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THE TRADE REFORM WAVE OF 1985-1995

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ABSTRACT

The decade from 1985 to 1995 was an unprecedented period of declining barriers to global trade. The reform wave was especially pronounced in developing countries where overvalued currencies were eliminated, quantitative import restrictions dismantled, and import tariffs reduced. What accounts for this remarkable transformation in policy? This paper focuses on how many of these restrictions were imposed for balance of payments purposes. As the benefits of managing payments imbalances through exchange rate adjustments rather than import controls came to be understood, economists in high-ranking government positions had the opportunity to shift policy in this direction. Perhaps surprisingly, special interests played little role in fostering the move to more open markets.

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THE TRADE REFORM WAVE OF 1985-1995

I. Introduction

For more than forty years after World War II, the world was divided into three economic blocs that operated in relative isolation from one another. The first world of North America, Western Europe, and Japan consisted of democratic, market-oriented states that sought to increase trade through the General Agreement on Tariffs and Trade (GATT). The second world of the Soviet Union, Eastern Europe, and China consisted of communist states with centrally planned economies that managed trade with each other through institutions such as the Council for Mutual Economic Assistance. The third world countries of Latin America, Africa, and South Asia were generally non-aligned states with mixed economies that restricted trade through import substitution policies aimed at promoting domestic industry.

Between 1985 and 1995, the walls obstructing trade between these separate worlds crumbled. Developing countries around the globe reduced their trade barriers and adopted more market-oriented policies. The fall of the Berlin Wall and the collapse of communism led Eastern European countries to do the same, with a particular focus on integrating their economies with Western Europe. China and Vietnam remained communist states but opened their economies to global trade. These moves were reinforced by liberalization at the regional level, such as the expansion and single-market initiative of the European Economic Community in 1986 and the North American Free Trade Agreement in 1994. At the multilateral level, the Uruguay Round of trade negotiations reduced trade barriers, established new trade rules, and created the World Trade Organization (WTO) in 1995. Whereas developing countries previously had been granted exemptions from making tariff concessions and adhering to some GATT rules, these negotiations included them as equal participants.

These policy changes transformed the global economy and helped produce a world that was more highly integrated than ever before.[1] Figure 1 presents one measure of global integration, the ratio of world trade to world GDP, over the past 150 years. After creeping up before World War I, this measure fell during the interwar period due to economic dislocation and trade restrictions imposed during the Great Depression of the 1930s. The ratio rebounded slightly after World War II and jumped in the early 1970s with the oil price shock. But for twenty years after 1985, global integration soared to historic levels, before stalling after the 2008-09 financial crisis.

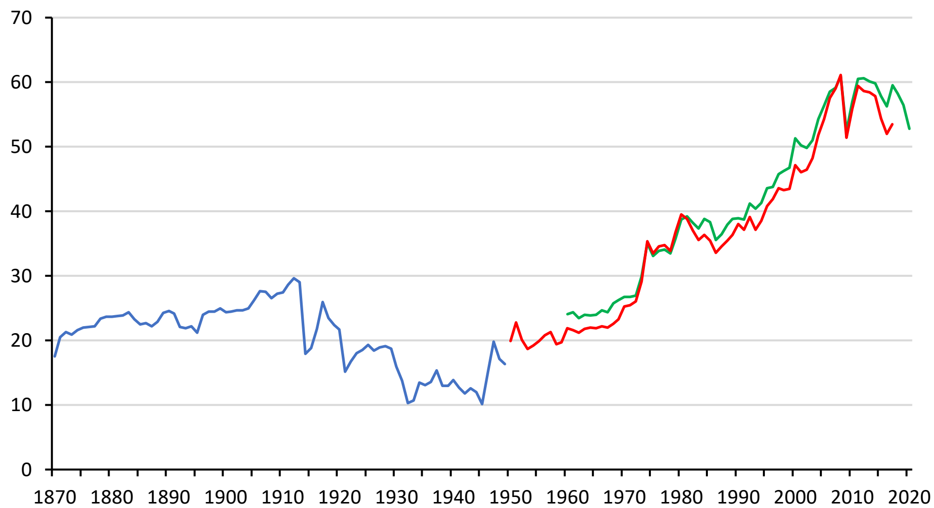

FIGURE 1. WORLD TRADE (EXPORTS + IMPORTS) AS PERCENT OF WORLD GDP, 1870-2020

Sources: Klasing and Milionis (2014) for 1870-1949 (in blue), Penn World Tables for 1950-2017 (in red), and World Bank for 1960-2020 (in green).

This paper examines some of the factors behind the historic shift in developing country trade policies between 1985 and 1995. Efforts to liberalize trade are usually met with stiff

[1] Another contributing factor was the decline in trade costs due to shipping containers and airfreight; see Bernhofen, El-Sahli, and Kneller (2016). These changes in transport costs and trade policy made global supply chains possible.

opposition from powerful interest groups. Yet this period was remarkable for the speed and sweep of the movement undertaken by so many countries toward a more open economy. What confluence of circumstances made this dramatic change possible?

This paper highlights the fact that many of the trade restrictions relaxed by developing countries during this period were originally imposed for balance of payments purposes. That is, in an era when fixed exchange rates were prevalent and devaluation was viewed as something to be avoided, countries opted for import controls instead of exchange rate adjustments as a way of managing the balance of payments and conserving foreign exchange reserves. In the early 1980s, developing countries faced an acute shortage of foreign exchange due to deteriorating terms of trade, declining international lending, and reductions in foreign aid. As these sources of foreign exchange dried up, countries were forced to face the stark choice of reducing the imports they were consuming or increasing exports to pay for those imports. Beyond a certain point, import compression was an unattractive policy. Imports of raw materials and intermediate goods (including spare parts) were necessary to keep the economy going and continued imports of technology and capital goods were necessary to modernize.

