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12 Structural Adjustment Policies in Highly Indebted Countries

Sebastian Edwards

12.1 Introduction

Five years after the eruption of the debt crisis most countries of the developing world are still struggling to get back on their feet. Although the collapse of the world financial system predicted by some overly pessimistic observers has not materialized, the debt crisis is far from over. In fact, when traditional creditworthiness indicators, such as debt-exports or debt-service ratios are analyzed, the highly indebted countries are now (late 1987) in an even weaker position than in 1982 (see Edwards 1987a). It has now become apparent that a long-term resolution of the debt problems will be a painful and protracted process, that will still require major additional adjustment efforts by the indebted countries, as well as extensive negotiations between debtor governments, creditor governments, the multilateral institutions, and the banks.

The adjustment approaches followed until now by most of the highly indebted countries can best be described as *emergency stabilization programs* geared towards generating very large trade balance surpluses in very short periods of time. Given the sudden halt in external financing after 1982, these countries had little choice but to use every possible tool at their disposal to achieve the needed turnaround in their current

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accounts. As a consequence the adjustment process has been quite costly, generating drastic declines in real income and important increases in unemployment. In fact, in a number of Latin American countries in 1986 real per capita GDP was below its 1970 level (Edwards 1987a)! A long-run solution to the debt crisis problem would entail: (1) the regaining of creditworthiness by these countries, and thus the resumption of voluntary lending by the international financial community; and (2) the resumption of sustained growth.

The purpose of this chapter is to analyze a number of issues related to structural adjustment in the highly indebted developing countries. The chapter begins with a review of the main features of the adjustment process followed during 1982–87; it is noted that in almost every case this has been a period of recessionary adjustment based on investment and import cuts. Then, the potential role of trade liberalization reforms in the resumption of sustained growth in these countries is examined. The analysis deals with (1) the relation between outward orientation, export promotion, and growth; (2) appropriate sequencing of trade liberalization and stabilization programs; (3) tariff reform and unemployment; (4) credibility and structural reforms; and (5) the role of devaluations in structural reform programs.

12.2 The Nature of the Adjustment, 1982–87

12.2.1 Origins of the Crisis

During the second half of the 1970s and the early 1980s most of the developing nations embarked on a foreign borrowing binge. Between 1975 and 1982 the developing world's long-term foreign debt more than tripled, growing from \$162.5 billion to \$551.2 billion. Naturally, this huge increase in indebtedness was made possible by the liberal way in which, after the first oil shock in 1973, the international financial community and in particular the banks, provided funds to these countries. There is no doubt that the pace at which the developing countries were accumulating debt in the late 1970s and early 1980s—at a rate exceeding 20 percent per year—was not sustainable in the medium to longer run; some type of adjustment was bound to take place. The world, however, was shocked by the severity of the crisis; instead of there being an orderly and slow reduction of the flow of borrowing, a major crisis that brought capital flows to a virtual halt took place.¹

The behavior of the world economy during the early 1980s, and in particular the increase of interest rates, the decline in commodity prices, and the sluggish growth of the industrial countries, played an important role in determining the magnitude and timing of the crisis. Also, in many cases macroeconomic mismanagement in the borrowing coun-

tries contributed greatly to the crisis. In particular, lax fiscal policies and inadequate exchange rate policies that resulted in acute overvaluations greatly weakened the external sector in many of the highly indebted countries. Perhaps one of the most devastating effects of the generalized tendency towards real exchange rate overvaluation is that it fueled massive capital flight out of the developing world. In country after country, as it became increasingly apparent that the overvaluation was unsustainable in the longer run, the public began to speculate heavily against the central bank by acquiring foreign exchange and moving it abroad. In fact, in a recent empirical study Cuddington (1986) has found that there is a significant relation between overvaluation and capital flight.

