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The Political Economy of Economic Liberalization

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Two of the major policy problems facing governments of developing countries in the 1980s have been unsustainable external and internal disequilibria, and implementation of politically feasible stabilization cum liberalization programs which become necessary to correct these imbalances. This article discusses these "crises" and subsequent policy reform. The analysis suggests that balance of payments and fiscal deficits are frequently the result of use of an incorrect accounting system in a fixed exchange rate economy, and of public sector expansion beyond its economically feasible size; that governments usually seek to liberalize their economies during a crisis to regain control when the growth of the "transfer State" has led to generalized tax resistance, avoidance, or evasion; that reduction of the government role will be required to alleviate these crises; that sharp departures from past policies rather than gradual reform may be politically necessary; and that, contrary to the current technocratic opinion on this matter, the sequencing of a consistent and credible package of reforms which will most effectively reduce the costs of adjustment is initial liberalization of domestic capital markets simultaneous with cuts in the fiscal deficit, followed by floating the exchange rate and then commodity market liberalization.

With the growing importance of Internal Monetary Fund (IMF) stabilization and World Bank structural adjustment programs, there has been concern about the proper sequencing of the standard stabilization cum liberalization measures contained in these packages. In particular, there is grave concern at the very mixed and in some cases disastrous effects of liberalization attempts on incomes and employment in the Southern Cone of Latin America in the late 1970s and early 1980s. Much of the existing discussion of the order of liberalization is conducted within the traditional technocratic framework,¹ which seeks to determine the welfare-cost-minimizing deployment of policies in the standard stabilization and

1. This assumes a benevolent and well informed government maximizing a social welfare function subject to resource and technological constraints.

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adjustment packages. Not surprisingly, no clear-cut answers are possible to the unavoidably second best welfare questions that arise.

In a companion paper (Lal 1986a) these issues are analyzed using a standard two-good, two-factor Australian model of "real" trade theory, supplemented by a monetary model.² The effects of alternative policies on real wages and rental and exchange rates in the short and long run were examined. Here also, no absolute and generalizable answers about the optimal set of policies was found. The comparative static effects depend upon the relative factor intensities of the two goods (traded and nontraded), the degree of wage flexibility, and the extent of sectoral capital mobility. Comparative static results derived within this framework are summarized in the appendix for the case where the traded good is capital intensive (compared with the nontraded) and receives a subsidy to the use of capital. The apparent variations in these effects are compounded on the dynamic path of the real variables, which, depending upon the relative speeds of adjustment in the relevant markets, can lead to over- or undershooting from their relevant "equilibrium" values.

Nevertheless, based on the recent experience of the Southern Cone, there seems to be an emerging consensus that in liberalizing the foreign exchange, domestic credit, and labor markets, the capital account of the foreign exchange market should be liberalized last. Capital inflows should actively be discouraged (or held at a low constant level) while the other markets are being liberalized. (Edwards 1984 provides a good survey; see also Krueger 1984.)

In this essay I take issue with this emerging consensus on the order of liberalization. I argue that it is based on an implausible model of the attributes and behavior of the State and its citizens, and I suggest that a different, positive "political economy" approach may be more useful in answering questions concerning the sequencing and timing of measures of economic liberalization.

The typical stabilization cum adjustment program is launched when a country is in a "crisis," usually an incipient or actual balance of payments crisis³ that necessitates a reduction in the level of current expenditures. If there is underutilization of domestic capacity, an expenditure switching policy such as a devaluation may partly (or even fully) offset the extent of the cut in domestic absorption that may be required. Also, if the proper policy measures are taken, the country may be able to obtain some foreign resource inflows which could allow a grad-

2. The real models within this framework are based on Jones (1971), Mussa (1974), Burgess (1980), Neary (1978, 1982, 1985), and Corden and Neary (1982); the monetary model on McKinnon (1981), McKinnon and Mathieson (1981), Dornbusch (1974, 1980), and Krueger (1974); and the integration of the real and monetary aspects on Corden (1977), Corden and Jones (1976), and Prachowny (1981, 1984). Lal (1986b) provides an application of the real model to the Philippines and Lal (1985) of the real cum monetary model to Sri Lanka.

3. For our purposes, it makes little difference whether the crisis is caused by an increase in domestic expenditure, or, say, a decrease in the terms of trade facing the country. It also makes little difference whether the crisis arises from what are sometimes referred to as "insolvency" problems or to "liquidity" problems (though the validity of the conceptual framework underlying this distinction has recently been criticized by Eaton, Gersowitz, and Stiglitz 1986).

ual rather than sudden reduction in real expenditures. With any rate of social time preference greater than the cost of the foreign borrowing, the gradual approach must dominate any sudden shock treatment, if the former is feasible.⁴ But it is this very feasibility which is usually in question, essentially on grounds of the likely behavior of particular governments.

It may be possible to alleviate the crisis by persuading foreign creditors to extend more credit. This in turn may require that the foreign creditors believe that the country will actually carry out the proposed adjustment measures. This credibility will in turn be based on the reputation derived from the government's past policies.⁵ Thus, in the 1970s and 1980s the newly industrialized Southeast Asian countries (unlike many Latin American countries) have found it relatively easy to obtain external credit to smooth consumption following external shocks (from changing interest rates, commodity prices, and world demand). This is because the adjustment programs announced by these countries are credible given their reputations. By contrast, the announcements made by many Latin American and African countries may not be credible. If in the past a government has reversed preannounced plans because the costs of reversal (say, increased inflation) seemed to be lower than the benefits (say, financing a public sector deficit), then an announced adjustment program which is reversible may be unsustainable. Even if the "new" government has in fact changed its character, before outside creditors are willing to provide capital for smoothing intertemporal consumption, the government may have to demonstrate its newfound resolution by undertaking more Draconian disabsorption measures than would have been required if its announcements were credible. To improve its credibility, a government might choose to precommit itself to the new regime through external commitments, such as the binding covenants signed by Austria and Hungary with the Council of the League of Nations in the 1920s. These covenants reordered their fiscal and monetary systems, raised the costs to the governments of reversing their preannounced policies, and thus made the stabilization plans credible, which succeeded in stopping their hyperinflations almost immediately (see Sargent 1985).