The shortage of foreign exchange led countries to reorient their policy from conserving foreign exchange to earning more foreign exchange. The use of imports controls to manage the balance of payments was abandoned in favor of exchange rate adjustments instead. As Collier (1993, 510) put it: “The heart of liberalization is the conversion from using trade policy for payments balance to using the exchange rate.” The first step in the reform process was a devaluation to eliminate any exchange rate overvaluation (evidenced by a black-market premium) and thereby promote exports. This was followed by the adoption of a more flexible exchange rate regime to prevent the currency from becoming similarly overvalued. These steps would allow import barriers to be relaxed, first by eliminating quantitative restrictions and then by gradually reducing tariffs.

In general, policymakers did not open their country's economy in response to pressure from domestic interest groups or the demands of international institutions such as the International Monetary Fund (IMF) and World Bank. Instead, trade and exchange policy changes were usually undertaken unilaterally under the influence of economists (technocrats) in high-ranking governments positions. These economists understood the growing evidence that exchange rate adjustments were a more effective way of managing balance of payments problems than import controls. As they rose to important policymaking positions around the world, economists were well placed to influence the decisions made by governments in the 1980s. Thus, a conjunction of changing ideas about policy and opportunities that economists had to affect policy helps explain the trade wave of 1985-1995.

II. Background

The postwar restrictions on trade and payments in developing countries had their roots in the Great Depression of the 1930s. The collapse of export prices for commodity producers and the outflow of capital led many countries to impose exchange controls and import restrictions for balance of payments purposes. They chose to protect their gold and foreign exchange reserves by limiting spending on imports and other foreign exchange outflows in the hopes of avoiding a depreciation or devaluation of their currencies (Eichengreen and Irwin 2010, Irwin 2011).

These exchange and trade controls persisted into the post-war period. Although the 1944 Bretton Woods conference established a regime of fixed but adjustable exchange rates, most countries were still reluctant to devalue their currencies. Officials feared that devaluation would fuel inflation, deteriorate the terms of trade, add to the burden of foreign debt, redistribute income in undesirable ways, and reduce the standard of living of urban workers. Economists were also skeptical about whether exchange rate changes would help equilibrate the balance of payments.[2] Many developing countries, however, ran high rates of inflation and the failure to adjust nominal exchange rates led them to have overvalued currencies and recurring balance of payments difficulties.

To avoid exchange rate adjustments under these circumstances, countries employed a battery of discretionary controls – including foreign exchange rationing, non-automatic import licensing, and advance import deposit requirements – as a way of regulating imports and keeping foreign exchange outflows in line with inflows.[3] These administrative controls could be tightened or relaxed depending on the level of a country's foreign exchange reserves. The exchange control regime – the set of policies involving the exchange rate and the disposition of foreign exchange – had a purpose beyond the mitigation of foreign competition at the behest of domestic producers. While these policies to limit imports are sometimes called protectionist, their goal was more the protection of foreign exchange reserves from depletion than the protection of domestic industries from foreign competition.[4] Of course, these controls were reinforced by the idea that trade policies should promote industrialization via import substitution.

[2] A survey by Metzler (1948, 232) concluded: "Both the interwar experience with fluctuating exchange rates and the theory of exchange stability which emerged during the interwar years have clearly shown that adjustments of exchange rates are not likely, in the short run, to be an efficient or effective means of eliminating a deficit or a surplus from a country's balance of payments."

[3] As Edwards and Santaella (1993, 406) note: "Even under conditions of obvious 'fundamental disequilibrium,' the economic authorities in the developing countries tended to resist devaluing their currencies. Instead, they often imposed trade and exchange controls in an effort to avoid a balance of payments crisis. This historical resistance to devaluations had its roots in a deep skepticism about the effectiveness of exchange rate adjustment." Because of their adverse effect on the balance of payments, overvalued exchange rates have long been recognized as giving rise to import restrictions (Schatz and Tarr 2002).

[4] The World Bank (1979, 67) pointed out: "Frequently, however, protection has been introduced as a means of limiting imports in response to balance of payments crises, rather than as a conscious effort to encourage the rational development of industry." Little (1979, 260) argued that "reliance on [import] controls, not tariff protection, is the bigger challenge . . . Of course, all controls protect – and sometimes protect absolutely. But the primary motive [for import controls] was balance of payments management, not protection."

In either case, these import restrictions led some domestic interests – namely, producers competing against imports and importers with preferential access to foreign exchange – to have a stake in ensuring that such policies remained in place, even though those interests were not necessarily the original impetus for them.

Very few countries undertook trade and payments liberalization in the Bhagwati and Krueger (1973) sense of moving away from disequilibrium exchange rates through a devaluation, relaxing quantitative import restrictions, and using just tariffs to regulate imports at an equilibrium exchange rate. Two countries that moved in this direction relatively early were Taiwan (1958-62) and South Korea (1964-65). In each case, an important motive for reform was the need to compensate for declining U.S. foreign aid by increasing foreign exchange earnings from exports. Both countries gained attention for their success in doing so, but few countries followed their example. In the 1970s, an abundance of foreign exchange, due to higher commodity prices and greater international lending in the aftermath of the oil price shocks, meant that most countries could maintain their existing trade and payments regimes without much pressure to reform.[5]

This world changed dramatically in the early 1980s. The difficulty in obtaining foreign exchange, due to the collapse of international lending and the deterioration in the terms of trade for commodity exporters, put many countries under severe balance of payments pressure if not a full-blown debt crisis. The continued reluctance to devalue meant that nearly half of all countries in the mid-1980s had overvalued currencies, often with black market premia above 40 percent (Easterly 2019, figure 2a).

[5] In choosing to open their economies during this period, Chile (1975) and Sri Lanka (1977) were two notable exceptions.

For reasons that will be explored more fully below, this scarcity of foreign exchange, and the failure of import compression to overcome that scarcity, led to a shift in policy. Whereas deteriorating current account positions in the 1950s-70s led to tighter import controls in lieu of a devaluation, current account deficits in the 1980s were followed by a greater reliance on exchange rate adjustments and the relaxation of trade controls (Little, Cooper, Corden, and Rajapatirana 1993). In fact, the decade after 1985 saw an unprecedented number of trade liberalization episodes. Figure 2 presents the number of countries that switched from being "closed" to being "open" in the half century after 1950, according to the Sachs and Warner (1995) criteria.[6] The figure shows the pronounced wave of trade reform undertaken by developing countries between 1985 and 1995. The contrast with the absence of trade reforms in the 1970s is stark.

