sustaining stronger propositions in regard to their own experience. This also suggests that, to a large extent, the reader should approach the present volume as a manual.[7] Anyone who wishes to examine a specific country's foreign trade regime and its consequences can read the present volume and readily have access to possible hypotheses and techniques of analysis (as also evidence, mainly from the Project) that may be used for the reader's own analysis. Many chapters in the present volume are therefore deliberately ambitious in their taxonomy; this should make the manual aspect of the volume's analysis more valuable to the reader.

Nonetheless, both the present volume and the companion volume of Anne Krueger do suggest that, in regard to the famous issue raised by Ragnar Nurkse and others in the early 1950s about the appropriate foreign trade strategy to be pursued by the developing countries, the results of the present Project strongly indicate that the export-promoting strategy has turned out to be superior. This "prescriptive" conclusion, discussed at some length in Chapter 8 here, is important. It warrants a careful scrutiny by the reader of the meticulous and systematic synthesis by Anne Krueger of the findings of the Project on the problems attending on the attempts at liberalizing the foreign trade regime and thus on the lessons to be borne in mind in successfully transiting from a restrictive, import-substituting strategy to a liberalized, export-promoting strategy.[8]

NOTES

1. The studies were conducted with reference to a common plan of research worked out in the form of an analytical framework authored by Bhagwati and Krueger and finalized in light of discussions with the country authors.

2. The ten countries for which studies were undertaken are: (1) *Turkey*, by Anne Krueger, (2) *Ghana*, by J. Clark Leith, (3) *Israel*, by Michael Michaely, (4) *Egypt*, by Bent Hansen and Karim Nashashibi, (5) *The Philippines*, by Robert Baldwin, (6) *India*, by Jagdish Bhagwati and T.N. Srinivasan, (7) *South Korea*, by Charles Frank, Jr., Kwang Suk Kim, and Larry Westphal, (8) *Chile*, by Jere Behrman, (9) *Colombia*, by Carlos Díaz-Alejandro, and (10) *Brazil*, by Albert Fishlow. A study of Pakistan, by Nurul Islam, was commissioned and exists in first draft; it was interrupted by the events that resulted in the creation of Bangladesh. Reference to the Pakistan draft is however repeatedly made in the present volume. The present volume also has had to be written despite the failure to complete the Brazil volume, so that references to that work are to an early and incomplete draft thereof.

3. Chapter 2 is thus written to aid the economist or civil servant who intends to examine the exchange control system in a specific country in an economically meaningful way.

4. On the other hand, the phrase "foreign trade regime" is used generally synonymously with the phrase "exchange control regime" but obviously would also apply to the case where exchange controls have disappeared and only price instruments are deployed.

5. A summary description of the five Phases, as set out initially in plans for the country studies, will be found in the appendix at the end of this book.

6. See also the Krueger synthesis for a more direct focus on the effects of liberalized regimes on economic efficiency.

7. The reference here is to the celebrated *OECD Manual* of I.M.D. Little and James Mirrlees (Paris: OECD Development Center, 1970), which relates to social cost-benefit analysis of projects. While, however, the *OECD Manual* was addressed primarily to civil servants and planners, the present volume is written for professional economists, whether academic or bureaucrats.

8. In fact, the present project differs primarily from the earlier OECD project on trade and industrialization, directed by Messrs. Little, Scitovsky, and Scott, in analyzing in far greater depth the growth effects as well as the conditions determining a successful transition from restrictive to liberalized regimes. Cf. I.M.D. Little, T. Scitovsky, and M. Scott, *Trade and Industry in Some Developing Countries*, OECD Development Center, Oxford University Press, 1970.