Moreover, the announced speed of adjustment may be an important factor in determining the credibility of the stabilization cum structural adjustment program. For while from a technocratic viewpoint a gradual cut in expenditures may be desirable, the government may find that gradualism allows time for

4. This assumes concave adjustment costs. If adjustment costs are convex, discrete adjustments may be optimal.

5. Fellner (1976, 1979) stressed the importance of the credibility of macroeconomic policymakers. Kreps and Wilson (1982) have provided one formalization of the notion of reputation. The formalization closest in spirit to that presented in the text, however, is that of Shapiro (1983). The literature arising from the problems of time inconsistency of optimal programs (see Kydland and Prescott 1977; Calvo 1978; Barro and Gordon 1983a, 1983b; Fischer 1980) has been extended by Backus and Driffill (1985a, 1985b, 1985c) in a series of papers which model dynamic games in which the credibility of the government's announcements is a central issue, as private agents are uncertain about the government's preferences.

those hurt by the cuts to combine and exert irresistible pressure for their reversal. Politically, a long drawn out cut in real expenditures may thus be more difficult for a government to implement than a single, quick cut. One would expect that certain patterns of government behavior would be discernible which could provide some guidance on the question of the credible speed of adjustment. While this issue is of importance, I do not discuss it in any great detail in this article. But there is a presumption, given the fragility of many governments in the developing world, that long drawn out expenditure cuts will not be feasible in many developing countries.

There is another variant of the "easing of the pain" argument for gradualism in reducing real expenditures and removing policy-induced microeconomic distortions in the economy. These distortions place the economy well within the potential production possibility frontier (PPF). The various policy reforms undertaken to improve the overall efficiency of the economy are likely to induce growth in future real income and output (from the ongoing processes of growth—shifts in the PPF—as well as those increments induced by the improved policies—movement from inside the PPF to the frontier). As aggregate supply rises to eliminate the excess aggregate demand, this growth may preclude real cuts in current or future expenditures.⁶ Again, theoretically this would be uncontroversial. Controversy arises because of differing judgments on the *credibility*, tenacity, and political will of governments to complete a phased program of policy reform when the pain experienced by various sectional groups hurt by the removal of various "distortions" from which they have benefited is more immediate and more vocally expressed than the promised future joys from greater efficiency. This is also an empirical question of positive political economy.

Underlying these questions is a prior one: why countries get into a "crisis," and why some then choose and even succeed in not merely stabilizing but also liberalizing their economies. Section I considers this issue. The directions for the sequencing and timing of economic liberalization measures suggested by this discussion are used in section II to reexamine the question of the order of liberalization prescribed by the usual technocratic framework,⁷ which seeks to determine the welfare-cost-minimizing adjustment cum stabilization package for countries in "crisis." A brief final section summarizes my conclusions.

I. WHY DO GOVERNMENTS UNDERTAKE ECONOMIC LIBERALIZATION?

Most of the existing literature on the order of liberalization is based on the economist's traditional picture of disembodied, altruistic policymakers maximizing some social utility function subject to the usual resource and technological

6. This seems to be the argument underlying many of the contributions in Killick (1982).

7. I have found a specific factor version of the standard trade theoretic Australian model, supplemented by a simple monetary model, a useful heuristic device in answering these technocratic questions, as in Lal (1986a).

constraints. This view of the State is highly misleading, particularly when one considers the heterogeneous group of countries that comprise the developing world.

By contrast, it is more useful to follow the "new political economy" and view the State as composed of a group of self-regarding individuals and groups interacting strategically with private agents (see Staniland 1985; Findlay 1986; Lal 1984a; Srinivasan 1985). The State is then seen as seeking to maximize its own utility (including incomes, perquisites, and power) and not necessarily the welfare of its citizens. Nevertheless, in the resulting game between the State and its citizens (which will at different times have both cooperative as well as noncooperative elements), the latter may undertake various strategies which lead the State to serve the interests of its citizens.⁸ Thus, there may be mutually beneficial outcomes in some, perhaps most, circumstances.

Without setting out a formal model, I show in this part how a particular interpretation of past development experience may help to explain why and when States in the developing world choose to undertake economic liberalization (particularly structural adjustment programs) and also suggest the essential elements which must underlie a sustainable stabilization cum liberalization program. This analysis also leads to some empirical judgments about the order of liberalization.

Some Stylized "Crises," and When is a "Crisis" a Crisis?

It is useful to begin by presenting a taxonomy based on three sources of the excess absorption which usually leads to "crises." First, consider the case of excess absorption generated by monetary expansion accompanying increased government expenditure during the political cycle.⁹ With flexible money wages, the increase in absorption will initially lead to a rise in real wages.¹⁰ But with the ensuing leakage of the domestic money supply through the resulting payments deficit (at a fixed exchange rate), or else a contraction of real money balances

8. See Barro and Gordon (1983b); and Backus and Driffill (1985b, 1985c), for game theoretic models which provide a formal analysis of the problems of credibility and sustainability of a new policy regime when the reputation of the government is uncertain. However, while providing some useful insights, the robustness of these models may be questioned. Backus and Driffill (1985b), in an interesting paper which attempts to provide an endogenous explanation of the "political cycle" (as outlined by Nordhaus 1975; Lindbeck 1976; and Frey 1978), develop a two-person, noncooperative model in which an inflation conscious private sector is uncertain if the government which cares about output and employment will stick to its preannounced plan to disinflate (or not to inflate) on coming to office. "Instead of having a government create a pre-election boom in order to increase its chance of reelection, our analysis generates a pre-election boom as the solution to a game with a wet lame-duck government. In fact, if there were a chance of reelection, the incentive to preserve reputation may actually restrain the spending spree" (p. 536). They show that inflating at the end of its term is the rational response of a "wet" government that cares about employment. I doubt whether this conclusion is at all a plausible reason for the usual political business cycle; even if particular governments are mortal, parties are not!

9. Lal (1983, 1986b) provides an illustration from the Philippines.

10. This assumes that wages are more flexible (upward) than prices.

through a devaluation, all real variables would eventually return to their original values. In the process, the initial rise in real wages would eventually be reversed, as absorption falls back to its original, sustainable level. During this process of temporary excess absorption, the country will lose reserves, which may present a problem for the government. If the excess absorption is not reversed, however, or if reserves (which for this purpose should include access to external borrowing) are insufficient, at some stage the country will face a crisis. Appropriate expenditure reducing and (if there is nominal wage or price rigidity) expenditure switching policies such as a devaluation will be part of the resolution of the crisis. All this is well known. What is of concern here is why some countries, mainly in Latin America, are prone to follow highly inflationary macroeconomic policies which lead to dramatic periodic crises of overabsorption.

Second, one can consider another stylized case exemplified by the group of countries, mainly in South Asia, which have by and large followed fairly conservative macroeconomic policies. They have introduced a host of policy induced distortions in the working of the domestic price mechanism, however, which have led to rigidities in employment and output. Periodic stabilization crises arise when one of these countries faces a shift in taste or technology or some exogenous shock such as a harvest failure or a terms of trade deterioration.¹¹ Any of these changes requires an alteration of domestic relative prices to smoothly switch expenditures and outputs to maintain internal and external balance. The country may then suffer from an unsustainable excess of absorption, at the old unchanged relative prices. As is well known, an appropriate combination of policies to switch and reduce expenditures may be able to resolve the crisis. Again, what is of concern here are the reasons why and when such microdistorted economies are likely to reduce the rigidities which lead to their intermittent stabilization crises.