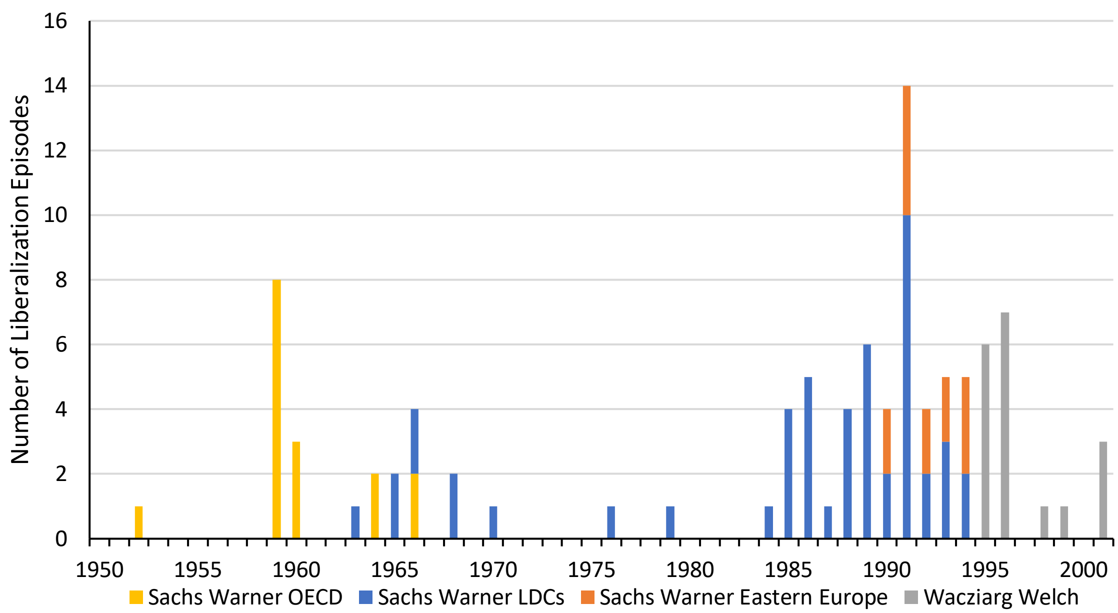

FIGURE 2. NUMBER OF COUNTRIES BECOMING OPEN, 1950-2000

Note: Sachs and Warner (1995). Yellow represents OECD countries, blue represents developing countries,

[6] Sachs and Warner (1995) defined a country as "closed" if it had an average tariff of more than 40 percent, a nontariff barrier coverage rate of more than 40 percent, a black-market premium on its currency of more than 20 percent, a state monopoly on exports, or a socialist economic system.

orange represents Eastern European countries, and grey represents other countries later added by Wacziarg and Welch (2003).

Several countries stand out as leading examples of this liberalization wave. Mexico had long maintained tight import restrictions and had initially responded to the debt crisis of 1982 with import repression. In 1985, it changed its approach by devaluing and making more periodic adjustments to its exchange rate, as well as by eliminating quantitative import restrictions and reducing tariffs. In the mid-1980s, India began to adjust its exchange rate more frequently and relax some import controls. It went much further in 1991 when a sharp loss of foreign exchange reserves led it to devalue the rupee and adopt a more flexible exchange rate. The government simultaneously abolished export subsidies and eliminated import licensing for capital goods. China and Vietnam also began to open up by ending state monopolies on foreign trade, allowing foreign investment, and establishing a realistic exchange rate.

Such changes were not confined to these countries alone. Rather, many governments throughout East Asia, Latin America, Eastern Europe, and South Asia – and to a lesser extent sub-Saharan Africa – opened up their economies and increased their country's participation in world trade.[7] The speed and global sweep of this movement was unprecedented. The question is: why did this happen?

III. Possible Explanations

In considering possible explanations for the trade reform wave, two factors that are sometimes believed to be important – interest groups and international institutions – actually played minor roles.

[7] For a general overview, see Dean, Desai, and Riedel (1994).

Special interests usually take center stage in work on the political economy of trade policy. Government policy is thought to be biased in favor of trade restrictions because of an imbalance in the political power of different interests. The benefits of those restrictions are concentrated on a few domestic producers competing against imports whereas the costs are dispersed among many consumers and exporters. This makes it advantageous for the beneficiaries to unite and lobby for protection, while making it difficult for the losers to organize, leaving them politically weak.

The sweeping trade and payments reforms of 1985-95 brings this logic into question. In most countries, domestic producers benefiting from trade restrictions did not suddenly fragment and become politically feeble, and exporters and consumers did not suddenly mobilize and gain political strength in a way that would explain the change in policy. More generally, the reduction in trade barriers did not occur because of the demands of domestic producer interests. As Bates and Krueger (1993, 455) conclude from a number of case studies: "One of the most surprising findings is the degree to which interest groups fail to account for the initiation" of economic policy reform.[8]

The political economy logic just mentioned helps explain why: it is easier to mobilize political support in defense of existing trade restrictions (the status quo) than to organize groups in favor of initiating reform. In many cases, beneficiaries of reform, such as current exporters,

[8] Geddes (1995, 202) notes that there is "little evidence that economic reforms are initiated in response to interest group pressure," although there is evidence that reforms can be abandoned because of public opposition. Corden (1987, 12) states that "large scale [trade] liberalization is rarely the result of specific interest group activities." Similarly, Biersteker (1992, 113) argues: "it is difficult to identify the interest-based sources of the 'demand' for this particular form of policy change in the developing world. While there are certainly some beneficiaries of the policy changes, they have not consistently organized themselves to obtain or pursue their material interests in a deliberate, rational manner. Interest explanations appear more suited to explain the potential bases of opposition to economic reforms than account for the origins of support for them." In the case of Sri Lanka, Moore (1990, 351-52) says that "'private enterprise' was not in practice strongly committed to economic liberalism. . . . the private sector had otherwise grown up in symbiosis with a large state sector and a relatively interventionist state and did not generally demand any radical change in those arrangements."

were not well organized for political action at all.[9] Fernandez and Rodrik (1991) provide another reason: potential exporters who will benefit from a reform ex post remain politically inactive because they do not know whether they will benefit ex ante. This explanation is consistent with the trade policy experience at the time. Many of the reforming countries had significant export potential because their policies suppressed exports and kept the ratio of exports to GDP artificially low. (To take an extreme case, South Korea's exports were one percent of GDP in 1960. India's exports were just 5 percent of GDP in 1985.) While many producers would become internationally competitive at more realistic exchange rates and access to inputs at world prices, it is almost impossible to know precisely which ones they might be. As a result, producers did not actively press for reforms.