12.2.2 The Adjustment

In August of 1982, immediately following Mexico's announcement that it was facing serious financial difficulties, the international financial community greatly reduced the amount of funds intermediated to the developing world. For the developing countries as a whole external financing was reduced by almost 40 percent between 1981 and 1983. Moreover, the major debtors were forced to fully close a current account deficit that by 1982 had exceeded \$50 billion in less than 3 years. By 1985 the aggregate current account had reached virtual equilibrium (−\$0.1 billion) (see table 12.1). These very rapid adjustments were achieved entirely by reductions in imports and in investment. Moreover, for the IMF's category of "15 highly indebted countries," the

Table 12.1 Selected Indicators for Major Debtors, 1979–88^a

Year	Trade Balance (U.S. \$ billions)	Current Account (U.S. \$ billions)	Rate of Change of Per Capita Real GDP	Ratio of Gross Capital Formation to GDP	Central Government Deficit as Percentage of GDP	Average % Change Consumer Price Index
1979	−1.9	−24.6	3.6	24.9	0.8	40.8
1980	4.4	29.5	2.6	24.7	0.8	47.4
1981	−7.5	−50.3	−1.6	24.5	3.7	53.2
1982	3.2	−50.6	−2.7	22.3	5.4	57.7
1983	28.3	−15.2	−5.5	18.2	5.2	90.8
1984	43.2	−0.6	−0.1	17.4	3.1	116.4
1985	40.8	−0.1	0.9	16.5	2.7	126.9
1986	22.9	−11.0	1.4	16.8	4.5	76.2
1987	18.8	−14.0	1.2	17.6	3.6	86.3
1988	22.3	−10.5	2.4	n.a.	n.a.	87.2

^aThese data refer to the IMF's highly indebted countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia. These data have been obtained from IMF, *World Economic Outlook*, 1987. n.a. = not available.

dollar value of exports was lower in 1986 than in 1980, with the magnitude of this decline exceeding 15 percent. This drop was basically the result of a decline in the prices of these countries' exports of almost 25 percent between 1980 and 1986.

For the major debtors as a group, investment declined from an average of 26 percent of GDP in 1973–77 to an average of 17.2 percent in 1983–86. In most cases public investment and investment in the construction sector were the components most severely curtailed. Naturally, this decline in investment has serious consequences for the prospects of renewed growth.

Most countries faced the need to reverse the direction of the net transfers by resorting to a combination of expenditure-reducing and expenditure-switching policies, including devaluation, the imposition of capital controls, and import quotas. The adjustment required both a significant increase in real interest rates as well as major relative price changes or real devaluations. In most cases the selection of policy packages was based on the perceived "effectiveness" of these policies in the short run, rather than on efficiency, income distribution, or welfare considerations. As a result of the efforts made to implement rapidly effective policies a number of trade-offs between different objectives, including improvement in the current account and inflation, emerged during the process (Edwards 1987a).

In spite of the relatively successful efforts to reduce public expenditures, fiscal deficits increased in relation to the precrisis period in the major debtors as a group. In many of these countries total tax revenues were negatively affected by the recessions that followed the crisis. As a consequence of this decline, the reliance on inflationary financing increased substantially (see table 12.1).

The restraint of wage increases was, in most countries, another major component of the expenditure-reducing package. In most countries the adjustment also relied on higher real interest rates, which helped keep expenditure, and in particular investment, in check.

After August 1982 most countries also relied on expenditure-switching policies; these consisted in most cases of a combination of nominal devaluations and, at least initially, of a major escalation in the degree of trade restrictions. The extent of the devaluations varied from country to country, being particularly severe in Latin America. In an effort to assure that the effects of the nominal devaluations on the real exchange rate did not erode via inflation, most countries adopted some kind of active exchange rate management where the exchange rate continued to be adjusted after the initial parity change. In fact, as of July 1986, out of the 15 major debtors 12 had some sort of crawling peg regime consisting of periodical adjustments of the nominal rate somewhat related to the differential between internal and external inflation (Edwards 1987a).

Another important feature of the exchange rate policy followed by many countries was the adoption of multiple exchange rates. Immediately following the crisis in many (but not all) of the major debtors the devaluation policies were supplemented by the imposition of trade restrictions. In some countries the extent of trade restrictions has recently been somewhat relaxed, while others have announced some easing up in the near future.

In spite of the significant efforts to adjust made by most of these countries, and of the costs incurred in the process, the magnitude of their trade surpluses has systematically fallen short of their interest payments. In Latin America, for example, in 1986 the interest bill amounted to 5.3 percent of GDP while the trade surplus reached 2.3 percent of GDP. In most countries up to this point this financing gap has been closed, usually after long and protracted negotiations, by packages of funds provided by the banks and the multilateral institutions.

