

BIBLIOGRAPHIC DATA SHEET1. CONTROL NUMBER
PN-AAK-0572. SUBJECT CLASSIFICATION (695)
DK00-0000-0000

3. TITLE AND SUBTITLE (240)

Liberal policies vs. controls in the foreign trade of developing countries

4. PERSONAL AUTHORS (100)

Kindleberger, C.P.

5. CORPORATE AUTHORS (101)

AID/PPC

6. DOCUMENT DATE (110)

1967

7. NUMBER OF PAGES (120)

41 p.

8. ARC NUMBER (170)

9. REFERENCE ORGANIZATION (130)

PFC

10. SUPPLEMENTARY NOTES (500)

(In A.I.D. Discussion Paper no. 14)

11. ABSTRACT (950)

12. DESCRIPTORS (920)

| | |
|-------------------|-------------------|
| Foreign exchange | Control |
| Foreign policy | Control processes |
| Exports | Devaluation |
| Economic analysis | |
| Imports | |

13. PROJECT NUMBER (150)

14. CONTRACT NO.(140)

PPC

15. CONTRACT
TYPE (140)

Res

16. TYPE OF DOCUMENT (160)

70

A.I.D. DISCUSSION PAPER NO. 14

**LIBERAL POLICIES
vs.
CONTROLS IN THE FOREIGN
TRADE OF DEVELOPING
COUNTRIES**

C. P. KINDLEBERGER

A.I.D.
Reference Group
Room 1006 HS

OFFICE OF PROGRAM COORDINATION - A.I.D.

DEPARTMENT OF STATE
AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D.C.

Office of Program Coordination

A.I.D. Discussion Paper No. 14

LIBERAL POLICIES vs. CONTROLS IN THE
FOREIGN TRADE OF DEVELOPING COUNTRIES

C.P. Kindleberger

A.I.D. Discussion Papers are circulated for the information of the addressees and their staffs. These papers are intended to serve several functions: to improve knowledge of analytical studies; research results and assistance policies among Agency personnel; to encourage the careful recording and analysis of Agency experience and problems by persons currently engaged in them; and, to share such experience and ideas with interested persons outside the Agency. These papers are designed to stimulate and serve as background for discussion. They represent the views of the authors and are not intended as statements of Agency policy.

April, 1967

Introduction

This paper was prepared for the Office of Program Coordination as part of the 1966 Summer Research Project sponsored by that office. It was based on the various studies of foreign trade sectors conducted by other members of the Project. Professor Kindleberger's summary of his paper can be found on the following two pages. The paper served as the basis of discussion at the October 8, 1966 session of the Administrator's Advisory Committee on Economic Development. The minutes of that session are attached as an appendix.

The other studies which were done on the foreign trade sector for the 1966 Summer Research Project are available on request from the Policy Planning Division, Office of Program Coordination.

SUMMARY

The memorandum is designed to review the case for and against foreign-exchange controls on the one hand, and decontrol and devaluation on the other, in the light of a series of memoranda on foreign trade policies in Brazil, Chile, Colombia, Pakistan, Turkey prepared by AID Summer Consultants.

The "disequilibrium system" of overvaluation and incentives to exports plus controls on imports may have evolved through widespread ineptitude in developing countries, but probably serves an economic function. Incentives to exports take the form of special exchange rates, tariff drawbacks, tax and transport rebates, access to cheap credit, and access to special foreign exchange. These are adjusted between prime and marginal exports. The system usually has some additional special handicaps to exports in addition to the overvalued rate, such as prohibitions to hold down goods significant for the cost of living. A general handicap to exports is the need to maintain surveillance over all export transactions to collect the exchange proceeds to prevent capital exports.

Offsets to imports which are stimulated by an overvalued rate include tariffs, surcharges, special taxes, special rates for exchange, a system of advance deposits.

The disequilibrium system is partly justified as an attempt to improve the terms of trade by raising the prices of prime exports. Largely, however, it is the consequence of domestic inflation originating independently of the foreign sector, but accelerating whenever an attempt is made to

cut down on the foreign deficit by devaluation and decontrol. Since supply is generally inelastic, correction of the balance-of-payments deficit requires a cut in expenditure by some group or groups. Each group in defending its level of living contributes to the inflation. The disequilibrium system of successive piecemeal adjustments seems to be more successful in effecting the necessary equilibrium among income groups than thorough-going devaluation and decontrol.

The disequilibrium system has the disability that it discourages exports, wastes resources, tends to lead to an escalation between overvaluation and offsetting measures to expand exports and restrain imports (as inflation continues). But it has a survival value greater than that of any obvious alternative.

A freely fluctuating exchange rate or annual devaluations when domestic monetary and fiscal conditions are not highly stable, seem to have the drawback of accelerating internal inflation, which feeds back to depreciation, sometimes in an explosive fashion. Multiple exchange-rate systems have a short half-life before evasion and arbitrage among the separate rates overtake them and lead to capital export and breakdown.

The hope for a liberal system seems to rest in the once-and-for-all devaluation. The conditions for its success are that domestic supply is elastic, especially of food and other wage goods, that import of intermediate products are made available to permit expansion of products depending upon foreign inputs, and that there be political consensus, or effective political power to enforce a solution, that various groups will cut their real expenditure in some agreed and tolerable fashion. It is doubted whether these conditions obtain currently in India.

Liberal Policies vs. Controls in the Foreign Trade
of Developing Countries

This memorandum is designed to review the economic, but not the purely political arguments for and against foreign-trade controls on the one hand, and trade relatively free of control but at a devalued exchange rate on the other. It is stimulated partly by a question whether the Bank, the Fund, the Consortium and A.I.D. were right in putting so much pressure on India to devalue last spring and partly by A.I.D.'s need for criteria to determine when a country is doing what it should in improving its balance of payments. It leans heavily upon a rather random assortment of memoranda prepared for A.I.D. on the experience of Brazil, Colombia and Turkey by a number of consultants.¹

A wide range of less developed countries operate what might be called a "disequilibrium system" in foreign trade by analogy with what Kenneth Galbraith called the "disequilibrium system" of price controls, materials allocations, and rationing followed by most countries during

1

See P.G. Clark and R. Weisskopf, "Import Demands and Import Policies in Brazil," draft of August 7, 1966; N.H. Leff, "Export Stagnation and Autarkic Development in Brazil, 1947-1962," preliminary version, July 1966; A.O. Krueger, "Brazilian Exports: Policies and Potential", dittoed, no date; J. Sheahan, "Imports, Investment and Growth: Colombian Experience since 1950", revised, March 1966; A. Carlin, "Alternatives to the Turkish Import Control System and their Advantages", preliminary draft, no date; A.O. Krueger, "Some Economic Costs of Exchange Control: the Turkish Case", no date; A.C. Harberger and Marcelo Selowsky, "Key Factors in the Economic Growth of Chile", April 1966 (presented at The Next Decade of Latin American Development Conference at Cornell University); see also Richard H. Leftwich, "Exchange-Rate Policies, Balance of Payments, and Trade Restriction in Chile", Economic Development and Cultural Change, Vol. XIV, No. 4 (July 1966) pp. 400-13.