In terms of international institutions, the IMF, the World Bank, and the General Agreement on Tariffs and Trade (GATT) were also not the driving force behind the reforms.[10] Although they supported the changes in trade and payments regimes being made at this time, these changes were initiated by the countries themselves and often went beyond anything proposed by these organizations.

Of the three institutions, the IMF arguably contributed the most to the reform process. The IMF consistently objected to exchange controls, multiple exchange rates, and other restrictions on current account payments. It urged countries to devalue their currencies to correct for fundamental exchange rate misalignments and to use the exchange rate as an adjustment mechanism. Although it could not insist that countries eliminate quantitative import controls, the

[9] Bienen (1990, 717) observes that "It is striking that African agricultural exporters generally have not been well organized into powerful political groups."

[10] Rodrik (1994, 79) observed that "external actors have played at best a modest role in initiating recent reforms."

IMF help create conditions under which such controls could be dismantled by encouraging countries to establish and maintain realistic exchange rates.[11]

The World Bank had little to say about member country trade policies before it began structural adjustment lending in 1979. In the 1980s, the Bank began making special loans available for countries willing to undertake trade policy reforms. These loans and lending conditionality required by the IMF may have facilitated reform in some countries that were already determined to change their policies but were generally viewed as a failure in countries that were reluctant to do so.[12] That said, the World Bank played an important role in the reform process by serving as a training ground for staff who later became country officials. At the Bank these individuals were exposed to the latest thinking on economic reform and forced to think about their country in a comparative context.[13]

Even though its purpose was to serve as a forum for the negotiated reduction of trade barriers, the GATT played a small role in the developing country reform effort. Import controls and nontariff barriers related to trade payments were permitted under Articles XII and XVIII of the GATT – dealing with restrictions to safeguard the balance of payments and government assistance to promote economic development, respectively – and were not subject to objection from other countries. Developing countries also benefited from special status in the organization

[11] The IMF historian Margaret de Vries (1994, 229) has argued that economists have underrated the Fund's contribution to policy change in the postwar period, overlooking "how the gradual lifting of exchange controls enabled world trade and services to increase, and how real exchange rate depreciation by developing countries helped integrate them into the world economy." She suggests that the IMF "was instrumental in persuading [developing] countries of the need for non-inflationary macroeconomic policies and in pushing countries to lift trade restrictions in line with their improving external payments position."

[12] Edwards (1997, 47) suggests that "the Bank has contributed somewhat (but not a whole lot) to these [trade liberalizing] policies." It is difficult for external groups to push countries to reform when officials do not want to reform. Wei and Zhang (2010) find that trade-reform conditions in IMF programs worked mainly in countries willing to reform. "When resources are made available to governments disposed *against* reform," Haggard and Webb (1994, 27) note, "the financing allowed governments to postpone, rather than pursue, adjustment."

[13] Gavin and Rodrik (1995, 332) argue that "it is difficult to overemphasize the part played by the Bank . . .as a conveyor belt of ideas about development policy to the borrowing countries." Here mention must be made of Bela Balassa, whose prolific writings about economic policy reform were widely circulated within the Bank.

(special and differential treatment) and were exempt from reducing their tariffs in trade negotiating rounds (Srinivasan 1998). The tariff reductions that started in the late 1980s were largely unilateral and not the product of GATT negotiations. Although developing countries agreed to reduce their bound tariffs in the Uruguay Round negotiations, but these were much higher than their applied tariffs, which remained largely unchanged.[14] From 1983 to 2003, the weighted average tariff of developing countries fell from 29.9 percent to 11.3 percent. Of this 18.6 percentage points reduction, Martin and Ng (2004) find that two-thirds were undertaken unilaterally, one quarter in multilateral negotiations, and one tenth in regional trade agreements.[15]

If interest groups and international institutions were not primarily responsible for the policy changes undertaken during the reform decade, then what factors were? An underappreciated explanation for the trade reform wave of 1985-95 was the growing recognition of economists that exchange rate adjustments were a better way of dealing with balance of payments problems than trade controls. This recognition had an impact on policy because a growing number of economists came to hold high-ranking government positions in developing countries during this period.

As noted earlier, the trade and payments regime of many developing countries was shaped by balance of payments considerations and exchange rate policies. Import controls arose as an ad hoc way of addressing the shortage of foreign exchange that came with the reluctance to use exchange rates to align foreign exchange earnings with payments. Foreign exchange is the

[14] See Finger, Ingco, and Reincke (1996). For example, Argentina agreed to bind all of its tariff lines in the Uruguay Round negotiations, but its average bound tariff was 31 percent while its average applied tariff was 10 percent.

[15] In the later period of 2001-13, Bureau, Guimbard, and Jean (2019) also find that most developing country tariff reductions were made unilaterally, although WTO accession was important in some cases, including China, Vietnam, and Saudi Arabia.

lifeblood of every small open economy because it enables the purchase of foreign goods, many of which cannot be produced (or can only be produced badly) at home. Imports of food, fuel, raw materials, capital goods, and spare parts are necessary for an economy to function and for a certain standard of living to be maintained.

