

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Reform, Recovery, and Growth: Latin America and the Middle East

Volume Author/Editor: Rudiger Dornbusch and Sebastian Edwards, eds.

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-15745-4

Volume URL: <http://www.nber.org/books/dorn95-1>

Conference Date: December 17-18, 1992

Publication Date: January 1995

Chapter Title: Introduction to "Reform, Recovery, and Growth: Latin America and the Middle East"

Chapter Author: Rudiger Dornbusch, Sebastian Edwards

Chapter URL: <http://www.nber.org/chapters/c7647>

Chapter pages in book: (p. 1 - 10)

Introduction

Rudiger Dornbusch and Sebastian Edwards

The debt crisis unleashed in 1982 generated serious dislocations in most developing countries. Balance-of-payments deficits soared, and in most cases the foreign debt almost paralyzed investment. Growth came to a halt and inflation increased dramatically. After some hesitation and in some cases a brief flirtation with heterodoxy, adjustment programs based on fiscal austerity, real exchange rate devaluations, trade liberalization, privatization, and deregulation were implemented in a large number of nations.

In many countries considerable progress has been made in the implementation of structural adjustment reforms. The results, however, have been uneven, with some countries successfully moving toward recovery and growth, while others continue to exhibit a timid performance. Chile is, perhaps, the prime example of a successful adjuster: inflation is moving toward one digit, exports have boomed, wages have grown rapidly, and aggregate growth is solid. Bolivia, on the other hand, is a case where growth has continued to be shy even years after the completion of the basic adjustment program. The experience of a large cross section of countries during the last few years suggests that the connection between structural reforms and economic recovery is not automatic. Even though structural reforms appear to be a *necessary* condition for growth, they are not a *sufficient* one.¹

A key question, then, is why some countries have succeeded in engineering

Rudiger Dornbusch is the Ford International Professor of Economics at the Massachusetts Institute of Technology and a research associate of the National Bureau of Economic Research. Sebastian Edwards is chief economist for Latin America and the Caribbean at the World Bank. He is also the Henry Ford II Professor of International Business Economics at the Anderson Graduate School of Management, University of California, Los Angeles, and a research associate of the National Bureau of Economic Research.

1. See Dornbusch (1991) for a discussion on the distinction between necessary and sufficient conditions for growth.

a recovery, while elsewhere per capita income stagnates a decade after the eruption of the debt crisis. The papers collected in this volume deal with this issue, and concentrate on aspects of the transition from stabilization and adjustment to growth. In particular they address the following questions:

- What are the requirements for a successful stabilization policy that reduces inflation to *acceptable* levels in a reasonable amount of time, and at a reduced cost?
- What is the effect of structural reforms, and especially trade liberalization, deregulation, and privatization, on growth in the short and long runs?
- How do macroeconomic instability and adjustment policies affect income distribution and poverty in the long run, and in the period immediately following a major stabilization effort?
- What is the role of the external environment in the recovery process that follows major structural reforms?
- In what form, if any, does the specific design of the structural adjustment effort—including its speed, scope, and sequencing—affect its results?

We clearly recognize that *macroeconomic populism*—an approach based on the use of overly expansive macroeconomic policies to achieve distributive goals—has failed again and again throughout the world.² Policies that rely on large fiscal deficits, price freezes, and real exchange rate overvaluation generate, at best, short-run economic growth. As history has shown repeatedly, in the medium run they result in serious crises, lower real wages, runaway inflation, and chaos. The question, then, is not whether macroeconomic stability and equilibrium should be sought, but *how* to implement stabilization and structural adjustment policies. We are convinced that the specific design of adjustment policies has important effects on growth and income distribution. In addressing these questions the papers collected in this book deal with broad analytical and theoretical issues and review the recent experiences in a number of countries in Latin America (Argentina, Bolivia, Brazil, Chile, Mexico, and Peru), and the Middle East (Israel and Turkey).