World War II. In a disequilibrium system, prices give the wrong signals for resource allocation but major errors in economic efficiency which would be thereby introduced are offset by direct controls. In foreign trade, the disequilibrium system consists in an exchange rate for a country which is overvalued, given the relationship between domestic costs and prices and those abroad. The attempt is made to correct for this overvaluation, in its impact on the balance of payments and on the allocation of resources between foreign trade goods (exports and import substitutes) and domestic uses, by special inducements to exports and restraints on imports.

It is possible that the disequilibrium system survives in a great many developing countries through faulty economic policy or operational ineptitude. When a phenomenon is so widespread, however, there is a possibility, which must be examined, that the system commends itself to various national authorities, or their constituents, either serving particular ends, or representing a position into which a country can readily drift and to which there is no clearly superior and feasible alternative. In this memorandum, the first section will describe the disequilibrium system, the second will examine reasons for its existence, the third will treat its consequences, and a fourth section will examine various alternatives.

The Disequilibrium System in Foreign Trade

Offsets to export disincentives - An overvalued exchange rate penalizes exports. Where domestic prices and costs have risen, relative to foreign prices, with a fixed exchange rate, there is a strong incentive to divert to the domestic market goods formerly sold abroad or to shift resources altogether out of exports into production of other goods for the domestic market. To sustain the level of exports, or to enable exports to grow in conformity to the growth of the market, it is necessary to counteract the diversionary pressure. A wide variety of devices has been developed for this purpose.

These may be listed as follows:

- 1) special exchange rates for particular commodities;
- 2) drawbacks on tariffs on imported materials or components;
- 3) rebates on income and sales taxes;
- 4) rebates on transport charges;
- 5) access to particularly cheap sources of credit;
- 6) rights to retain for the exporter's use, or to sell in the free market, a portion of the foreign-exchange proceeds of exports. Where the exporter uses the foreign exchange himself, this is often combined with 2) above, so that he is permitted to import materials or components on a duty-free basis.

Some of these concessions approach normal practice in an equilibrium system: i.e. the rebating of cascaded sales taxes on exports (and their addition to imports). This is of course an implicit depreciation of the rate of exchange. But all six devices can be thought of as equivalent

to depreciation. Where a special rate is given, or a tax concession which is made up by a countervailing levy on importers, the system approaches a simple devaluation, despite its cumbersome features. But where the exporter is given concessions on imports, credit or transport, the distortion of resource allocation occurs at the expense of other importers, borrowers, or shippers, or involves an undue drain on the resources involved. To give exporters special rights to import at an overvalued rate, for example, encourages them to substitute foreign machinery for domestic labor.

While it is possible to calculate an implicit average exchange rate for these offsets, and Miss Krueger has done so for Brazil within certain limitations, there is a wide dispersion about the averages, since in the usual system different offsets of varying amounts are allowed for different goods. The attempt is made to hold the exchange rate high for goods in inelastic foreign demand, and to provide a subsidy to marginal products which would not be sold at the average rate. To the extent that various interests can make the case that the authorities have calculated wrongly, or to the extent that renewed bouts of inflation further raise domestic costs and prices relative to the rest of the world, changes are required in the separate devices for offset. Under the normal fixed exchange-rate system, costs and prices are in flux and change in response to various macro-and micro-economic forces. In the disequilibrium system, there is continuous change in controls as well.

Not all governmental action taken in relation to exports is designed to compensate for the overvaluation of the exchange rate. Some is called for by the operation of the disequilibrium system domestically; some is part of normal taxation; and some is the surveillance required of trade under a disequilibrium system to ensure that under-invoicing of exports and over-invoicing of imports do not enable foreign traders to speculate against the overvalued domestic currency and export capital needed at home. India forbade the export of peanuts and peanut oil in an effort to hold down the price of oil to the consumer. The Brazilian government restricted the export of castor beans to assist the development of castor-bean processing in the country. Export taxes are levied partly for revenue, partly in an effort to raise the export price and improve the terms of trade, but in either case they reduce export values to the extent that the foreign demand curve has an elasticity greater than 1 over time. Perhaps the greatest interference with exports under the disequilibrium system, however, is the necessity to supervise each transaction to ensure that it is not being used for capital exports. Foreign-exchange control systems have an efficiency which varies with the degree of overvaluation on the one hand, which creates the inducement to cheat, and the discipline of the public and incorruptibility of officials on the other. The discipline and incorruptibility are functions of national character in part, but also of the national purpose and the length of time the system has been submitted to strain.

It is impossible to measure the efficiency of exchange control, but it has been suggested that the most efficient system ever operated, that of Nazi Germany in the 1930s, never collected better than 90 percent of the proceeds of exports, and the ordinary control of the ordinary developing country would do well to reach 75 percent. But these are wild guesses at best.

Offsets to Import Incentives

The overvalued rate stimulates imports by making foreign goods cheap relative to domestic goods and factors. To counteract this incentive there exists a wide spectrum of devices ranging from outright prohibitions of certain types of imports - relied on heavily in Turkey - to establishing quantitative limits or setting some financial penalty. The quantitative limits approach the financial constraint when licenses to import a limited amount of a good are auctioned off. In the normal case, however, the licenses are distributed through some rationing system, and afford substantial rents to those who obtain them. Tariffs, surcharges or special taxes, like the auctioning of licenses, capture the scarcity value of the right to import for the government.

One favorite device for limiting underpriced imports is to require the purchaser to deposit the purchase price long in advance with the exchange authorities. This converts the constraint in part or whole into one of access to credit. Differential tariffs, taxes or surcharges may distort relative prices in the developing country from those in world

markets. In Argentina, for example, there are seven lists with different rates of surcharge ranging from List 1, with none; 2, 20 percent; 3, 46 percent; to 6B, 172 percent; and list 7 with 230 percent.

The disequilibrium system is not necessarily an alternative to currency depreciation and liberal trading in foreign exchange. Most developing countries have both controls and depreciation, with the stimuli to exports and the penalties on imports insufficient to balance the demand and supply of foreign exchange at overvalued prices. The result is depreciation, and a continuously changing system of controls.

