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Volume Title: Anatomy and Consequences of Exchange Control Regimes

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Volume Publisher: NBER

Volume ISBN: 0-884-10487-7

Volume URL: <http://www.nber.org/books/bhag78-1>

Publication Date: 1978

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Chapter URL: <http://www.nber.org/chapters/c1020>

Chapter pages in book: (p. 53 - 63)

Sequential Phases and Contrasting Structures in Exchange Control Regimes

The preceding chapter analyzed taxonomically, with several illustrations from the country studies in the Project, the numerous dimensions on which exchange control regimes can, and do, differ from one another in their use of both QRs and price instruments. In the present chapter, we now shift the focus of our analysis to two sets of questions about exchange control regimes or, more broadly, foreign trade regimes, regarded as integrated structures or “clusters”:

(1) Can we state any general propositions about the economic consequences of different exchange control regimes?

(2) Can we delineate certain basic “types” or stages of exchange control regimes in a manner that is economically meaningful for analyzing the time sequencing of the regimes within a country and across countries?

I. GENERAL PROPOSITIONS

The analysis of exchange control regimes and their consequences in the different country studies reflects and underscores three basic propositions that may now be stated and briefly discussed.

Proposition (1): Identical component features of exchange control regimes have, generally speaking, differential economic consequences if the exchange control regime is dissimilar on other dimensions.

Proposition (2): The economic consequences of an identical exchange control regime will, generally speaking, vary with differences in the structure of domestic objectives and attendant policies.

Proposition (3): Alternative exchange control regimes have, generally speaking, different economic consequences.

A. Proposition (1)

The differential effects of identical component features of exchange control regimes, arising from differences in the regimes on other dimensions, may be briefly spelled out here by reference to specific examples.

1. NON-TRANSFERABILITY OF LICENSES.

The effects of non-transferability of import licenses clearly depend on the exact structure of the exchange control regime. Thus, in India, where the non-transferability rules had been carried to the utmost extreme such that firms could not legally sell import licenses or imports, the adverse effects *via* the creation of bottlenecks were progressively blunted as the regime was amended—as part of moves in the direction of export subsidization—to allow for growing numbers of import entitlement schemes under which eligible exporters retained varying fractions of their export earnings for their own use. This was also the effect of the introduction of the export bonus voucher scheme in Pakistan. Under both schemes, the regime enabled the importation of items fetching high premiums and hence reflecting critical bottlenecks and shortages.

2. ITEMWISE SPECIFICATION OF LICENSES.

Yet another illustration of Proposition (1) is afforded by the itemwise specification of import licenses. If such specification is *combined* with the sourcewise specification of licenses, then the effect is equivalent to that of effective “double-tying” of aid. The results, in terms of the additional expense of importing the specified items *via* exercise of monopolistic power by suppliers, are correspondingly more probable. By contrast, mere itemwise specification of importable items, with the sources of origin left open, need not cause monopolistic pricing by suppliers because it would always be possible to switch sources and thereby introduce competition among suppliers.

B. Proposition (2)

We now turn to the proposition that identical exchange control regimes will, in general, lead to different consequences depending on the structure of domestic policies with which they operate. This is ideally illustrated by the following example.

INTERACTION WITH INDUSTRIAL LICENSING.

The allocation of imported intermediates, on a *pro rata* basis related to capacity installed in an industry, is an occasional feature of the import-licensing regimes, as noted in Chapter 2. However, it is clear that its deleterious effects on competition, for example, are seriously aggravated if it is combined with domestic industrial licensing (in pursuit of economic objectives such as the regulation of the pattern of investment or of non-economic objectives such as the control of concentration of economic power).

Thus, in India and to some extent in Pakistan, the *pro rata* to capacity allocations of imported materials would have blunted competition in any event by giving existing firms "equal, guaranteed access" to the imported inputs regardless of their efficiency. In the marketplace, however, without this regime these firms would have had to compete for this access, and the inefficient firms would have been at a disadvantage.¹ But given the strict industrial licensing of both expansion by existing firms and investment by new firms, within overall targets, the effect was to reduce "potential" competition by entry to negligible levels. Not merely could the more efficient existing firms not drive out the less efficient ones but free entry was not possible by new firms either. In addition, foreign competition was ruled out by a policy of automatic protection. Hence the total effect was virtually to eliminate effective competition except in industries that had happened to overexpand by miscalculation of the planners and the investors.

