The Open Economy

tools for policymakers in developing countries

edited by

Rudiger Dornbusch
F. Leslie C. H. Helmers

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Preface

THE ECONOMIC DEVELOPMENT INSTITUTE (EDI) of the World Bank has several objectives. One is to teach officials in the developing world the principles and practices of project analysis. Another is to familiarize government officials with current issues of economic policy. To meet these objectives, the EDI organizes courses and seminars in cooperation with its partner institutions in the developing world. In addition, the EDI makes its materials available for independent study. In principle, EDI materials are written in nontechnical language so that they will be understandable to interested persons outside the economics profession.

This volume was produced at the request of EDI. The editors drew up an outline of the aspects of economic policy concerning an open economy and assembled a team of economists to write about the issues. The book does not offer specific policy prescriptions for every conceivable situation a country might face, but the writers give valuable advice based on their experience. Although intended for use in courses and seminars at EDI and its partner institutes, the study should also be of interest to government officials and policymakers in the developing world who want to have an overview of the various policy issues. Professional economists may also find it useful.

The editors would like to express their thanks to the fourteen other authors who contributed to this volume. They all welcomed with enthusiasm the idea of producing in nontechnical language a guide to the issues facing an open economy, and all met the deadlines for their own contributions.

Numerous persons gave support or advice or constructive critical comments. Unfortunately, the list of indebtedness has become too long to be produced here. An exception may be made, however, for Sonia Hoehlein, Carman Peri, and Marshall Schreier, who processed the manuscript in record time.

One of the editors, F. Leslie C. H. Helmers, died on March 3, 1988, just before this book went to press. An economist's economist, he brought economic analysis to bear on topical problems of public management in such a way that the noneconomist could understand and apply the concepts developed, and he helped developing countries build their own capacity for economic management. His contributions to this volume and to the work of the Economic Development Institute and of the World Bank are gratefully acknowledged.

Contents

1

Introduction

F. Leslie C. H. Helmers

DIFFERENT ECONOMISTS writing about a subject inevitably have, in addition to different styles, nuances, and judgments, different perceptions of the economic background of the reader. In addition, they sometimes use different terminologies. To give the interested noneconomist reader a basic understanding, this book begins with the present overview, and a discussion in chapter 2 of how the real exchange rate is used as a policy instrument. Four appendixes deal with data sources and basic economic concepts. Readers familiar with real-exchange-rate analysis and basic economic concepts need not read chapter 2 and the appendixes.

No summary can do justice to a writer's views. The following paragraphs therefore present only a few salient aspects of the various chapters in this volume.

Part I deals with policy issues and policy tools. In chapter 3, which sets the tone, Dornbusch derives the basic balance of payments identity, which provides the unifying theme for the following chapters. The identity equation shows that a current account surplus has three guises. It is at one and the same time (a) the excess of the nation's income over its expenditures, (b) the excess of the nation's exports of goods and services over its imports, and (c) the net increment to the nation's foreign asset holdings.

If national income exceeds domestic expenditures, then the surplus manifests itself as an excess of current foreign exchange inflows over current foreign exchange outflows, or (in other words) as a surplus in the current account of the balance of payments. Conversely, if domestic expenditures exceed national income, then current foreign exchange outflows exceed current foreign exchange inflows, and the current account of the balance of payments will show a deficit. Surpluses or deficits in the current account of the balance of payments of course mean that the country's foreign assets position has improved or deteriorated, respectively. It is also self-evident that, if there is a surplus, the country must build up its foreign exchange reserves, lend abroad, or invest abroad. The converse also holds: if there is a deficit, foreign exchange reserves are being drawn down, or foreigners must finance the deficit.

The equality of the three separate ways of measuring the current account surplus or deficit is an ex post identity that holds at every and any level of domestic activity. Labor may be unemployed or fully employed; exports and imports may be at low levels or at high levels, depending on the openness of the economy. In all cases, the basic identity will be valid. The interesting aspects appear if one analyzes how one moves from one equilibrium to another. Basically, this book considers the different policy measures that can be taken to move from one situation to another and the different effects.

In principle, three types of policy measures, corresponding to the three guises of the current account can be distinguished. Expenditure-changing policies, such as fiscal and monetary policies, directly affect the level of economic activity. They act on the national income and domestic expenditure part of the basic equation. Expenditure-switching policies, such as trade and exchange rate policies, change the pattern of economic activity. These policies lead to changes in the composition of production, spending, and foreign exchange flows. Finally, financial policies toward the rest of the world concern capital flows, debt management, and the net foreign assets position of a country. In addition, there are the so-called structural policies, the objective of which is to enhance the efficiency of domestic production processes. These policies are not, however, discussed in this volume because this study deals principally with balance of payments issues.

