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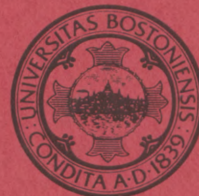

THE FUTURE OF MACROECONOMIC POLICY: LATIN AMERICA

by
Daniel M. Schydlowsky

Published as "Interdependent Development" in
Harvard International Review, November 1985.

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Latin America is a region well known for its high levels of inflation and recurrent balance of payments problems. It is not suprising, therefore, that macroeconomic policy has occupied a central place in the policy debates of the continent.

In the 1950's and early 1960's, the debate was between structuralists and monetarists, and became famous. The structuralists, drawing on insight from experience in the Southern Cone of the continent (Argentina, Chile, Uruguay) argued that the development process inexorably brought about inflation and balance of payments problems; these were essentially signs of growth. To try to cure inflation by monetary contraction would simply stop growth without eliminating the causes of inflation. To try to cure balance of payments problems by devaluation was useless because the relevant price elasticities were far too low to make devaluation effective. Inflation and balance of payments problems, rather, would eventually disappear as a consequence of the development process itself, which would in time rebalance the economy. In the meantime, one could repress

inflation somewhat with price controls, but otherwise would have to live with it; the balance of payments problem was best repressed by tariffs and quantitative controls, which would in any case lead to import substituting growth and thereby gradually cause the balance of payments problem to disappear. Prices in this view of things served mainly a distributive function; their allocation role was thought to be severely hampered by low price elasticities, monopolies, oligopolies and other institutional circumstances which made markets function in a manner very different from competitive assumptions.

Monetarists, on the other hand, drawing from established economic theory and viewing the world largely from the vantage point of the IMF's Washington, D.C. headquarters, argued that without excess demand no inflation or balance of payments problem could exist. Excess demand, in turn, was caused by excessive government expenditure and loose monetary policies. Thus, fiscal discipline was of the essence, government expenditure needed to be cut back, the printing press correspondingly slowed down and, if necessary, the currency devalued to reestablish its true international parity.

It will be noticed that the monetarist view is more aggregative, less specific to the institutional situation at hand and thereby more broadly sweeping.

By the late 1960's and early 1970's, monetarism had won the intellectual battle for control of macroeconomic policy. The level of technical training of government economists was continuously increasing and with it the influence of established economic theory. Structuralism on the other hand, had not been able to make a good enough intellectual case. Concurrently, central banks acquired more influence compared to national planning agencies, which had earlier flourished with the support of the Alliance for Progress. But while monetarism was winning the intellectual debate for macroeconomic policy, structuralism was capturing the development policy: Import Substituting Industrialization swept the continent.

The essence of Import-substituting-industrialization (ISI) is the furtherance of domestic production of as many of the country's existing imports as possible. It implies a deliberate violation of static comparative advantage on the basis of dynamic arguments relating to infant economy and infant industry claims, learning by doing, externalities, etc. Moreover, ISI is asymetrical with regard to industrial

growth. It stimulates industry insofar as it supplies domestic demand; no comparable export drive is part of the plan. Inward-looking industrialization is butressed by tariffs and quantitative restrictions which constitute a *de facto* multiple exchange rate system. Industrial labor participates in the benefits of industrialization by an increase in wages, be it through expanded unionization or through political pressure and legislative action on minimum wages and fringe benefits. Increased labor migration to the cities follows; new migrants cannot be absorbed into organized industry and thus a so called "informal sector" appears in which incomes are determined in noncompetitive ways based on work and income-sharing. The investment policy furthers the accumulation of capital stock in industry. However, there is no concern with the level of utilization of real capital stock. Indeed, the relative price of machinery and labor, the structure of the tax system, the depreciation rules, the import licensing, and the natural proclivities of entrepreneurs all interact to generate very substantial levels of underutilization of capacity.

Growth under ISI implies that industry expands rapidly, well in excess of the rates of growth of the primary sectors. But since industry requires imported raw materials while selling to the domestic market, it is a foreign exchange using

sector. In turn, foreign exchange is supplied only by the primary sector. The growth pattern is therefore one in which the foreign exchange demanding sector is growing much more rapidly than the foreign exchange supplying sectors. As a result, ISI produces balance of payments crises due to the structure of production which this policy furthers. Too much of the country's savings have gone to the foreign exchange using industrial sector, and too little into the foreign exchange producing primary sectors. This imbalance in the distribution of capital stock means that full utilization of existing capital and labor, i.e. (internal balance) is inconsistent with balance of payments equilibrium (external balance).

