

tify." The preacher then put this query to the chairman, "Then why did you fire me?" The chairman replied, "You didn't show wherein."

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**Economic Liberalism in the Cone of
Latin America**

T. J. Congdon

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In this book, T. J. Congdon discusses and analyzes the economic policies of Southern Cone countries during the 1970s and 1980s. Particular emphasis is given to the opening of domestic markets through the removal of trade barriers, the attempts to reduce government intervention in the economy, the denationalization or privatization of publicly owned enterprises, and the liberalization of the financial system. This review is organized accordingly.

The author provides an eloquent account of rent-seeking behavior by bureaucrats and special interest groups favoring protectionism. His analysis explains why the political process produces inefficient regulatory policies such as quotas and trade restrictions, which are more amenable to side payments, rather than taxes. Several economic distortions are identified by the author in Chapter 2. These include a high and arbitrary tariff system, exchange rate restrictions, government ownership of domestic industries, and inflation.

The arbitrariness of the tariff system, the widespread government ownership, and distortions in the financial system made, in some cases, rent-seeking activities more profitable than productive activities. Hence, it is not surprising to find entrepreneurs devoting a great deal of resources to these activities.

The available evidence supports the author's conclusion that trade policy changes were the most successful components of the liberalization scheme. Persuasive evidence is presented in Chapters 3 and 4 that even with the absence of export subsidies, trade liberalization stimulated the production of nontraditional exports. However, the author fails to analyze one important aspect of the liberalization scheme, namely, the incidence of lower tax rates. If one is prepared to assume that Chile is a small economy, then it follows that its domestic taxes will unambiguously fall on internationally immobile factors of production. In some instances, the incidence of the taxes will reduce the domestic factors' returns by more than the full amount of the taxes.¹ It follows that the liberalization scheme (i.e., tax rate reductions) will cause a more than proportionate increase in the after-tax rate of return of internationally immobile factors and quite possibly in the nontraded goods sector as well. Therefore, an incidence analysis of the liberalization scheme can explain the resurgence of domestic asset values, the observed expansion of the nontraded goods sector, and the appreciation of the real exchange rate.

¹Victor A. Canto, "Property Rights, Land Reform, and Economic Well-Being," *Cato Journal* 5 (Spring/Summer 1985): 51-66.

To measure the extent of government intervention, the author uses tax revenues as a percentage of GNP. One must keep in mind, however, that in Southern Cone countries tariffs were not imposed as revenue-raising measures. Rather, the tariffs were imposed to protect domestic industries from foreign competition. Thus, looking at the average take of the government will certainly underestimate the degree of intervention and distortion in the domestic economy.

With respect to privatization, Congdon's analysis lends support to the view that policy failure is largely the result of poor implementation. For example, privatization as implemented in Chile transferred control from the government to *grupos*, but this transfer did not increase the competitiveness of the economy. Indeed, the evidence clearly shows that the *grupos* were highly integrated and few in number. Given the rent-seeking behavior documented in Chapter 2, it is not surprising that these private groups would be inefficient. In short, even though the privatization policy substituted private-sector *grupos* for a government agency (CORFO), it did little to increase the degree of competition.

Two distinct arguments are presented as to why inflation results in major distortions to the financial system. One is based on limitations on interest payments and reserve requirements. The other is based on transaction costs generated by uncertain and variable inflation. The only valid argument, however, is the first one. The latter problem may be easily resolved through currency substitution or a change in numeraire (that is, accounting in dollars).

Given the limitation on interest rate payments and reserve requirements, a reduction of the inflation rate will clearly reduce the distortions of the banking system, improve resource allocation, and stimulate financial development. Hence, the need of a stabilization program to lower the inflation rate. The author correctly points out that faster economic growth requires higher financial intermediation. However, the reduction of the inflation rate will not eliminate the financial distortions nor will it ensure that the banking system is flexible enough to easily accommodate an expansion of the economy; a liberalization of interest rates and reduction of reserve requirements would.

Also in Chapter 2, Congdon argues that the use of government controls can increase demand for the local currency. This insight, however, is ignored in the author's analysis of financial liberalization, presented in Chapters 3 and 4. During liberalization periods, the removal of controls will reduce the demand for the local currency. Other things constant, liberalization thus will result in a depreciation of the exchange rate and an increase in the inflation rate as measured in the domestic currency.³

In Chapter 3, Congdon's analysis is very critical of the "Chicago Boys'" monetary program. However, none of the many arguments presented inval-

³Victor A. Canto, "Monetary Policy, 'Dollarization,' and Parallel Market Exchange Rates: The Case of the Dominican Republic," *Journal of International Money and Finance* 4 (December 1985): 507-22.

idates the fixed-exchange rate system along the lines of the monetary-approach-to-the-balance-of-payments as the appropriate long-run policy. In the case of Chile, the evidence presented in this study suggests that the liberalization aspects of the program increased the openness of the Chilean economy. Since the long-run impact of these policies is to increase the tradability and mobility of goods and services produced in the Chilean economy, it follows that the increased openness of the economy, combined with the relaxation of exchange rate controls would eliminate a great deal of the variables that made Chile an "optimum currency area" for the peso. The elimination of trade barriers and "currency substitution" effects would clearly make a fixed-exchange-rate-system the appropriate long-run policy.