In sum, in spite of the involvement of the IMF in this first phase of the adjustment process, the actual policy packages implemented by most of the debt-troubled countries differed markedly from what we can describe as an orthodox IMF-type stabilization program. Generally speaking, the current adjustment process has been inflationary with high and persistent fiscal deficits, and with increasingly distorted external sectors, with a profusion of quantitative restrictions (QRs) and multiple exchange rates.

12.3 Trade Liberalization and Adjustment with Growth

The emergency packages implemented until now have succeeded in averting what some considered to be an almost sure collapse of the world financial system. This has been achieved, however, at a significant cost for the major debtors in terms of decline in employment, income, and standard of living. The key question now is how to move from the current situation towards what we can call phase 2 of the adjustment process, a phase characterized by adjustment and growth. A number of authors—and indeed the supporters of the Baker plan, as well as the IMF—believe that a rapid trade liberalization, coupled with devaluation, privatization, and financial reform, is the most reasonable strategy for achieving these objectives. For example, Balassa et al. (1986, 88) have recommended that, among other things, the developing nations should eliminate all QRs and reduce, during a period of five years, imports tariffs to a uniform 15 to 20 percent; these tariff reforms should be coupled with significant devaluations, in order not to “deprotect” the tradable goods sectors. In this section we analyze the potential role of trade liberalization in the next phase of the adjustment process in the developing countries. We emphasize the relation between trade liberalization and export promotion, the employment

effects of liberalization, and the relation between liberalization and anti-inflationary policies.

12.3.1 Outward Orientation, Export Promotion, and Trade Liberalization

There is little doubt that a longer-run solution of the debt crisis will require the adoption of policies that rely more heavily than in the past on export growth.² Even ECLA/CEPAL, the former champion of import substitution development, has recommended outward-oriented policies for the troubled Latin American nations (Bianchi et al. 1987).

Outward orientation and export promotion require some kind of trade liberalization and tariff reduction, especially of imported inputs and capital goods. Indeed, the historical evidence clearly shows that those countries that have successfully pursued export promotion (i.e., the East Asian nations), have had a trade regime substantially more liberal than those countries that have followed indiscriminatory import substitution based on protectionism (Edwards 1987a). Although outward orientation requires *some* trade liberalization, there are no reasons, either theoretical or empirical, that suggest that the “optimal” degree of liberalization implies zero, or even very low, tariffs coupled with no government intervention in any sphere of the development process. Indeed the rich historical lessons emanating from the Southern Cone suggest that this kind of extremely liberal reform may backfire at an immensely high cost in terms of output and employment (Edwards and Cox-Edwards 1987). The successful experiences with export-led growth in the East Asian countries also support this view; although in these countries trade regimes have been significantly liberal, government intervention in promoting exports has been important and tariffs have never been anything close to a very low uniform level (Edwards 1987a).³

Although it is not possible to make broad generalizations, the evidence suggests that at the present time in the majority of the highly indebted countries the trade regime is still not sufficiently liberalized. In order to take advantage of more rapid growth based on the external sector, most of these countries will need to go through some type of rationalization and liberalization of their imports sector (Edwards 1987a).

12.3.2 Trade Liberalization with a Government Budget Constraint

An important policy question is whether the trade liberalization component of an outward-oriented strategy should be attempted at the same time as a country is embarked on a severe stabilization and anti-inflationary program. Not surprisingly, the answer depends on the intensity of the trade reform and of the ongoing inflation.

Historically, there has been a close link between *mild* trade liberalizations and stabilization programs.⁴ It is important to notice that most