Structural Reforms and Growth

Trade liberalization has probably been the central component of most adjustment programs undertaken in the developing world during the 1980s and 1990s. The main objective of these reforms is to reverse the negative consequences of protectionism and, especially, its antiexport bias. Basic static international trade theory suggests that a trade liberalization process will result in a reallocation of resources according to comparative advantage, in a reduction

2. See the collection in Dornbusch and Edwards (1991) for a detailed discussion on the macroeconomics of populism, including a series of case studies based on the Latin American experience.

of waste, and in a decline in imported goods prices.³ Moreover, to the extent that the new trade regime is more transparent—for example, through a relatively uniform import tariff—it is expected that lobbying activities will be greatly reduced, releasing highly skilled work from “unproductive” jobs. According to traditional international trade theory it is expected that, once negative effective rates of protection and overvalued exchange rates are eliminated, exports will not only grow rapidly but will also become more diversified.

From a growth perspective the fundamental objective of trade reforms is to transform international trade into “the engine of growth.” In fact, newly developed models of “endogenous” growth have stressed the role of openness.⁴ For example, Romer (1989) has developed a model where by taking advantage of larger markets—“the” world market—an open economy can specialize in the production of a relatively large number of intermediate goods and thus grow faster. Other authors have recently concentrated on the relationship among openness, technological progress, and productivity growth. Grossman and Helpman (1991) and Edwards (1992), for example, have argued that openness affects the speed and efficiency with which small countries can absorb technological innovations developed in the industrial world. This idea, based on an insight first proposed by John Stuart Mill, implies that countries with a lower level of trade distortions will experience faster growth in total factor productivity and, with other things given, will grow faster than countries that inhibit international competition.

In recent papers a number of authors have tried to test the general implications of these theories using cross-country data sets.⁵ Although different empirical models have yielded different results, the general thrust of this line of research is that indeed countries with less distorted external sectors appear to grow faster. As Dornbusch (1991) has pointed out, openness affects growth not only through one channel, but through a combination of channels, including the introduction of new goods, the adoption of new methods of production, the new organization of industries, the expansion in the number of intermediate goods available, and the conquest of new markets that permit the expansion of exports.

The importance placed by liberalization strategists on the reduction of the antiexport bias has resulted in significant emphasis on the role of exchange rate

3. Of course, this amounts to the important textbook notion that freer trade increases the level of domestic welfare. However, modern approaches go beyond this goal and also consider the acceleration of growth as a goal of trade policy (see Edwards 1992).

4. Traditional neoclassical growth models concentrated on the effect of national economic policies on the *level* of income per capita. The new generation of endogenous growth models have shifted the attention to relationship between different policies and the rate of growth of the economy. See Lucas (1988).

5. See Tybout (1992) for a general survey on empirical models of the relationship between trade orientation and growth of total factor productivity. See also Edwards (1992) and De Gregorio (1992).

policy during a trade reform effort. A number of authors have argued that a large devaluation should constitute the first step in a trade reform process (Bhagwati 1978; Krueger 1978). It has been pointed out that in the presence of quotas and import licenses a (real) exchange rate depreciation will reduce the rents received by importers, shifting relative prices in favor of export-oriented activities and thus reducing the extent of the antiexport bias.⁶

The papers by Sebastian Edwards, Aaron Tornell, Federico Sturzenegger, and Anne Krueger in this volume address some important issues related to trade liberalization, including the timing of reforms, the appropriate speed and sequencing of trade liberalization, and the consequences of these policies on exports expansion and growth. The chapter by Arnold Harberger, on the other hand, deals with the actual design of trade reform and discusses the merits of alternative tariff structures, including uniform tariffs.

Social Conditions, Stabilization, and Adjustment

The impact of stabilization programs on the poor has been a source of important controversies in recent analyses of adjustment and reform in the developing and east European countries. A rapid rate of economic growth has traditionally been considered the main vehicle for reducing inequalities and poverty. In particular, the multilateral financial institutions, and especially the World Bank, have argued that the “right type” of growth, based on comparative advantages, employment creation, and productivity growth, would generate higher wages and better economic conditions for the poor. Increasingly, however, empirical evidence has indicated that, although crucially important, higher growth is not enough. In general, it takes a long time for the fruits of faster growth to spread to the most vulnerable and poorest segments of society. As a result of this, in the late 1980s and early 1990s an increasing number of authors began to argue in favor of a two-pronged approach toward human resources, where faster growth is supplemented with social programs targeted at providing social services to the neediest (World Bank 1992).

