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PROJECT SUMMARY

Project Title : Exchange Control, Liberalization and Development

Proposed Contractor : National Bureau of Economic Research (NBER)

Principal Investigators : Jagdish N. Bhagwati, M.I.T.
Anne O. Krueger, University of Minnesota

Duration : 2-1/2 years

Estimated Cost : \$426,000

Approximate Funding required	FY 1970:	\$ 28
	FY 1971	225
	FY 1972	133
	FY 1973	40
		<u>\$426</u>

Action Officer : PPC/POL/PPD:Michael Roemer

1. BACKGROUND

The proposal was originated by Professors Krueger and Bhagwati. The NBER has made the project part of their proposed work program and are proposing it to A.I.D. for financing. NBER will coordinate and provide logistical support.

2. DESCRIPTION OF THE PROPOSED PROJECT

Virtually all of the developing countries have utilized restrictionist trade and payments regimes at some time since World War II. Economists and policy makers are well aware that exchange controls may have serious disadvantages. In some cases, restrictionist policies are defended on the ground that the benefits of these policies - particularly the stimulus to industrialization via import-substitution - outweigh the costs, although the costs may be inadequately known. In most cases, however, policy makers anticipate insupportable ex-ante payments imbalances and see no other course than to heighten trade and payments controls.

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Many students of trade and development problems, including the authors of this proposal, have come to the conclusion that highly restrictionist trade regimes have strongly adverse effects on economic growth. Conversely, it is widely believed that successful liberalization of restrictionist regimes could result in an increased growth rate for the countries concerned. Yet the experience of those countries which have attempted liberalization has been mixed. It is not readily apparent from the evidence available why some attempts at liberalization seem to have met with success, while others have largely failed to accomplish any significant, lasting relaxation of the trade regime.

The purpose of the proposed research will be to investigate the experience of various developing countries in a systematic way, with a view to answering two interrelated sets of questions. The first set concerns the nature and effects of restrictionist regimes. What sorts of political and economic factors lead to the adoption of restrictionist measures? Once adopted, what sorts of economic and political pressures operate to increase restrictions, and what factors resist greater controls? Do the types of measures employed in a restrictionist regime significantly affect the operation of the control system over time and its effects? What are the effects on resource allocation, income distribution, and economic growth of such regimes? How can one measure and compare the restrictiveness of different systems of control? Is there some tolerable degree of restriction which can be maintained without significant retardation of growth rates?

The second set of questions concerns the factors determining the outcome of liberalization attempts. Are some types of regimes more amenable to liberalization than others? What are the necessary ingredients of a "liberalization package" in order to provide the best chance for more rapid economic development within liberalized trade regime? Can we measure the impact on growth rates, and if so, on which factors does it depend?

Investigation of these questions will require refinement of a number of concepts. Among these will be the degree of restrictionism and, conversely, the degree of liberalization. While empirical measures of abstract concepts are always imperfect, progress in this direction will provide a useful by-product of the research effort: it should move analyses of trade and payments policies away from the realm of casual empiricism, implicit theorizing and institutional investigations, toward a more scientific framework wherein the lessons drawn from the experiences of some countries can be meaningfully applied to new situations as they arise.

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Not least, such a framework of analysis should yield a better understanding of the structure and problems of those countries to be studied. While the primary purpose of the research will be to increase understanding of the effects of restrictionism and liberalization on economic development, this cannot be achieved without greater understanding of individual countries.

A great deal of knowledge and insight have been acquired by economists who have, at one time or another, analyzed individual situations. NBER proposes to provide a framework wherein this knowledge can be marshalled, compared, and synthesized. A series of detailed case studies will be undertaken, based on a common analytical framework. Inter-country comparability will be stressed, and the individual studies will be used to find generally applicable answers to the fundamental questions posed above.