C. Proposition (3)

Having noted briefly the interaction effects between (1) the different components of an exchange control regime and (2) the exchange control regime and domestic policies, we may finally address a few remarks to the simpler fact that differences in exchange control regimes will generally result in differential consequences. It should suffice to draw attention to one pointed illustration.

PRO RATA ALLOCATIONS OF MATERIALS.

Thus, a regime that makes allocations of imported materials to firms *pro rata* to installed capacity, as was the case in Pakistan and India, will have consequences such as the creation of a bias toward expanding capacity in the face of underutilized capacity.² It will also affect the structure of incentives among different industries for expansion, thus implying differential resource allocational effects, depending for example on the rate at which such *pro rata* allocations are made in the different industries.³ If, however, the allocations were to be made *via* the use of tariffs that mopped up most of the premium⁴ or the use

of exchange auctions (as in Brazil after 1953) or the use of traders/importers who then earn the import premium rather than the producers, these effects would be eliminated and different consequences would follow.⁵

II. SEQUENTIAL PATTERNS AND PHASES

The foregoing general propositions can be supplemented by more specific delineation of exchange control regimes into certain basic types or, what we term, Phases that have a broadly differentiated impact on economic efficiency and performance.⁶

This notion of Phases, shortly to be defined but essentially based on the restrictionist content and associated blend of control and price instruments, reflected initial familiarity with the evolving exchange control regimes in specific countries⁷ and the strongly suggested hypothesis that these regimes went through a sequencing. In the analytical framework that defined the broad contours of the country studies in the Project, this notion of sequencing was sharpened and spelled out in the shape of alternative Phases in the exchange control regime. These Phases in the exchange control regimes were designed essentially as a classificatory and descriptive device to capture meaningfully the evolution of the exchange control system in terms of its restrictionist content and the dimensions and pattern of its use of control and price instruments.

The analytical framework distinguished among five Phases. The exchange control regimes in the countries in the Project were to be traced through, placing them in one of these Phases at a point in time.⁸ It was expected that the resulting patterns would also be highly suggestive of hypotheses concerning the success or failure of attempts at liberalization, hypotheses that are considered explicitly in the companion volume by Krueger.

A. Phase I

This Phase is characterized by the systematic and significant imposition of quantitative controls. It might start in response to an unsustainable payments deficit resulting from intense or sustained prior inflationary pressure (due, for example, to the initiation of a large-scale development plan and consequent extraordinary increases in government expenditures) or from a sharp drop in world prices for some major exports (as in 1953). These reasons for instituting controls are of interest in ascertaining the logic of the evolution of exchange control regimes but are not critical to the definition of Phase I.

Throughout Phase I (which, of course, can be of varying duration), controls are generally maintained and often intensified. This continuation or increased severity might result from any of several interrelated factors: (1) the

continuation of initial controls might be necessary to contain an *ex ante*, unsustainable payments deficit; (2) the initial set of controls might result in evasions of the system through illegal transactions that negate any possible impact on the balance of payments; (3) once controls are instituted, policy-makers may perceive the new instruments as handy for a variety of purposes in addition to controlling the payments situation and begin employing them for such purposes; and (4) policy-makers may perceive their actions as freed from a balance of payments constraint and adopt policies that in fact require restrictiveness afresh to offset further adverse effects on the balance of payments.

B. Phase II

This Phase is characterized by continued reliance upon quantitative restrictions and, indeed, generally increased restrictiveness of the entire control system. However, Phase II is distinguished by two additional and related aspects of the QR system, both relatively unimportant during Phase I: (1) for a variety of reasons, indicated below, the detailed workings of the control system become increasingly complex; and (2) price measures are adopted to buttress the functioning of the control system. Both of these characteristics of Phase II stem from dissatisfaction with the results of an undifferentiated system and are often the result of many small decisions rather than an overall policy design.