The order of the chapters in this book follows closely the above-mentioned typology of policy instruments. After chapter 3, which provides the basic framework, Krugman in chapter 4 gives an overview of expenditure-changing and expenditure-switching policies. In chapters 5, 6, and 7, Dornbusch, Fischer, and Collins explain issues of real exchange rate, multiple exchange rates, and trade policies. In chapters 8 and 9, external financial policies are discussed by Williamson and Fishlow. In chapter 10, Bruno discusses the order in which the different policy instruments should be used. Finally, in chapter 11, Harberger provides persuasive documentation that small economies do as well as large economies and that professional economists' policy prescriptions lead to better economic progress. The five country studies in Part II review the types of policies the countries have actually followed in the recent past.

1. Policy Issues and the Main Policy Tools

After Dornbusch sets the stage in chapter 3, Krugman starts in chapter 4 with a detailed account of the type of external adverse disturbances a country can encounter and then reviews the difference between expenditure-reducing and expenditure-switching policies. The objective of both types of policies is to transform a deficit in the current account of the balance of payments into a surplus. The former policies have the disadvantage that cutting domestic expenditures may cause the economy to enter into a recession and that consequently unemployment may increase; moreover, private investment may be reduced to such an extent that future growth may be jeopardized. In contrast, expenditure-switching policies, which increase the domestic prices of the internationally traded goods, will curtail imports and stimulate exports so that the economy can continue to grow. The problem here, however, is that the price increases of imports as well as of export goods sold in the home market may lead to a demand for wage increases. This demand may lead to an inflationary spiral, which may make import goods again attractive and production of export goods less profitable, so that the effects of the policy will be negated. It becomes immediately clear that the objective of expenditure switching is not only to increase the nominal prices of the traded goods but also to increase their real prices. The real exchange rate therefore emerges as an important policy instrument. Krugman sees the need to combine nominal increases in the prices of traded goods with expenditure-cutting policies to curtail domestic demand or to reform the labor market to permit increases in real prices. He recognizes that political reality may lead policymakers to stray from policies of strict economic efficiency.

In chapter 5, Dornbusch discusses the question of overvaluation. He introduces a number of real-exchange-rate indexes. Basically, each of these indexes tries to measure in real terms the international competitiveness of the domestic producers of traded goods. A very powerful concept is to define the real exchange rate as the ratio of domestic wages, say, pesos per hour, to the nominal exchange rate in pesos per dollar. In this case the real exchange rate is defined as simply the domestic wage in dollars. If wages in dollars are high, then domestic producers of tradables will have difficulty competing with imports and producing export goods because neither type of activity will be very profitable in competition with the world market. A high real exchange rate, as defined here, means that the exchange rate is overvalued: the high value of domestic currency, reflected in the high wage rate in dollars, leads to high imports and low exports. This definition is very powerful because it quickly conveys an understanding of how difficult it sometimes is to move from an overvalued currency (with real wages that are above the level at which labor supply equals labor demand) to an equilibrium level with significantly lower wages.

In the remaining part of chapter 5, Dornbusch emphasizes again the importance of the real exchange rate as a policy instrument. He also discusses in detail how a domestic currency can become overvalued and reviews all the possible adverse impacts on the economy. In addition, a number of detailed country experiences are reviewed. His conclusion may be put in this way: no automatic mechanism will ensure that exchange rates will not become misaligned. The real exchange rate must therefore be considered an important policy guideline.

Fischer's chapter 6 complements Dornbusch's review in chapter 5. After a brief discussion of different exchange rate arrangements, Fischer provides helpful guidelines to determine whether the domestic currency is overvalued. Also, Fischer points out that a devaluation must be accompanied by restrictive macroeconomic policies to ensure that domestic price and wage increases do not offset the effects of a nominal devaluation. According to Fischer, "every successful stabilization program has been preceded by an unsuccessful attempt in which the government sought to stabilize purely by fixing the nominal exchange rate, without taking accompanying macroeconomic measures."

In chapter 7, Collins discusses multiple exchange rates and quantitative restrictions. These policies have been introduced for a variety of reasons. The objective behind special nominal exchange rates or special restrictions, for example, may be to favor certain food or energy imports and to keep prices in these sectors low. It may be to stimulate the domestic production of some types of exports or some types of import substitutes or to protect an infant industry. Countries may also introduce a series of special rates and restrictions in hopes of curtailing total imports and capital outflows and improving their balance of payments. Collins points out, however, that other effects of these policies can make them very harmful. In particular, they alter relative prices, and they affect the government budget. They create distortions in the incentive system and can be very difficult to enforce, thereby encouraging illegal activity. Collins concludes that these special measures are not appropriate remedies for large and persistent balance of payments deficits. They will not, for example, enable a country with a substantially overvalued exchange rate to postpone devaluation indefinitely but may in fact exacerbate the problem. Collins identifies some situations in which the special policies can be useful. Capital controls, for example, can provide an effective buffer against disruptive speculative capital flows.