Third, windfall losses and gains of foreign currency are another common cause of "crises"; these are dealt with in greater detail in this section. Here, it is useful to distinguish between those windfalls which accrue directly to the public as contrasted with the private sector. Two recently occurring types of windfall are the foreign currency rents from minerals accruing to the public sector (for example, oil exporters such as Indonesia and Nigeria)¹² and the foreign currency receipts of the private sector derived from remittances by their relatives working abroad (as in Pakistan, Philippines, Sri Lanka, and Turkey).¹³ In the following

11. It has been argued within the technocratic literature that *temporary* falls in income should be partly financed by external borrowing, while if the fall in income is expected to be *permanent*, the country should adjust (see Cooper and Sachs 1985). The problem in practice is that except possibly for harvest failures it will be very difficult to judge whether a particular adverse shock to national income is temporary or permanent.

12. See Gelb (1986) for a discussion of the uses and abuses of these rents by various oil producers in the 1970s and 1980s.

13. See Swamy (1981) for some estimates of these remittances in the 1970s.

subsections, I assume with the technocratic literature that the government is optimizing and benevolent but nevertheless gets into a crisis if it is myopic or badly informed.

Private Sector Windfalls. First, consider *remittances*. Assume the exchange rate is fixed and there are exchange controls. The private sector receives foreign exchange remittances, which it exchanges for domestic currency at the central bank. This rise in the bank's foreign currency assets is initially matched by an equivalent increase in the currency and demand deposit component of the domestic money supply. High powered money has risen, however, and the domestic money supply *pari passu* will expand, unless the government takes some countervailing action, by either reducing its own demand for credit through a reduction of the fiscal deficit or reducing commercial credit by raising the reserve ratio.

Suppose it does not sterilize the effects of these inflows on the domestic money supply. All other things being equal, at the fixed exchange rate, the expansion in money supply will lead to a rise in the price of nontraded goods and a trade deficit. In the standard trade theoretic framework, the effect on the real wage will be ambiguous. But with the loss of foreign exchange reserves accompanying the trade deficit, the high powered money base and thus the domestic money supply will contract automatically until the initial equilibrium is restored. In this process the "real goods" counterpart of the foreign remittance transfer on the capital account will have been affected through the trade deficit.

Is there any problem or "crisis" for such a country? It will experience an initial boom with inflation and a balance of payments deficit. Though these are usually symptoms of a crisis, in this case such a diagnosis would clearly be mistaken.

Suppose, however, as is likely, that there is some time lag between the receipt of the remittances on capital account and their subsequent implicit spending through the trade account. In the interim, foreign exchange reserves would have risen. Suppose, as is common in many developing countries, the government does not use the notion of high powered money in its budgetary planning. The treasury is advised by various economists that it should use the rising foreign exchange reserves for development purposes by running a larger budget deficit than it would have otherwise. If, as is usual, the government has not sterilized the foreign exchange inflows, the increase in high powered money entailed by the larger budget deficit provides a further boost to the money supply. Without this increase in the government's fiscal deficit, both the domestic inflationary process and the trade deficit would have been self-correcting, but this further expansion will entail more inflation and a larger trade deficit. Their correction through the "money-specie" flow mechanism will entail a *loss of foreign exchange reserves greater than those that had been received through the remittances*. The government, which had not intended to run down its initial level of reserves, *de facto* finds itself with an incipient rundown. It *now* has a balance of

payments problem, the cure of which will require the disabsorption we have already discussed.¹⁴

But this crisis is due to a misperception of the correct accounting system in a fixed exchange rate economy, with a government which is unable or unwilling to sterilize foreign currency flows. In particular, it arises from a misunderstanding about the relationship between high power money, the fiscal deficit (properly defined), and the movements in foreign reserves. Unless these are understood and the proper accounting framework is adopted, even though the government may (through financing or adjustment) adequately manage this crisis, it is likely that such problems will continually recur. The failure to adopt the correct accounting framework for budgetary and monetary management may thus be as important a factor in the generation of crises as any shocks administered by nature or by the external world.¹⁵

Public Sector Windfalls. The second type of "crisis" arises from windfall foreign currency gains or losses accruing to the *public sector*. Consider two radically different ways in which the government could in principle spend these rents. First, suppose it decides to distribute them annually, based on some suitable criterion of equity.¹⁶ A seemingly equivalent policy would be for the government to expand its expenditures by the annual inflow of these rents or to reduce general taxation. If the social value of increased government expenditure is considered to be greater than that arising from giving a form of national dividend or tax cuts to its populace, then the direct public use of these rents would seem to be desirable. Moreover, as long as the increase in government expenditure is covered by sales of the foreign currency to the central bank, the fiscal deficit which needs to be covered by domestic borrowing need not rise. Nevertheless, high powered money will increase with these inflows of foreign currency, unless the government actually reduces domestic credit, that is, unless they are sterilized.

The consequent rise in domestic money expenditure will raise the price level as (at a fixed exchange rate) the money prices of nontraded goods rise; part of the excess money demand will spill over into a trade deficit, financed by running down the newly built up foreign currency reserves. Assuming downwardly flexible prices of nontraded goods, this will tend to reduce the domestic money supply and bring the prices of nontraded goods down to their original level, and with it the overall price level.

But at a fixed exchange rate, if the inflow of foreign currency rents continues, the size of the domestic tradables sector will decline as demand for tradables is met by imports, and the relative price of nontraded goods will remain higher. To

14. Fry (1980) provides an illustration from Turkey in the early 1970s.

15. Of course, from the "political economy" perspective which I discuss in the next section, governments may deliberately choose not to employ a fully informative accounting framework, as this may allow them to conceal the implicit or explicit politically determined entitlements they wish to generate.

16. The U.S. state of Alaska did this with its oil revenues.

induce and then maintain the relative expansion of nontradables, *the real exchange rate (defined as the relative price of nontraded to traded goods) will remain at an appreciated level* for some time, depending upon how long it is expected to take the foreign currency rents to run out. The requisite rise in the relative price of nontraded goods need not come about through this inflationary process, if instead the government chose to *appreciate* the nominal exchange rate by the appropriate amount.

A problem would arise if the increased level of government expenditure was unsustainable over the long run. This could happen if the government misjudged the size of the annual foreign exchange flows and committed itself to long maturing investments or unsustainable consumption support programs, which would need to be cut back if there were any falling off in expected foreign exchange rents. The public sector expenditure program may thus be unsustainable.

If, however, the rents had been transferred to the general populace, each individual would have had his or her current income increased and expectations of future rises in income improved. The resulting decentralized decisions concerning the privately optimal consumption/investment mix would, in an open economy, involve portfolio choices between different domestic and foreign financial assets. The associated patterns of deficits and surpluses on the current/capital accounts of the balance of payments would have no overall welfare significance.