(1) Although neither term is quite appropriate, Phase I decision-making and policies may be characterized as "crude" and "unsophisticated." Quantitative restrictions are applied with relatively few rules, and treatment of competing claims to import licenses tends to be relatively undifferentiated in the sense that rules for allocation tend to be of an "across the board" nature, such as allocating to everyone a certain percentage of this person's imports over a specified number of earlier years or allotting licenses *pro rata* with applications. The major motivation for changes in the control system during Phase I is a concern with evasions, both legal and illegal, of the system. Thus, export licensing may be adopted to ensure that exporters do not succeed in their attempts at capital flight; controls over tourist and other invisible transactions are aimed at preventing the emergence of a black market, and so on.

In Phase II, however, the rules of the regime have become more complex and differentiated. The growth of the bureaucracy to administer the allocations and the inevitable tendency to differentiate increasingly among alternative end uses and claimants as the control regime is perceived to be a continuing state of affairs interact to produce a complex system (whose possible dimensions ought to be generally evident to the reader from Chapter 2).

(2) The other major feature of Phase II is an increasing resort to price

measures to supplement the QR regime. This generally occurs with respect to both exports and imports. The continuation or intensification of foreign exchange shortage leads to recognition that additional export earnings would be desirable. Rebate schemes, import replenishment schemes, special credits for exporters, and a variety of other devices may be instituted that offset part or all of the discrimination against exports implicit in an overvalued exchange rate. Like the quantitative restrictions discussed above, however, export incentives tend to be adopted in a piecemeal and fragmented fashion. As for imports, price measures are also adopted to absorb part of the excess demand for imports. Tariffs may be increased or surcharges added to the cost of importing. Guarantee deposits are generally required on various categories of imports. These and other measures tend to reduce (but hardly eliminate) the windfall gain or premium accruing to the recipients of import licenses.

The following aspects of the price situation in Phase II are then evident: (1) the exchange parity is "overlaid" by tariffs and subsidies, levied in lieu of formal parity change; (2) the effective exchange rate for exports, on the average, is rarely as high as the effective exchange rate on imports, implying a bias against the (relative) incentive to export; (3) the domestic currency is overvalued at the current parity plus trade tariffs and subsidies, implying a premium (on the average) on imports; and (4) this import premium varies across different activities, implying differential incentives to produce and invest in these different activities.⁹

C. Phase III

Phase III is entered against the backdrop just defined, and it can take various forms. It may consist of a mere "tidying-up" operation directed at replacing the diverse import premiums by reasonably uniform tariffs such that the differential incentive effects caused by diverse premiums on different imports are greatly reduced or virtually eliminated. Alternatively, the tidying-up operation may replace the existing tariffs and export subsidies with a formal parity change, the result being that the (average) effective exchange rates on exports and imports do not change much but the dispersion of tariffs is replaced by the uniform devaluation—an action again of rationalization in this instance. On the other hand, Phase III may be substantially ambitious and take the form of what might be described as a devaluation cum liberalization package. Such a package may have a gross devaluation large enough to leave a net devaluation despite the removal of the trade tariffs and subsidies, with accompanying grants by donors of additional credits to facilitate early expansion of imports, debt rescheduling, and similar measures aimed at quick and easy liberalization of imports.

D. Phase IV

Phase IV is entered when Phase III has resulted in *continued* liberalization. This means that the average import premium has fallen, the bias against exports has substantially diminished (the effective exchange rate for exports having come closer to the effective exchange rate for imports), and the degree of dispersion in the incentives to expand different activities has diminished through greater uniformity in these incentives *via* the foreign trade sector.

Needless to say, this outcome can only be anticipated from a Phase III episode when the latter takes the ambitious form of a concerted effort of the kind presupposed in a devaluation cum liberalization package. Even then, as is documented in the companion Krueger volume, the outcome has often been a reversion to Phase II. But the transition to Phase IV, which can be regarded as the successful culmination of Phase III efforts, cannot be expected when Phase III takes the form of a simple tidying-up operation, consisting of rationalization measures of the type already described above.