successful liberalization accompanied by anti-inflationary policies have seldom consisted of the complete elimination of QRs and major tariff reductions of the kind now recommended for the indebted countries. The Chilean episode with liberalization and stabilization between 1975 and 1983 illustrates very vividly one of the most serious trade-offs that emerges when a substantial liberalization reform is undertaken at the same time as a major anti-inflation program. As in most successful stabilization programs, in the last phase of the Chilean stabilization effort, when inflation was reduced from 40 percent to 9 percent per annum, there was a significant real exchange rate appreciation that reduced the degree of competitiveness of the tradables sector at a time when, because of the trade reform among other factors, the *equilibrium* real exchange rates had significantly depreciated. In the Chilean case this real appreciation was partially the result of the active use of exchange rate management to bring down inflation; in mid-1979 the nominal exchange rate was fixed relative to the dollar. As is well known by now this real appreciation played an important role in the disappointing outcome of the Chilean episode; it seriously deprotected the tradables sector, it generated perverse expectations of devaluation and, ultimately, it conspired with the high real interest rates to provoke the worst financial debacle of Chilean history (Corbo de Melo, and Tybout 1986; Edwards and Cox-Edwards, 1987).

A crucial objective of any stabilization program—and, indeed of those undertaken by the major debtors—is to reduce the magnitude of the fiscal deficit. Many times there will be an important trade-off between a trade liberalization that reduces import tariffs and the achievement of this fiscal objective. Surprisingly, the policy and theoretical literatures on trade liberalization policies have most times tended to ignore the fiscal role of tariffs in the developing nations. However, in many of the poorer countries governments use tariff proceeds extensively to finance their expenditure. Table 12.2, for example, contains data on the fiscal importance of taxes on international trade for eight countries. As may be seen, in some cases taxes on trade are as high as one-third of total revenue of the central government.

As long as tariff rates are below the maximum revenue level there will be a trade-off between trade liberalization and the generation of the government surplus required to finance debt servicing. Then, short of reducing government expenditures, what is required is to replace trade restrictions by less distortive taxes that can generate the same (or a higher) amount of revenue. This, of course, means that major reforms of the tax system (i.e., the adoption of VATs) would be required in most countries. Tax reforms are not only politically difficult to have approved, but from an administrative perspective it is many times very difficult to get them going (see Conrad and Gillis 1984). This, of course, imposes some fiscal restrictions on the speed at which tariffs can be reduced.

Table 12.2 Taxes on International Trade as a Percentage of Government Revenue: Selected Developing Countries, 1984

	$\left(\frac{\text{Import Tariffs}}{\text{Total Tax Revenue}} \right)^a$	$\left(\frac{\text{Taxes on Trade}}{\text{Total Revenue}} \right)^a$
Argentina	4.9%	13.3%
Bolivia	25.6	30.0
Chile	13.4	10.8
Indonesia	3.5	3.3
Korea	16.1	14.0
Mexico	3.0	2.7
Peru	10.2	n.a.
Philippines	22.1	23.7

Source: Constructed from raw data from the International Monetary Fund's *Government Finances Statistics Yearbook*.

^aRefers to central government.

n.a. = not available.

Although in most cases the implementation of a major tax reform will take a substantial amount of time, there are some policies conducive both towards improved efficiency and higher revenues in the short run. The most obvious one is the replacement of QRs, (i.e., licenses, prohibitions, and so on) by import tariffs (Edwards 1987a).

In terms of the sequencing of reform, then, an important principle is to make sure that tariff reduction reforms should only be undertaken once the fiscal deficit is under control. In many cases this will mean that the tax system has to be reformed and other sources of revenue have been found. Replacing QRs by tariffs, or devising a QR auctioning system are measures that can be implemented without producing fiscal costs, while at the same time they improve efficiency. Also, by solving the fiscal imbalance first, the probability of a dangerous real exchange rate overvaluation is reduced.

12.3.3 Tariff Reform and Unemployment

The effects of trade reform on employment are a key consideration when evaluating the short-run effects of these policies. This is particularly the case under the current conditions, when the highly indebted countries are already experiencing very high levels of unemployment. Moreover, from a political economy perspective the unemployment effects of any policy are crucial; democratic governments—and even those not so democratic, but in a weakened position—will try not to generate massive unemployment: The costs of employment are recognized in the short run, while the benefits of the structural policies that provoked it usually are reaped in the medium run, when a different government is in office.