For many years it was thought that income distribution only changed slowly through time. This belief was largely based on data from the advanced nations, which suggests that there is significant persistence in distributional data. Most analysts argued that in the absence of major shocks—such as a revolution or war—the distribution of income would only change gradually, as the result of policies aimed at improving education and other social services. New research based on time series data for some Latin American countries suggests, however, that in some of these countries income distribution can exhibit very large changes in relatively short periods of time. For example, the contribution by Eliana Cardoso, Ricardo Paes de Barros, and Andre Urani to this volume shows that the Gini coefficient in Brazil exhibited large cyclical variations be-

6. See Krueger (1978, 1981) and Michaely, Choksi, and Papageorgiou (1991).

tween 1980 and 1991. They show that real exchange rate overvaluation has negatively affected the poor, as have increases in the level and variability of inflation. These results are confirmed by the multicountry study by Mauricio Cárdenas and Miguel Urrutia, also in this volume.

There are two fundamental reasons why macroinstability negatively affects poverty. First, in many poor countries real exchange rate overvaluation hurt labor-intensive exports, and thus employment and wages. Second, the poor are significantly more vulnerable to inflationary forces, as they do not have the ability to protect themselves from the direct and indirect consequences of the inflation tax. These findings support the view that programs aimed at reducing macroeconomic imbalances—particularly programs that reduce inflation—will tend to have a positive effect on income distribution. In fact, there is abundant evidence that ending very rapid inflations tends to reduce poverty, as was the case of Bolivia in 1986.

Historical experiences in Latin America with populist policies have dramatically shown the links between macroeconomic disequilibrium and income distribution. Dornbusch and Edwards (1991) argue that, although populist episodes have had specific and unique characteristics in different nations, they tend to have some fundamental common threads. In particular, populist regimes have historically tried to deal with income inequality problems through the use of overly expansive *macroeconomic* policies. These policies, which have relied on deficit financing, generalized controls, and a disregard for basic economic principles, have almost unavoidably resulted in major macroeconomic crises that ended up hurting the poorer segments of society. At the end of every populist experiment, inflation is out of hand, macroeconomic disequilibria are rampant, and real wages are lower than they were at the beginning of these experiences.

Overview of the Volume

The first part of the volume contains two papers that deal with trade policy, foreign direct investment, and privatization. In chapter 1 Edwards argues that in open economies it is important to distinguish between technological innovations and imitations. He develops a simple model where commercial policies affect a small developing country's ability to absorb technological innovations developed in the more advanced nations. According to this model more open economies will experience faster rates of productivity growth than countries that distort their external sectors. His analysis, based on a broad cross-country data set and on evidence from recent Latin reforms, supports this view. However, a comparison between the Chilean and Mexican cases suggests that, in order for productivity increases to be widespread, it is necessary to first implement broad reforms and deregulation programs that affect a wide range of sectors. The analysis also suggests that maintaining a "competitive" real exchange rate is the most important requirement for successful trade liberalization reforms. In chapter 2 Tornell deals with the timing and scope of structural

adjustment reforms. He notes that some developing countries recently have embarked on reform programs, including trade liberalization, in response to economic crises. What is particularly interesting in these cases is that groups that have traditionally lobbied for protectionism—and have strongly opposed any liberalization measures—have tended to *support* the reduction of trade barriers. This has been the case, for example, among powerful industrial groups in Mexico. Tornell develops a game-theoretic model to investigate this apparent puzzle. He argues that in difficult times structural adjustment is like musical chairs: when the music stops, one of the players will have no chair and will be out of the game. In hard times, then, rent-seeking groups will support a reform program if they believe that they will maintain (at least) some of their rents.