The "Chicago Boys'" liberalization policy is justly criticized for failing to take into account the impact on long-run equilibrium. Liberalization did result in an appreciation of the real exchange rate and the real rate of interest. The effects should have been fully anticipated once an incidence analysis of the reform was completed. If these effects had been incorporated in the implementation of the stabilization policy, allowance would have been made for the exchange rate to change by the amount of the terms of trade change. In this regard, Congdon was correct in concluding that the "Chicago Boys'" model was too rigid and that the mini devaluations were not large enough. However, the author is mistaken in asserting that the devaluation should have been used to reverse the adverse terms-of-trade effect. The empirical evidence on the real effects of devaluation is not supportive of Congdon's views, nor is the theoretical literature. If money is neutral, then a devaluation will have no real effect on the economy.

In general, even if the devaluation could alter the terms of trade, it could not have done so in the case of Chile. Since Chilean wages were indexed, the real wage rate was fixed. In addition, if capital is mobile, its rate of return in Chile must equal that of the rest of the world. These relative prices imply a terms of trade that is predetermined and independent of the policy changes. Furthermore, there is no reason to expect the implied terms of trade to be the same as the equilibrium terms of trade that would result from the implementation of the liberalization scheme. This leads to what I believe was the major flaw in the stabilization scheme: the liberalization program and indexation were incompatible. The reason is quite simple—indexation prevented the relative price from reaching its new equilibrium.

That liberalization and indexation were incompatible is consistent with Congdon's statement that the Peruvian liberalization, the largest of all Southern Cone countries, resulted in little protest. He attributes this to the Peruvian commitment to floating exchange rates. However, it is worthwhile noting that Peru was the only country considered that had no experience with galloping inflation rates. Hence, it had little or no indexation experience.

If accompanied by further inconsistencies, the liberalization of the financial system will unambiguously fail. In the case of Argentina, the authorities guaranteed deposits at domestic banks. A bank failure therefore resulted in

the monetization of the deposits, increased domestic money creation, and loss of international reserves.³

The failure of stabilization efforts is attributed to what the author calls a "competitive exchange rate system"—a system consistent with the differential inflation rate. The economic policies of Chile are in some sense similar to those pursued by the Reagan administration (i.e., tax rate reductions, changes in monetary policy, etc.), and the effects of these policies on the Chilean economy were similar to those experienced in the United States: an initial recession, reduction of the inflation rate, an eventual recovery, a deterioration of the trade balance, appreciation of the real exchange rate, and an increase in the real interest rate. All of this occurred while the United States had a "competitive" floating exchange rate system, as opposed to Chile's *tablita* system. The similarity of results between Chile and the United States amid differences in exchange rate policies reduces the credibility of the hypothesis that financial liberalization was the cause of the Southern Cone debacle.

In sum, this book discusses whether the apparent failure of the liberalization policies enacted in Southern Cone countries stems from a poorly designed stabilization strategy or a grossly unfavorable external environment.⁴ Although Congdon states that the results are not clear-cut, he proceeds to emphasize that it was the mishandling of the financial liberalization and not the choice of exchange rate regime or trade liberalization that was responsible for policy reversals. In my view, this analysis signals that more attention should be given to the implementation of economic policies and that allowance should be made for changes in the terms of trade. Furthermore, my interpretation of the events leads me to conclude that there is much danger in embarking on simultaneous liberalization and stabilization programs. As I see the evidence, the optimal policy is to liberalize first and then to stabilize the economy. The analysis presented in this book clearly suggests that even with well-defined objectives, poor implementation of stabilization policies can result in aborting the liberalization experiment.

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³Guillermo Calvo, "Lecciones del Monetarismo: el Cono Sud," paper presented at the 37th anniversary of the Dominican Republic Central Bank, Santo Domingo, 1983. An account of Chilean inconsistencies is found in Sebastian Edwards, "Stabilization with Liberalization: An Evaluation of the Years of Chile's Experiment with Free-Market Policies, 1973-1983," *Economic Development and Cultural Change* 33 (January 1985): 223-54.

⁴Compare Larry A. Sjaastad, "The Failure of Economic Liberalization in the Cone of Latin America," *The World Economy* 5 (March 1983): 1-25.