In chapter 8, Williamson deals with foreign exchange reserve policies. When a country experiences, say, an export boom, how much of the extra foreign exchange receipts should it add to its foreign exchange reserves and how much should it spend on imports? The answer depends on how far the country may wish to diverge from the long-run equilibrium path—that is, the path along which the country produces its normal, maximum output level (internal balance) while the balance of payments is also in equilibrium (external balance). Williamson leads us step by step through the different considerations, such as the size of the external shock, the costs of reserve depletion, the opportunity cost of holding reserves, the speed of adjustment, the type of exchange rate regime, the structure of the balance of payments, the opportunity for foreign borrowing, and so on. In the final analysis, the speed of adjustment is a very important factor because countries that cannot adjust quickly will need to hold relatively large reserves. The strategy proposed by Williamson is that, except in special circumstances, countries should target reserves at 30–40 percent of a year's imports. In addition, a continuous review should seek to determine whether divergences from internal and external balance are occurring and whether within a time frame of five years the reserve targets can again be reached in cases of shortfall.

In chapter 9, Fishlow provides a historical overview of international capital movements and makes the important point that, from a historical perspective, the present debt of the developing countries is not high. Its maturity, however—six to ten years—is much shorter than that of the pre–World War I debt. Furthermore, the debt is expressed in U.S. dollars, and much of it has floating interest rates. For these reasons and others, several developing countries at present have problems paying off their debts.

In general, the developing countries coped well with the first oil-price shock of 1973, but they had problems with the second oil-price shock of 1980. The reasons were that since 1980 countries worldwide had followed restrictive monetary and fiscal policies, which led to a decline in the developing countries' export earnings at the same time as interest rates rose worldwide. The developing countries continued to borrow, but the new debt was used to a large extent to service the old debt at higher interest rates. Often when there was some inflow of foreign exchange, capital flight emerged and caused much of it to disappear. Serious debt servicing problems started to appear in 1982, especially for Mexico. The response consisted of a rescheduling of debt combined with restraints on domestic demand, mainly on investments.

It became clear, however, that continuation of expenditure-reducing policies would lead to intolerably low consumption levels. Fishlow therefore welcomes the 1985 plan of U.S. Treasury Secretary James Baker, which again stresses growth. Specifically, the Baker plan seeks for the developing countries an enhancement of the productivity of domestic assets through liberalization and through more capital lending from external official and private bank sources. Fishlow endorses the overall thrust of the plan but believes that more resources than planned should be made available to the fifteen debtor countries in greatest trouble and that a greater diversity in internal liberalization strategies should be welcomed because this will ensure a greater internal commitment to the implementation of liberalization. He sees the need for an active import-substitution strategy in developing countries to curtail imports. (Appendix D offers a different point of view.) In the final part of his analysis, Fishlow also makes the point that financial openness cannot be pursued as a substitute for effective adjustment policies. Capital inflows may temporarily resolve balance of payments deficits, but a country must effectuate real adjustments in order to solve the problem in the longer run.

Numerous studies have shown that growth will be higher in countries that follow open-economy policies than it will in closed economies. The explanation for this phenomenon is basically very simple: when the economy is opened up, domestic production processes will become competitive with those of the rest of the world, thus ensuring enhanced efficiency. Suppose we are at a relatively closed stage, characterized by high tariffs, quantitative restrictions, foreign exchange controls, and so on. How should we go about liberalizing the economy? Bruno addresses this question in chapter 10. Bruno makes the important point that adjustment in the financial markets may be very fast, whereas the response of exports and import-substitute producers to changes in the real exchange rate tends to be sluggish. Rapid liberalization may thus lead to high unemployment costs, and in such cases Bruno favors a gradual approach to the liberalization of commodity flows while maintaining controls on capital flows. The latter are necessary because massive short-term capital inflows may lead to an unwanted appreciation of the domestic currency, which will result in increased imports and reduced exports. In Bruno's view, the wrong order of liberalization of markets has in many cases caused crises, and he argues strongly that the liberalization of goods markets should precede the liberalization of capital markets. Bruno also reviews the stabilization attempts in high-inflation countries. In such cases, he concludes that the approach should consist of policies that provide not gradual disinflation but very fast disinflation, because prolonged contractionary monetary and fiscal policies will entail substantial unemployment.