Part 2 concentrates on some aspects of the political economy of reform, including the distributive consequences of macroeconomic policies. In chapter 3 Cárdenas and Urrutia argue that macroeconomic stability is necessary for sustained social progress. They use cross-section analysis to investigate whether more stable countries have higher rates of growth in social indicators, including infant mortality, life expectancy, birth rates, school enrollment, and income inequality. They examine eleven social indicators in four coffee-producing countries—Côte d’Ivoire, Kenya, Costa Rica, and Colombia—and conclude that higher government budget deficits and lower social indicators go together. The fastest social progress occurs when the macroeconomy is most stable. Chapter 4, by Raúl Labán and Felipe Larraín, deals with the profound transformation undergone by the Chilean economy since the mid-1970s. From very high levels of protection, with pervasive state intervention, Chile has been transformed into an economy integrated to world markets, with a vigorous private sector. Today Chile seems one of the few Latin American countries where the reform program has entered into a consolidation phase. Since 1990, when democratically elected authorities replaced sixteen years of authoritarian rule, the government has reduced inflation and trade barriers and increased social spending, raising taxes to pay for it. The authors show that the transition from stabilization to growth in Chile took a significant amount of time and was not free of partial setbacks, including a major financial crisis in 1982–83. They argue that, in spite of the progress made in structural reforms during the last few years, there are still a number of areas—especially related to the social sectors—that will require great attention. More specifically, Labán and Larraín argue that in order to achieve sustainable rates of growth there will be a need to improve the coverage and quality of education and to increase the level of investment. Moreover, they point out that the implementation of environmentally sound policies and the reduction of poverty appear to be the major policy challenges facing Chile today.

Part 3 deals with specific country experiences in Brazil, Israel, Argentina, and Bolivia. In chapter 5 Cardoso, Paes de Barros, and Urani deal with the relationship among macroeconomic policy, income distribution, and poverty

in Brazil. They estimate that income inequality in Brazil—measured as the ratio of the income of the richest 10% to the poorest 10% of the population—has fluctuated significantly in Brazil in the last three decades; it rose from 22 in 1960 to 40 in 1970, 41 in 1980, and 80 in 1989. The authors argue that rising unemployment increases inequality, because low-skilled, poorly paid workers lose their jobs before other workers do. Very high inflation also increases inequality, because the rich have access to assets that are fully indexed, while the poor hold cash and thus pay the “inflation tax.” Wage differentials by education level are responsible for almost half of the inequality in labor incomes in Brazil, the authors report. But they conclude that increased macroeconomic instability during the 1980s was the major cause of rising inequality. Chapter 6 deals with the Israeli experience. Gil Bufman and Leonardo Leiderman re-examine Israel’s post-1985 disinflation and concentrate on the transition from stabilization to growth. They argue that economic recovery was delayed in Israel because the government neglected policies aimed at increasing public investment in infrastructure. They also argue that the exchange rate policy followed in the post-1985 period affected economic performance. More specifically, they point out that Israel’s exchange rate band from 1989 to 1991 lacked credibility, because it maintained a fixed central parity rate while domestic inflation continued to exceed world inflation. The shift to a crawling band in 1992 played an important role in restoring at least part of the policy’s credibility and in generating a policy environment conducive to growth.

In chapter 7 Rudiger Dornbusch discusses the recent Argentine efforts to stabilize the economy. He notes that pervasive reforms in Argentina, ranging from deregulation and privatization to trade opening, have raised productivity and helped reduce budget deficits. In less than two years, inflation has been greatly reduced and growth has returned, and with it a sense of great confidence in the future. However, Dornbusch argues that the recent policies have generated a familiar malaise: overvaluation. He notes that a nominal devaluation is likely to be counterproductive, since it would disturb expectations and would introduce significant uncertainty. According to him an adjustment package based on sharp fiscal controls and a reduction of aggregate demand is more likely to succeed. Chapter 8 is devoted to the Bolivian experience with adjustment and structural reform. Sturzenegger analyzes the sources of growth for the Bolivian economy and investigates why, almost eight years after the defeat of hyperinflation, growth is still so meager. His empirical analysis suggests that historically total factor productivity in Bolivia has been closely related to the price of mineral products. He also finds that macroeconomic instability, and especially inflation, has had a significant negative effect on the level of productivity, while political instability has not. During the hyperinflation, the economy worked at about 80% of its potential productivity, and productivity has not grown since 1985. Stabilization’s positive impact on productivity barely compensated for the decline in Bolivia’s terms of trade, Sturzenegger concludes.