The foreign exchange that made these critical imports possible could be earned through exports, received in foreign aid, or borrowed via foreign lending. When these channels made foreign exchange abundant, as was the case in the 1970s, maintaining the status quo was easy and governments could postpone major policy changes.[16] However, when foreign exchange was in short supply – whether due to adverse terms of trade shocks (a reduction in export earnings or an increase in import payments), cutbacks in foreign aid, or declines in foreign lending – countries were forced to confront the hard (foreign exchange) budget constraint imposed by the balance of payments.[17] Without an adjustment of some sort to these shocks, a country's foreign exchange reserves could be quickly depleted.

Of course, governments could respond to balance of payments problems either by limiting foreign exchange spending on imports through controls or increasing foreign exchange earnings by promoting exports through devaluation. In the 1980s, this choice broke in favor of export promotion. Several factors contributed to this outcome. In terms of circumstances, a key question facing many governments in the mid-1980s was not how to limit spending on imports but how to generate enough foreign exchange to pay for imports. Imports controls had been tried in the past and had failed to solve the underlying problem of foreign exchange shortages. Even if

[16] There is a saying that "foreign exchange reserves kill the will to reform" (Calvo-Gonzalez 2021, 128). This is related to the adage that good times make for bad policy.

[17] For example, the curtailment of U.S. foreign aid to South Korea in the early 1960s and the decline in Soviet aid to Vietnam in the late 1980s, among other cases, were catalysts for reform. Sometimes withholding aid proved more effective in producing policy reforms than providing aid. Michael Bruno, the former chief economist at the World Bank, once said: "We did more for Kenya by cutting off aid for one year, than by giving them aid for the previous three decades" (Devarajan and Kehmani 2018, 216).

import controls saved foreign exchange, they risked impairing domestic production when critical imported intermediate goods could no longer be obtained. There was a limit to how much imports could be suppressed before the economy was seriously harmed and many countries were believed to be at this point.[18]

Therefore, a primary objective of many countries in opening up the economy was to boost exports and earn more foreign exchange.[19] The case of India illustrates the importance of increasing foreign exchange earnings as a justification for major trade and exchange rate reform. In a 1991 national address explaining the rationale for the reforms, Prime Minister P. V. Narasimha Rao said that the change in the exchange rate (he avoided using the word devaluation)

> "was done so that we can export more . . . This will not only earn us Foreign Exchange but also create new employment at home. And why do we need to earn foreign exchange so badly? Not to import luxury items but to buy commodities like kerosene and diesel, fertilisers, edible oil, and steel. The adjustment in exchange rate will discourage the import of nonessential goods. And will therefore save foreign exchange for the imports of essential goods of consumption."

"After changing the value of the rupee," he continued, "we undertook a major overhaul of the trade policy. Our message was simple – you cannot import if you do not export. . . . My objective is to make India truly self-reliant. Self-reliance is not a mere slogan for me. It means the ability to pay for our imports through our exports."[20]

[18] Krueger (1999, 77) concluded that "the trigger point [for reform] came when financing for imports deemed essential could no longer be found."
[19] For some countries, the need to repay foreign creditors during the debt crisis of the 1980s added to the urgency of increasing foreign exchange earnings.
[20] Quoted in Ramesh (2015, 68-69).

The changing ideas of economists on adjustment strategy also helped set the stage for the trade reform wave. Early in the postwar period, many development economists warned against devaluations and recommended import controls and foreign exchange rationing instead.[21] During the 1960s and 1970s, economists accumulated a mounting array of evidence about the costs of import controls and their adverse effect on exports (Little, Scitovsky, and Scott 1970, Krueger 1997). Discretionary trade intervention and quantitative restrictions were shown to be administratively complex and a breeding ground for special interest lobbying and corruption. Import substitution policies were increasingly seen as inefficient and even counterproductive (Irwin 2020).

Furthermore, import controls had been tried in the past and were somewhat discredited for having failed to solve the underlying shortage of foreign exchange. In particular, country experiences had demonstrated that import controls were a bad way of addressing an overvalued exchange rate and a poor substitute for a devaluation (Bhagwati 1978, Krueger 1978). Dervis, de Melo, and Robinson (1981) showed that a devaluation was much better way for a country to adjust to a foreign exchange shortage than foreign exchange rationing. A major problem with trying to conserve foreign exchange reserves through import controls is that they did nothing to increase export earnings. The lessons of experience suggested that import controls simply could not match the ability of a devaluation to encourage exports, discourage imports, and help achieve external balance at one stroke.[22]

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[21] For example, Myrdal (1956, 80) argued that experience had demonstrated that “a large and sudden devaluation of the currency . . . is neither a wholesome nor an efficient means of curing a structural disequilibrium in trade and payments.” A devaluation, he said, would intensify inflationary pressures and worsen the terms of trade. However, as even he admitted: “Though I have come to the conclusion that underdeveloped countries will be compelled to rely upon quantitative controls as a regular means of restricting imports, I am bound nevertheless to recognize the serious difficulties they create for economic development” (284).

[22] As Killick (1980, 377) concluded at the time, “recent studies of the effects of alternative instruments of balance-of-payment management on the course of economic development have, I believe, shifted the debate strongly against the use of direct controls in favour of an active exchange-rate policy. A combination of controls and an

As a result, economists had come to appreciate the benefits of exchange rate adjustment over import controls as a way of managing the balance of payments. These ideas were given force as more and more economists were appointed to senior policymaking positions around the world in the 1980s (Markoff and Montecinos 1993). When foreign exchange reserves were low and policy adjustments were required, economists in policymaking positions helped tip decisions in favor of devaluation and the liberalization of import controls. In country after country, high-ranking economists in government – sometimes with past World Bank experience, often with advanced degrees in economics from U.S. or U.K. universities – have been tied to the spread of trade liberalization around the world (Weymouth and McPherson 2012). Examples include Manmohan Singh, India's Minister of Finance from 1991-96, whose 1961 Oxford doctoral thesis was on his country's poor export performance, or Carlos Boloña, Peru's Minister of Finance from 1991-93, whose 1981 Oxford doctoral thesis was a tariff history of his country. The idea of using exchange rate policy instead of trade policy to achieve balance of payments adjustment usually entered the policymaking process from economists in central banks and finance ministries, where economic expertise within the government was concentrated (Biersteker 1995, 181-82).