E. Phase V

The transition from Phase IV to Phase V occurs when the exchange regime is virtually liberalized in the sense that there is full convertibility on current account and quantitative restrictions are not employed as a means of regulating the balance of payments. Thus, an economy in Phase V is not an exchange control regime in the usual sense of the term, and Phase V represents a total alternative to the QR regimes of Phases I and II. The pegged exchange rate is at its equilibrium level, a flexible exchange rate policy is in operation, or monetary and fiscal policies are employed as the instruments to achieve payments balance in contrast to a reliance on the exchange control mechanism.

It will be evident shortly that Phase I has characterized the early experience with exchange control in nearly all the countries in the Project. Indeed, it is no more than the period of entry into exchange control regimes of a sustained variety. At the same time, Phase V turns out to have been more an ideal than a reality even for the few countries (with the possible exception of Israel) in the Project that have managed to transit from Phase II into seriously sustained Phase III episodes and Phase IV.

III. PHASE EVOLUTION AND PATTERNS IN COUNTRIES IN THE PROJECT

For each country in the Project, the delineation of Phases was undertaken. For details the reader should consult the country volumes. Here, it should suffice

to put these countries onto a common chart, Figure 3-1, which helps underline possible patterns among the countries. In drawing conclusions, we need to keep in mind that the delineation of Phases cannot be exact. Phase II, III, and IV in particular are difficult to differentiate sharply. Hence it is wise to forego the temptation to discuss questions such as the length of the periods under each Phase in the different countries. Instead, the following points of interest need to be made.

A. Patterns

Although the detailed Phase evolution is different for each country in the Project, certain suggestive groupings are indicated. One group seems to have more or less progressed through the Phases from I to IV. This group contains Brazil, Israel, and South Korea. Another group appears to have made repeated attempts at Phase III episodes, which have not endured but rather been followed by relapse into Phase II. The behavior of these countries is best described as cycling back and forth mainly between Phases II, III, and IV and, rather rarely, Phase I as well. The countries that clearly fall into this group are Chile and Colombia. In a similar vein, Ghana and the Philippines seem to have gone through one major such cycle and Turkey through two. Finally, there are the countries that have generally been in Phase II over *long-sustained* periods with rare (if any) jabs at Phase III episodes that were unsuccessful. The classic case here is India, with Egypt falling neatly into the group before the nationalizations of the early 1960s (and after, if one construes the nationalization of foreign trade as Phase II).

B. Discernible Trends

We may look at the Phase experiences from yet another angle by examining trend differences during the period 1950-1972. A few observations are in order.

One notices that Phase I is really an early form of exchange control regime as a liberal regime is initially abandoned. It rarely seems to be a Phase to which a regime at a *later* stage *reverts*, so that cycling through the Phases, for example, generally bypasses Phase I altogether and is confined to Phases II, III, and IV. Moreover, Phase V appears to have eluded most countries. The success stories in the transition to a liberalized regime are mostly ones of transition to Phase IV, as with South Korea and Brazil. Israel is the only exception to this observation.

As for trends, the following propositions may be advanced.