Reasons for the Disequilibrium System

The disequilibrium was not designed; it grew as one and another developing country underwent inflation with a fixed exchange rate. In part, the developing countries rationalized a messy system of international economic relations with the Prebisch notions that it is impossible to grow by means of exports in the twentieth century, in contrast with the 19th, **that** the terms of trade are moving against primary products, and that import substitution is the road to growth rather than export expansion. Primarily, however, it was found to be difficult if not impossible to halt the inflation given the needs of government, business, and households, and the inadequate supply of savings; nor was it obvious that devaluation would succeed in limiting expenditure to output plus capital obtained from abroad, since no domestic group whose real expenditure had to be cut would fail to see through the device of raising foreign-trade prices while leaving their money income unchanged.

The debate over whether inflation in the less developed countries is monetary or structural is largely beside the point. To the extent that government, business or households maintain their spending through increased loans when the prices at which they buy rise, it is appropriate to call the inflation monetary. Certainly, no set of monetary authorities, whether central bank or Treasury, seems to be able to withstand the demand for credit in the face of rising prices, given unstable governments and strongly organized interests. The structural-inflation analysis fits Latin America perhaps better than India or Turkey where extra spending spilled over into imports rapidly without raising prices sharply. In Latin America, the extra burdens imposed by development were shifted from sector to sector by successively rising farm prices, wages, taxes, and industrial prices before spilling over into reduced exports and increased imports. There was no substantial group which was unable to defend itself against a cut in absorption, and none with money illusion which prevented it from seeing through the rise in prices.

For devaluation to be effective there must be a substantial increase in output in response to the new set of relative prices - an increase which is greater than the rise in consumption which accompanies it, or there must be a reduction in expenditure. A large increase in output of exports or import-competing goods resulting from elastic supply schedules and higher prices for exports and imports after devaluation would avoid the necessity actually to reduce expenditure of any group or groups, so

long as expenditure rose less than output. It would further limit the rise in prices, and the decline of real income of fixed-income sectors in the economy. Such increases in output may occur if there are unemployed or underemployed labor and capital and no foreign-exchange bottleneck limiting the purchase of foreign components or materials. In the usual developing-country case, however, there are serious limitations on capacity to expand output, because of inelasticity of supply in agriculture or because of limitations on imports of components and materials. Where such is the case, devaluation must rely almost entirely on cutting the expenditure of some group, and this is strenuously resisted.

Some economists, notably Machlup and Sohmen, argue that an increase in real income can be obtained from more efficient resource allocation, even when there are no unemployed factors. Theoretically this notion encounters the difficulty that measurement of real income is subject to the index-number problem with prices changed after devaluation. More practically, devaluation under conditions of full employment is successful when the rise in foreign-trade prices shifts income from spenders, i.e. typically labor, to savers, primary-product producers and industrialists producing import substitutes. Alexander tends to dismiss income-redistribution along with money-illusion and the Pigou effect (which induces individuals to save when prices rise in order to restore the real value of their savings). In my judgement, based on Diaz-Alejandro's study of the Argentine devaluation of 1958, and observation of the French devaluations of 1946 (unsuccessful) and 1958 (successful), devaluation under full employment

succeeds or fails depending on whether or not the income redistribution can be made to stick. If the groups who lose by devaluation increase their spending through credit or by raising administered prices, all prices and incomes are quickly raised by the percentage of devaluation and the balance of payments is not improved.

If some groups would be hurt and some helped by devaluation, it follows that some groups gain and others lose from the disequilibrium system and the vitality of the system can be explained in terms of the political power of these groups. Importers, for example, who buy at world prices and sell at high prices owing to the scarcity of import goods created by the controls, may like the system, as may the regulatory agencies. Ford has observed in Argentina at the end of the 19th century, that the political power of export interests led that country to adopt a fluctuating exchange rate when world prices were falling, and the gold standard when they were rising. Today, export interests tend to have lost political power in the less developed countries whereas industry gains from limited access to cheap imports on the one hand, and high domestic prices for import-competing goods on the other. In some countries, such as India, the industrial importing interest may be governmental. Government has another parochial interest in overvaluation to enable it to pay foreign debt service with the least amount of local currency. Similarly, where foreign investors are permitted to transfer profits at the official rate - profits which are maintained at a high level by

reason of the limits on imports - it is obvious that they have an interest in the disequilibrium system, although it is doubtful whether they exercise a significant pressure for its maintenance.

Where domestic output can be expanded, especially in items which bulk large in the cost of living, such as food and textiles, the chances of success in devaluation, are substantially improved, as already noted. There is also a possibility of holding down the prices of wage goods through imports. This would involve running an increased deficit in the short run, in order to reduce it over time. But there is another case where imports must increase before they can be reduced, and this is where domestic production and production for exports depend significantly on intermediate products - components, raw materials and fuel imported from abroad. Where there is a foreign-exchange bottleneck, rather than a lack of overall savings, devaluation requires expansion of at least certain kinds of imports and possibly an increase in the deficit as a transitional matter after devaluation. Where there is doubt whether the increased imports can be financed under a liberal system, the argument for controls is improved.

One of the most widely-used arguments in favor of the disequilibrium system is that it enables the developing country to exploit its monopoly advantages to the full. Devaluation followed by expanded output of primary export products would worsen the terms of trade, because of the inelasticity of foreign demand. The overvalued rate holds up export prices and receipts, reduces the trade deficit, and improves real income. Multiple-

exchange rates, or differing rates of subsidy and tax on exports and imports enable a country to optimize its gains from trade. This argument, however, is readily answered with the reply that it is possible to impose export taxes equal to the degree of depreciation, and thereby to retain the monopoly advantage of high export prices to foreigners in goods in which the country is dominant.

A distinct reason for the disequilibrium system operated in New Zealand is to provide employment. Since this is a rich, if not a highly developed country, the case is perhaps primarily of intellectual interest, but it should be included in a complete statement. Best practice in sheep and cattle-grazing and dairy farming is land-intensive, with only limited employment opportunities. To maintain its population of 2 1/2 millions, New Zealand governmental authorities are persuaded that they must maintain import controls on manufactures and encourage labor-intensive, import-competing industry. They recognize that this involves a trade-off of efficiency against employment opportunities, but are prepared to slow down the development of exports and imports, and limit the possible gains from trade, in exchange for a higher population engaged in relatively inefficient industry. What is remarkable about the New Zealand case is that brimful employment - with job vacancies vastly in excess of the handful of unemployed - and import controls produce so little in the way of inflation. The prices of home goods have risen only from 100 in 1958 to 111 in 1965. It appears that industry and labor are neither very aggressive in raising prices under conditions of great shortage.