Dirigisme, Fiscal Crises, and Government Control

The above examples illustrate how most so-called balance of payments crises are in large part crises for the public sector and reflect misjudgments about its appropriate and feasible size and composition.¹⁷ They also suggest the reasons why self-regarding governments may choose to reverse their previous dirigisme (inducing macro and/or micro distortions) and liberalize an economy they have hitherto repressed.

One of the paradoxical dynamic effects of the past dirigisme of many countries in the developing world (as, of course, in some developed countries) has been that attempts to exercise political control over ever-increasing areas of economic life have often led, after a certain stage, to a diminution of the government's effective areas of control as private agents find numerous ways of avoiding them. What concerns us is the empirical observation that there appears to be a sort of "Laffer curve" of government intervention, so that after a certain stage, increased government intervention, instead of increasing the area of government control, diminishes it. It is rare for liberalization to follow some intellectual conversion of policymakers who, having seen the errors of their ways, seek to find a second best welfare maximizing transition from a controlled to a market economy. Rather, various measures of economic liberalization and/or stabiliza-

17. This is the important insight contained in Corden (1977).

tion are most often sought in order to reassert government control over the economy. It is important to determine the *costs to the State* of *not* liberalizing the economy. For sustained liberalization to be undertaken, these must be greater than the apparent costs of liberalization, namely, the inevitable political pressures which will follow from the changes in distributional rewards and rents which are entailed in any measure of liberalization.¹⁸ This subsection elaborates on these points.

A major motivation for liberalization from the viewpoint of many States in the developing world lies in an attempt to regain control over an economy which seems to be less and less amenable to the usual means of government control. Usually the most important symptom of this malaise is a creeping but chronic fiscal crisis (also reflected sometimes but not always in a balance of payments crisis), which has in different forms beset most economies—including developed ones—in the last decade (see Lal and Wolf 1986 for a fuller discussion). Its origins lie in the creation of politically determined “entitlements” to current and future income streams for various groups in the economy (the deserving poor; industrial labor; regional interests; old age pensioners; infant, declining, or sick, industries—to name just a few). As these entitlements are implicit or explicit subsidies to particular groups, they have to be paid for by implicit or explicit taxation of other groups in the economy. However justifiable on grounds of social welfare, the gradual expansion of this “transfer State” leads to some surprising dynamic consequences.

The gradual expansion of politically determined entitlements creates specific “property rights.” The accompanying tax burden to finance them leads at some stage to generalized tax resistance, avoidance, and evasion and to the gradual but inevitable growth of the parallel or underground economy. This has been the case with both developed and developing countries in the past decade. Faced with inelastic or declining revenues but burgeoning expenditure commitments, incipient or actual fiscal deficits become chronic. These can only be financed by three means: domestic borrowing, external borrowing, or levying of the inflation tax.

Many countries, particularly those in Latin America, have tried all three—with dire consequences. Domestic borrowing to close the fiscal gap may crowd out private investment (see Blejer and Khan 1984) and diminish the future growth of income—and thus the future tax base. The fiscal deficit may be financed by foreign borrowing for a time, particularly as in the mid-1970s, when

18. One could, following the “State as pressure group” school of political economy, seek to explain the move to liberalization as resulting from a new pressure group equilibrium (see Becker 1983). But this model of political economy relies on political institutions corresponding to those in Western democracies. Its applicability to the varied authoritarian regimes in the developing world would seem to be limited. Hence my attempt to explain why a developing world government which is *relatively* (but not completely) immune to democratic pressure group activity would seek to liberalize its economy. Another way of making this point is that instead of considering the State to be a passive transmitter of pressure group activity, one looks upon it as an autonomous agent with its own goals (see De Jasy 1984).

real interest rates were low and even negative. But this form of financing is inherently unstable. The debt service ratio can become unviable if, as in the late 1970s, world interest rates rise and the ability of the economies to generate the requisite export and fiscal surpluses to service the higher interest costs of publicly guaranteed debt is limited. This is often due to policy induced distortions inhibiting exports—for example, the maintenance of overvalued exchange rates and high and differentiated effective rates of protection which are an indirect tax on exports—and the difficulty in generating fiscal surpluses to match the interest on the debt. Thereupon, foreign lending can abruptly cease, leading to the kind of “debt crisis” which has plagued Latin America in the 1980s. The third way of financing the deficit, through the use of the inflation tax, is also unviable over the medium run, for it promotes a further growth of the parallel economy and a substitution of some indirect or direct form of foreign currency based assets for domestic money as a store of value. The tax base for levying the inflation tax thus shrinks rapidly.

With taxes being evaded, with domestic and foreign credit virtually at an end, and with private agents having adjusted to inflation to evade the inflation tax, the government finds its fiscal control of the economy vanishing. The growth of entitlements, moreover, reduces the *discretionary* funds available to the government, and it is discretionary funds which give the government power. It may not even be able to garner enough resources to pay the functionaries required to perform the classical State functions of providing law and order, defense, and essential infrastructure. This dynamic process whereby the expansion of the transfer State leads to the unexpected and very unMarxian withering away of the State has rarely reached its full denouement, although in some Latin American countries it may be close.¹⁹

But well before things come to such a dire pass, attempts are usually made to regain government control. Two responses by the government are possible—an illiberal and a liberal one. The former (which is rarely observed) consists of a further tightening and more stringent enforcement of direct controls. Tanzania provides an example of this response. If this tightening is effective, and the private utility of after-tax income received from legal productive activity declines to the level at which untaxed subsistence activities are preferable, however, producers may seek to escape the controls by ceasing to produce the taxed commodities altogether. The tightening and enforcement of controls could lead to an implosion of the economy.²⁰ The government might then find that as producers return to untaxable subsistence activities, the very production base over which it seeks control has shrunk or disappeared.

19. For example, in Peru it is estimated (by Hernando de Soto in private communication) that over 70 percent of the labor force in Lima works in “illegal” activities, the government has no domestic or foreign credit, inflation is high and rising, and nearly 70 percent of the money supply is in dollar denominated deposits.