Finally, in chapter 11, Harberger argues persuasively that small developing countries (as a cutoff rate he takes countries with a 1983 population of less than 20 million) should economize on the use of governments because they have relatively few trained officials. Policies should therefore be simple and robust. At the same time, however, the many ties among and within the small leadership elite require the policymaker for the sake of survival to take into account the many special interests of the educated elite. Can we expect to find special interest pressures so large that most small developing countries will have inferior economic growth? Far from it! Harberger's review shows that one small group of small countries has done badly but also that a much larger group has done relatively well. Furthermore, according to his review, the small countries with policy weaknesses show symptoms similar to those revealed by larger countries with policy weaknesses.

2. Country Studies

Part II of the volume consists of five country studies, which review briefly the types of policies these countries have followed in recent years.

Although Argentina had a spectacular growth during the first three decades of this century, its performance deteriorated substantially during the 1940s and 1950s. Cavallo contends that the reason was mainly the effect of trade distortions and domestic currency overvaluation. Very elucidating too is Cavallo's analysis of the period 1956–84, which shows that economic policies rather than external shocks led, through large fluctuations in the real exchange rate, to several stagflation crises.

Simonsen reviews Brazil's economic policies. Brazil could be considered to have been an open economy until 1929, but with the collapse of coffee prices in that year, Brazil started a thirty-five-year period of inward-looking policies. Emphasis on investments and diversification led to high growth rates, but the economy became more and more closed. Imports as a percentage of gross national product (GNP) fell from about 24 percent in 1929 to less than 6 percent in 1964, when a major change in policy emphasized real-exchange-rate adjustments. The results were spectacular through 1973, the year of the first oil-price shock, and remained very good because of external borrowing through 1980, the year of the second oil-price shock. At about that time, it became apparent that Brazil's external debt was becoming a problem. Subsequent adjustments resulted in a severe decline in investment. The crucial issue in Brazil will be to maintain growth by restoring the savings ratio to its old levels.

From 1965 to 1986, Indonesia has had a spectacular economic performance matched by only a small number of other countries. To a large extent, Gillis and Dapice ascribe this to the very sensible real-exchange-rate policies followed by the Indonesian government. Although Indonesia's exchange rate strategy may be characterized as outward looking, trade strategy has turned inward looking since 1973, when import quotas and bans were imposed on automobiles, motorcycles, some textiles, and newsprint. The protection of domestic industry by means of quantitative restrictions accelerated after 1980: by 1984, some 22 percent of imports had some form of restriction. One possible explanation for Indonesia's success, offered by Gillis and Dapice, is that the deft management of exchange rate policy and the economic cushion provided by petroleum earnings enabled Indonesia to withstand the protectionistic excesses.

Park looks critically at the development process in the Republic of Korea. Like many other authors, Park argues that Korea's spectacular economic progress has been due to its outward-looking strategy, in particular its export-led industrialization. Unlike other authors, however, he argues that this progress took place in a regime that was not laissez-faire but highly centralized and interventionist, a regime in which the government gave high priority to export promotion. In addition, he believes that Korea's highly educated and disciplined work force, together with massive foreign assistance, paved the way for Korea's outstanding growth. As negative results of these policies he sees too much concentration of economic power in a few hands and an excessive susceptibility to external shocks. He believes that the pursuit of economic growth has led to too much borrowing from abroad. In retrospect, Park feels that if Korea had relied more on market mechanisms than on interventionist policies, it would have prevented some misinvestments in heavy industries.

Cardoso and Levy review Mexico's economic policies. During the "Mexican miracle" period from 1956 to 1970, gross domestic product (GDP) grew at 6.7 percent a year. The government budget had small deficits or surpluses, and the average inflation rate was only 3.8 percent a year. Investment increased from 14 percent to 23 percent of GDP. Although absolute poverty decreased, some authors criticized the policies during this period for not having improved relative income distribution.

The "shared development" policies during 1971–76 emphasized the public sector as the engine of growth and import substitution by means of protection. The public deficit rose from 2 percent of GDP in 1971 to 10 percent in 1976. Public debt increased from $7 billion in 1971 to $21 billion in 1976.[1] Substantial deficits in the current account of the balance of payments made an adjustment program necessary, which was, however, abandoned when oil production and exports came on stream.

The oil euphoria caused many problems. Between 1977 and 1981, the domestic currency was allowed to become more and more overvalued. Exports increased spectacularly because of oil exports, but imports increased even more so. Current account deficits soared, and the public debt tripled. A substantial capital flight ensued. In 1982, the budget deficit reached a peak of 17 percent of GDP; inflation reached 60 percent. As Cardoso and Levy write, "overvaluation and budgets deficits proved to be a deadly combination."

In 1982, Mexico could no longer service its debt, and a massive adjustment program was undertaken. Between 1982 and 1986, public investment was reduced by some 60 percent in real terms; similarly, real wages were reduced by more than 30 percent. The adjustment process