A final argument for the disequilibrium system is that devaluation is likely to exert upward inflationary pressure in a way that the disequilibrium system does not. In effect, this implies that sector incomes can be reduced by a series of direct controls with public acceptance, while the sectors hurt by devaluation would react vigorously against it. Partly the case is made that direct controls enable the authorities to impose sacrifices in a more equitable fashion, for a given balance-of-payments deficit or surplus, partly it rests on the view that the disequilibrium system develops through myriad separate steps, no one of which is sufficiently harmful to a particular interest so as to lead it to react strongly, whereas devaluation as a single, discrete, and far-ranging act tends to attract opposition. The analogy is with piecemeal tinkering with the tax system, rather than the once-and-for-all major reform which, in reaction to Nicholas Kaldor's proposals for tax reform, led to riots in Ghana, British Guiana and India. The disequilibrium system enables the authorities to simulate money illusion, in this view, whereas the public would see through the redistributive effects of devaluation.

These then are the main rationalizations for the disequilibrium system. On the external front it survives because countries typically cannot finance the additional imports of intermediate products necessary to expand production of exports and import-competing goods. On the domestic front, its persistence is the result of the greater political ease (as a rule) of taking many little steps rather than one big one of far-reaching effect on the several income groups in the economy.

Consequences of the Disequilibrium System

Stagnant exports - It seems to be a clear result of the disequilibrium system that exports stagnate. The phenomenon is usually explained by the less developed countries along Prebisch lines, as the result of low income elasticities, the substitution of synthetics for natural products, protective policies in the developed countries, etc. It is difficult to make the case stick. Benjamin Cohen and Manmohan Singh have independently demonstrated that the growth of Indian exports has been slower than that of the demands for its major products.² The result has been a reduction of the Indian share of its export markets. Similar export stagnation is found in Argentina, Bolivia, Brazil, Ceylon, Chile, Colombia, New Zealand, Turkey, etc., which operate this sort of system.

Theoretically, of course, it is possible for the various subsidies and special arrangements for exports to compensate for the depressing effect of overvaluation. In practice, however, the record seems to demonstrate that this is seldom achieved, and that the disequilibrium system tends to lead to export stagnation. Both Miss Krueger writing about Turkey, and Harberger and Selowsky on Chile have observed an increase of the real rate of exchange in recent years, i.e. the (or a particular) exchange rate divided by the domestic price level. Government seems to have a propensity to substitute import restrictions for exchange depreciation, with deleterious effects on exports.

²B.I. Cohen, "The Stagnation of Indian Exports, 1951-1961, "Quarterly Journal of Economics, Vol. LXXVIII No. 4, (November 1964), pp. 604-20; M. Singh, India's Export Trends and the Prospects for Self-Sustained Growth, Oxford, Clarendon Press, 1964.

Waste of resources. The disequilibrium system leads to waste of resources in a variety of ways. The most obvious, perhaps, is that resources engaged in producing import-substitutes could produce more of the same goods if they were engaged in export industries and the proceeds of foreign sales were used to purchase the goods from abroad. This assumes, of course, that the demand for exports is elastic with respect to price, and that incremental exports would not reduce foreign exchange earned. Such is not the case for certain major exports, like tea from India, or coffee from Brazil. But for lesser exports it is certainly true. Miss Krueger's attempt to estimate the loss quantitatively for Turkey rests on the somewhat dubious assumption of constant costs, which equates average with marginal costs. It happens, of course, with upward-sloping supply curves, that resources can earn the same marginal return in exports and in import-competing lines - the test of equilibrium - but at the same time a given batch of resources would earn more on the average in exports than in imports. Despite this possible defect, Miss Krueger's study helps to demonstrate the waste of resources in moving away from static comparative advantage, with widely differing average costs in export and import-competing industries.

An argument can be made that import-competing lines are more productive than exports on a dynamic basis, whether because of economies of scale, long-run risk factors, or price instability. This will of course be true in particular cases. But the presumption is otherwise, when tariffs, surcharges, special taxes and prohibitions are required to restrain imports.

There are other wastes than those involved in the allocation of resources to relatively inefficient industry. One is the need to maintain high inventories when imports are subject to an arbitrary and uncertain control. Another is the apparatus of control in the government, and of personnel maintained by industry to conduct trade in the face of that apparatus. But the most serious waste seems to be that resulting from the distortion in the relative prices of imported equipment and domestic factors. To the private firm it looks profitable to substitute foreign capital for domestic land and labor. A planning office may have a set of shadow prices for foreign exchange and labor, in which the price of the former is well above market, and that of the latter, much below. But firms operate as a rule with market, rather than shadow prices, which leads to overly capital-intensive techniques being employed in countries with excess labor and capital deficiencies.

Finally, of course, there is the loss of foreign exchange through capital exports, illicit expenditure on prohibited goods, and a certain social toll in the corruption of public and bureaucracy alike.

Escalation - Inflation is a way of life in many of the developing countries. The question is not whether there will be inflation or not, but how much. Albert Hirschman has suggested that inflation is basically a political phenomenon, and a means whereby the various sectors which have difficulty in agreeing on the distribution of income evade and postpone that decision in a stylized fashion.³ As inflation proceeds, the pressures

³A.O. Hirschman, Journeys Towards Progress, New York, Twentieth Century Fund, 1963.

to maintain exports and restrain imports have to be built up. This leads to more and more complex interference with the market.

Finally the system becomes so distorted and complicated that there develops an interest in starting over again, and replacing the disequilibrium system with devaluation and decontrol. Colombia devalued in March 1951, June 1957, March 1960, November 1962 and September 1965. The Brazilian cruzeiro has been devalued from 138.5 to the dollar in 1958, to 205 in 1960, 319 in 1961, 475 in 1962, 620 in 1963, 1850 in 1964 and 2,220 in 1965 (with a higher rate, ranging from 37 in 1958 to 939 in March 1966 for coffee exports). But devaluation fails to cure anything unless the inflation is stopped, and the devaluation tends to restimulate inflation. So the disequilibrium system proceeds as a rule, with the exchange rate depreciated in successive steps. Controls are taken off, but they are soon put back. All that devaluation buys is time. Whether the escalation picks up speed or not will differ from case to case, and a wide range of possibilities of course exists. In Brazil, Chile, Colombia, Turkey, and perhaps prospectively in India, however, the disequilibrium system is both impossible to operate effectively and impossible to abandon.

Alternatives to the Disequilibrium System

Freely Fluctuating Exchange Rate - The liberal or perhaps libertarian solution for developing countries with continuous inflationary pressure is a freely fluctuating exchange rate. Its purpose is to ensure that the internal depreciation of the currency is matched by external depreciation so that the balance of payments will stay in equilibrium. Instead of domestic

inflation leading to overvaluation, escalating controls, devaluation to an equilibrium level and more inflation to repeat the process, the thought is that the exchange rate will remain in equilibrium as inflation proceeds, with continuous depreciation, no controls, and balance-of-payments equilibrium.