20. See Collier and others (1985) for such an interpretation of recent Tanzanian economic policy and its outcomes.

The more usual response is to regain a degree of fiscal control through some liberalization of controls on the economy. Typically, however, these liberalization attempts are half-hearted and include some tax reform, monetary contraction, and some measures of export promotion. Their aim is to raise the economy's growth rate as well as the yield from whatever taxes are still being paid and to improve the debt service ratio in the hope that this will lead to a resumption of voluntary foreign lending. But unless the underlying fiscal problem (which is largely that of unsustainable public expenditure commitments) has been tackled, these liberalization attempts have usually been aborted.²¹

Without a commitment to reducing unviable levels of entitlements, the liberalization attempts have tended to worsen the fiscal situation. With the lowering of tax rates and lags in supply response, revenues do not rise and may even fall initially. The necessary reductions in money supply to contain inflation reduce the limited seigniorage previously being extracted.²² Government unwillingness to allow either public or private enterprises to fail entails absorbing the deficits of public enterprises as well as any newly sick units taken over, as the liberalization exerts competitive pressures on unviable firms. Moreover, where liberalization has been accompanied by large public or private capital inflows (often to finance the public sector deficit), there has been an appreciation of the real exchange rate sometimes accompanied by inflationary pressures arising from inappropriate nominal exchange rate policies (as in Sri Lanka; see Lal 1985). This appreciation thwarts potential export growth, so that as capital inflows diminish, the incipient fiscal deficit is once again reflected in a chronic balance of payments problem which the government then seeks to control in the old unviable ways—and the liberalization process is reversed.

The above patterns have been observed in a large number of countries which have attempted to liberalize in the 1970s.²³ The major lesson to be drawn is that liberalization is often undertaken to gain fiscal control, but if nothing is done to rescind unsustainable public expenditure entitlements a stabilization cum balance of payments crisis eventually emerges which undermines the attempt to liberalize the economy. It would thus seem that a sine qua non of a sustainable liberalization attempt must be the prior establishment of fiscal control through a reduction of unsustainable public expenditure commitments.²⁴ The stabilization

21. Some examples are the Sri Lankan 1977 liberalization episode (see Lal and Rajapatirana, forthcoming); the 1978 Argentina liberalization (see Nogués 1981, Calvo 1986); and the latter part of the 1974 Uruguay reform episode (see Hanson and de Melo 1985).

22. At the end of a period of hyperinflation, however, the demand for money will increase, as will the seigniorage associated with any increase in money supply to meet this incremental demand for the newly stable money.

23. This experience is being analyzed in two sets of multicountry comparative studies undertaken by the Trade Policy Research Centre and the World Bank. My reading of their preliminary findings provides empirical support for the following remarks.

24. Unless, of course, there are sufficient underemployed domestic resources so that an expenditure switching policy such as a devaluation can rapidly increase aggregate supply and thence public revenues by the requisite amount.

of the economy no less than any prospective liberalization also entails a willingness to overcome the resistance of those whose entitlements will be rescinded.

The *political* problem governments most usually face when considering economic liberalization is that the pressures from the potential losers from the liberalization tend to antedate the support which will subsequently be provided by all those who gain. As can be readily shown, under many circumstances there will be losers in the short run from the changes in relative prices and/or disabsorption flowing from stabilization and structural adjustment programs, particularly those whose relative returns on sector specific human and physical capital fall as a result of these changes. If the liberalization is sustained, however, it is likely to yield higher and more efficient growth in income, which will benefit most groups in the economy. Given the government's own rate of discount (which may be much higher than that of society), even if the resulting purely technocratic economic welfare integral is positive, policymakers may still be reluctant to undertake the reforms if they feel uncertain about their ability to survive the political pressures during the transition.²⁵

II. MINIMIZING THE WELFARE COSTS OF ADJUSTMENT

Consider now the problems facing the government of a developing country which finds itself in a "crisis" but has the requisite political will to implement the policy recommendations commonly contained in stabilization and adjustment programs.²⁶ These are (a) measures to reduce absorption by cutting the fiscal deficit, limiting overall domestic credit and devaluing the currency (if expenditure switching is required), and (b) measures to improve the supply side of the economy by reducing foreign trade and wage-price controls and by removing interest rate ceilings, changing reserve requirements, and possibly eliminating exchange controls.

The first group of disabsorption measures is unavoidable in a crisis situation. Only their extent is an issue, which (as was argued in the beginning of this article) depends upon the level of foreign financial accommodation available. The desirable level of this accommodation is a matter of judgment, and I have little to add to the earlier discussion.

The remaining questions concern the sequencing of the supply-side policy reforms and whether there are accompanying policies which might be able to minimize the inevitable costs of adjustment during the process of economic liberalization.

25. The "optimal" subsidy route for cushioning the transition for "losers" does not make much sense in this context, for it again assumes an omnipotent and omniscient government. The *political* difficulties I am emphasizing arise precisely because the government does not possess these attributes. Moreover, even if the government were able to implement this gradual adjustment policy, such a policy may not be time consistent and hence feasible.

26. Discussion of these will be found in Guitian (1981) on the IMF's conditionality, and in Stern (1983) on the World Bank's structural adjustment programs.

Optimal Sequencing of Policy Reforms

This subsection addresses welfare theoretic questions posed in the usual technocratic framework, which assumes a benevolent government concerned with maximizing some social welfare function. It is obvious that for an economy in which adjustments in both capital and labor markets are rapid, each of the policy changes proposed in the package must necessarily improve efficiency and hence lead monotonically to higher level of real national income until the new undistorted equilibrium is reached.

Moreover, within the standard trade theoretic Australian model the effects on real wages, particularly in the long run, of all these possible policy reforms is positive if, as one would expect, the factor market distortions are in the capital-intensive traded good sector. At least for the fairly flexible textbook economy outcomes which correspond to the Marshallian long run, the standard adjustment package will not lead to any efficiency or equity losses.²⁷ In these circumstances, there would be little sense in examining the sequencing and timing of liberalization measures, as there should be a simultaneous and instantaneous liberalization of all the relevant markets.

Short run immobilities of capital and rigidities in wages, however, can lead to short run falls in real income or real wages. This is one reason why governments seem unwilling to liberalize all markets simultaneously (see Krueger 1984). Two questions then arise: first, whether there are feasible supplementary policies which could minimize these efficiency and/or equity losses during the transition, and second, whether there is a policy sequence within the adjustment package which will reduce the pain of the transition. Arguments are presented below in favor of *one* plausible sequencing of policies which runs counter to the currently favored sequence (namely, opening the capital account last). This is to underline the fragility of much of the current argument for particular orders of liberalization being derived in the technocratic literature.

On the first question, consider the case of wage rigidity. It is well known from the literature on project evaluation that, given certain assumptions, any stickiness or rigidity of wages may make the shadow wage lower than the actual wage rate (see Lal 1974 for a summary of the literature on the determinants of the shadow wage rate). In theory, a wage subsidy financed by lump sum taxes would yield the best outcome during the transition. If this is not possible, then some suitable tax-subsidy combination which essentially subsidizes the output of the labor-intensive industry may be desirable. Because self-employment predominates in most developing countries, it will not be feasible to institute a general wage subsidy, and a tax-subsidy scheme on output may be the only feasible policy. The required general subsidy to the labor-intensive sectors can be provided by in effect taxing the output of the capital-intensive sector, that is, by appropriate changes in the real exchange rate. Bhagwati (1979) and Krueger

27. We assume that there is little weight to be placed socially on the losses suffered by those capitalists who lose from the removal of the capital market distortion.