When the structuralist-inspired growth policy produced balance of payments problems, the monetarists technocracy responded the only way they knew how, by devaluing the currency and deflating the economy. The deflation part typically worked. The price adjustments through which the devaluation was to rebalance the economy typically did not work: the ISI policy had succeeded in substantially reducing elasticities and removing flexibility from the economic system. With deflation being the principal effective macro policy tool, the underlying imbalance rooted in the maldistribution of capital stock between foreign exchange

using and foreign exchange generating sectors was not touched. Rather, the symptoms of this imbalance were being temporarily repressed while the deflation lasted. Whenever reflation was undertaken again, in short order the same problems would recurr. Argentinians called this the "stop - go" economy.

The frustration generated by successive stop - go cycles, combined with the impact of the first oil crisis and some rather inept experiments in populist macroeconomic policies (e.g. Peron II, Allende) helped usher in a new macroeconomic conception accompanied by a new macroeconomic instrument. The conception was the New Monetarism which basically accepted the structuralist argument of a fundamental imbalance in the productive structure but which resolved to clean house so that markets could in the future work the way they should. It was necessary to "get the prices right". This would be accomplished by opening the economies to imports. The domestic price level would be controlled courtesy of East Asian exporters and thanks to the Law of One Price (i.e. domestic prices cannot diverge from ceilings set by import competition). Domestic economic efficiency would be achieved by virtue of the "winds of competition" which would also blow from East Asia. To this end, the exchange rate would be suitably managed while any transitory problems

that this policy might cause in the balance of payments would be dealt with by the newly available policy instrument: capital inflow. Along with opening the economies to import trade they would also be opened to private capital flows. Interest rates would be encouraged to rise to a level sufficient to bring in world capital in whatever amount was necessary; indeed, the proper amount would flow in by virtue of the workings of the free market.

The new fashion first appeared, as is usual in the economic policies of Latin America, in the Southern Cone; the time was the second half of the 1970's. In its original habitat, the New Monetarism coincided with a turn towards authoritarianism. However, the fashion spread to other countries with different political climates such as Costa Rica, Colombia and Venezuela.

Reality was not kind to the economic policy of the New Monetarism. Import competition did not work quite the way it was supposed to. To begin with, it turned out that importing is a business that requires know-how and commercial connections. Thus, in many instances the first importers were the same firms who were marketing the corresponding domestic products. That, however, meant non-competitive markets! Combined with the novelty value of imports, it soon

appeared that import prices were not setting the ceiling to domestic prices, but rather, domestic costs were setting the floor to the pricing of imports! As these import monopolies began to be eroded, the pendulum swung to the other side. The novelty of owning import goods caught on and spread like wildfire; demand shifted massively from the purchase of domestically produced goods to the purchase of import goods.

Domestic producers attempted to ride out the loss of markets by going into debt. Since the capital markets had been opened, money for lending was readily available. The interest rate on this debt was not initially very high. Part of the New Monetarism involved pegging the exchange rate or having it devalue more slowly than the domestic rate of inflation, since otherwise world prices would not have an anti-inflationary effect. The by-product was that high rates of interest in dollars translated to low or negative real rates of interest in local currency.

Consumers also went into massive debt; the financial liberalization meant for many of them that they had access to credit for the first time. What interest they had to pay was secondary compared to their previous inability to borrow at all (i.e. an infinitely high interest rate), so the rates demanded did not seem unreasonable, particularly when they

made it possible to buy coveted import goods. The inflow of foreign capital thus fueled an import boom. The winds of competition had become a tornado which blew a sizeable part of the industrial sector into bankruptcy. At the same time, it inflated a huge foreign debt balloon which was bound to burst at some time.

The foreign debt resulting from the New Monetarism added to the debt Latin America had accumulated from the oil deficits and the oil boom (for both oil importing and oil exporting countries had borrowed generously). When interest rates rose in the early 1980's, the balloon burst. The Latin American debt crisis had arrived.

In the midst of the scramble to contain the fallout from the debt crisis, the New Monetarism was largely abandoned; most governments reverted to Old Monetarism under the IMF's supervision: exchange rates were devalued, fiscal expenditure was cut, credit was tightened and interest rates were raised. GNP fell in many countries of the hemisphere. In Argentina the fall was 11% from 1980 to 1982, in Chile it was 15% from 1981 to 1983, in Peru it was 12% in 1983 alone, etc.. Industrial output showed even greater falls: particularly in Brasil, Chile, Mexico and Peru. Inflation did not fall together with output, as the old monetarism

might have predicted. Instead, it sky-rocketed: Argentina reached an inflation of 344% and rising in 1983, Chile's inflation went from 9% to 23%, Peru's went from 73% to 125%. On the other hand, open unemployment went to double digits while underemployment was above 25% of the labor force. The only posititive achievement of this incarnation of Old Monetarism was the improvement in the balance of trade which resulted from the depression.