3. SIGNIFICANCE OF PROJECT TO A.I.D. OBJECTIVES

The proposal centers on topics of central concern to the Agency. During the last two years, 62% of our development loans have been program loans. Typically, program loans are conditioned on liberalization of the foreign exchange regime of the recipient country. Thus it is no exaggeration to say that we have been using a substantial amount of our aid resources to effect changes of the kind to be investigated by Krueger and Bhagwati. If their research is successful in improving our knowledge of the mechanisms and impacts of liberalized exchange regimes, we could use the results to increase substantially the productivity of U.S. aid. As an important by-product, we will have more and better data on critical aspects of countries receiving the bulk of U.S. aid.

4. RELEVANCE OF PROJECT TO EXISTING KNOWLEDGE

There is an extensive literature on the theory of restrictionist trade regimes, to which the principal investigators have made important contributions. (The proposal cites several examples, pp. 4-8.) However, the theory provides no a priori basis for judging the quantitative importance of these effects, and empirical research is required.

There exist many studies of individual aspects of exchange-control regimes in different countries (see pp. 15-17 of the proposal for citations). Each of these tends to focus upon the effects of the regime on some particular aspect of the economy or else on the overall effects, but without any attempt to quantify systematically the relative importance of the different components of the regime. These studies provide

no basis for comparison and evaluation, and few lessons can be drawn relevant for other countries' circumstances. In particular, the empirical evidence available cannot answer such basic questions as whether or not there is a systematic relationship between types of controls and economic growth. Unlike the empirical studies of exchange-control regimes, there have been several attempts to study liberalization episodes on a cross-country basis. In a recent study for A.I.D., Richard N. Cooper tried to relate exchange-rate changes to subsequent shifts in the balance-of-payments position and a few other key variables ("Currency Devaluation in Developing Countries: A Cross-Sectional Assessment", Mimeo, 1969). Cooper termed his study,

"... a preliminary report and a tentative agenda for further work, and it is hoped that the generalizations made here will stimulate such work, of which surprisingly little has been undertaken to date."

In considering 24 countries, he was necessarily unable to go into depth in any individual case, and did not study the changes in trade and payments restrictions that accompanied the exchange rate change. It is evident that simple cross-country regression techniques will shed only limited light on the questions posed above. On the one hand, institutional differences among countries are such that estimates of the degree of restrictionism of individual regimes can be seriously wide of the mark in the absence of fairly detailed knowledge of the economy's structure. On the other hand, one would expect that the quantitative effects of the same policies would differ significantly, depending on the economic structure of the country in question.

The proposed study, by providing up to a dozen detailed country studies, organized under a common analytical framework and utilizing common measures of the important variables, is expected to overcome the problems of incomparability and over-aggregation which limit the usefulness of the existing literature.

5. PLAN OF RESEARCH

The first stage of the research is the preparation of a more detailed statement, the Analytical Framework, which will cover three main topics: 1) the theory, 2) hypotheses and questions about the relative importance of the various factors suggested by the theory, and 3) derivation of alternative measures of the effects of restrictionist regimes.

Up to 12 economists will be invited to undertake research on a country with whose economic structure they are familiar, basing their study on the Analytical Framework. Each invitee will be asked to devote the equivalent of one academic year, half-time, or two summers to his

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research. It is anticipated that most researchers will need to go to the countries studied to renew their contacts and obtain additional information. This stage of the research will yield a set of research papers, one on each 10 to 12 countries, evaluating the experience of that country with exchange control and liberalization. The selection of countries will be based on 1) geographical distribution, 2) the inherent interest and diversity of their experience, 3) the availability of adequate data for research, and, most importantly, 4) the availability of professionally competent economists, with specific country knowledge, to undertake the research. The investigators expect to include two or three Latin American countries, probably including Colombia and Chile, with Brazil and Peru as possibilities; Ghana or Nigeria among the African countries; Turkey (for which Krueger will be responsible), Egypt and Israel in the Middle East; and India (with Bhagwati taking responsibility), Pakistan, and South Korea in Asia, with Thailand, the Philippines, Ceylon and Indonesia as additional possibilities.