Models of adjustment in an open economy discussed in Edwards (1988) suggest that, contrary to the most simplistic textbook view, as long as it takes time to reallocate capital from one sector to the other and (real) wages exhibit some inflexibility, a tariff reduction reform may very well result in large unemployment in the short run. A first-best solution to this problem is to (fully) eliminate the source of real wage rigidity; with complete flexibility wages will, in the short run, go down until all the labor force is absorbed. In the longer run, however, as capital is reallocated, real wages will increase and surpass their prereform level. If for political or other reasons real wages cannot fall sufficiently in the short run, a second-best solution is to proceed slowly with the trade reform; tariffs should be reduced gradually in a preannounced fashion. In theory, in this way capital owners will have time to reallocate capital, avoiding the short-run unemployment effects of the trade reform (see Edwards 1988). A crucial point, however, for this solution to work is that capital allocation in fact responds to the *announcement* of reform; that is, the reform should be *credible*.

The limited existing evidence on the short-run aggregate employment consequences of trade liberalization indicates that in the case of mild reforms there have not been significant aggregate unemployment effects. This, indeed, would seem to be one of the preliminary conclusions of the exhaustive cross-country study undertaken at the World Bank and directed by Papageorgiou, Michaely, and Choksi (1986). In terms of substantial trade reforms the Chilean experience, with its textbook-type policies, is educational. Between 1974 and 1979 Chile underwent one of the most, if not the most, ambitious trade liberalization of the modern time: Quantitative restrictions were fully eliminated, a multiple exchange rate system consisting of up to 15 different exchange rates was unified, and tariffs were slashed to a uniform 10 percent. Edwards (1985), for example, calculated that an upper bound for the unemployment effects of the trade reform was 3.5 percentage points of the labor force, or 129,000 people, with the bulk of this unemployment located in the food, beverages, tobacco, textiles and leather products subsectors (57,000 people). More recently, de la Cuadra and Hachette (1986) have calculated that the trade reform generated a reduction of employment in the manufacturing sector of approximately 50,000 workers. Even though these are not negligible numbers, they clearly indicate that an explanation for the bulk of the Chilean unemployment should be sought elsewhere (Edwards and Cox-Edwards 1987).

In sum, a gradual lowering of tariffs offers a number of attractive features for economies such as the debt-ridden countries. First, this strategy is likely to reduce the short-run unemployment consequences of the trade reform. Second, there will likely be positive effects on savings helping growth prospects.⁵ Third, it will tend to improve the

current account. And finally, a gradual reduction of tariffs will have positive effects on the government budget. On the negative side a gradual trade reform may lack credibility, in which case it may even induce perverse responses (see section 12.3.5).

12.3.4 Structural Adjustment and Devaluation

Nominal devaluations are an important component of most stabilization programs, and they have played a central role in the adjustment efforts following the debt crisis. The purpose of these nominal devaluations is to generate a *real* exchange rate adjustment, that would reverse the real appreciation that usually precedes the balance of payments crisis.

Until quite recently most traditional structural adjustment programs in the developing nations have contemplated discrete nominal devaluations, where the official nominal exchange rate is abruptly adjusted by a fairly large percentage. More recently, however, more and more countries are opting for the adoption of some sort of crawling peg after the devaluation. In a recent study on 18 devaluation episodes in Latin America, Edwards (1987b) found that those countries that had adopted a crawling peg had been significantly more successful in sustaining a real depreciation than the discrete devaluers. This study indicates that among the Latin American crawlers in Bolivia (1982), Peru (1975), and Mexico (1982) the higher real exchange rate was sustained at the cost of substantial permanent increase in rate of inflation.

In spite of the prominent role of devaluations in conventional adjustment programs, very little work has investigated empirically the effects of devaluations on the real level of economic activity or on income distribution. A study by Edwards (1986) suggests that in the short run devaluation has led to a slight fall in output in the developing countries. A 10 percent depreciation leads to a one-time loss of almost 1 percent of GNP. In the second year, the economy returns to trend. To the extent that more rapid trade liberalizations require larger devaluations, these results provide new arguments in favor of gradual reforms.

12.3.5 Credibility, Sustainability, and Reversibility of Trade Reforms

Credibility is a fundamental ingredient of successful structural reforms. If the public attaches a nontrivial probability to policy reversal, it will try to anticipate this event, generally introducing strong destabilizing forces into the structural adjustment process. Latin America's history is replete with frustrated economic reforms that have failed because of the lack of credibility. (See Rodriguez 1983 for an analysis of the Argentine experience under Martinez de Hoz.)