Not only is the freely fluctuating exchange rate listed by economists of all persuasion, and recommended by the liberals, it has been tried. Chile allowed its rate to float from 1878 to 1925, and Leftwich for one is disposed to regard the experiment as a success. The balance of payments stayed in equilibrium. Domestic inflation and exchange depreciation proceeded, to be sure, but the foreign-trade sector did not suffer great distortion.

Economic theorists suffer great frustration because of the continuous rejection of freely fluctuating exchange by practical authorities. The reason, in my judgement, is that the implicit model of the freely-fluctuating exchange system which the theorists have in mind is usually overly simple. The model typically assumes no capital movements, or only capital movements of a stabilizing character; and that the rate of domestic inflation is independent of the position in the foreign exchanges. Moreover, it fails to take account of the need for a stable unit of account of some sort in long-term contracts. Under conditions of continuous internal inflation and external depreciation, if they could be run in neat parallel with no under- or overvaluation, it is likely that debt contracts would be

made in foreign exchange, real commodities or local currency deflated by a price index. In this circumstance the adoption of a free fluctuating exchange rate implies the abandonment by the local currency of much of its monetary function and the necessity to find substitutes.

The Chilean experience from 1878 to 1925 was not so successful that the country clung to the freely fluctuating exchange standard. In 1925 with a far-reaching monetary reform, the peso was stabilized on a gold-exchange standard. With the help of borrowings in New York, this lasted until 1931, since which time Chile has maintained a "managed exchange rate," i.e. the disequilibrium system. The attempt to stabilize the currency at a newly depreciated level in 1959, after a change of government, failed because of inability to stop the inflation. Leftwich concludes innocuously that fixed exchange rates are not compatible with continuous inflation.

But exchange depreciation may stimulate inflation in a country uneasily poised on the verge of financial stability. A freely fluctuating exchange rate is not necessarily an equilibrium one. With capital imports, the rate tends to be overvalued and to retard inflation with the help of an import surplus. With capital exports, however, undervaluation will accelerate domestic inflation. The managed exchange system evolved from attempts to cut off this extra source of inflationary pressure. Harberger and Selowsky's recommendation that the Chilean real rate of exchange be lowered, i.e. that the country move from systematic overvaluation to undervaluation, or at least a substantial reduction in overvaluation, fails to consider the impact this would have on domestic inflation and the possibility of its acceleration.

In continental experience after World War I, exchange depreciation fed back and accelerated inflation leading ultimately to monetary collapse. It was on this account that the countries of Europe after World War II adopted the disequilibrium system of overvalued currencies and controls. After domestic inflation was gotten in hand, with aid from the United States, the external controls were dismantled. The difference between this experience and that of the developing countries - apart from a few like Greece, Taiwan, Peru, etc. is that the internal inflation in developing countries is not brought under control. A freely fluctuating exchange rate, however appropriate for a country with stable monetary conditions, adds fuel to the inflation where domestic financial discipline is lacking.

Moreover unless foreign traders can be relatively certain that the external and the internal depreciation of the currency will run in parallel, they may be unwilling to commit resources to exporting over the long run. Foreign trade is not conducted deal by deal, as profit opportunities present themselves singly. Investment is needed in transport and storage facilities, in marketing connections abroad, as well as in productive capital. The payout of such investments covers a span of years, and entry is not likely to be undertaken under conditions of great uncertainty.

The point is readily made that the disequilibrium system fails to provide the certainty needed for long-term allocation of resources to exporting, and indeed it is frequently said that the uncertainty merely takes different forms, residing less in the exchange rate and more in the

controls, regulations governing foreign trade, and in domestic costs and prices as affected by inflation. This is true. But there may be something to the view that where the authorities of a country are trying to hold down inflation and hold up the exchange rate, there is a little greater possibility-admittedly not much - that the investor can plan on relative costs and prices at home and abroad over the necessary time horizon. In general both the disequilibrium system and the freely-fluctuating exchange rate discourage foreign trade and therefore involve a departure from comparative advantage. But where domestic inflation and the exchange rate are left to fend for themselves with no attempt to hold them in check, the uncertainty, and hence the penalty to investment in foreign trade, may be somewhat greater.

Multiple Exchange Rates - A multiple exchange-rate system is akin to a system of taxes and subsidies on exports and imports. As such it can be operated for a variety of different purposes, assuming appropriate knowledge of the elasticities over the appropriate time periods and a system of surveillance which prevents arbitrage among the different rates. The system could be run to maximize government revenue, to achieve optimum gains from trade, to provide varying degrees of protection to import-competing industry, to maximize employment, etc., etc. But it requires the various markets to be held separate, in the face of the incentive of exporters to sell at the highest rate, and importers to buy at the lowest. The difficulty of effecting and maintaining this separation of markets is what leads as a rule to consolidation of a sophisticated system of many rates into just two, the official rate which penalizes exporters and favors

importers, and the free rate which clears the rest of the market, much as under the freely-fluctuating exchange system. It is still necessary to prevent exporters of goods in which the country has a monopoly - tea and jute in India, coffee in Brazil, copper in Chile - from selling at the free rate, and importers of luxuries from acquiring exchange at the official price. All the exchange obtained from monopolized exports must be collected, and access to exchange at the official rate must be limited to essential imports. The task is easier with a two-rate system than with a dozen.⁴ It still doesn't work very well.

A multiple exchange-rate system is a contest between the ingenuity of the market and the defensive skill of the authorities. The market always wins in the long run. The half-life of the game, moreover, is probably declining as the moral exhortations which introduce the system fall on deafer ears and officials running the controls are worn down by bribery and corruption. In periods of patriotic fervor, as in war, or under the stress of an emotional dedication to national objectives of development, the efficiency of the system can be raised. It works better for disciplined people like Scandinavians, and worse for more individualistic temperaments, like the Latin. But over time, it always deteriorates.

In effect, the multiple-exchange system in its various forms, is merely a particular version of the disequilibrium system, a version which

⁴Edward Holland tells me that Venezuela decided in favor of its last consolidation of a multiple-exchange rate system into a single depreciated rate when it was calculated that the loss of government revenue from the difference between the buying and selling rates would be broadly made up by the 70 percent corporation tax on the higher profits of exporters selling at the depreciated rate.

is more logically consistent, than one with additional surcharges, prohibitions, subsidies, entitlements and deposit schemes, but a disequilibrium system nonetheless. One particular version of the multiple exchange-rate system, that of a fixed rate for exports, and an auctioning off of the resultant exchange proceeds is highly thought of by some economists. This has a strong revenue effect. But it poses the same problems as any others: how to isolate the exporters from the importers, so that they do not trade with each other at rates more favorable to the importers than the auction rate. The pressure to arbitrage is there. As a rule, it wins.