(1978) detail various ways in which the removal of trade distortions and changes in the nominal exchange rate can be combined to yield the requisite change in the real exchange rate.

The devaluation and reduction in output distortions required to obtain the real exchange rate change is likely to have an ambiguous short run effect on real wages if capital is immobile in the short run (see section 4 of Lal 1986a). By contrast, removing the capital market distortion in the capital-intensive traded good sector (with a given distortion in the labor market, and unchanged trade distortions) will raise both real output and real wages in the short and long run. This suggests the following sequencing of the adjustment package. First, remove the capital market distortion, and as the real output and real wage gains begin to appear, begin a phased program to reduce distortions in the commodity markets (particularly for traded goods). The possible short run declines in real wages resulting from the second phase will be mitigated by the wage increases arising from the continuation of the first phase of policy reform.

Removing the capital market distortion, however, is a tricky problem for a financially repressed economy (see McKinnon 1981). It is clear that, as a first step, interest ceilings on deposits and loans should be removed. If the distributional impact of these changes is to be spread over a period of time, then any quantitative credit controls (which imply capital subsidies to favored borrowers) should be converted into explicit subsidies and shown as part of the government budget. Without an increase in government revenues, the consequent rise in the fiscal deficit will require the levying of a higher inflation tax and a suitable adjustment of the reserve ratio on interest bearing domestic money deposits (this need not necessarily imply an increase in that ratio; see McKinnon and Mathieson 1981).

But most important, it will be necessary to keep the economy at the new steady state inflation rate to alter the nominal exchange rate at the same pace as the steady state inflation rate. A fixed nominal exchange rate would not be sustainable. In time, to reduce the inefficiencies of the financial repression associated with high reserve ratios, it will be necessary to reduce the fiscal deficit and thence the inflation rate. Whether this reduction in the steady state inflation rate will be welfare-improving depends on the alternative net social costs of reducing government expenditure and raising taxes to reduce the fiscal deficit. It may then seem to be better to sequence the inflation control program *after* the removal of interest ceilings, the introduction of flexibility in exchange rates, and the start of a phased program of trade liberalization. As real national income rises in response to the policy changes, government revenue will also rise to some extent. Then, if the government's real expenditure remains unchanged, the real fiscal deficit and hence both the reserve ratio and inflation rate should fall.

Though in theory one can couch arguments in terms of steady state inflation rates, in practice it will be very difficult (even for an omniscient and benevolent government) to maintain this steadiness. It may, therefore, be best to combine the reform of the domestic capital market with the reduction of the fiscal deficit

and inflation. The last part of this initial package will be made easier by the likelihood that some deficit cuts will have formed part of the initial disabsorption required to deal with the crisis. So the first stage of the adjustment package should probably combine the reduction of domestic capital market distortions with the reduction of the fiscal deficit and inflation.

What exchange rate regime should be adopted by the liberalizing government during and after the transition? I have argued elsewhere (Lal 1980) that an exchange rate regime with an *automatic* balance of payments mechanism be adopted in a world of irreducible uncertainty, where discretionary government action (required in all forms of managed exchange rate regimes) cannot be expected to achieve convergence or reduce deviations from an unknowable equilibrium. The only two choices are a completely fixed or a fully floating exchange rate regime.

It may be worth noting that Chile—unlike the other two Southern Cone countries, Argentina and Uruguay—followed the conventional sequencing pattern: it first controlled its fiscal deficit, second, liberalized its trade regime, and third, liberalized its domestic capital market and opened the capital account of its balance of payments. The Chileans also implemented the advice of international monetarists on exchange rate policy to the letter: they progressed from a crawling peg through a preannounced exchange rate regime to a fixed exchange rate system.²⁸ Prima facie, the subsequent Chilean debacle presents a dramatic real life argument against this exchange rate choice.

In my judgment, a fully floating rate would have served the Chileans much better: it would have choked off some of the short run capital flows which supposedly destabilized the economy in the early 1980s.²⁹ Moreover, as Black (1976) and Lal (1980) have noted, the institutional requirements of a floating exchange rate system are probably exaggerated, as the recent floating of a number of African currencies demonstrates.

In summary, my suggested sequencing of liberalization would be as follows: first, reduction of the fiscal deficit, accompanied by removal of domestic capital market distortions; second, elimination of exchange controls and free floating of the exchange rate, accompanied by an announcement of a phased program for removing commodity market distortions; and third, the implementation of this preannounced phased program.

On Liberalizing the Capital Account

A number of objections can be raised against this sequencing, however, and in particular against the proposed liberalization of the capital account simultaneously with the initiation of a phased program of trade liberalization. These

28. See McKinnon (1982), who wrote: "the correct order of liberalization . . . approximates the successful Chilean experience after 1975" (p. 159).

29. For alternative views about the role of the pegging of the exchange rate in the Chilean debacle, see Dornbusch (1985) and Harberger (1985).

objections have supposedly gained greater credence as a result of the effects of the liberalization of the capital account in the 1970s in a number of countries in the Southern Cone of Latin America.³⁰

But *prima facie*, it is not obvious that this experience provides arguments against my preferred sequence. As I have noted above, Chile liberalized its trade account before its capital account, and yet it suffered a debacle, arguably because it maintained a fixed exchange rate with real wage indexation and lax regulation of domestic financial institutions. Argentina liberalized its capital account without undertaking either any substantial trade liberalization or (more importantly) fiscal stabilization and instituted the system of preannounced exchange rates (the *tablita*). This program was clearly inconsistent and hence not credible or sustainable (see Fernandez 1985; Calvo 1986). Uruguay started with the opening of its capital account and the deregulation of its domestic financial system before it undertook trade liberalization. As Hanson and de Melo (1985) note, "no major imbalances occurred before 1979, when the financial liberalization was completed and the real exchange rate did not appear to be in disequilibrium from the viewpoint of the allocation of real resources in the long run," and hence "its experience does not seem to support the common view that the current account should be liberalized before the capital account" (p. 934). The debacle occurred because in October 1978, Uruguay adopted the *tablita*, and in 1982 and 1983 its fiscal deficit increased "due to an increase in social security payments and government salaries and a reduction in labor taxes" (Hanson and de Melo 1985, p. 933). These policies were clearly inconsistent. Thus, rather than blame the opening of the capital account for the crises, it would seem that in all three cases the *tablita* and/or pegging of the exchange rate made the programs inconsistent.

The lesson I would draw from this experience is that an appropriate exchange rate regime during the liberalization process and the maintenance of fiscal stability are essential for a sustainable liberalization program. For the reasons given earlier, a floating exchange rate which requires both domestic financial liberalization and the opening of the capital account would seem to be preferable to a fixed or managed exchange rate regime when liberalization is undertaken. We must consider, however, various technocratic *a priori* arguments that are raised against opening the capital before the current account of the balance of payments.