The inability to establish consistency between fiscal and exchange rate policies has many times been at the heart of the trade reform credibility crisis in Latin America. For example, in most cases where (mild) trade reforms have been reversed, the public early on perceived that the inflation tax required to finance the fiscal deficit was inconsistent with maintaining a predetermined nominal exchange rate. Under these circumstances expectations of overvaluation, speculative attacks, exchange controls, and future devaluations developed. In trying to anticipate these events the optimizing private sector will usually take steps—such as diversifying its portfolio internationally (i.e., “capital flight”)—that will sometimes move the economy in the opposite direction from that intended by the reform. Edwards (1987b) has found that more than 80 percent of reversals of trade liberalizations in Latin America can be traced to inconsistent fiscal policies.

An important question is whether a gradual (i.e., slow) trade reform will be more or less credible than an abrupt one. Theoretical models of credibility of economic policy are only now being developed, and have not yet reached a level that enables us to answer this question with enough precision. In principle, it is possible to argue that gradualism has characteristics that work in both directions, at the same time enhancing and compromising credibility. On one hand—by reducing the unemployment effect and by allowing for a firmer fiscal equilibrium—a gradual trade reform will tend to be more credible; on the other hand, a slow reform will allow those groups negatively affected by it (i.e., the import substitution manufacturing sector) to organize and lobby against the policies. At the end, as is so often the case in economics, whether gradualism will enhance credibility will depend on factors specific to each country. What is clear, however, is that policymakers should always pay special attention to the establishment of credibility when pursuing important long-term structural changes.

Although at this point, given our knowledge of the policymaking process and its interaction with the private sector, it is not possible to derive a precise theorem, the arguments presented in this section—including unemployment, fiscal, and other considerations—suggest that, in general, it would be more prudent to implement the trade reform component of an outward-orientation policy in a gradual way.

12.4 Conclusion

The adjustment packages of 1982–87 sought “effectiveness.” On some grounds, and especially in terms of the turnarounds of the current accounts, the results have been quite impressive. The costs, however, have been high. Not only did real income decline, but real wages de-

clined in most countries, and unemployment soared. There is little doubt that this is not a sustainable adjustment path. A successful adjustment means that debtor countries will have to bring down their debt-to-GDP ratios to a level consistent with the reestablishment of creditworthiness, while recovering their growth of output and consumption. The first objective means that the country has to transfer a given discounted value of resources to the rest of the world. The second means that the country has to increase its rate of capital formation and the efficiency of resource use. The problem faced by the highly indebted nations can be posed as follows: how to minimize the present value of the consumption costs associated with making a transfer of a specific discounted value? The problem then has two dimensions: how to minimize the cost of the transfer at each moment of time, including its distributive aspect, and what should be the flow of transfers over time consistent with a given present value of the flow?

A sustained increase in the indebted countries exports, which is, of course, a prerequisite for a long-term solution to the crisis, will not only require an efficient tradables sector and a "realistic" real exchange rate but, more important, that the current protectionist trend in the industrial countries and in particular in the United States be reversed. Data presented in Edwards (1987c) indicate that at this time the extent of nontariff barriers as a form of protection in the industrial countries is very significant. Moreover, the data show that these trade impediments are particularly important for goods originating in the developing nations, and that their tariff equivalents are in many cases very significant. Asking the highly indebted developing countries to pay their debts and at the same time impeding their exports from reaching the industrialized markets is not only unfair, but also politically unwise.

Notes

1. The cause behind the spectacular growth in borrowing during the 1974–82 period varied from country to country. See Edwards (1987a) for a detailed discussion.

2. There is now a vast literature that clearly suggests that outward-oriented countries have greatly outperformed those nations that have followed discriminatory import substitution policies. See, for example, the World Bank 1987 *World Development Report* and the literature cited therein. On CEPAL see, for example, Bianchi, Devlin, and Ramos (1987).

3. The case of Korea, for example, is highly educational. In 1985, 90 percent of Korean imports were subject to automatic approval (i.e., were not subject to any form of licensing) and the average tariff was only 26 percent.

4. See, for example, Krueger (1978) and Little (1982).

5. This will take place by means of the change in the consumption rate of interest (Edwards 1987a).

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