The case of Mexico illustrates how the changing ideas of economists helped influence the policy choices made by the government. In 1982, when Mexico declared that it could no longer pay its foreign debts, several key economic officials in the government of Jose Lopez Portillo had received their degrees from Cambridge University under the supervision of Ajit Singh, Joan Robinson, and Nicholas Kaldor, some of whom also served as government advisers. Representing an older tradition, they argued strongly in favor of import repression and a closed

overvalued currency has been shown to lead to economic distortions which hamper development, and a good deal of evidence has accumulated which suggest that currency depreciations are a more effective instrument of policy than has often been supposed."

economy model (Rattner 1982). On their advice, the government subjected 100 percent of imports to quantitative restrictions and introduced exchange controls through a dual exchange rate. When Miguel de la Madrid took over the presidency, he relied on a different set of economists who had been educated at U.S. institutions, such as Yale University and the University of Chicago.[23] This group strongly supported the abolition of import controls and the opening of the economy, a process that began in 1985.

Thus, the demand for policy reforms did not originate from the private sector but came from within the government itself. In the case of Mexico, Cronin (2003, 64-5) notes that "the decision to embark on the path toward significant trade liberalization was solely the product of preferences in the government. The economically and politically most important societal group – the industrial sector – opposed the change." If so, what requires explanation is not the lack of interest group support for reforms but how entrenched opposition to policy change was overcome. In many cases, opposition from domestic producers was less formidable than expected.[24] This may be because the opening of the economy was accompanied by a significant real exchange rate depreciation that insulated domestic producers from foreign competition, at least initially.[25]

[23] The leading proponents of reform included Manuel Mancera (a master's degree in economics from Yale) as central bank governor, Francisco Gil Diaz (doctorate from the University of Chicago) as research director at the central bank, and Pedro Aspe at the ministry of planning and budget (doctorate from MIT).

[24] In the case of Mexico, Ten Kate (1992, 670) reports: "A perhaps surprising element in the Mexican trade reform is that there has never been a strong opposition. In fact, the process has never been in real [political] danger." More generally, as Haggard and Webb (1994, 18) note: "Contrary to conventional political economy expectations, relatively low levels of business resistance to trade reform were found in countries studied here, in part because policies were packaged effectively." Rodrik (1994) suggests that the usual distributional conflicts over trade policy that previously blocked reform were overwhelmed by the need to manage the debt crisis.

[25] Chile, Mexico, and other countries followed this approach early in their reform efforts. Senegal is an example of a country that reduced tariffs without undertaking a devaluation, to disastrous effect.

The key battles over policy reform were not fought between the government and private interests but between different agencies within the government.[26] In the case of Africa, Bienen (1990, 715) noted: "The most politically powerful pressures for import substitution and/or overvalued exchange rates have come from civil servants, politicians, and the military," not private businesses.[27] Commerce and trade ministries usually opposed the relaxation of controls, reflecting personal as well as institutional interests. Central banks and finance ministries supported the dismantling of import controls and were able to overcome internal opposition and convince political leaders of the necessity of trade and exchange liberalization. [28]

The first step in opening an economy was almost invariably a devaluation to establish a realistic exchange rate.[29] The central bank and finance ministries had broad authority to change exchange rates and relax nontariff import restrictions without legislative approval and with few direct political constraints. Once countries eliminated the overvaluation of their currencies, they did not have to use import controls for balance of payments purposes. The decision to lift administrative import controls was usually made by a small group of officials in executive agencies who were largely insulated from political pressures and special interests.

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[26] As Haggard and Webb (1994, 13) note: "Frequently, the most vociferous opposition to a change in policy comes not from interest groups, legislators, or voters, but from ministers and bureaucrats within the government or even from the executive himself." Biersteker (1992, 121) writes that "in many instances, state bureaucracies remained sharply divided, and particular policy choices emerged in the aftermath of an internal bureaucratic struggle over different alternatives." With respect to Africa, Bienen (1990, 714-15) notes: "The halting steps toward trade liberalization and foot-dragging on tariff reform and export promotion . . . come less from mass political protests against reform policies . . . than they do from opposition within the government."

[27] Geddes (1995, 197) agrees that "the biggest and certainly most articulate and politically influential losers from structural adjustment in many countries are government officials, cadres of the ruling party, and their closest allies."

[28] Of course, as Bates and Krueger (1993, 463) point out: "Economic technocrats become power because politicians choose to make them so and organize the political process in a way that enables them to exploit the technocrats' informational advantage. The fundamental question then becomes: when will politicians delegate to technocrats control over key areas of economic policy?"

[29] "In practice, the celebrated success of so-called 'outward looking' or 'export promoting' strategies of development is built largely around the use of 'realistically' valued exchange rates," Keesing (1979, 24) noted at the time. Krueger (1999, 78) also concluded that "a realistic exchange rate was an essential prerequisite to an outer-oriented trade strategy."

Consequently, the trade reform wave coincided with a dramatic reduction in the number of countries with overvalued currencies.[30] Figure 3 shows that the share of countries with large black-market premia over their official exchange rate fell considerably between the late 1980s and the mid-1990s. Similarly, Figure 4 shows that the number of countries with multiple or dual exchange rates fell sharply between 1985 and 1995 as countries moved to create unified exchange rates and establish current account convertibility for exchange transactions.