Part 4 is devoted to the tax reform and deregulation. In chapter 9 Harberger focuses on some lessons from a large number of experiences with tax reform in a number of developing countries. He discusses uniformity of tariffs as a way of improving administration and compliance, and describes “radial reductions of distortions” as the most effective way to implement a tariff reform. He also specifies ways to build a system of value-added taxation that is moderately progressive. Finally, he discusses in some detail the relationship between evasion and coverage, shows how better choices concerning coverage can help control evasion, and comments on the relationship between enforcement and evasion. In chapter 10 Arturo Fernández discusses the role of deregulation in Mexico’s structural reforms program. He notes that, before privatization took place, the vast network of regulations was strangling production and productivity. Further, certain workers benefited more than others from labor regulations, and abuses were widespread. He describes in great detail the way in which regulations on Mexico’s trucking industry generated large inefficiencies and rents. Deregulation gave a boost to the automobile and telephone industries, in particular. Fernandez argues that an often ignored positive side effect of these reforms is that now Mexicans are becoming more mindful of potential side effects of deregulation, such as pollution.

The last part of the volume contains two papers on economic stabilization. In chapter 11 Krueger deals with the 1980 Turkish stabilization program. She argues that the program had two fundamental objectives: moving to a market-oriented economy integrated with the rest of the world, and lowering the rate of inflation from triple digits. Reforms designed to liberalize the economy—including trade and financial reforms—continued throughout the 1980s. Despite the difficult external environment, exports grew at an average annual rate of over 20%, and GDP growth by the latter half of the 1980s exceeded 7% annually. However, failure to control public finances resulted in resumption of rapid monetary expansion and, with it, inflation. By the early 1990s, inflation was accelerating very fast. At this point there are still questions whether the successful microeconomic reforms were sustainable in the presence of these macroeconomic difficulties. Chapter 12, by Miguel Kiguel and Nissan Liviatan, discusses recent stabilization efforts in Argentina, Brazil, and Peru aimed at eliminating hyperinflations. The authors point out that, in contrast to the European hyperinflations of the 1920s, these more recent inflations were not caused by a sudden, large increase in the budget deficit and seigniorage. Instead, they were the final stage of a long process of high and increasing rates of inflation that lasted for around two decades. In addition, the process of restoring price stability in the recent episodes appears to be longer and more costly than Sargent’s evaluation of the end of the European hyperinflation suggested.

References

- Bhagwati, Jagdish. 1978. *Anatomy and Consequences of Exchange Control Regimes*. Cambridge, MA: National Bureau of Economic Research.
- De Gregorio, José. 1992. Economic Growth in Latin America. *Journal of Development Economics* 39 (1): 59–84.
- Dornbusch, Rudiger. 1991. Policies to Move from Stabilization to Growth. In *Proceedings of the World Bank Annual Conference on Development Economics*. Washington, DC: World Bank.
- Dornbusch, Rudiger, and Sebastian Edwards, eds. 1991. *The Macroeconomics of Populism in Latin America*. Chicago: University of Chicago Press.
- Edwards, Sebastian. 1992. Trade Orientation, Distortions, and Growth in Developing Countries. *Journal of Development Economics* 39 (1): 31–58.
- Grossman, Gene, and Elhanan Helpman. 1991. *Innovation and Growth in the Global Economy*. Cambridge: MIT Press.
- Krueger, Anne. 1978. *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences*. Cambridge, MA: National Bureau of Economic Research.
- , ed. 1981. *Trade and Employment in Developing Countries*. Chicago: University of Chicago Press.
- Lucas, Robert. 1988. On the Mechanics of Economic Development. *Journal of Monetary Economics* 22 (1): 3–42.
- Michaely, Michael, Armeane Choksi, and Demetris Papageorgiou, eds. 1991. *Liberalizing Foreign Trade*. Oxford: Blackwell.
- Mill, John Stuart. 1848. *Principles of Political Economy*. New York: Appleton and Co.
- Romer, Paul. 1989. Capital Accumulation in the Theory of Long-Run Growth. In Robert Barro, ed., *Modern Business-Cycle Theory*. Cambridge: Harvard University Press.
- Tybout, James. 1992. Linking Trade and Productivity: New Research Directions. *World Bank Economic Review* 6 (2): 189–211.
- World Bank. 1992. *Poverty and Income Distribution in Latin America: The Story of the 1980s*. Washington, DC: World Bank.

This Page Intentionally Left Blank