The first objection concerns the foreign capital inflows which might be induced as a result of the liberalization of the capital account while there are still distortions in domestic commodity markets. Theoretically, it is possible that capital inflows to a domestically distorted economy may be immiserizing (see Brecher and Diaz-Alejandro 1977). In my proposed package, however, the liberalization of the capital account would be accompanied by an announcement of a

30. See the symposium issue of *Economic Development and Cultural Change*, April 1986, and that in *World Development*, August 1985, on the liberalization experience of the Southern Cone.

future (dated) phased program of reduction in commodity market distortions. If one assumes that expectations are rational, and the public announcements credible, it is unlikely that long term capital flows (based on investors' time horizon extending beyond the trade liberalization phase) would be immiserizing. Because some foreign capital with shorter maturities is likely to flow into activities where private and social rates of return diverge during the trade liberalization phase, there may be a case for temporary and preannounced taxes on such flows by maturity, which are gradually reduced to zero as the trade liberalization proceeds.

The second objection relates to the likelihood of an initial appreciation in the real exchange rate with the removal of exchange controls, before trade has been liberalized. The argument can be stated as follows. With the liberalization of the domestic capital market, domestic real rates of interest will rise. Given the relative scarcity of capital in developing countries, they are likely to be higher than foreign interest rates at the original exchange rate. Hence, the removal of exchange control and the institution of a free float will appreciate the nominal exchange rate to establish interest rate parity. If, in the ensuing process of balance of payments adjustment, foreign capital also flows into the country, the real exchange rate will rise as the country runs a balance of trade deficit to match the surplus on the capital account of the balance of payments.³¹ This will lead to resource movements opposite to those required during the process of trade liberalization when the real exchange rate is likely to fall. Hence, it is argued that the opening of the capital account before the trade liberalization is completed will lead to unnecessary shifts in resources, in effect away from traded to non-traded goods industries.

Before discussing this resource shifting argument, it is desirable to contrast the alternative sequencing of the opening of the trade and capital accounts. Suppose, instead of floating, a managed exchange rate system requiring capital controls is maintained during the trade liberalization process. The government will have to judge the precise extent of the *nominal* exchange rate change required to yield the appropriate *real* exchange rate at each point during the transition. Suppose it misjudges and at some point during the transition undertakes a nominal devaluation which is *less* than that required to yield the appropriate real exchange rate. This will lead to an incipient or actual balance of payments deficit which the government may be tempted to reduce through import controls—thus aborting the trade liberalization.

Furthermore, as can be readily shown (depending upon the dynamic structure of the economy, the relative factor intensities of traded and nontraded goods and the degree of short run mobility of capital), the trade liberalization process could lead to an initial real depreciation greater than that required in the final equilibrium. In this case also, the real exchange rate would first fall and then rise, with

31. The resulting short and long run resource and real wage movements can be readily derived in the framework provided in Lal (1986a).

unnecessary resource movements similar to those caused by the opening of the capital account. It is not apparent how one could determine the extent, and choose between these two alternative sets of unnecessary resource movements, in advocating one sequencing pattern over the other.

By contrast, one of the major advantages of instituting a free float before trade is liberalized is that the nominal rate changes which are required during the process of liberalization become automatic. Given the uncertainty in the dynamics associated with the process of adjustment, it is very difficult in practice to judge the precise extent—and in some cases even the direction—of the *nominal* exchange rate changes required in a managed exchange rate system as trade liberalization proceeds. Arguments for a crawling peg, to be followed by a fixed exchange rate regime once full liberalization of commodity markets is achieved (advanced for instance by McKinnon 1982), ignore these difficulties. The arguments for this set of policies are based on the erroneous view that the government, by pegging the *nominal* exchange rate for a set period of time, can also peg the *real* exchange rate (see Stockman 1982, p. 189). Because a major cause of the crises in Latin America's Southern Cone was mismanagement of the nominal exchange rate, a floating rate, by obviating the need for discretionary nominal exchange rate management, will relieve the government of concerns about the balance of payments consequences of other measures of economic liberalization.

The third objection to capital market liberalization in the initial stages of liberalization relates to the likely dynamic effects of foreign capital inflows. These are symmetrical with those discussed in connection with the "Dutch disease" (see Corden and Neary 1982). If there is a sustainable level of foreign capital inflows following the liberalization of domestic capital markets and the capital account of the balance of payments, then the resulting real exchange rate appreciation cannot be said to constitute a problem for the country. Real income will be higher, even though the resulting sectoral shifts in resources will entail distributional shifts in the returns to sector specific factors of production. But these shifts will also result from other policies required to liberalize a repressed economy. They cannot in themselves constitute an argument against liberalization, but they do provide an indication of the likely directions from which opposition to particular liberalization measures might be expected.

The real worry of the opponents of the liberalization of the capital account is that it could lead to an overshooting of capital inflows with an accompanying overshooting in the real exchange rate.³² It is certainly conceivable that such overshooting may occur and that it will entail greater reversals of resource movements than on the "equilibrium" path of the real exchange rate. But with short run immobility of domestic capital, trade liberalization too will entail reversals in resource movements. In fact, in any dynamic economy with changing relative prices, such reversals (or more correctly changes) in resources move-

32. See Edwards (1984) for a summary of this argument, and the references to the Southern Cone experience with liberalization on which this currently dominant view is based.

ments can be expected to be taking place continually. Moreover, *all* resource movements involve adjustment costs. Unless some divergence between the social and private values of the adjustment costs associated with reversals in resource movements can be discerned, their mere existence does not in itself tell one whether moving resources in and out of particular industries during a dynamic process constitutes a policy problem which should determine the order of liberalization.

Consider the case where it is known by private agents (whose expectations are rational) and the government's Platonic advisers that, with my preferred sequencing of capital and current account liberalization, the real exchange rate will first appreciate and then depreciate over time, so that the relative profitability of nontraded relative to traded goods industries will first rise and then decline. Corresponding to this expected real exchange rate movement, private agents can calculate the present value of investments as relative prices change at any date during the transition, including the cessation of current income streams from investments which fail to cover variable costs. This will yield a private profit maximizing allocation of resources in the two sets of industries over time, which may well involve an initial expansion and then contraction of the non-traded good industry.

Moreover, as this dynamic sequence of investments and sectoral outputs is ex hypothesi based on the same expected real exchange rate movements as those foreseen by the government's advisers, this is also the "optimal" sequence.³³ Even a temporary capital inflow, by improving domestic resource availabilities, must raise the current and the discounted present value of future national income as long as either the domestic rate of time preference (if the inflow finances consumption) or the domestic rate of return of investment financed by the inflows is higher than the effective real interest rate on the capital inflows. It is only if one assumes that the government knows the correct time path of the real exchange rate while myopic and/or ignorant private agents do not that an argument against this sequencing can be made based on a divergence between the private and social costs of adjustment in this dynamic process.