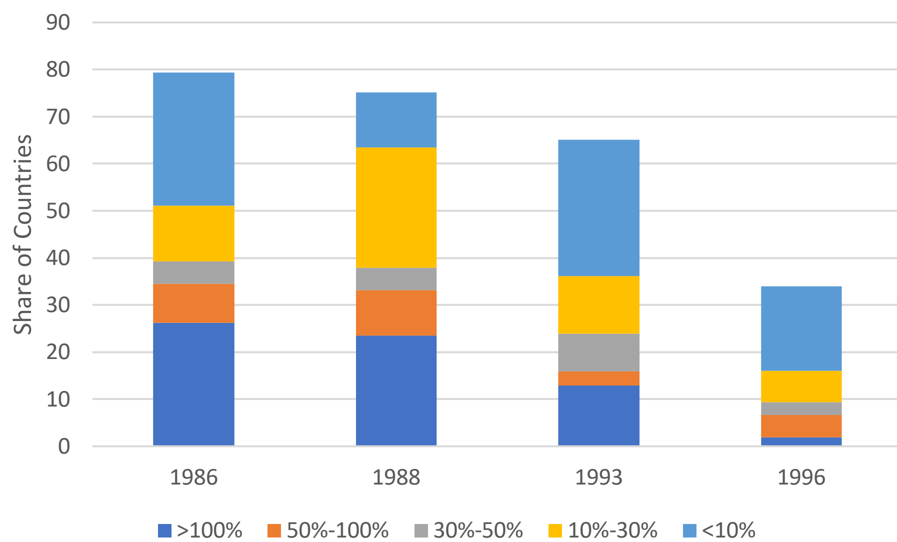

FIGURE 3. PERCENT OF COUNTRIES WITH BLACK MARKET PREMIA OVER OFFICIAL EXCHANGE RATE, BY DEGREE OF OVERVALUATION

Source: Based on *World Currency Yearbook* (1988, 1990, 1994) and World Bank (1998, Table 5.6).

[30] See Easterly (2019) and Ilzetzki, Reinhart, and Rogoff (2019).

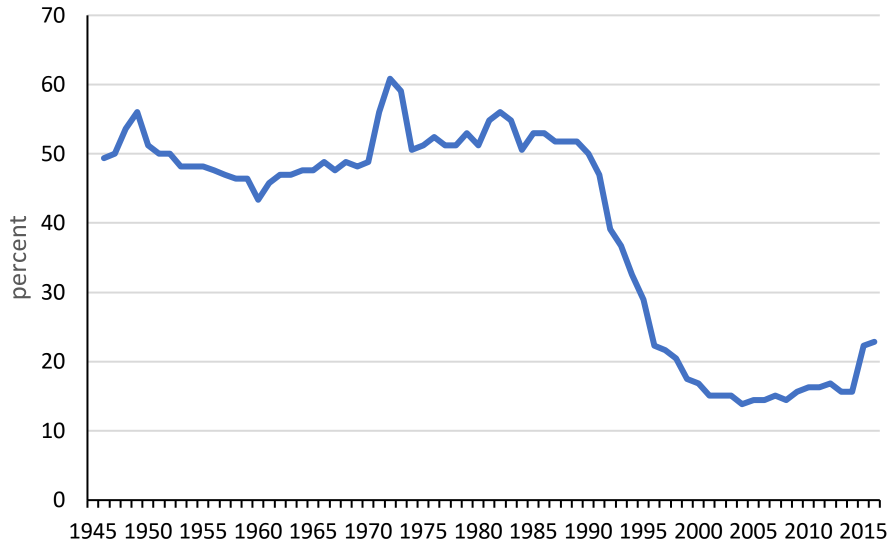

FIGURE 4. PERCENT OF COUNTRIES WITH MULTIPLE OR DUAL EXCHANGE RATES, 1946-2015

Source: Based on Ilzetzki, Reinhart, and Rogoff (2019).

The unification of exchange rates was facilitated by the fact that many developing countries moved toward more flexible exchange rate regimes. As Figure 5 shows, over the course of the 1980s, developing countries abandoned fixed exchange rates and adopted more flexible exchange rate regimes, either floating rates or crawling pegs. In most cases, the move to a more realistic and flexible exchange rate proved effective in stimulating a country's exports and increasing its foreign exchange earnings.[31] Levy-Yeyati and Sturzenegger (2003) find that developing countries with more flexible exchange rate regimes enjoyed faster economic growth and lower output volatility than countries with fixed rates.

[31] Freund and Pierola (2012) find that export surges tend to follow major exchange rate devaluations.

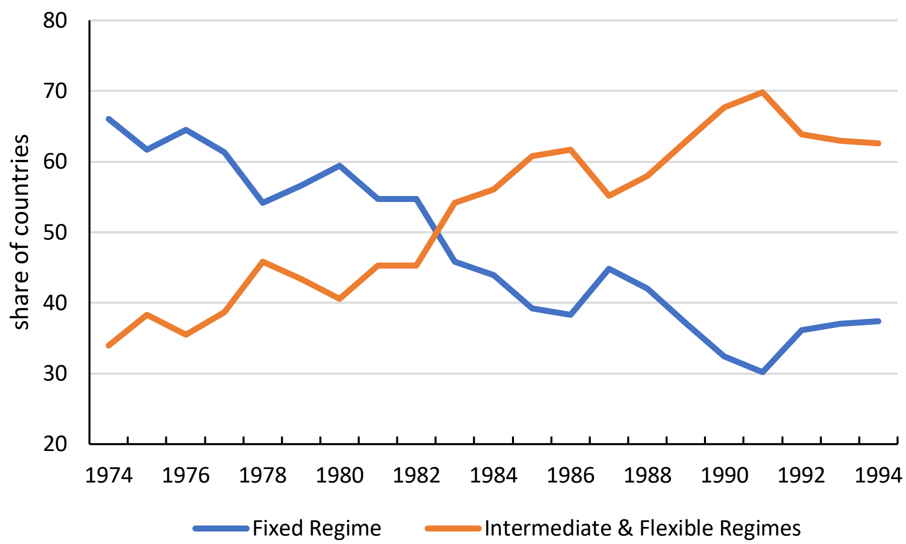

FIGURE 5. EXCHANGE RATE REGIMES IN DEVELOPING COUNTRIES, 1974-1994

Source: Based on Couharde and Grekou (2021).