Successive Devaluations, perhaps annually - Clark and Weisskopf have suggested that if Brazil manages to restrain the rate of inflation to 10 to 25 percent a year, it should maintain the positions of exporters and import competitors by a series of discrete devaluation approximately annually, "timed in relation to the cycle of wage and price adjustments". This seems almost a counsel of despair. It is, in effect, a form of the freely fluctuating rate, but one without the possibility of decontrol.

Continuous inflation and sporadic depreciation would quickly lead to destabilizing speculation, with exporters withholding the proceeds of exports and anticipating the exchange requirements of imports. If the successive devaluations went further than inflation to produce an undervalued rate and an export surplus, there would still be difficulty in collecting it, given the likelihood of devaluation in future. Moreover the undervaluation would give a fillip to inflation. If devaluation went only to the equilibrium rate, persistent inflation would make the rate overvalued shortly.

If inflation cannot be corrected, there is probably no choice but to operate a disequilibrium system using a variety of devices to offset the incentive to import and the reluctance to export. Devaluation is desirable when there is a pause in the inflation, though it must be recognized that the devaluation risks a renewed bout of price increases. But to incorporate devaluation as a regular process seems likely to lead, like the freely-fluctuating exchange rate, to an explosive degree of domestic inflation.

One variant of the policy of a freely fluctuating exchange system, or regular devaluations, is advocated by Harberger and Selowsky as a means of promoting export expansion. It is the announcement by the authorities, publicly and explicitly, of an intention to maintain the "real exchange rate" at a certain level, or within a certain range. The real exchange rate calculated by these authors is a particular Chilean exchange rate, the banking market spot rate, and not the banking market futures or the brokers' market divided by the price index of home goods. Difficulties of selecting the appropriate exchange rate and price level may be ignored, as well as the lack of allowance for movement in foreign prices. The critical issue is whether it is reasonable to introduce a new exchange rate assuming other things equal, or whether overvaluation restrained the rate of inflation and its removal would accelerate it.

Once-and-For All Devaluation - The effort should be to curb domestic inflation and to undertake a single devaluation which permits decontrol. Miss Krueger has suggested that this devaluation should go beyond the equilibrium rate to an undervalued level, and be combined with export

taxes on the items in which the country had a strong market position. As the short-run inelasticities gave way to longer-run high elasticity, the export taxes could be reduced to assist exporters in maintaining their volume. Apart from this device for preventing worsening the terms of trade, the devaluation would be accompanied by decontrol.

Conditions for a Successful Devaluation

The familiar condition for devaluation to improve the balance of payments by means of exchange depreciation is the Marshall-Lerner condition that the sum of the elasticities of demand be greater than 1. This assumes, as is well known, infinite supply elasticities, a balance of trade of zero, and the absence of controls. When supply elasticities are less than infinite, the sum of the elasticities of demand can be less than 1, as Hirschman has pointed out. If the initial condition is a large import surplus, the geometric balance of trade is always improved even though the arithmetic balance may be worsened. If devaluation is substituted for controls, domestic prices may actually decline, rather than rise, as a more efficient means of preventing an import surplus is substituted for a less efficient.

The elasticities of demand cannot be ignored, and the use of export taxes to replace overvaluation on goods where foreign demand is highly inelastic has been mentioned at various places above. It is important to recall, however, that the elasticity of net demand for the exports of a devaluing country is not the same as the elasticity of demand for the commodity. The difference is the elasticity of supply in potential com-

petitors. By holding up the price of coffee, Brazil and Colombia encourage output in East Africa; and the same is true of India in tea. Over the longer run which allows time for foreign competitors to enter into production, therefore, the demand elasticity for the exports of a particular country is higher than the demand for the product as a whole.

Inelasticity of domestic supply may lower the tolerable demand elasticities in the Marshall-Lerner condition but is otherwise only harmful. For marginal exports, it is obviously important to expand output. To limit the rise in prices of imports, it is desirable to have a high supply elasticity of import-competing goods.

A number of writers, such as Sheahan, have pointed out the importance of an elastic supply of foodstuffs. If food is exported or imported, devaluation tends to raise its price, but a high supply elasticity holds it down. An increase in food prices - or in the price of any other important wage good, such as cotton textiles, makes clearer to consumers the reduction in the level of living required by devaluation, and reduces the chances of maintaining money illusion. Where food supplies are supply-elastic, because of a margin of unemployed resources, the task of subtracting from the economy the goods needed to fill the balance-of-payments gap is much easier.

As already indicated, many of the less developed countries depend on imports for intermediate goods important to their development programs. Where the foreign-exchange gap is more important to development than domestic savings, devaluation should expand exports rather than reduce

imports, and raising exports may require still more imports. The balance of trade may have to get worse before it can improve. In these circumstances, a devaluation may require foreign aid in the form of loans or grants, or reserves which the country is willing to draw down, before it can expect devaluation to work.

If loans, grants or reserves are available, and the domestic supply of wage goods is inelastic in the short run, but elastic over time, it may be useful to increase imports of wage goods such as food in the short run to hold down the loss of real consumption during the period needed to expand output. The added imports hold down the price rise needed to stimulate production, and so detract from the necessary incentives. At the same time, they undermine the inflationary pressure from groups resisting a cut in real income.

Among the most elusive of the conditions for devaluation to succeed is what Sheahan calls "ambiente", i.e. political calm. This can take a number of forms. It can be imposed from the top, as in the 5th Republic of President deGaulle, which devalued in 1958 at the expense of the laboring classes which were politically and economically powerless to resist. There can be a concensus that it is necessary to take action to cope with the balance of payments, and all groups in the society must bear a share of the burden. Or the groups that suffer a loss in real income can be obtuse, i.e. suffer from money illusion, and fail to push for higher wages or higher prices because they are not quite aware of what is happening to them. The chances for this last condition are

limited in a country which has experienced a long bout of inflation, but it is not altogether excluded. Decontrol and procedural simplification in moving from the disequilibrium system to equilibrium at a devalued rate after inflation has been brought under control may disguise exactly what groups are bearing the brunt of reductions in real income. The more difficult task is to stop the inflation.

The basic condition for successful devaluation is to halt the inflation. The inflation and the resistance to devaluation are both symptoms of politico-economic failure to agree on income distribution, a failure which would be much more readily overcome if production could be expanded. The reason that devaluation adds fuel to the flames of inflation is that it alters income distribution in ways which some groups find unacceptable and seek to counter by expanding their spending on credit or raising administered prices. If a tolerable consensus on income distribution can be found, it should be used first to halt the inflation, and then gently, without disturbing the monetary-fiscal-pricing balance, to substitute an equilibrium for a disequilibrium system.