The availability of top-quality authors will be the key factor in the final determination of countries for study. The principal investigators have already had exploratory talks with a number of economists meeting these criteria, and have found a lively interest in the project. They cannot ask for firm commitments, however, until the project is funded, and it is impossible to state now exactly who the participants will be. In addition to the country authors, a group of five to ten economists will be invited to join in the meetings of participants and to serve as outside commentators at all stages of the research.

An initial conference of the authors and observers will be held in mid-1970 to discuss the Analytical Framework and research strategies for the case studies. Each author will then proceed to undertake the fresh research necessary to meet the objectives of the project, concentrating his efforts during the time best suited to his circumstances during the period June 1970 to August 1971. Those who wish to be in residence at the National Bureau will be given this possibility and encouraged to do so.

Coordination of the research will be achieved through the Analytical Framework, the initial conference, and subsequent informal contact. Professors Bhagwati and Krueger will keep in touch with individual participants. Moreover, the professional commitments of the economists tend in any event to promote fairly frequent contact. Should it prove desirable, a second meeting of the group will be held while research is in progress, possibly in conjunction with an American Economic Association meeting.

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By the end of the summer of 1971, authors will be expected to have completed and circulated a draft of their results to other participants. At this point, a second (or third) meeting of participants will be held to determine (1) ways in which individual papers can be improved and made more comparable in terms of coverage, and (2) the generalizations that begin to emerge.

After that working session, the case study papers will be revised and prepared in final form; Bhagwati and Krueger will complete the summary-and-generalizations paper, and papers on any special topics will be prepared. Finally, a larger and more formal conference will be held to provide an overall critical review of the entire research output, including the final drafts of the case studies and the Bhagwati-Krueger paper. Bhagwati and Krueger will edit a volume containing the summary and generalizations, the Analytical Framework, the case studies, and any special-topic papers. The target date for submission of the final manuscript to the National Bureau will be February 1972.

6. EVALUATION OF RESEARCH COMPETENCE OF THE INVESTIGATORS

Professor Krueger is one of the best and most active applied researchers in the field of trade and development. She has been a regular consultant to A.I.D., working on trade and payments problems for missions in Brazil, India and Turkey. Her work has been illuminating and relevant to Agency problems, and she remains in great demand here. Professor Bhagwati is one of the foremost trade theorists, and has done several empirical studies, including an extensive one on India, the country he would study under this proposal. The other researchers are expected to be academic economists of comparable background and competence. In fact, one of the strongest features of this proposal is its intention to bring together several economists of such high caliber to study one important aspect of development.

7. APPRAISAL OF RESEARCH RESOURCES AND BUDGET

The budget appears generally adequate to carry out the study. One item, "field work by case study authors," may be a bit short, and could be increased by as much as \$10,000. However, indirect costs probably could absorb any such overrun. Projected salaries are probably sufficient to induce scholars of high caliber to participate, especially as research assistants have been allowed for.

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8. TECHNICAL AND SCIENTIFIC REVIEW OF PROPOSAL

An ad hoc committee, consisting of Edward Hogan, AFR/DP, Glenn McClelland, PPC/RCS, Ronald Ridker, NESAD/DP, and Michael Roemer, PPC/PPD, reviewed the proposal. It was generally agreed that the project employs an innovative design which carries both high risk and the potential for very significant results. Few research projects are able to concentrate so many well-qualified economists on a single, important issue. The research effort has potential for a substantial breakthrough, both in the state of knowledge about exchange controls and in policy prescriptions of specific interest to A.I.D. However, in order to achieve this concentration of talent, it is necessary to employ researchers at different institutions and to coordinate them through conferences, with informal contacts in between. This research design runs the risk that independent scholars will produce papers inadequately related to the Analytical Framework, but this risk can be reduced by diligent supervision by the principal investigators. In any case, it may be worthwhile to take the chance in view of the potentially important results. The ad hoc committee unanimously endorsed the project.

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