Two widely held hypotheses about reform are that it takes a macroeconomic crisis to start reforms and it takes an authoritarian government to push through reforms. Neither view is entirely accurate. Macroeconomic crises present opportunities for reform, but they are neither a necessary nor a sufficient condition for policy change. The foreign exchange problems of the 1985-95 period, which were often the forcing event for policy change, did not always occur amid a crisis marked by hyperinflation or a growth collapse. India's 1991 reform arose because the country had nearly exhausted its foreign exchange reserves, not because it was amid a severe recession or experiencing high inflation. Colombia was not in an economic crisis when it embarked upon trade and market reforms in 1989-91 (Edwards and Steiner 2000). Meanwhile, other countries such as Nigeria have chronic macroeconomic crises and foreign exchange shortages and yet consistently fail to reform.[32]

[32] As a 2017 Financial Times headline put it: "Nigeria has let a crisis go to waste." https://www.ft.com/content/2f7d3a24-66eb-11e7-8526-7b38dcaef614\

In terms of the relationship between the political regime and trade reform, it is commonly thought that democratic governments face electoral pressures that make it difficult to undertake economic reforms that are painful in the short run. By contrast, authoritarian governments or military regimes can suppress political opposition and force through such measures. This observation is not consistent with the trade reform wave that began in 1985, or even the period before it. While it is certainly the case that some authoritarian governments adopted trade reforms prior to the 1980s, most did not. As Geddes (1994, 107) writes: "although some authoritarian governments have carried out successful transitions to more market-oriented economies, there is little evidence that authoritarianism as such increases the likelihood of such transitions."[33]

As Figure 2 showed, there was a lack of reform prior to 1985, a period when democracies were rare and autocratic governments were common in the developing world. To stay in power, autocratic regimes often had to buy the support of elites by granting privileges and sharing rents. Trade controls and the preferential allocation of foreign exchange were among the principal ways of doing this. As Geddes (1994, 113) noted: "In many countries, the biggest, and certainly the most articulate and politically influential, losers from the transition to a more market-oriented economy are government officials, ruling-party cadres, cronies of rulers, and the close allies of all three . . . [these groups] explains why many authoritarian governments have had difficulty liberalizing their economies."

[33] Bates and Krueger (1993, 459) find "little evidence for a relationship between economic reform and political authoritarianism." Biglaiser (2002, 13) points out: "Contrary to popular belief, an important common denominator among most military officers in the developing world is their intense opposition to policies supported by neoliberal economists." Haggard and Webb (1994, 27) also note cases in which "the military did not traditionally favor devaluation and did not see any benefits in stimulating a more outward-oriented economy."

In fact, Giuliano, Mishra, and Spilimbergo (2013) find that democracies have been more likely to undertake economic reforms than other forms of government.[34] The reform decade of 1985-95 provides evidence of a close relationship between trade reform and democracy. The "third wave" of democratization that swept the world in the 1980s and 1990s changed politics in a way that fostered trade reform. As Milner and Kubota (2005) point out, new democracies opened a country's political system to previously disenfranchised groups and broke up established coalitions of interest groups and political leaders where trade policy (and foreign exchange scarcity) had been used for political purposes. Unlike autocracies that depend on a narrow base of political support, elected officials had a stake in pursuing policies that would improve the performance of the economy for the general benefit of the voting public. Democratic politicians campaigned against the corruption of previous regimes that had distributed rents as a way of winning support of select groups. Taking away rents from corrupt insiders proved to be politically popular and the availability of cheaper foreign goods led to broad consumer support for more open trade (Baker 2009).

While the era of dramatic unilateral trade reforms began to subside by the mid-1990s, there have been few major policy reversals subsequently. When those reversals have taken place, it was often the result of the pressures stemming from the overvaluation of the currency when the exchange rate was used as a nominal anchor rather than adjusted to equilibrate the balance of payments.[35]

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[34] Geddes (1995, 205) notes that "the reason economic reform has posed less of a threat to democratic governments than expected is not that costs are unexpectedly light but that interests are unexpectedly weak." Meseguer and Escribà-Folch (2011) find that democracies confronting economic crises are more likely to liberalize trade because of learning from other country experiences, whereas personalist dictatorial regimes are the most resistant to reform.

[35] As Bienen (1990, 714) notes: "African governments have backed off trade reforms when their competitive trade positions did not improve, when they were losing foreign exchange, and when they had not devalued sufficiently." This phenomenon has also been observed in Latin America (Frankel and Rapetti 2012) and in the case of transition economies (Drabek and Brada 1998).

IV. Concluding Remarks

The decade from 1985-1995 was a historic period in which the world economy was transformed by the opening of developing countries to global trade. This process involved not just tariff reductions, which actually came late in the process, but a wholesale change to the trade and payments system, including the exchange rate, the disposition of foreign exchange, and the discretionary nontariff barriers that regulated imports. The reform decade fundamentally remade the global economy, taking three separate worlds and integrating them into one.

This paper has focused on the balance of payments origin of these import restrictions because that helps us understand how those restrictions were removed. Over the postwar period, economists amassed evidence that exchange rate adjustments were a better way of addressing balance of payments problems than import controls. Other economists rose to important policymaking positions around the world during the late 1980s and early 1990s where they could act upon those ideas. Import controls were lifted not because of the demands of special interests or international institutions. While the traditional focus on special interests can be useful in understanding which groups supported or opposed a policy change, it is not always useful in explaining why policy changes takes place. "Because of their neglect of ideas," Rodrik (2014, 205) has argued, "political economy models often do a poor job of accounting for policy change."[36]

The consequences of these trade policy changes continue to be debated, including their impact on income inequality (Goldberg and Pavcnik 2007), economic growth (Irwin 2019), and other outcomes of interest. However, the global policy shift was followed by, and arguably contributed to, two important developments. Starting around 1990, developing countries began to

[36] Krugman (2021) recently argued that the trade policy revolution of the 1980s and 1990s was driven by ideas, namely the disillusionment with import substitution and the apparent success of export-oriented trade strategies.

grow more rapidly and catch up to the higher income levels enjoyed by advanced economies (Patel, Sandefur, and Subramanian 2021; Kramer, Willis, and You 2021). That growth, in turn, contributed to a massive reduction in global poverty. According to the World Bank, the share of the world's population living in extreme poverty fell from 42 percent in 1981 to 10 percent in 2015.[37] With the benefit of hindsight, the decade from 1985 to 1995 stands out as a remarkable transition period in the history of the world economy.

[37] https://data.worldbank.org/topic/poverty

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