Thus the condition for successful devaluation is basically political. A consensus among the various economic groups is best. An imposed solution will work provided the pressure from above is maintained, but few of the political structures in the less developed countries are sufficiently sturdy to accommodate that. A very adroit series of economic steps which fool the public, as with money illusion, is possible, but not likely.

The question arises whether India in June 1966 experienced the conditions needed for a successful devaluation. The answer is largely no.

The monopoly position in tea and jute is preserved in the short run by export taxes, but may be eroded in the long by the price support given to competitors. Decontrol was carried only a short distance in the import liberalization of June 21, and by August of 1966 new exports subsidies were being provided for iron and steel products, engineering goods and woolen carpets. Food was in short supply and also raw materials and components. While the Government of India proposed to spend the foreign exchange it had accumulated in the last quarter of 1965 and the first half of 1966, together with new credits from the consortium, it is by no means clear that this could be put into operation rapidly enough to halt the rise in prices which started to shoot up in March of this year. The devaluation took place while the inflation was building up, not when it had subsided. And worst of all, there was no political consensus on the need to make sacrifices for development, but rather strong political discentent, between parties and within the Congress party. It is difficult to see in the Indian picture the ideal conditions for the success of devaluation.

APPENDIX

1966 SUMMER RESEARCH PROJECT: FOREIGN TRADE

Professor C.P. Kindleberger (MIT)
Professor Paul Clark (Williams College)

Proceedings of the October 8, 1966 session of
the Advisory Committee on Economic Development

Dr. Ranis opened the meeting by reviewing past projects and by giving a brief description of the 1966 Summer Research Project. Unlike previous years, sector analyses and specific country guidance accounted for a good deal of work undertaken. In several instances, notably, Brazil, Pakistan, and Nigeria, the work had direct relevance to the Region's and to the Agency's programming process.

Professor Kindleberger then made some remarks on his work done in the foreign trade sector based largely on Latin American experience.* In response to the frequent rather "light hearted" suggestions for devaluation he stressed that the disequilibrium system providing these suggestions was not necessarily a mistake or bad economics. The IDC's find themselves in positions in which controlled exchange rates and licensing of foreign exchange are a better situation in the short-run than a freely floating exchange rate would be. While the desirable end result may be equivalent to a freely floating exchange rate, the path followed in reaching it is not irrelevant. It is probably as important to choose the correct path (which will be dependent on country situations) as it is to reach the goal. For instance, the Harberger-Selowsky recommendation that the purchasing parity of exports be maintained at all costs in Chile could produce an explosive condition, as could the freely floating exchange rate. A once-and-for-all devaluation, unless accompanied by increased exports and a stable domestic scene, would probably produce additional inflation.

The disequilibrium system, even though the product of a condition and not a theory, exists for very real economic reasons. Perhaps the most important of these is the reluctance of any one group in the economy to accept the necessity of having its status change relative to that of other groups. It is politically and psychologically easier in many situations to encase in a very complex shell a change in the relative position of economic groups than it is to accomplish the same thing via an obvious method which makes not only the presence and degree of "hurt," but also the escape route, very apparent. The final goal should be establishment of the equilibrium system and a free market, but in countries like Colombia, Chile, and Brazil, a rapid movement towards this is impossible.

*The "disequilibrium system" is characterized by an overvalued exchange rate, incentives to export and controls on imports. Incentives to export take the form of special exchange rates, tariff drawbacks, tax and transport rebates, access to cheap credit, and access to special foreign exchange. These are adjusted between prime and marginal exports. The system usually has some additional special handicaps to exports in addition to the overvalued rate, such as prohibitions to hold down goods significant for the cost of living. A general handicap to exports is the need to maintain surveillance over all export transactions to collect the exchange proceeds to prevent capital exports. Offsets to imports which are stimulated by an overvalued rate include tariffs, surcharges, special taxes, special rates for exchange, a system of advance deposits.

The Marshall Plan's success in Europe was an instance in which countries did move out of a disequilibrium system position. Mr. Wriggins (White House) pointed out, however, that it is dangerous to draw too many parallels between Marshall Plan Europe and the developing countries, especially with respect to moving out of a disequilibrium situation. Many of the LDC's, unlike the European countries after World War II, do not satisfy the conditions which Mr. Wriggins suggested for a successful devaluation: a relatively stable political situation, adequate food supplies, and an idle productive system ready to roll.

Dr. Chenery pointed out that if a number of conditions must be satisfied in order to move to an equilibrium system, then a policy package, not just one policy, is needed. Adjustment of the foreign exchange rate is not always panacea. He suggested trying to isolate the situations in which any one set of policies will work before applying them. For example, the Harberger Chile package includes exchange rate recommendations that are based on the assumption that the excess foreign exchange reserves needed to make this successful are available. While all of the SRP papers include recommended policy changes for tariff rates, not all of them consider the total package of fiscal, monetary, and foreign sector policies required to make the tariff recommendations successful.

Professor Clark commented that the policy suggestions developed for Brazil could be considered such a package. They include policies dealing with several features of the rather complex foreign trade system, and aim at reinforcing present efforts to move closer to an equilibrium system both in trade and in the domestic economy.

1. The tariff suggestions emphasize a narrowing of the spread of tariff rates as a means of reducing discrimination between different commodities which are closely related.
2. The present exchange premium system appears to have a greater discriminatory effect than the tariffs, however. The approach of reducing the size of the premium paid to buy exchange for imports in the "special category", itself, could reduce this discrimination while retaining the possibility of offering a higher exchange rate to non-traditional exports.
3. The proposal to make approximately annual adjustments in the exchange rate and to time adjustments to coincide roughly with the wage contract negotiations would fit trade policies into the other elements of the government's program to reduce price inflation in a step-by-step pattern. Given the present foreign exchange surplus, combining a devaluation with import liberalization could have its full effect on export promotion while its domestic inflationary effect is partly offset.
4. Present slack in domestic capacity, even while price inflation continues, would permit a rise in the rate of investment, particularly in sectors stimulated by these trade policies.

Dr. Despres remarked that the Kindleberger paper deals mostly with the Latin American situation. The question of whether, given chronic inflation, sporadic adjustments of the exchange rate are preferable to frequent adjustments is answered only to the extent that doing something about inflation is more important than adjustment of the exchange rates. He would criticize the paper for what it neglects to say: it does not consider the effects of devaluation and adjustments in the exchange rate on the allocation of investment and incentives. Devaluation and decreased aid are not thought of as remedies; usually devaluation is associated with increases in the trade balance deficit. Hazlitt has pointed out that in aid-receiving countries, the balance of payments deficit is often caused by the U.S. assistance. A decrease in the level of aid would help reduce this deficit, but Despres doesn't recommend this. Kindleberger said that he viewed the problem as determining the U.S.'s response to an IMF stand that a particular country needs to devalue. He recommends that we not be doctrinaire.