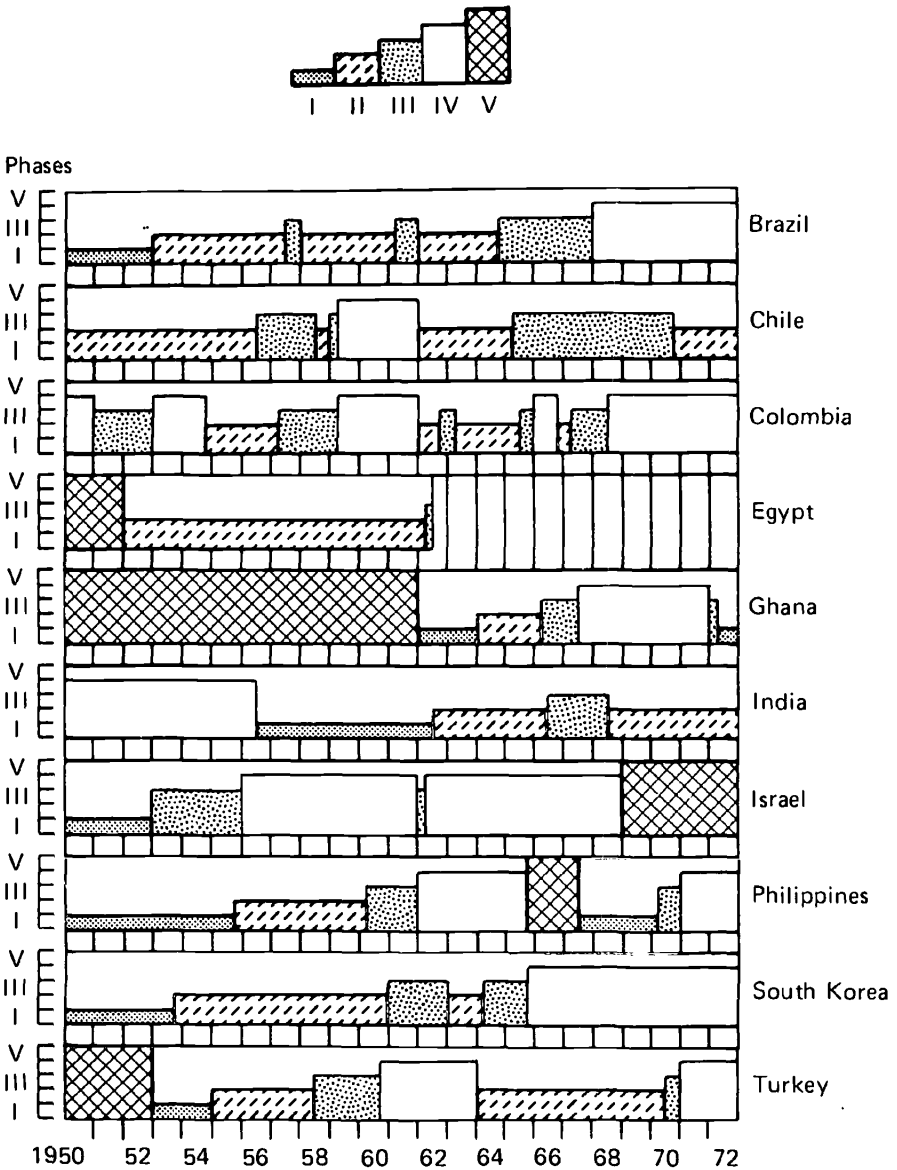


Figure 3-1. Phases of Exchange Control Regimes.

Source: Based on the country volumes, *op.cit.*, in the NBER Project and compiled by Krueger, *Liberalization Attempts*, *op.cit.*, from these country regimes (except for Colombia) with the assistance of the country authors and Hal Lary.

(1) It is clear that, by the mid-1950s, there was practically no country (the only exception being Ghana, which achieved independence in 1957 and joined the ranks of restrictive regimes only in the early 1960s) that had not gone over from a Phase V situation into Phase I or further into Phase II. Liberal trade and payments regimes had thus virtually become non-existent by the mid-1950s.¹⁰

(2) Furthermore, during the latter half of the 1950s, fully half of the countries studied appear to have remained in Phase II or Phase I type restrictive regimes. This was true of the Philippines, South Korea, India, Egypt, and Brazil. Israel, however, had already made the transition to Phases III and IV, and Chile, Colombia, and Turkey had taken steps in this direction.

(3) The 1960s were to witness substantially increased attempts at Phase III type liberalization. In Brazil and South Korea this was to culminate in a successful shift to Phase IV, with Israel managing to shift even to Phase V.¹¹

By and large, therefore, one might conclude that the decade of the fifties was one of restrictive regimes in major part, and the decade of the sixties was one of greater shift to more liberalized regimes. The analysis in the rest of this volume is then addressed primarily to the issue whether the transition between the 1950s and (especially) the late 1960s from exchange control regimes of the Phase II variety—a phenomenon that is broadly evident from the country studies in the Project, though not shared by those countries that had only abortive Phase III episodes—was desirable from an economic viewpoint. Put another way, our analysis will now be concerned with the question of the economic impact of exchange control regimes of the Phase II type. This analysis will naturally encompass some discussion of the *alternative* regimes such as Phase IV. It will also attempt to distinguish, where appropriate, between different dimensions *within* the Phase II regimes.