Frenkel (1982) does present an argument based on divergences between private and social costs on alternative orders of liberalization. He argues that "if the capital account is opened up first, portfolio decisions are likely to correspond to the long-run undistorted conditions, but real investment will still be carried out in a distorted environment as long as the trade account is not opened up. Due to the distortions, the social cost of the investment is likely to exceed the private cost. These real investments will have to be reversed once the trade account is liberalized. Due to the difference in private and social costs, it is likely that the first order should be preferred" (p. 200).

33. I assume, of course, in this example that there is no divergence between social and private rates of time preference. But I do not seek to imply that this path is necessarily Pareto efficient. The main point is that there is *no policy* which in the postulated circumstances can yield a welfare improvement.

The crucial assumption in this argument is the assumed asymmetry of information between farsighted foreign portfolio investors and ignorant or myopic domestic real investors. Exactly the opposite outcome is likely if both groups are *equally well informed*. For as Frenkel himself argues, it is much "easier to reverse wrong portfolio decisions than to reverse wrong real investment decisions." Thus, it will be in the self-interest of investors involved in production decisions to have much longer time horizons in considering their real physical investments than do financial investors!

Finally, if this overshooting argument against the removal of capital controls is correct, it should apply to the liberalization of the capital account *at any time*, irrespective of whether or not trade liberalization has taken place. It would imply that permanent capital controls should be maintained because of the presumed suboptimal resource movements which myopic agents will undertake in response to any overshooting accompanying the liberalization of the capital account. This is hardly a credible argument.

I would conclude, therefore, that some of the currently conventional arguments against opening the capital account at the same time as a phased program of trade liberalization is announced must ultimately be based on the erroneous (but also common) assumption of the limited foresight of private agents and the clairvoyance of governments and their advisers.

III. CONCLUSIONS

Most of the "crises" which require the stabilization cum structural adjustment medicine are primarily crises of the public sector. For many developing countries in the past three decades, a vast expansion of the government bureaucracy, of the public sector, and of controls on industry, prices, and foreign trade have created a new system of subfeudation, in which politically created property rights to rents for various groups are financed by implicit or explicit taxation of the general populace. In many countries these groups include a significant portion of the bureaucracy, public sector functionaries, industrial labor, and those who have been granted the monopolistic protection of the use of their labor or capital by the State's prohibitions on entry and exit of economic enterprises.

A crisis arises as the existing means of funding these entitlements become unviable. Economic liberalization is then seen as a way to regain government control of the fiscal accounts and the economy. The process of gaining fiscal control by reducing public expenditure to a sustainable level and the subsequent liberalization program must inevitably entail either confronting these vested interests or buying them out. The latter approach will only be viable, however, if it is ensured that the economic and legal framework contains enough checks and balances to prevent the State from creating future artificial rents for other vested interests. This is the strongest political and practical case—as distinct from that based on the controversial grounds of economic efficiency—for the promotion of a market economy.

Therefore, if a government can demonstrate its political strength in establishing fiscal control, the question of the order of liberalization which minimizes the pain to be suffered by sectoral and sectional interests during the movement to a market economy becomes politically less important. Moreover, for the *credibility* of the process, speed in implementing the liberalization of the various repressed markets may be of the essence. This speed is necessary both because of the time inconsistency of technocratic programs (whereby for the government it is usually optimal to renege on its past commitments)³⁴ and to preempt the formation of coalitions by the losers from the liberalization. To assure its credibility, the government might wish to institute a speedy bonfire of *all* controls and Ulysses-like tie itself to the mast by signing a stabilization and structural adjustment program with an international organization. If backed by sufficient resource inflows, this *could* provide the restraints necessary to forestall any future temptation for itself or its successors to reverse the liberalization and thus could make its announced program of liberalization sustainable.

Looked at from this perspective, most of the technocratic literature on the order of liberalization does not seem too relevant, though I have provided some arguments against the currently fashionable view that the capital account of the foreign exchange market should be liberalized last. There is still the controversial technical question of the exchange rate regime the liberalizing government should adopt during the transition, and the regime it should aim for when the liberalization is completed (if different). It was the inconsistency of exchange rate policy which largely explains the Southern Cone debacles. I have provided some reasons why an automatically adjusting floating exchange rate system may be desirable. These are essentially to minimize the information required to set particular nominal values at their optimal levels, and hence to avoid the risk of mistakes in the desirable extent and even the direction of changes of the *nominal* exchange rate.

There is, however, one major unresolved issue which the recent Chilean experience in particular highlights. This concerns the desirable form of regulation of domestic financial institutions which a developing country seeking to liberalize its domestic capital market should adopt during the transition, and as part of its ultimate economic framework. Besides wage indexation and exchange rate policy, it is the mishandling of the financial liberalization which many observers see as the third crucial ingredient in the Chilean debacle with economic liberalization (Congdon 1985). But these policies raise issues which go beyond the scope of this article.

34. Kydland and Prescott (1977) is the seminal contribution on this issue; also see Elster (1979).

Appendix. *Stabilization and Liberalization Policies: Direction of Change from Initial Equilibrium*

Policy changes and assumptions	Flexible wages								Sticky wages			
	Short run, sector-specific capital				Long run capital mobility				Short run, sector-specific capital			
	Real wage	Interest: nontraded goods	Interest: traded goods	Real exchange rate	Real wage	Interest: nontraded goods	Interest: traded goods	Real exchange rate	Real wage	Interest: nontraded goods	Interest: traded goods	Real exchange rate
Capital markets: removing nontraded good tax or traded good subsidy	+	0	-	-	+	-	-	-	0	0	-	-
Product markets: remove distortion in traded goods markets (assume no devaluation; demand management keeps nontraded good price constant)	?	+	-	-	+	-	-	-	+	+	-	-
Exchange rate market: devaluation:												
(1) No other change	?	-	+	-	0	0	0	0	?	-	+	-
(2) Increased preference for traded goods (assume fixed or no distortions)	?	-	+	-	-	+	+	-	?	-	+	-
Monetary policy: monetary expansion:												
(1) Fixed exchange rates	?	+	-	+	+	-	-	+	-	+	-	+
(2) Flexible rates (assume fixed or no distortions)	0	0	0	0	0	0	0	0	0	0	0	0
Capital account: sustained constant addition to capital stock in each period	?	+	-	+	+	-	-	+	-	+	-	+

Note: All prices are real, rather than nominal values. This analysis assumes that the nontraded good is labor-intensive and that the traded good is capital-intensive.

Source: Lal (1986a).

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