Dr. Despres's basic objection to the Kindleberger paper is that the framework used is the same as that used for post World War II Europe. There is little analysis of the structural and developmental effects of the recommended policies, and this is what we are after rather than the effects on the rate of inflation. Because of the insufficient definition of the model, the question of dynamics raised in the Kindleberger paper are basically unanswerable.

Dr. Chenery outlined conditions under which the Harberger recommendations for Chile would be appropriate: a good aid level, excess capacity, the possibility of increased production as a result of import liberalization, and excess foreign exchange reserves. The Government of Chile is working towards decreasing the inflationary impact of its public expenditures and this would be even more difficult without an exchange rate that produces investment incentives of the desired type. For a small country, such as Chile, the aid bill required by a policy that moved towards the equilibrium system would probably not be much greater than that at present. In a large country, such as Brazil, this is probably not the case. If the cost of instituting an equilibrium system is too great (in terms of inflation, etc.) then the disequilibrium system is preferable.

Dr. Ranis added that the importance of knowing the initial conditions in the country with which you are concerned should not be underestimated. Before looking through our tool kit to decide what policies should be recommended, it is imperative that we know the historical rate of inflation in the country, the size of the economy and the relative size of the trade sector, and the presence and nature of distortions (causes of them; indirect vs. direct control systems).

Once these are known, we can choose the appropriate devaluation technique from among the following: once a year, once and for all to an undervalued rate, or continuous (accomplished through either de jure or "salami" -- de facto -- techniques).

Emile Despres then went on to outline four propositions on which he felt the Committee members would agree:

1. Devaluation and liberaization in the absence of additional aid and increased imports would prove disasterous.
2. Chronic overvaluation, and the structural consequences of this, seems to be inherent in the chronic inflation process. The freely floating exchange rate cure to overvaluation could produce increased inflation and hence no reduction in the overvaluation.
3. While devaluation may alter price and profit incentives so as ultimately to stimulate exports, it is crucial to have an added dose of immediate imports. In India, for example, the recent devaluation could prove to be a fiasco unless the increased aid, which was a part of the package, is forthcoming. The end result could be inflation in a country with no prior history of this.
4. The real significance to the overvaluation system is that it is an income transfer arrangement providing powerful incentives for expansion, but possibly having harmful effects on backward linkages. Within any given political context, however, the needed injection of imports ought to be used to span the time necessary for production to grow to the point where rational incentive schemes can take over. The idea is to help the previously hurt groups in the economy and not to hurt those previously favored.

Professors Millikan and Mason wanted to know if Professor Kindleberger had meant that in a country like India, domestic controls should be used as a short-run means of correcting the distortions in the foreign sector. Professor Kindleberger said that he didn't exactly mean this. Import liberalization and freely floating exchange rates depend on certain long run economic changes in order to be successful. Until these changes become evident, it may be necessary to maintain the disequilibrium system and the controls which are usually associated with it. For example, in India there are two markets for food, one based on domestic production and the other on imported food stuffs. While devaluation will affect the foreign sector as a whole in the desirable direction, it may adversely affect the already bad agricultural sector. What is needed is both devaluation and a shift in the domestic terms of trade for agriculture. The political facts of life, however, make it too difficult to force one group to be hurt relative to others via a devaluation scheme. Also, the production prerequisite, present in Europe during the Marshall Plan, is not present. Mrs. Bergmann mentioned that the success of devaluation also depends on whether people require that their relative share or their relative position remains the same.

Dr. Ranis pointed out that in the case of India we are dealing with a country with an historical rate of inflation of only 5-10% a year.

Devaluation and import liberalization has been directed in the first instance towards maintaining the price level and increasing imports. Unless the import liberalization affects raw materials and spare parts and hence the productive system, the end result will not be a beneficial change in the domestic economy. Import liberalization interpreted to mean only an increased flow of intermediary goods will not reduce the inefficient allocation of domestic resources.

Dr. Despres emphasized the need to maintain domestic savings. The original purpose of tariffs may have been to curb consumption, but an unintended effect may be to increase domestic production of the goods. Liberalization may reduce the relative prices of these same goods and further increase consumption at the expense of savings. Dr. Despres would not want automobiles and televisions to be as cheap in Brazil as they are in the U.S. Perhaps an excise tax to decrease consumption of luxuries and not redistribute income could be imposed. Professor Millikan pointed out that this policy will work better the lower the income level of the country.

Professor Clark commented parenthetically that he favored attacking the savings problem directly rather than through the pricing mechanism. If the government follows fiscal policies which generate a sufficient flow of savings, he sees nothing wrong in general with allowing consumers to choose between clothes and cars, rather than have a pricing system in which cars are priced out of the range of most consumers. The main thrust of Professor Despres' comments, however - the need to adjust the pattern of production as the economy moves closer to an equilibrium system - makes clear that the speed with which the adjustment occurs is of great importance. The Brazilian Government has been criticized for not stopping the inflation, devaluing, and altering trade policies in one fell swoop. But it one starts from a disequilibrium system and realizes that the necessary changes in patterns of production cannot occur overnight, than a series of partial steps seems the proper way to carry through an anti-inflation program combined with rationalized import and export policies.

Dr. Ranis asked for advice on the general question of de jure vs. de facto devaluation. Professor Kindleberger's paper gives some support to de facto methods, but Dr. Ranis sees disadvantages to this in the cumbersomeness and the inefficiency of the bureaucratic process. Dr. Pye noted that a criticism made of de jure devaluation was that correct timing could be a critical factor, but he suggested that de facto devaluation could also suffer from poor timing. Mr. Gaud questioned whether the choice between the two devaluation methods was not largely a political question. Dr. Despres pointed out that the two methods were not necessarily equivalent unless strong measures were taken to tax foreign investment. Mr. Glaessner stated his belief that the administrative difficulties of a de facto devaluation lead to the worst of all possible worlds.

Dr. Chenery related the above discussion to the process of programming aid by saying that the important problem is usually one of restructuring the economy so as to increase efficiency. In converting from the disequilibrium to the equilibrium system, both the planned sequence of policies to be used and the time table for instituting them are necessary. The time table should take into account the fact that the same set of policy decisions can have very different results in different countries. The capstone to the whole process is growth. Programming of aid should be on a step-by-step, sector-by-sector basis leading to a general devaluation measure, if necessary.

PC/PPD:EOppenheimer