NOTES

1. Similar blunting of competition would have occurred even under allocations based, for example, on historical shares.

2. See the analysis in Chapter 5 below.

3. Cf. Bhagwati and Desai, *op. cit.*, Chapter 17; also see Chapter 7 below.

4. For examples of this from the country studies, see Chapter 2.

5. Note also that the distributional and political implications of these alternative regimes would also be different: for example, the former would lead to more opposition by producers to devaluations than the latter for the premium on imports would already have been lost to the producers under the latter. These issues have been discussed in *India*, *op. cit.*, and *Turkey*, *op. cit.*

6. Within each of the Phases to be defined, we must note that economically significant differences may exist among some of the dimensions distinguished in Chapter 2: for example, in Phase II, the QRs may be used to confer automatic protection or protection only within prespecified limits of excess cost over c.i.f. values.

7. Thus, writing in 1968 with the Indian experience in mind, the present author had argued:

The typical stages in the transition of a less developed country, from one parity to another, may be described as follows:

(1) Balance-of-payments difficulties, under a fixed parity, lead to the establishment and frequently to the more or less permanent continuation of a regime of quantitative restrictions. The result is the establishment of several *ad hoc*, *de facto* effective tariffs on different activities—a set of multiple import rates. There also comes about a net export rate (equal to parity) that falls below the effective import rates. (They exceed parity by the premium on imports, which may vary between different imports if the exchange markets are effectively segmented.) This export rate not only discriminates against exports but also compounds the distortions that would arise from a multiplicity of rates on imports.

(2) Gradual shift towards a system of effective export subsidies occurs as the tight balance-of-payments situation and the quantitative restrictions continue, in order to increase export earnings. The effect is to reduce the differential between the export and the import rates, while often leading to multiple rates on exports as well, since official subsidies on exports almost always are discriminatory in practice.

(3) As the import premium continues, while lessened (*ceteris paribus*) by the export subsidization, governments turn gradually (under public criticism) to using tariffs more actively so as to cut into this premium and earn the scarcity profits themselves. The result is that, with both export subsidies and import tariffs being used in this fashion, there comes about a *de facto* devaluation on current visible transactions (extended gradually again to invisibles, such as remittances from settlers abroad and tourist earnings, but practically never to transactions on capital account). The *de facto* devaluation, however, is characterized by numerous rates on imports and exports, and conceals effective export rates on specific commodities that may exceed or fall below their effective import rates, so that numerous distortions remain embedded in the system.

(4) As the realization grows that a *de facto* devaluation has occurred, in an inefficient manner, the way is seen to rationalize the situation by devaluing the rate formally and thereby managing to reduce, if not eliminate, the reliance on export subsidies and import tariffs, though even this is done with considerable reluctance.

(5) Then the process can, and frequently does, start all over again, with the system of quantitative restrictions again taking the brunt of initial adjustment and then gradually being eased by export subsidies and import tariffs.

There are several variations on this general sequence, of course. In place of a freer use of import duties, for example, exchange auctions (as in Brazil) or multiplicity of exchange rates, fixed directly by exchange-control authorities (in many Latin American countries), have been used. Similarly, there are wide variations in the forms of export subsidy and the manner in which selectivity is exercised in granting them.

See J. Bhagwati, *The Theory and Practice of Commercial Policy*, Frank Graham Memorial Lecture (1967), Special Studies in International Economics, International Finance Section (New Jersey: Princeton University Press, 1968), pp.48-49.

8. Clearly, as will be evident below, identification of Phases must rest partly on judgments. On the whole, however, the identification process has been both relatively uncomplicated and fruitful.

9. See the appendix for the definition of effective exchange rate and other concepts (as well as a summary description of Phases) at the end of the book.

10. In Chile, this had been so since the early 1930s! Cf. *Chile*, op. cit., pp. 21-27.

11. None of these countries, however, had dismantled the QR mechanism.