At work in this unraveling of the New Monetarism seemed to have been a combination of elements. Nominal wages seemed to reassert a fundamental indexation to the price level, even though real wages did suffer some erosion. Profit rates, in turn, seemed to maintain their levels, making up in the rate of mark-up any fall in volume of sales. Relative prices inside the Latin American economies began to deviate again from world relative prices, and thanks to a new protectionism moving closer to their earlier "traditional" levels. Fundamental societal forces determining the income distribution which had been repressed during the period of the New Monetarist policies were now reasserting themselves. When the government, in the pursuit of Old Monetarist policies, administered a price shock such as the removal of subsidies or a devaluation, all it achieved was to accelerate the inflation; structural rigidities had reasserted

themselves with a vengeance and were now more powerful than ever.

The basic outline of a new response to the Old Monetarism is now beginning to appear in several Latin American countries. It takes from structuralism the recognition that history matters and that institutions and the structure of the capital stock and of production must be taken into account. Distinct from the New Monetarism, however, it does not regard these structures as illegitimate and worthy only of being swept away. Rather, it declares them legitimate and attempts to enlist them in the evolution towards an improved future. The hallmark of these policies is pragmatism; their goal is maximizing the achievement of the possible.

On the real side, the New Pragmatism starts from a recognition that the well-nigh intolerable social stress caused by the recessive policies of Old and New Monetarism is unnecessary since there is idle labor and idle capital stock in the economy. However, for these factors to be put to work, foreign exchange is also needed. Thus, a proper macroeconomic activation policy requires taking into account differential import requirements. Enter, therefore, selective import protection and a new phase of import substitution. Concurrently, however, and drawing on

historical experience of the past, New Pragmatism emphasizes the promotion of non-traditional exports, trying to convert installed capacity and available industrial labor into export revenue from industrial goods. Since excess capacity is spread unevenly throughout the economy, and costs of production are by no means uniform, the export policy has to be selective no less than the import substitution policy. The result is an exchange-rate system which combines one or more exchange rates, import duties, export taxes and export subsidies in a coherent manner.

The gravity of the debt situation (a net capital outflow of $30 billion in 1982/83 alone) underlines for the New Pragmatism the importance of saving and earning as much foreign exchange as can efficiently be done.

On the control of inflation, the New Pragmatism takes into account that factor returns are formed in imperfect markets. The existence of a large informal sector of the economy leads to labor incomes that are constrained by the need to share poverty and avoid mass starvation. Thus a large part of labor incomes are determined non-competitively. In turn, the monopolistically competitive and oligopolistic nature of product markets allows mark-up pricing and non-competitive returns to investment. Two major consequences result from

these features. On the one hand, the existence of "administered" prices and incomes provides a pivot on which to base a prices and incomes policy, including temporary price and wage freezes as well as offsetting changes in nominal wages and interest rates. The second important implication arises for the evaluation of efficiency in production. Since factor incomes are not competitively determined, private profitability of production is no longer a good measure of national economic efficiency. The latter needs to be measured at shadow prices. It follows that tax and commercial policy should be set so as to bring private profitability and national economic benefit into equality. A proper underpinning for the differentiated features of the import-export regime is thereby provided.

The New Pragmatism also recognizes that response to policy will vary across the economy. In part, such differences arise from non-uniformity of underlying conditions (e.g. some sectors have plentiful excess capacity, others do not); other differences result from the distribution of decision-makers across sector (some are tight oligopolies of a handful of firms while others are relatively competitive). Throughout, the new policy attempts to gear macro policy to take advantage of these differences by looking for high response elasticity sectors and tailoring policy accordingly.

Finally, the New Pragmatism has a much more sophisticated view of expectations. Rather than assuming that economic agents directly extrapolate the past (adaptive expectations) or that they truly know how the economic system operates or at least act as though they did ("rational" expectations), the New Realism starts from the recognition that the key economic agents are relatively few in number and that their expectations (and actions) can be critically affected by enlisting them in the implementation of the new policy. The old central banking technique of "moral suasion" is thus combined with the principles of indicative planning to yield a policy tool which supports short term stabilization policy.

At the time of this writing, the New Pragmatism is only beginning to be tested in practice, notably in Argentina, Peru and Venezuela. Time will tell how broadly it will spread and how national variants will differ from each other. The appearance of a new departure in macroeconomic policy in Latin America may, nonetheless, be one of the more hopeful signs that the continent will resolve the major economic problems it faces.

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